

FEDERAL RESERVE SYSTEM**[Docket No. R-1152]****Federal Reserve Bank Services; Imputed Investment Income on Clearing Balances****AGENCY:** Board of Governors of the Federal Reserve System.**ACTION:** Notice with request for comments.

SUMMARY: The Board requests comment on a proposal to modify the method for imputing priced-service income from clearing balance investments. The Federal Reserve Banks impute this income when setting fees and measuring actual cost recovery each year.

Specifically, the Board requests comment on a proposal to impute the income from its clearing balance investments on the basis of a broader portfolio of investment instruments than used today, selected from instruments available to banks and subject to a portfolio management framework. Selection of the portfolio mix would be subject to a risk-management framework that includes criteria consistent with those used by bank holding companies and regulators in evaluating investment risk. The Board also requests comment on two different implementation methods for imputing this investment income.

This proposal focuses on the imputed investment of clearing balances; it would not change the terms or conditions under which depository institutions hold clearing balances. If adopted, the changes would be effective for the 2004 fees for Federal Reserve priced services.

DATES: Comments must be submitted on or before July 14, 2003.

ADDRESSES: Comments, which should refer to Docket No. R-1152, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551. However, because paper mail in the Washington area and at the Board of Governors is subject to delay, please consider submitting your comments by e-mail to regs.comments@federalreserve.gov or faxing them to the Office of the Secretary at 202/452-3819 or 202/452-3102. Members of the public may inspect comments in Room MP-500 between 9 a.m. and 5 p.m. weekdays, pursuant to § 261.12, except as provided in § 261.14 of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

FOR FURTHER INFORMATION CONTACT:

Gregory L. Evans, Manager (202/452-3945) or Brenda L. Richards, Sr. Financial Analyst (202/452-2753); Division of Reserve Bank Operations and Payment Systems. Telecommunications Device for the Deaf (TDD) users may contact 202/263-4869.

SUPPLEMENTARY INFORMATION:**I. Background**

The Monetary Control Act (MCA) requires Federal Reserve Banks to establish fees for "priced services" provided to depository institutions at a level necessary to recover, over the long run, all direct and indirect costs actually incurred and imputed costs.^{1,2} In addition, the Reserve Banks impute a priced services return on capital (profit).³ The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF). Just as the PSAF is used to impute costs that would have been incurred and profits that would have been earned had services been provided by a private business firm rather than the central bank, the Reserve Banks impute income that would have been earned on the investment of clearing balances customers hold with the Reserve Banks had those balances been held by a private business firm. This imputed income, less the costs associated with the clearing balances, is referred to as the net income on clearing balances (NICB).

Since 2002, the imputed elements of the Reserve Bank pricing process reflected in the PSAF and NICB calculations have become more integrated. For example, by using a small portion of the investable clearing balances as a financing source for the assets used in the delivery of priced services, the financing costs embedded in the PSAF are reduced. This proposal extends the review of the key features of the methods for computing the imputed elements.

Calculating the PSAF includes projecting the level of priced-services assets, determining the financing mix used to fund the assets, and the rates used to impute financing costs.⁴ Much

¹ Priced services include primarily check, automated clearinghouse, Fedwire funds transfer, and Fedwire securities services.

² Imputed costs include financing costs, taxes, and certain other expenses that would be incurred if a private business firm provided the services.

³ The return on capital is imputed using the average of the results of three economic models, the comparable accounting earnings model, the discounted cash-flow model, and the capital asset pricing model.

⁴ Equity is imputed based on the Federal Deposit Insurance Corporation's (FDIC) definition of a

of the data for the PSAF are developed from the "bank holding company (BHC) model," a model that contains consolidated financial data for the nation's fifty largest (based on deposit balances) BHCs.⁵ As part of this process, a core amount of clearing balances is considered stable and available to finance long-term assets.⁶

The method for deriving the NICB is reviewed periodically to ensure that it is still appropriate in light of changes that may have occurred in Reserve Bank priced services activities, accounting standards, finance theory, regulatory practices, and banking activity.⁷ The current methodology for imputing investment income assumes that the Reserve Banks invest all clearing balances, net of imputed reserve requirements and the amount necessary to finance long-term assets, in three-month Treasury bills. The imputed income on the Treasury-bill investments net of the actual earnings credits granted to clearing balance holders based on the federal funds rate is considered income or expense for priced-services activities. The net income associated with clearing balances is one component in pricing decisions and in evaluating cost recovery.

A. Clearing Balances

Depository institutions may hold both reserve and clearing balances with the Federal Reserve Banks.⁸ Reserve balances are held pursuant to a regulatory requirement and are not a result of an institution's use of priced

"well-capitalized" institution for insurance premium purposes.

⁵ The top fifty BHCs are used as the data peer group as they are considered to be the private-sector providers of services most analogous to the Reserve Bank priced-services activities.

⁶ The Board classified clearing balances of \$4 billion as core beginning with the 2002 price-setting. Core balances have not fallen below \$4 billion since 1992. (66 FR 52617, October 16, 2001)

⁷ In 1994, the Board requested comment on a proposal to modify the methodology for imputing clearing balance income. The Board proposed replacing the three-month Treasury-bill imputed investment with a longer-term Treasury investment based on the earning asset maturity structure of the largest BHCs. As a result of issues related to interest rate risk raised in the comments, the Board did not adopt the proposal. The proposal would have created an asset and liability mismatch that created interest rate risk exposure inappropriate for Federal Reserve priced services. In addition, Federal Reserve priced services would not have assumed the interest rate risk associated with longer-maturity investments because the imputed return would have been adjusted monthly to reflect current rates. (59 FR 42832, August 19, 1994)

⁸ "Clearing balances," unless otherwise indicated, refers to total clearing balances including contracted balances and balances in excess of the contracted amount, held by depository institutions with the Federal Reserve Banks.