UNITED BANKERS' BANK

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May 29, 2009

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Private Sector Adjustment Factor: Docket No. OP-1354

Dear Ms. Johnson:

We appreciate the opportunity to comment on the proposed changes to the Private Sector Adjustment Factor (PSAF). The PSAF is part of the Board's calculation that establishes the fees that the Reserve Banks charge for certain financial services provided to depository institutions. The PSAF was required by the Monetary Control Act of 1980.

Our organization, United Bankers' Bank (UBB) is headquartered in Bloomington, Minnesota and provides a comprehensive suite of correspondent banking services to community banks in a 12 state market area primarily located in the upper Midwest. We were chartered in 1975 as the nation's first bankers' bank.

We are concerned about the Federal Reserve Bank's proposal to significantly modify the formula upon which the PSAF is based and feel that the effect of such proposed changes will be to empower Reserve Banks' to arbitrarily price services to the detriment of private market competitors.

We would like to note that UBB is both a competitor and user of 9th District Federal Reserve Bank services. For many years UBB has been one the largest customers of the Minneapolis Fed.

Our understanding of the Fed's current position is that a portion of its traditional business has moved to the private sector, Fed faces competition from a variety of market participants in electronic transaction processing and it has witnessed a decline in total dollars held on deposit in correspondent clearing account balances. A major source of "imputed" income for the Fed in the calculation of the PSAF comes from the investment value of those correspondent clearing balances. As those balances decline so does the investment income calculated by the Fed and used in the calculation of the PSAF. The overall effect of these changes (in the view of the Fed) has been to artificially maintain Fed prices at levels higher than other market participants limiting its ability to compete. Over time the Fed has found it more difficult to compete with private sector market participants and without the PSAF change feels that its decline as a market provider will continue and possibly at an accelerated rate.

The Fed has proposed a new PSAF based on a formula known as "The Publicly Traded Firm Model." UBB has many questions about the formula itself as well as its effective implementation.

We feel that the following points are important in the evaluation of the Fed's proposed changes to the PSAF:

1. **For market participants, the Fed is both the "rule-maker" and a "market competitor."**
   In our private enterprise system the Fed occupies a unique position. It competes with the private sector and makes the rules under which all market participants compete. It is easy to make the assumption that if the Fed finds that the current PSAF is to its disadvantage, the only reason why it would wish to change it is to gain advantage. This is an option that those of us in the private sector do not have available to us. The Fed accurately notes that there has been a considerable migration of business away from Fed services. So, it would appear that since Fed cannot compete under the current PSAF it simply uses its authority to change the rules so it can compete. In addition, there is no discussion about the outcome of the proposed adoption to "The Publicly Traded Model" in regard to the current Fed fee structure.
2. **The Fed controls the pricing on its own products: its earnings credit rate, the Fed Funds rate and interest paid on excess reserves.**
   The Fed notes in its proposal that there has been a migration of funds from its "Clearing Balances" to Excess Reserves. It further notes that Fed customers receive a higher rate of return on Excess Reserves than they would receive for their earnings credit and speculates that "Clearing Balances" will continue to decline. In the private sector it is customary to define a strategy and adjust pricing (as one component) to implement that strategy. If "Clearing Balances" are important (unless trumped by monetary policy) the Fed should improve the rate it pays on its earnings credit that may encourage more financial institutions to utilize balances to support service usage.
3. **The Fed's discussion of competitor "user-owned utilities" needs clarification.**
   There was significant discussion of the competitive threat to the Fed posed by "user-owned utilities." CHIPS and EPN are specifically mentioned as cooperatives owned by their members that "do not hold overnight balances for their customers." However, the term of "user-owned utilities" is never fully defined. Nor is the level of competitive issues created by "user-owned utilities" ever fully developed. In addition, by defining "user-owned utilities" as holding overnight balances significant market participants such as bankers' banks are excluded. Our perspective is that competition is critical to our free enterprise system. If "user-owned utilities" have created some competitive issues for the Fed that should encourage Fed officials to identify strategies whereby it might compete at a higher level. The marketplace tends to vote with its "pocket-book." Innovation, speed to market with new ideas, operational efficiencies, need satisfying customer service and reasonable prices normally grows business and improves market share.
4. **The proposed "Publicly Traded Model" raises many questions.**
   a. It is very likely even under the most difficult scenarios that there will always continue to be balances left at the Fed. The new model would **disregard** imputed income gained from those balances.

b. The new formula does not include an FDIC assessment. Given the current state of the FDIC insurance fund not to include an assessment is wrong.
c. The "Publicly Traded Model" departs from the financial services world to utilize the "Standard and Poor's Compustat database as the source for the capital structure and effective income tax rate of all U.S. publicly traded firms." As we understand, this is an index of 6000 publicly traded firms. We would take issue with Fed adopting a peer group reference that is in large part non-financial companies. The many aspects of commercial banks such as capital requirements and regulatory overhead are not taken into account. The Fed is still a bank regulating, competing and providing services to the nation's banking industry. Commercial banks should be its peer group reference point.
d. The Fed's standard for federal income taxes would be based on a "five year mean." Given our nation's current financial circumstances it would seem that future tax rates are more likely to go up than down. We would argue that there needs to be additional thought given to this important issue.
e. As recently as October 17, 2005 the Board published "modifications to the method for calculating the private sector adjustment factor..." In Docket No: OP-1229 Fed reaffirmed, "The Board's method for setting the level of equity capital imputed to priced services would continue to be based on the Federal Deposit Insurance Corporation guidelines for a well-capitalized depository institution for insurance premium purposes. In addition, the Board will continue using the financial data from the top fifty bank holding companies by deposit balance to determine the priced services effective tax rate each year. The Proposed PSAF Model states, "The imputed capital structure, debt and equity financing rates, and effective income tax rate would be based on data for the U.S. market as a whole and would be calculated using the various market data sources and time frames discussed below." Given the timeline between October 1, 2005 when there was substantive affirmation of the current PSAF formula and the proposed changes out for commentary today we question the motivation and rationale. Our perspective is that the Fed should continue its peer group comparisons with other financial institutions rather than the equity markets as a whole.

5. **The Fed's PSAF proposal represents "unknown consequences."**
As discussed in item #1, there is no specific outcome identified as a result of the adoption of "The Publicly Traded Model." What would the adoption of this PSAF formula mean for Fed pricing in all its many facets? Private industry can make assumptions but on the surface it is impossible to judge the impact. The Fed should be more transparent in its goals. If the Fed's intent is to re-assert itself in the marketplace to compete at a much higher level with what the Fed terms "user-owned utilities" (and others) with significantly lower prices it needs to specifically state its intent.
6. **The Fed may be maintaining significant "legacy infrastructure."**
The calculation of the PSAF "imputes the costs that would have been incurred and the profits that would have been earned, including the return on equity capital, had the Federal Reserve Banks' priced services been provided by a private sector business." We believe that an important aspect of this calculation is the level of fixed overhead maintained by Fed. The dramatic success of the Fed's check imaging innovations has created the opportunity for Fed to engage in major cost reduction initiatives. To Fed's credit, there have been a number of office closures. However, has Fed adjusted to the new reality of check image exchange in the manner that is required due to the vast reduction in the volume

of paper items? We would encourage that Fed continue to evaluate consolidation opportunities. Fixed overhead cost reduction could be helpful in counteracting the loss of imputed income due to the decline of Fed "Clearing Balances."

7. **Fed needs to avoid, "The Law of Unintended Consequences" in regard to "systemic risk."**
   The PSAF has been in place as a part of MCA since 1980. We believe that most market participants would say that it has worked reasonably well. The Fed should be very cautious in evaluating what might happen as a result of changes to the existing formula and (the assumed) pricing changes that would later take place. Would pricing changes made by the Fed create a "systemic risk" to our financial system? If there are financial pressures created through an artificial price reduction in specific product areas could "systemic risk" be created through pricing pressure on key market participants? Given the information that we have as a market participant we feel that Fed needs to be very cautious in the construction of any changes to the PSAF. UBB is also concerned about the inter-relationships of recent changes in regulatory structure. Excess Balance Accounts offering rates higher than marketplace Fed Fund rates is a new phenomenon. The combination of a major change in the PSAF formula (with an unknown outcome) with the ability of the Fed to pay above market interest rates on EBA's creates a situation worthy of review.

While UBB feels that it is important that the Fed continue to offer a variety of operational services to the banking industry, we do not believe that any change is necessary in calculating the PSAF and that what the Fed is currently experiencing is nothing more than what all private market participants deal with on a day to day and year by year basis. Today the Fed has widespread ability to develop new products, price many of its key services and control its costs through many different means including consolidation. We would urge that Fed more carefully review its existing authority as opposed to making PSAF formula changes.

In summary, there is no question that the Fed faces more competition today than it did even several years' ago. The Fed has worked diligently to reduce its "legacy infrastructural" costs through office consolidation but perhaps not at the pace that it may need to in order to meet the changing dynamics of the marketplace. The highly unusual market conditions of the last year created unique circumstances requiring creative solutions that the Fed provided such as interest payment on excess reserves that could be playing a role in the movement of funds within various Fed market participant programs. But it also has the authority to modify its pricing to achieve its goals.

As both the "rule-maker" and a "market competitor" UBB feels that the Fed needs to maintain an enterprise pricing discipline as reflected in the original PSAF formula under the Monetary Control Act of 1980.

We thank the Board of Governors for this opportunity to comment on the PSAF proposal.

Sincerely,

William C Rosacker

William C. Rosacker
President