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PNC

July 21,2005

Ms. Jennifer 3. Johnson,
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Attention: OMB No: 7100-0035
regs.comments@federalreserve.gov

Re: Request for Comment on the Federal Reserve Board Services Private Adjustment Factor - Docket No OP-1229

Dear Ms Johnson:

PNC Financial Services Group, Inc. ("PNC") appreciates the opportunity to comment on the proposed modifications to the method for calculating the target return on equity (ROE) in the private-sector adjustment factor (PSAF) by the Board of Governors of the Federal Reserve System ("Board").

The PNC Financial Services Group, Inc. is one of the largest diversified financial services organizations in the United States with $83.4 billion in total assets as of March 31, 2005. Our major businesses include community banking, corporate banking, real estate finance, asset-based lending, wealth management, asset management and global fund services. PNC's lead bank, PNC Bank National Association, Pittsburgh, Pennsylvania, has branches in Indiana, Kentucky, New Jersey, Ohio, Pennsylvania and most recently, the District of Columbia, Virginia and Maryland.

RECOMMENDATIONS

With regard to the Board's proposed changes to the methodology used to estimate the target ROE for priced services, we agree the CAPM mode] could solely be uti]ized to estimate ROE. The Comparable Accounting Earnings ("CAB") Model's reliance on historical data and failure to incorporate future earning expectations, and the difficulty in determining accurate inputs for the Discounted Cash Flow ("DCF"), provide a sound basis for a CAPM only methodology.

As noted, the CAPM results are sensitive to the model's inputs. PNC offers the following considerations when determining the inputs to be used in the CAPM:

- Although the CAPM may produce the most volatility in ROE estimates (reference Table 2), it provides the best measure of investor's return expectations.

- The largest banks today operate many diversified businesses, each with their own unique risks. The businesses most similar to those of the Federal Reserve Bank most likely comprise a small proportion of their financial results, and therefore, using the top fifty bank holding companies ("B}lCs") as the peer group may not adequately capture the risk associated with the Federal Reserve Bank services. We would propose utilizing a peer group composed of processing companies such as FDC, BISYS and ADP.

- PNC would recommend matching the duration of the risk-free rate with the repricing frequency of the PSAF in order to better align Federal Reserve Bank pricing with investor return expectations. For example, if the PSAF repriced annually, then utilizing a 1-year treasury would be optimal. In addition, we would recommend a shorter duration with higher data frequency when calculating beta, as well as, a shorter period for estimating the risk premium to better reflect the market's current return requirement.

- The CAPM is flexible enough to adjust for leverage differences that may exist within the peer group. Unlevered betas can be estimated from levered betas calculated from market data (including dividends in the calculation) and then relevered to the Federal Reserve Banks' balance sheet capital structure. In addition, adjustments to reflect company size differences could also be incorporated.

- Finally, it should be noted that the Securities Market Line of the CAPM model provides an after-tax required return. The notion of a pretax CAPM as referenced in Table 2 is inconsistent with Finance theory.

Attached as Appendix A is a summary of a!] the requested comments with specific responses for your consideration.

Thank you for considering the ideas and commentary expressed in this letter. If you have any questions or are in need of any further information, please contact 412-762-5563.

Sincerely yours,

cc: Michael Carroll, Federal Reserve Bank of Cleveland
R. Chris Moore, Federal Reserve Bank of Cleveland
John 3. Wixted, Jr., PNC

Appendix A

VIII. Summary of Comments Requested

A. Imputed ROE

1) Are there models. other than the three in use, that the Board should consider?

There are other models that are used to estimate investor return expectations. An example would be the multi-variable Arbitrage Pricing Theory or APT model. However, if simplicity and transparency are guiding principals of the Board, then the CAPM is the preferred model.

2) What is considered to be a reasonable target ROE for institutions that provide services similar to those provided by the Reserve Banks?

A reasonable return can be estimated using a peer group comprised of processing firms. Check clearing, which represents more than 80 percent of the Reserve Banks' priced-services activities, is essentially a processing activity. A sample of processing companies also will capture the evolution from paper to electronic clearing.

3) What important elements of the ROE calculation might be excluded if the Board adopts the CAPM-only method?

PNC believes there are no material elements which might be excluded if the Board adopts the CAPM-only method.

4) *Are* there considerations that do not support the use of CAPM to impute the Reserve Banks' target ROE?

The CAPM is flexible enough to adjust for leverage differences that may exist within the peer group. Unlevered betas can be estimated from levered betas calculated for the peer group using market data (including dividends in the calculation), and then relevered to the Federal Reserve Banks' balance sheet capital structure. In addition, adjustments to reflect company size differences could also be incorporated.

5) Is the DCF model used to estimate a target ROE? What earnings estimates are the most useful?

PNC does not typically use the DCF model to estimate required returns due to the inherent difficulty of estimating cash flow and dividend growth rates.

6) Are recent published accounting earnings relevant when estimating a tar£et ROE?

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As noted in the briefing, the difficulty in estimating cash flow and dividend growth rates, the possible bias in earning projections, and the fact that recent published accounting earnings are not forward looking, limit the relevance of these earnings when estimating a target ROE.

7) Is the volatility of the CAPM-only method acceptable?

Although the CAPM may produce the most volatility in ROE estimates (reference table *2)*, it provides the best measure of investor's return expectations.

8) Should CAPM-only be viewed as a method to develop a ROE that may be modified; if so. why and how would one modify the model?

PNC would recommend matching the duration of the risk-free rate with the repricing frequency of the PSAF to better align Federal Reserve Bank pricing with investor return expectations. For example, if the PSAF repriced annually, then utilizing a 1-year treasury would be optimal. In addition, PNC would recommend a shorter estimation period and higher data frequency when calculating beta, as well as, a shorter period for estimating the risk premium. Finally, we would value weight beta and adjust for leverage. Also, please note the CAPM produces an after-tax return.

B. CAPM Methodology

1) Should the Federal Reserve's priced-services target ROE for the upcoming year be based on a short-term rate, which might reflect what the market expects its peers to deliver in the upcoming year, or should the target ROE be calculated using a long-term rate, which might better reflect the return that the market expects its peers to deliver, on average. over time?

PNC would recommend that the Federal Reserve's priced-services target ROE for the upcoming year be based on a short-term rate, which reflects what the market expects its peers to deliver in the upcoming year.

2) Is it reasonable for the Board to incorporate a ten-year Treasury bond less a term premium to reflect an expected average short-term risk-free rate over a ten-year horizon?

We do not believe this will lead to any significant improvement.

3) What are other factors that could be used to incorporate a long-term time horizon?

PNC would consider using a shorter period for estimating the risk premium. It should correspond to the risk free rate period.

4) What factors should be considered when determining the Federal Reserve's priced-services peer group?

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The largest banks today operate many diversified businesses, each with their own unique risks. The businesses most similar to those of the Federal Reserve, most likely comprise a small proportion of the banks financial results. Therefore, using the top fifty bank holding companies ("BHCs") as the peer group may not adequately capture the risk associated with the Federal Reserve services. We would propose utilizing a peer group composed of processing companies such as FDC, BISYS and AD?.

5) <u>Is selecting a peer group based on deposit balances, due-to balances, or a combination of both an appropriate peer group selection criterion?</u>

If Banks were the given peer group, then a combination of both deposit balances and due-to balances would be the selection criterion as a proxy for estimating correspondent banking activities.

6) <u>Are there other criteria the Board should consider?</u>

As mentioned above, PNC would propose utilizing a peer group composed of processing companies such as FDC, BISYS and AD?.

7) <u>Do the Tier I capital-to-risk-weighted assets ratio and solvency ratings filters improve the selection method?</u>

Yes, given a bank peer group, they might help to mitigate the effect of leverage, and improve the comparability of data.

8) <u>Does a rolling five-year period or a rolling ten-year period better capture elements that are relevant to calculating a meaningful beta for estimating the Reserve Bank priced-services ROE?</u>

PNC would recommend a shorter estimation period with higher data frequency (cx. 2 year beta calculated using either weekly or daily data) to better align the pricing of the Federal Reserve priced-services with investor expectations. A shorter estimation period would help to insure the timely incorporation of industry changing dynamics, for example, the evolution from paper to electronic processing. Also, cum dividend should be used in the calculation of beta

9) <u>Is equal-weighting or 'value-weighting the returns of each BHC in the peer group preferable when estimating beta?</u>

Value weighting is more theoretically sound if the goal is to compute the market value weighted return to this activity versus the average of the required returns to the firms engaged in this activity.

] 0) <u>Should an alternative weighting process, such as by deposit or due-to balances, be used?</u>

Since PNC would recommend changing the entire peer group, this question is not applicab]e.

11) <u>What are the strengths and weaknesses of each weighting method?</u>

Value weighting computes the market value weighted return to this activity versus the average market return.

12) Is a beta equal to 1.0 for Federal Reserve priced services a reasonable simplifying assumption when computing CAPM?

It is a reasonable simplifying assumption, and would have the additional benefit of eliminating the need for a Peer Group.

13) Are important elements that should be factored into the CAPM equation eliminated with this assumption?

By assuming a beta equal to one, analyzing or adjusting for the impact of leverage could potentially be eliminated.

14) If an adjusted beta should be considered. what is the best method for implementing it?

Using the average of the equity beta and 1 has long been considered a reasonable approach to beta adjustment.

15) Are the after-tax and pretax ROE results of the CAPM-only method reasonable?

The results presented in the briefing are reasonable. By definition the CAPM computes an afler-tax return. The notion of a pretax CAPM ROE is inconsistent with Finance Theory.

16) In what ways, if any, does this methodology oversimp1i the calculation?

The notion of a pretax CAPM ROE is inconsistent with Finance Theory.

17) In what ways, if any is the methodology overly complex?

The notion of a pretax CAPM ROE is inconsistent with Finance Theory.

C. Broader issues in the implementation of the target ROE

1) Do firms target a different ROE for near-term budgeting purposes than for multiyear, longer-ten strategic planning?

We have seen instances where annual reports have disclosed long-term ROE goals, which have been different than actual performance. In addition within strategic planning, the notion of a product life-cycle is consistent with multiple ROEs across time.

2) What advantages or disadvantages are there to the Federal Reserve setting a PSAF. including the priced-services ROE, more or less fruent1y than annually?

A tradeoff for setting the PSAF more frequently is-better incorporation of today's expectations into the CAPM calculation versus the cost and volatility introduced.

3) What, if any. are the implications if a longer-term approach to setting the ROE is adopted?

Given the yield curve typically slopes upwards, the results would be biased upwards which would mean the Federal Reserve priced-service activities would tend to be higher than warranted to provide the return required in the current period.

4) What are the advantages and disadvantages to the Board changing its current practice of setting the target ROE for priced services at an entity level and begin developing target ROEs for each service line?

Developing target ROEs for each service line is ideal. Better estimates would be provided with service line data, however, the cost and availability of data may make this prohibitive.

5) In what way should the Board adjust the target ROE to consider the decline in use of paper-based check products. given that the check service presents a majority of priced-services activities?

The CAPM model will adjust to reflect these changes. A shorter estimation period coupled with higher data frequency (ex. 2 year beta calculated using either weekly or daily data) would be of benefit.

D. Looking ahead

1) The Board requests comment on the possible implications that payment industry and regulatory changes may have on the approach to calculate PSAF.

A market-based approach like the CAPM is robust enough to capture and incorporate theses changes.