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The Clearing House℠

June 11, 2009

Board of Governors of the
Federal Reserve System
20th and C Streets, N.W.
Washington, D.C. 20551
Attention: Jennifer J. Johnson, Esq.
Secretary

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

Governors:

The Clearing House Association L.L.C. and The Clearing House Payments Company L.L.C.[1] are pleased to respond to the Board's request for comment on its proposed modification of its method for calculating the private-sector adjustment factor ("PSAF").[2] The PSAF is the "allocation of imputed costs which takes into account the return on capital that would have been provided had the services been furnished by a private business firm" that the Federal Reserve Banks are required to take into account in setting the fees for their services.[3] Presently, the Board calculates the PSAF using a model based on the nation's 50 largest bank holding companies.

An important aspect of the present method is the clearing balance program, which allows a depository institution to maintain balances with its Reserve Bank similar to the

[1] The Clearing House Association L.L.C. ("Association") is the nation's oldest bank association and forum; it frequently files comment letters on matters of importance to the banking industry. The members of the Association are listed in Exhibit A. The Clearing House Payments Company L.L.C. ("PaymentsCo") is the leading private-sector payment system infrastructure for clearing and settling U.S.-dollar payments; it provide payment services to more than 1,600 financial institutions around the world, and services include check and electronic clearing (image exchange), ACH, and funds transfer. The members of PaymentsCo are listed in Exhibit B. Except where it is necessary to differentiate the Association and PaymentsCo, both organizations will be referred to collectively as "The Clearing House."
[2] 74 Fed. Reg. 15,481 (Apr. 6, 2009).
[3] 12 U.S.C. § 248a(c)(3).

balances it would maintain at a traditional correspondent bank. As with private-sector correspondents, these clearing balances are an important source of funding for the assets used by the Reserve Banks in their priced services. Moreover, the imputed cost of equity for the Reserve Banks is related to the amount of clearing balances they hold for their priced-services customers, and the net income from clearing balances ("NICB") is deducted from the PSAF in determining the actual fees charged to the Reserve Banks' customers. Thus the level of clearing balances has a significant effect on the PSAF, the NICB, and the Reserve Banks' ability to recover their costs as required by law.[4]

There are two reasons why the Board is now reconsidering its methodology for calculating the PSAF. The first is the reaction of depository institutions to the Board's action to require the Reserve Banks to pay interest on required reserves and excess balances. Since the Reserve Banks began paying interest in October 2008, there has been a significant decline in the clearing balances held by depository institutions, with consequent results on the PSAF.[5] The second impetus for the Board's reconsideration of its methodology is the change in the market for payment services over the past few years. With the decline in check volume, the most significant competitors to the Reserve Banks for payment services are no longer bank holding companies but user-owned utilities, like PaymentsCo, which provides funds-transfer and automated clearing-house services that compete with the Reserve Banks' Fedwire and FedACH services.[6]

Alternatives.

Publicly Traded Firm Model—The Favored Model. The Board is proposing a new model for calculating the PSAF based on data from all publicly traded firms. Under this proposal, the Board would create a pro forma balance sheet that would include all assets used by the Reserve Banks to provided priced services, with capital structure, debt, and equity financing rates all based on data derived from the S&P Compustat database.[7]

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[4] 74 Fed. Reg. at 15,483.
[5] *Id.* at 15,484.
[6] *Id.* at 15,485.
[7] *Id.* at 15,485–88.

Other Models. The Board also considered other models, including one based on user-owned utilities and another that uses a cost-plus model. While the Board has indicated that it does not favor these models, it has requested public comment on whether either of these would be preferable to the publicly traded firm model, and the Board has also requested comment on whether the Board should continue to use the bank holding company model.

Under the user-owned utility model, the priced-services balance sheet and imputed costs "would reflect either the financial characteristics of a peer group of user-owned utilities currently existing or theoretical characteristics of this type of organization."[8] Despite its appeal, the Board believes that this model has a number of drawbacks, including the small number of firms that would be part of the peer group, the lack of publicly available information on the Reserve Banks' principal competitor for payment services (PaymentsCo), and the fact that user-owned utilities do not have an incentive to maximize profits.

Under the cost-plus model, a markup would be calculated by applying an internal benchmark or market rate of return to the priced-services operating expenses. The Board acknowledges that this approach also has its appeal but believes that there are some weaknesses to using it to calculate the PSAF: If the benchmark is based on historical PSAF values, those values would be static, and if the benchmark is based on accounting-based values it would capture only book—not market—values of financing and other costs, and thus "not [be] consistent with current finance theory."[9]

Clearing House Comment.

The last time the Board sought comment on an aspect of its PSAF calculations, The Clearing House expressed the opinion that the Board's methodology "exhibits serious flaws that result in a PSAF that is lower than the law requires, leading to chronic underpricing of Reserve Bank services."[10] In particular, we stated that the use of large bank holding companies as the peer group was not appropriate because payment services

[8] *Id.* at 15,488.
[9] *Id.* at 15,489.
[10] Letter from Jeffrey P. Neubert, President and CEO, The Clearing House Association L.L.C., to Board of Governors of the Federal Reserve System at 2 (Aug. 5, 2005).

typically account for a very small portion of a holding company's activities, "and over reliance on this group results in the Board underestimating certain imputed costs, like required capital."

In 2005, we supported the comment of JPMorgan Chase & Co., which recommended that the Reserve Banks use a cost-plus and market rate of return formula.

> Under this approach, each product line would get a full and accurate accounting of all its direct and indirect costs. These costs would be compared against the costs of a peer group that would include nonbank providers of payment services. . . . The benchmarking against this peer group could also be used to determine a market-based rate of return to apply to the costs to determine the prices for Reserve Bank services. Set this way, prices would, as required by section 11A, recover direct and indirect costs, plus the return on capital, and "give a due regard to competitive factors."[11]

The Clearing House applauds the Board's move from a model that we have long thought inappropriate. We fully support the Board's proposal to abandon the use of a model that uses large bank holding companies as a peer group and move toward a more appropriate model. Nevertheless, we believe that the model that uses all publicly traded companies as the peer group contains significant flaws. Most significantly, the universe of all publicly traded firms is simply too diverse to be an appropriate peer group for the subset of Reserve Bank operations that clear and settle payments. We recommend that the Board consider a peer group that includes publicly traded payments-processing companies. Companies that could fall into this category (subject to evaluation of their business operations) would include Fiserv, Inc.; Fidelity National Information Services, Inc.; Metavante Technologies, Inc.; Jack Henry & Associates, Inc.; Computer Sciences Corporation; Total System Services, Inc., Heartland Payment Systems, Inc.; CyberSource Corporation; MasterCard Incorporated; and Visa Inc. The Board could add to this group by periodically conducting informal surveys of large bank holding companies to obtain relevant data on their payments-processing lines of business.[12]

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[11] *Id.* at 3.

[12] Holding companies do not report this information separately and would likely regard it as confidential. The Board could obtain this information from each company on an informal basis in confidence and report aggregate data.

The Clearing House continues to believe that the Board should carefully consider a cost-plus model that uses a markup derived from a peer group of payments-processing firms. The Federal Register notice, however, does not provide enough information to judge what the effect of moving to this model would be.

The Board estimates that using the current model would yield a net PSAF of $19.5 million. Moving to the publicly traded firm model (the one favored by the Board) would yield a net PSAF of $55.4 million, while the cost-plus model would result in a net PSAF of $157.5 million, and using a correspondent-banking model that does not take account of clearing balances would yield a net PSAF of $50.7 million.[13] Yet the markup in the cost-plus model used by the Board is based on value-weighted average data for all publicly traded U.S. firms,[14] not a peer group that might be more appropriate. Moreover, even assuming that a peer-group, cost-plus model would result in a PSAF substantially similar to the cost-plus model that the Board uses in its calculations, the increase in the PSAF from the current model (roughly 700%) may be too much to impose on the financial-services industry in current market conditions.

We also agree with the comment made by JPMorgan Chase & Co. that the Board and the Reserve Banks must make "an accurate assessment of what the market will bear for competitively priced services." Because banks will look for the lowest-priced payment services, "[t]he formation of private sector joint ventures where participants elect to leave the 'grid' . . . is a real issue for the payments industry."[15] We agree that the Reserve Banks should continue with cost-reduction efforts by considering services designed to increase the efficiency and cost effectiveness of the payments system.

The Clearing House recommends that the Board go forward with the present proposal for Reserve Bank fees to be set for 2010, but that it continue to evaluate the way that is sets the PSAF. We strongly recommend that the Board consider meeting with the major users of Reserve Bank priced services to examine the market. This will ensure that the Board has the benefit of the best thinking on this subject from the parties who are most familiar with the payments industry before it publishes another PSAF model for

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[13] 74 Fed. Reg. at 15,494. Net PSAF is total PSAF minus total NICB.
[14] *Id.* at 15,489.
[15] Letter of Susan J. Webb, Executive Vice President, JPMorgan Chase Bank, N.A. to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System at 2 (May 27, 2009).

public comment. The Board should begin these meetings at an early date so that a new proposal can be issued within a reasonable time rather than some years in the future. As most of the significant users of Reserve Bank payment services are members of The Clearing House, we would be happy to facilitate these meetings.

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We hope these comments are helpful. If you have any questions or would like to discuss any of these matters with us, please contact Joseph R. Alexander, Senior Counsel, at 212-612-9234 or joe.alexander@theclearinghouse.org.

Very truly yours,

Norman R. Nelson

EXHIBIT A

MEMBERS OF THE CLEARING HOUSE ASSOCIATION L.L.C.

ABN AMRO Bank N.V.
Bank of America, National Association
The Bank of New York Mellon
Citibank, National Association
Deutsche Bank Trust Company Americas
HSBC Bank USA, National Association
JPMorgan Chase Bank, National Association
UBS AG
U.S. Bank National Association
Wells Fargo Bank, National Association

EXHIBIT B

MEMBERS OF THE CLEARING HOUSE PAYMENTS COMPANY L.L.C.

Organizing Member

The Clearing House Association L.L.C.

Class A Members

Bank of America, National Association
The Bank of New York Mellon
Branch Banking and Trust Company
Citibank, National Association
Comerica Bank
Deutsche Bank Trust Company Americas
HSBC Bank USA, National Association
JPMorgan Chase Bank, National Association
KeyBank National Association
PNC Bank, National Association
RBS Citizens, National Association
UBS AG
Union Bank, National Association
U.S. Bank National Association
Wells Fargo Bank, National Association

Class AA Members

City National Bank
Fifth Third Bank
First-Citizens Bank & Trust Company
Manufacturers and Traders Trust Company