

currencies, repurchase agreements, and derivatives.

The Board requests comment on a proposal to impute the income on clearing balances from a broader portfolio of acceptable investment instruments, allocated within the constraints imposed by criteria used by BHC and regulators to evaluate investment risk. The Board also requests comment on two different implementation methods for imputing investments and the related income.

A. Investment Instruments

As noted in the Background section, the top fifty BHCs (based on deposits) were selected as the closest private-sector peer group for Reserve Bank priced services. Because the BHCs are a proxy for providers of priced-services activities, options for Reserve Bank priced services clearing balance investments should be comparable to those available to bank holding companies. In principle, all of the investment instruments available to bank holding companies could be appropriate clearing balance investments. The Board requests comment on whether investment options for Federal Reserve priced services should include all investment instruments permitted by regulators for bank holding companies.

In practice, the Federal Reserve proposes to limit its imputed investments to federal funds; investments suitable for a buy-and-hold strategy, such as Treasury securities, government agency securities, commercial paper, and municipal and corporate bonds; and money market and mutual funds.¹⁵ For investments with a fixed term, this strategy eliminates capital gains and losses from the investment returns and simplifies the recognition and reporting of imputed investment income. Realized gains and losses on imputed mutual fund investments would be incorporated in the total return and recorded as net earnings. The Board requests comment on whether this investment strategy is appropriate.

B. Risk-Management Framework

To ensure that the imputed investments are indeed comparable to the investments of a similar private-sector entity, the Board believes that a risk-management framework should be established to limit the imputed

investments to prudent levels in accordance with sound business practice and regulatory constraints. The exposure to any one type of risk, measured in terms of earnings or equity at risk, would be limited. The Reserve Banks currently use two risk measures in calculating the PSAF that manage liquidity and interest rate risk. The Board requests comment on two additional measures that would be part of the risk-management framework for the imputed investment of clearing balances, one to manage the longer-term effects of interest rate risk and another to manage credit risk. In addition, the Board requests comment on any other risk-management criteria that should be considered.

1. Liquidity Risk

While clearing balances are contractually short term in nature, a portion of clearing balances can be considered as core deposits that are expected to remain stable over time. When it made changes to the PSAF method, the Board determined that core clearing balances, which it initially established at \$4 billion, should be available to finance long-term assets used in the delivery of priced services, rather than invested only in short-term assets. (66 FR 52617, October 16, 2001) Limiting the use of clearing balances to finance long-term assets to only that portion that is deemed core clearing balances effectively manages liquidity risk. The Board proposes that the portion of core clearing balances not used to finance priced services assets be available for imputed investment in longer-term instruments. The Board requests comment on whether using core clearing balances for imputed longer-term investments is appropriate.

2. Interest Rate Risk

One aspect of interest rate risk arises when the cost of funds and the investment yield on those funds change at different intervals. Financing longer-term assets with short-term liabilities at rates that do not change concurrently could create unacceptable earnings volatility. The Board adopted a method to address interest rate risk as part of the recent change in the PSAF methodology. This method addresses the risk to earnings in a changing rate environment by requiring that longer-term investment of clearing balances be managed so that a 200-basis-point change in the rates for the yield on all relevant priced services assets—currently the three-month Treasury bill rate—and the cost of all relevant priced service liabilities—the federal funds rate—would not affect the overall priced

services recovery rate by more than 200 basis points. The Board intends to maintain this risk tolerance as a prudent constraint on the imputed investments.

The Board proposes to adopt a second measure of interest rate risk, known as economic value of equity (EVE), for use in conjunction with the earnings at risk measure. The EVE measure, which is used by BHCs and regulators, compares the present value of interest-bearing assets and liabilities in the current rate environment with the prospective present value given a change in interest rates; the comparison shows the change in present values as a proportion of equity. EVE is used as a complement to the interest rate sensitivity analysis already adopted to evaluate the effects of long-term mismatches between assets and liabilities on the value of an entity; the interest rate sensitivity analysis captures the risk to near-term earnings. Large BHCs typically manage the EVE measure within a risk-tolerance range of 5 to 10 percent.¹⁶ The Board proposes to adopt a risk tolerance of a change of 8 percent of equity for a 200-basis-point-rate change. The Board requests comment on whether these two measures of interest rate risk, earnings at risk and equity at risk, are together sufficient measures for monitoring and controlling interest rate risk. The Board also requests comment on whether a constraint on the EVE measure limiting the effect of a 200 basis point rate change to a change of eight percent of equity is an appropriate risk tolerance level.

3. Credit Risk

Credit risk results from the possibility that the issuer of a bond or other borrower cannot repay its obligations as promised. Criteria for managing credit risk are necessary when investment instruments other than Treasury securities are used. The overall level of credit risk compared with the level of equity is measured by the ratio of risk-adjusted assets to capital. The FDIC uses two risk-based capital measures as criteria in defining a “well capitalized” institution for insurance premium purposes. One requires a risk-based capital ratio of 10 percent or more for total capital and the other requires a risk-based ratio of 6 percent for tier one capital.¹⁷ Only tangible equity capital (tier one capital) is imputed to Reserve Bank priced services; therefore, the two measures are the same for priced services. Because the current investment

¹⁵ Mutual fund investments would be selected from those that are publicly available and widely held. The specific funds used for imputing income would be disclosed during the price setting process so that performance could be tracked and replicated.

¹⁶ More information on measurement of interest rate risk can be found at <http://www.occ.treas.gov/handbook/irr.pdf>.

¹⁷ <http://www.fdic.gov>.