THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

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August 5, 2005

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: Federal Reserve Bank Priced 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 comment on the Board's request for comment on potential modifications to the method for calculating the target return on equity ("ROE") component of the private-sector adjustment factor ("PSAF").[2]

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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, providing payment services to more than 1,600 financial institutions around the world; its services include check clearing and electronic-check clearing (image exchange), ACH, and funds transfer systems. The owners 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 70 Fed. Reg. 29,512 (May 23, 2005).

Section 11A of the Federal Reserve Act requires the Board to set fees for Federal Reserve Bank services, and further provides that the fees for these services shall include "an 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, except that the pricing principles shall give a due regard to competitive factors . . . ."[3]

In response to this statutory requirement, the Board has established a methodology for setting the PSAF and reviews this methodology periodically to ensure accuracy and consistency with private-sector practice. The Board is now proposing to revise the way that it calculates the ROE component of the PSAF because some of the models employed for this purpose are no longer used by private-sector companies.[4]

CLEARING HOUSE COMMENTS

The Clearing House believes that the method that the Board has used to calculate the ROE component of the PSAF exhibits serious flaws that result in a PSAF that is lower than the law requires, leading to chronic under-pricing of Reserve Bank services. The present proposal does nothing to correct these flaws.

The first and most obvious flaw is that many of the assumptions that go into the PSAF formulas are wrong because the Board has chosen to use only large bank holding companies as the Reserve Banks' peer group. Use of the wrong peer group results in underestimation of capital requirements and, possibly, the *beta* that should be used in the models. Another flaw is that both the current and proposed models ignore the competitive factors that private-sector firms must take into account when setting their prices.

We believe that the Board should adopt a model for ROE calculation that corrects these flaws. We suggest that the Board adopt a blend of two models: (i) a model that uses cost-plus benchmarking and a market rate of return to establish prices for individual Reserve Bank services, and (ii) a model that is similar to the one that the Board has proposed but that uses a more appropriate peer group to ensure that the cost-plus markup on individual services results in an appropriate rate of return.

COST-PLUS BENCHMARKING AND MARKET-BASED RETURN

Basic Approach. We have reviewed the comment letter on this proposal by JPMorgan Chase & Co.[5] and agree with its comment that the Board could ensure more accurate Reserve Bank fees and better cost recovery as required by the Federal Reserve Act by

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3 12 U.S.C. § 248a(c)(3).

4 70 Fed. Reg. at 29,517.

5 JPMorgan Chase & Co.'s lead bank is a member of both the Association and PaymentsCo.

setting prices using 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. This benchmarking would, as the JPMorgan Chase letter says, "(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.'" 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."

Peer Group. The Board has traditionally used large bank holding companies as the Reserve Banks' peer group when determining the PSAF. The Clearing House believes that this causes serious problems for the Board's models. Payment services typically account for a very small portion of a large BHC's activities, and over reliance on this peer group results in the Board underestimating certain imputed costs, like required capital. As the Board points out, bank holding companies are considered well-capitalized if they have at least a five per cent capital-to-assets ratio, but payment services are higher risk than other banking activities and require greater capital. In order to determine the amount of capital that ought to be attributed to Reserve Bank payment services, we believe that the peer group should be made up largely of nonbank companies that specialize in payment services. Such a peer group would include private-sector companies that provide payments-processing services, like First Data Corporation, Fiserv, Inc., and eFunds Corporation, as well as bank-owned payment networks like Visa International, MasterCard International, NYCE Corporation, Pulse EFT Association, and The Clearing House Payments Company.

Validation of Results. Prices set this way would be established on a product-line–by–product-line basis, as private-sector firms set their own prices. Given the unique characteristics of the Federal Reserve Banks, we believe that the it would be appropriate for the Board to validate this "microeconomic" approach with a more "macroeconomic" approach using a PSAF calculation similar to what the Board has proposed, although with some changes to address the significant flaws we believe the current proposal exhibits.

MODIFICATIONS TO THE BOARD'S PROPOSAL

The Three Models. The Clearing House agrees that the discounted cash flow model is too subjective and should no longer be used in calculating the ROE. We also agree that the capital-asset pricing model ("CAPM") is theoretically the best. We are concerned, however, that the CAPM is too theoretical and dependant on the assumptions that go into it. Because of this concern, we suggest that the Board consider using results derived from the comparable accounting ("CAE ") method, which are based on actual performance, as a reality check on the results of its CAPM calculations. There are several ways that the Board could accomplish this: we believe that the simplest and perhaps the best way would be for the Board to calculate ROE under both the CAPM and the CAE model and average the result to obtain the target ROE for Reserve Bank services.

Capital Requirements. Calculating a targeted return on equity requires that the Board assign to the Reserve Banks an imputed equity that the ROE will be applied against. While the Board has not specifically requested comment on the procedure that it uses for assigning capital to Reserve Bank priced services, we believe that this is a crucial element in the ROE and PSAF calculations and deserves comment, especially in light of our view that the Board's assumptions on the amount of capital that should be attributed to Reserve Bank services are highly questionable.

We recognize that Reserve Banks are unique institutions with unusual balance sheets, so some adjustments are needed to arrive at a proxy for the capital part of the ROE calculation. The Board's solution to this issue is to take the assets used to provide priced services to create a pro forma balance sheet for this aspect of the Federal Reserve's operations. The mistake comes in the next step, which is to apply the FDIC's capital requirement that would be applied to a bank holding company as a whole to the payments-related assets (five per cent). This skews the results.

As pointed out in the prior section, payment services are typically a very small part of a bank holding company's operations. This area is considered high risk because of the operational risks involved, so capital attributed to this area must be considerably higher than for the BHC as a whole.[6] If the Board is going to use only the Federal Reserve's payments-related assets as a proxy for a private-sector company's assets, then the capital attributed to it must be considerably higher than the five per cent that would be attributed to an entire bank holding company.

We believe that the Board should apply the capital ratio that is comparable to the capital-to-asset ratio maintained by large private-sector payments processing companies and bank-owned payment networks. Using this peer group will yield results that are more realistic than the five per cent figure used by the Board.

Beta. The heart of any CAPM analysis is the *beta*, which measures risk. The Board proposes to use a *beta* of 1, which is the measure of risk for a company with standard risk characteristics and also corresponds to the *beta* of most bank holding companies. But, as pointed out above, the risk of payments processing is higher than it is for the operations of a bank holding company as a whole, and the *beta* must reflect the higher risk. Again,

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[6] The Basle capital group initially proposed that 20% of economic capital be allocated to operational risk; this has been reduced to 12% in light of public comments. *See* Basle Committee on Banking Supervision, *Working Paper on the Regulatory Treatment of Operational Risk* at 10 (2001), available on-line at http://www.bis.org/publ/bcbs_wp8.pdf. As an additional example, PaymentsCo has a capital-to-assets ratio of 36%.

we suggest that the Board do an analysis based on a peer group that is made up largely of payments processing companies and bank-owned payment networks; the *beta* derived from that analysis should be used in the Board's analysis.

With respect to the *beta*-estimation period, we believe that the proposed 10-year period that the Board proposes may be too long a horizon. Because of the consolidation and innovation that has occurred in the banking industry in the past few decades, most of the large bank holding companies that the Board refers to as the Reserve Banks' peer group have changed enormously in the past 10 years; many would not be recognizable when compared to themselves 10 years ago. We therefore recommend that the Board use a rolling five-year *beta*-estimation period.

Risk-Free Rate. For the same reasons we recommend that the Board use a five-year *beta*-estimation period, we recommend that the five-year Treasury-note rate for the risk-free rate.

LONGER TERM CONSIDERATIONS

At the conclusion of its notice, the Board raises some questions about further changes in the PSAF as changes in the payments industry and the regulatory environment proceed. In particular, the Board suggests that while large bank holding companies are an appropriate peer group for PSAF estimation under current circumstances, a more complete shift to electronic payments may make other Reserve Bank competitors more appropriate for consideration in establishing the PSAF.

> Competitors in the electronic payment services, however, have typically been market utilities. Market utilities such as the Clearing House Interbank Payment [sic] System (CHIPS), which is the primary competitor for Fedwire funds transfer services, and the Electronic Payments Network (EPN), which is the only private-sector automated clearinghouse (ACH) operator, are both member-owned clearinghouses. As paper check volume continues to decline and as the check service increasingly becomes electronic, market utilities may replace correspondent banks as the Reserve Banks' primary priced-services competitor.[7]

We agree that changes in the payments industry should prompt the Board to reevaluate the Reserve Bank peer group form time to time, and, as noted above, we believe that bank holding companies, by themselves are not an appropriate peer group to use as a private-sector proxy for Reserve Bank payment operations. This does not mean, however, that the Board should look only to bank-owned utilities as a proxy. Shareholder-owned companies still form an important part of the market, and the Board should be expected to include them in any peer group to ensure that Reserve Bank prices include an appropriate return on equity as required by section 11A.

[7] 70 Fed. Reg. at 29,522. Both CHIPS and EPN are owned and operated by PaymentsCo.

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We hope that these comments are useful. If you have any questions, please call Joseph R. Alexander, Senior Counsel, at 212-612-9334

Very truly yours,

Exhibit A

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

Bank of America, National Association
The Bank of New York
Citibank, N.A.
Deutsche Bank Trust Company Americas
HSBC Bank USA, National Association
JPMorgan Chase Bank, National Association
LaSalle Bank, National Association
UBS AG
U.S. Bank National Association
Wachovia Bank, National Association
Wells Fargo Bank, National Association

Exhibit B

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

Bank of America, National Association
The Bank of New York
The Bank of Tokyo–Mitsubishi, Ltd.
Branch Banking and Trust Company
Citibank, N.A.
Citizens Bank of Rhode Island
Comerica Bank
Deutsche Bank Trust Company Americas
HSBC Bank USA, National Association
JPMorgan Chase Bank, National Association
KeyBank National Association
LaSalle Bank National Association
National City Bank
PNC Bank, National Association
SunTrust Bank
UBS AG
U.S. Bank National Association
Wachovia Bank, National Association
Wells Fargo Bank, National Association
City National Bank
Manufacturers and Traders Trust Company
The Clearing House Association L.L.C.