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July 27, 2005

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
Office of the Secretary
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Via e-mail (regs.comments@federalreserve.gov)
and via fax: 202-452-3819

Re: Federal Reserve Bank Services Private Sector Adjustment Factor
Docket No. OP-1229

Dear Ms. Johnson:

The Board of Governors of the Federal Reserve System (the "Board") has requested comments on potential modifications ("Modifications") to the method for calculating the target return on equity ("ROE") in the private-sector adjustment factor ("PSAF"). JPMorgan Chase & Co. ("JPMC"), on behalf of its lead subsidiary bank, JPMorgan Chase Bank, National Association and its affiliates, appreciates the opportunity to submit this response.

JPMC is a leading global financial services firm with assets of $1.2 trillion and operations in more than 50 countries. The firm is a leader in investment banking, financial services for consumers and businesses, financial transaction processing, asset and wealth management, and private equity. Under the JPMorgan, Chase and Bank One brands, the firm serves millions of consumers in the United States and many of the world's most prominent corporate, institutional and government clients. Information about the firm is available on the Internet at www.jpmorganchase.com.

Success in the transaction services business is reflected in the efficiencies that large processing companies derive from the scale and scope of their operating units. Establishing an accurate cost base and demonstrating the capability to recover costs and earn a market-based return are key performance measures. The Federal Reserve uses the PSAF to capture costs incurred in the private sector before setting fees for Federal Reserve services. However, since the Federal Reserve's historical annual results demonstrate an under recovery of "Total Costs", which include a return on equity, it appears that the model is not being followed or it is not functioning properly.

JPMC believes that the methodology currently employed in establishing the PSAF is flawed. We recommend that the Board consider an alternative approach to establishing a cost base and a market-based rate of return.

Cost-plus Benchmarking

Although ROE is an important metric in evaluating the pricing of transaction banking services, we think a more straight forward approach to determining cost, pricing and returns is a complete and accurate accounting of the direct and indirect costs for each of the priced services. A return which either meets an internal benchmark or is competitive in the market should then be applied. This approach is simple and avoids the need for equity assumptions, comparable analysis which can be skewed by accounting and methodological differences. The analysis should be product-specific because all products are expected to fully recover their costs. We believe that most of the industry follows a cost-plus approach by product in determining prices for services and recommend that the Federal Reserve consider using the same methodology.

Rather than relying exclusively on Reserve Bank "imputed" costs and a calculated rate of return, JPMC suggests the inclusion of bank and non-bank market comparables in benchmarking costs. Each priced service should be benchmarked to establish competitive market-based costs. We believe that benchmarking against the industry cost structure will: (1) enable the Federal Reserve Banks to assess how they are faring from a competitive point of view in regard to the incurrence of actual costs; and (2) establish a means for determining or validating "imputed" costs which the Federal Reserve is obliged to calculate under the Monetary Control Act of 1980. Benchmarking against the industry cost structure will result in a simple, accurate and comparable means to determine or validate "imputed" costs, from which to apply a market-based return to determine appropriate pricing.

A consortium of banks has engaged a consulting company in a study to benchmark industry costs, and it is possible that some of that work may be leveraged to develop peer-based comparables that the Board would find useful. Kindly let us know at your early convenience whether the Federal Reserve Banks might like to participate in the study.

Market-based Return

A component of the cost-plus approach is determining a fair market-based rate of return (profit margin or expense/revenue ratio) for each priced service. This can be accomplished with input from the aforementioned peer group banks, industry equity analysts and analysis of private sector payment processing companies. This market-based rate of return may be used by the Board in assessing the PSAF calculations or as an alternative to the calculation of imputed profits under the current proposal.

JPMC acknowledges that the approach discussed above provides a methodology for determining or validating imputed costs and profits that is different than the methodology used today in calculating the PSAF. However, we believe that a cost-plus benchmarking initiative will bring about consistency with private-sector practice and result in appropriate Federal Reserve fees for priced services. As a general matter, we believe that the fees for Federal Reserve Bank priced services are too low.

Modifications to the Current Methodology

Recognizing that it will take time to consider and implement a cost benchmarking initiative, JPMC wants to take this opportunity to provide comments on the Modifications to the current methodology used to compute a target ROE that have been proposed by the Board. Specifically, we are providing commentary on the three defining questions that the Board has asked:

1. What alternative approaches to the current method used to compute a target ROE should be considered?
2. Is there value in implementing a longer term planning horizon for targeting the ROE?
3. What will be the effect of future regulatory and industry change on the PSAF method?

Of the three methodologies discussed, the Capital-Asset Pricing Model ("CAPM") is theoretically the most appropriate model to use in computing a target ROE. JPMC proposes the use of CAPM in conjunction with the Comparable Accounting Earnings ("CAE") model. Recently published accounting earnings are relevant for estimating a target ROE if they exclude recent business combinations, restructuring activities and other special charges that do not provide a realistic view of ongoing operations. We suggest using the CAE model as a method to validate the results of CAPM.

JPMC believes that a 5% capital requirement level is not appropriate for calculating the imputed equity capital, which will be a key component in determining fees for priced services. We note that the 5% capital requirement is the threshold for a well-capitalized bank holding company that has a diversified portfolio of product and services, and that the "portfolio effect" of these offerings is a factor in establishing the 5% capital requirement threshold. Payment processing companies in the private sector, on the other hand, typically maintain a much higher percentage of equity capital to reflect the operating risks associated with their business. We recommend broadening the peer group to include a core group of private sector payment processing companies and that an assessment of services, risks and appropriate equity capital levels be made. We believe that a key conclusion will be that the 5% capital requirement threshold is too low.

The Board has suggested fixing the Beta value at 1. JPMC recommends that the Board utilize a broad peer group, similar to that used for the capital requirement analysis, as its determinant for the Beta factor. Our preliminary analysis suggests that in the current market, this is likely to result in a Beta value close to 1.

JPMC agrees with the Board that a longer term planning horizon should be used for targeting the ROE. We believe that most financial institutions manage their franchise over a longer time horizon than that represented by a 1 year risk free rate. The Board's suggestion to use a 10 year risk free rate versus a short term rate is more appropriate. However, we believe that the adjustment to the term rate proposed by the Board understates expected long term returns that should be embedded in the ROE. This could result in under pricing the services offered by the Federal Reserve Banks.

JPMC agrees that future regulatory and industry change could have an impact on the PSAF method. Our previous suggestions on broadening the peer group to include non-bank private sector payment processing companies, and the rationale for a higher capital threshold, will help mitigate the effect that these potential changes could have. We recommend incorporating these changes in the more immediate future as an effective way to address the changing landscape in the payments business.

Price Volatility

JPMC shares the Board's concern about volatility. We believe that benchmarking against the industry cost structure offers the best opportunity to achieve price stability over time. Any decision to incorporate benchmarking or make Modifications to the current model may have the unintended consequence of "price shocking" the market. In order to avoid this effect, JPMC recommends that any increases to the prices of Federal Reserve Bank services be phased in, with a cap on year-to-year increases. JPMC also recommends that the Board "back-test" its pricing model to ensure that results are consistent with its pricing strategy.

In closing, there is one additional consideration that we would like to put forward. A cost-based benchmarking initiative allows participants to evaluate their operational efficiency against industry peers. With the transformation that we are experiencing in the check processing industry, this may well be the right time for the Board to ask: why should the Federal Reserve remain in the check business? We would encourage the Federal Reserve to exit those products which market data suggests (a) they are not competitive with the private sector, (b) they are not recovering their costs and (c) the private sector can provide an adequate level of service to depository institutions nationwide. In this context, we take note of the downsizing and closing of check processing facilities by the Federal Reserve which have occurred or are planned, all without disruption to the check clearing and collection systems. Since the Federal Reserve has not been fully recovering its total costs over the past several years and in 2005 has had to increase prices for check clearing and collection services, we respectfully ask the Board to consider withdrawing from these businesses. With due regard to the Board's mandate to assure safety and soundness in the payments system, and the integrity, efficiency and access to the payment system, it no longer appears to us that it is necessary or desirable for the Federal Reserve Banks to clear and collect checks.

JPMC would be pleased to discuss any of the points raised in this letter in more detail. Should you have any questions, please contact me at 212-270-2650, or via e-mail at heidi.miller@jpmchase.com or Roy DeCicco at 212-552-0731, or via e-mail at roy.c.decicco@jpmchase.com.

Sincerely,