Memorandum

To: Board of Governors of the Federal Reserve System
From: Bankers' Bank Northeast; Peter J. Sposito President & CEO
Date: **May 29, 2009**

Re: Docket No. OP-1354; Federal Reserve Bank Services Private Sector Adjustment Factor

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We are opposed to the proposed changes to the PSAF. We believe that the PSAF has been reasonably effective over time and that it has in large part met the requirements of the Monetary Control Act.

Bankers' Bank Northeast is headquartered in Connecticut. We provide bank to bank services to over 200 banks in New England and New York State. We offer 35 services to meet the needs of our client community banks. Several of our offered services are in direct competition with the Federal Reserve. We are State chartered bank, a Federal Reserve member, and we are FDIC insured. In addition to competing with the Federal Reserve we are a major aggregator of volumes and use many Federal Reserve based services to provide the best mix for our client banks.

As a bankers' bank we strive to understand the impact of various issues that present opportunities or challenges to our client banks. As a resource for community banks our goal is to seek to understand what is beneficial to our client banks and to assist them in taking advantage of such opportunities. We perceive the existence of a PSAF calculation that reflects true market conditions as beneficial to competition and accordingly beneficial to our client banks.

With that being said, it should be noted that we are having difficulty responding to this request for comment for several reasons. The timing of the requested response coincides with a number of other significant events that require not only our attention but the attention of community banks. Consequently, we would suggest that the apparent light response to the request for comment can be attributed to a number of factors: First, the pool of participants in bank to bank services is of limited number. Second, many of the participants that would normally respond are overwhelmed with other issues during this period of economic turmoil. Lastly, the request for comment is extremely challenging to understand and without a greater understanding of the macro and micro economics of the proposed changes, many including me, are unable to grasp the potential impact on the competitive environment of the proposed change.

Accordingly we ask that a revised comment letter be published which sets forth a matrix of **proposed pricing** which would result from each of the possible new calculation models. This would provide the industry an opportunity to better understand the impact to the competitive environment. We could then respond appropriately.

Stepping back to examine the purpose of the PSAF may be worthwhile. It is our understanding that the PSAF was put into place to enable the Central Bank to compete within a fair market place as well as to recover the cost of doing business. The results to date seem to have achieved that objective. The Central Bank has priced it services appropriately as evidenced by the multiple private sector correspondent banks, including bankers' banks, which have been able to attract and retain bank to bank business while facing direct competition with the Central Bank. We believe that competition provides for efficient market activities and pricing. With that being said the question remains; is there truly a need to adjust the model used for calculating the PSAF.

It also occurs to us that community banks compete with large banks that have achieved unprecedented size. The largest banks in the country have attained up to 10% average market shares. In fact in local markets the share is often significantly greater. For example here in the Northeast the lead bank commands a share of check volume in excess of 30%. This fact indicates that it is important to keep the Federal Reserve in place to provide efficient check clearing and other bank to bank services as an active participant in the Nations' payment system. The implementation of image cash letter technology appears to provide a low cost system that the Federal Reserve can use to provide a structure that provides the redundancy necessary to protect the payment system from systemic risk associated with the National scale of payment processing. The Federal Reserve's continued involvement in the payment systems remains a requisite to maintaining the safety and soundness of the Nation's banking industry.

The fact that the Federal Reserve has measured a reduction in clearing balances does not necessarily indicate a failure of the PSAF. Clearing balances have been reduced in favor of other uses of funds because of the economic advantage of obtaining a higher rate offered through another vehicle. (The interest rate paid on the newly established "excess balance" offering is an example). It would go to reason that when clearing balances are reduced earned credits are reduced and therefore the hard dollar payments made to the Federal Reserve are proportionally increased. It would seem that if the model is working properly then the impact on overall earnings should be relatively minimal. It should also be noted that it is uncharacteristic for the rate paid on excess balances to be higher than the clearing balance earnings credit rate. We would expect in a more normalized interest rate scenario that the rate paid on excess balances would be set at a lower rate. The current relatively high rate paid on excess balances is in place to facilitate monetary control goals during this stressed economic environment.

The concept of the value of clearing balances has many moving parts. The major determinants of the value include the existence (or not) of true excess balances and the shape of the yield curve. During periods of high levels of excess balances (i.e. when rates are relatively high) the value of balances improves. When the yield curve displays a positive slope, the value of balances improves. Accordingly the value of balances becomes variable over various stages of interest rate cycles. Therefore pricing must be cost-plus-based using the value of payment in balances as either a supplement or a deduction to the revenue stream as indicated by the nature of the interest scenario at its various stages. We respectfully suggest that the private sector must deal with the changing tides of interest rate environments that either enhance or detract from net revenue streams. There may be no model that can respond to all the possible scenarios that could occur. Accordingly, pricing must be evaluated over a longer term than indicated the time used to measure the recent falloff in clearing balances especially since it has occurred during this low level business cycle.

Another aspect of offering bank to bank services has to do with cost control. As an aggregator of volume, the private sector works hard to keep our costs low when offering bank to bank services. To do so requires the development of systems and processes that are efficient. Effective cost control also has to do with attracting significant economies of scale; we have also been successful in that regard. We think that maintaining significant volume levels within the private sector is beneficial to the many banking publics because competition breeds efficiency. We would accordingly suggest that the Federal Reserve remain involved and that it continue to control costs by implementing new technology. The Federal Reserve has and continues to improve efficiency by eliminating traditional (and expensive) paper check processing sites. This activity is still a work in process that likely <u>needs additional time to positively impact its cost structure</u>. The Federal Reserve's leadership role in moving our National check clearing from paper to image has been monumental feat that will serve the banking industry well for decades to come.

We feel it necessary to better understand the threats posed by user-owned utilities to the market place by assessing and measuring their current and potential impact on the payment systems. It is unlikely that community banks will be able to participate directly in such entities because of the relative small size of the banks. However, aggregators such as correspondent banks can exert influence over such utilities because of the transaction volume that we handle within the community bank market.

We need to look at all payment systems, not just "checks" as we address the PSAF because other payment mechanisms are gaining share relative to check processing.

In summary, we request:

1) An extension of the comment letter deadline.

2) That the notice and request for public comment include more specific information, specifically the expected estimated pricing that would result from any proposed change in the PSAF formula components. (The currently provided information does not enable the reader to easily determine if the proposed changes will increase or decrease the Federal Reserve's price schedule).

3) The Federal Reserve to state its intention regarding its continued involvement in the Nation's payment systems.

4) The notice and request for public comment indicate how the proposed changes to the calculation of the PSAF will impact community banks.

5) The Federal Reserve provide additional insight as to its belief that user-owned utilities have become its predominant competitors.

6) All payment system processes be addressed relative to PSAF.

We thank the Board of Governors for the opportunity to comment on an issue that has a potentially profound affect on community banks and the correspondent banks that serve them. The concept of the PSAF is worthy of thoughtful review and discussion. We offer our commitment to continue the dialogue with you and your staff.

Sincerely,

Peter J. Sposito