BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

Date: October 25, 2000

To: Board of Governors

From: Edward W. Kelley, Jr.

Subject: Private Sector Adjustment Factor for 2001

The Committee on Federal Reserve Bank Affairs has reviewed staff's recommendation that the Board adopt a 2001 Private Sector Adjustment Factor (PSAF) for Federal Reserve Bank priced services of $206.9 million. I am forwarding the attached staff memorandum to the Board for its consideration as a summary item at its November 8 meeting.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

Date:	October 25, 2000
To:	Board of Governors
From:	Brenda Richards, Gregory Evans and Paul Bettge
Subject:	Private Sector Adjustment Factor for 2001

ACTION REQUESTED

Staff requests Board approval of its recommendation to adopt a 2001 Private-Sector Adjustment Factor (PSAF) for Federal Reserve priced services of $206.9 million. This amount represents an increase of $14.3 million, or 7.4 percent, from the PSAF of $192.6 million for 2000.

BACKGROUND

Each year, as required by the Monetary Control Act, the Reserve Banks set fees for "priced services" to depository institutions. These fees are set to recover all direct and indirect costs and imputed costs, such as financing costs, return on capital, taxes, and certain other expenses that would have been paid had the services been provided by a private business firm. These imputed costs are based on data developed in part from a model comprising consolidated financial data for the nation's fifty largest (asset size) bank holding companies (BHCs). The imputed costs and imputed profit are collectively referred to as the Private-Sector Adjustment Factor (PSAF).

Cost of Capital

The methodology for calculating the PSAF involves determining the value of Federal Reserve assets that will be used in providing priced services during the coming year, the financing mix used to fund them, and the rates paid for this financing. Assets are determined using Reserve Bank information on actual assets and projected disposals and acquisitions. The priced portion of mixed-use assets is determined based on the allocation of the related depreciation expense. Short-term assets are assumed to be financed with short-term liabilities and long-term assets are assumed to be financed with a combination of long-term debt and equity.

The long-term debt and equity rates are based on the average of these elements for BHCs in the model for each of the last five years. Because short-term debt, by definition, matures within one year, only data for the most recent year are used for computing the short-term debt rate.

Income Taxes

For simplicity, given that federal corporate tax rates are graduated, various credits and deductions can apply and state taxes vary, a specific tax rate is not calculated for Federal Reserve priced services. Instead, imputed taxes are captured by using a pre-tax return on equity (ROE). This result influences the dollar level of the PSAF and Federal Reserve price levels because this is the return a shareholder would expect in order to invest in a private business firm. The use of the pre-tax return on equity assumes a 100 percent recovery of expenses, including the targeted return on equity, will be achieved. The recommended PSAF is, therefore, based on a precise matching of revenues and actual and imputed costs. Should the pre-tax earnings be over or under the targeted ROE, the PSAF is adjusted ("variable PSAF") for the tax expense or savings associated with the adjusted recovery. The tax rate is the median of the rates paid by the BHCs over the past five years adjusted to the extent that BHCs are invested in municipal bonds.

Other

The PSAF also comprises the estimated expenses of the Board of Governors related to priced services. An assessment for FDIC insurance is imputed based on current FDIC rates and projected clearing balances held with the Federal Reserve.

DISCUSSION

The increase in the 2001 PSAF is due to higher priced service asset levels, primarily the net pension asset. Partially offsetting the increase in asset levels is the inclusion of short-term payables as a source for financing short-term assets.

Asset Base

The total estimated value of Federal Reserve assets to be used in providing priced services in 2001 is reflected in Table 1. Table 2 shows that the assets assumed to be financed through debt and equity are projected to total $1,162.4 million. This amount represents an increase of $45.9 million, or 4.1 percent, from the assets financed in 2000. Growth of $105.1 million in the net pension asset accounts for the majority of the increase, while higher Reserve Bank building and equipment assets account for an additional $20.9 million.

Partially offsetting the increase in asset levels is a reduction of $80.1 million resulting from the inclusion of short-term payables as a financing source. Only those short-term assets that cannot be financed with actual (rather than imputed) short-term liabilities, such as sundry items payable, earnings credits due depository institutions, and accrued expenses, are financed with short-term debt. This is a change for 2001, recognizing that these non-imputed liabilities could be used to finance assets, which resulted in a $4.0 million decrease in PSAF.

Cost of Capital and Taxes

Table 2 also shows the financing and tax rates and the other required PSAF recoveries proposed for 2001 and the rates used for developing the PSAF for 2000. The pre-tax return on equity rate increased from 23.3 percent for 2000 to 24.0 percent for 2001. The effective tax rate to be used in 2001 remains unchanged from the 2000 rate at 31.5 percent.

Capital Adequacy and FDIC Assessment

As shown in Table 3, the amount of capital imputed for the proposed 2001 PSAF totals 30.8 percent of risk-weighted assets and 5.3 percent of total assets. The capital to risk-weighted asset ratio and the capital to total assets ratio both exceed regulatory guidelines for well-capitalized institutions and BHCs. As a result of these capital ratios, the FDIC assessment decreased from $2.9 million for 2000 to zero for 2001.

Table 1
Comparison of Pro Forma Balance Sheets
For Federal Reserve Priced Services
(millions of dollars – average for year)

	2001	2000
Short-term assets		
Imputed reserve requirement on clearing balances	$742.4	$762.2
Investment in marketable securities	6,681.9	6,859.5
Receivables [1]	77.3	74.2
Materials and supplies [1]	3.6	3.4
Prepaid expenses [1]	23.4	21.4
Items in process of collection	3,606.7	3,804.2
Total short-term assets	11,135.3	11,524.9
Long-term assets		
Premises [1 2]	417.5	411.7
Furniture and equipment [1]	185.5	180.1
Leasehold improvements and long-term prepayments [1]	73.9	64.2
Prepaid pension costs [1]	718.5	599.8
Total long-term assets	1,395.4	1,255.8
Total assets	$12,530.7	$12,780.7
Short-term liabilities		
Clearing balances and balances arising from early credit of uncollected items	$7,424.3	$7,621.7
Deferred credit items	3,606.7	3,804.2
Short-term debt [3]	18.9	99.0
Short-term payables [4]	85.4	0.0
Total short-term liabilities	11,135.3	11,524.9
Long-term liabilities		
Postemployment/retirement benefits [1]	251.9	238.3
Long-term debt [3]	479.1	400.9
Total long-term liabilities	731.0	639.2
Total liabilities	11,866.3	12,164.1
Equity [3]	664.4	616.6
Total liabilities and equity	$12,530.7	$12,780.7

NOTE: Details may not add to totals due to rounding.

[1] Financed through PSAF; other assets are self-financing.
[2] Includes allocations of Board of Governors' assets to priced services of $0.7 million for 2001 and $0.5 million for 2000.
[3] Imputed figures represent the source of financing for certain priced services assets.
[4] For the 2001 PSAF, short-term payables attributable to priced services are included as a financing source for short-term assets such as receivables, materials and supplies, and prepaid expenses.

Table 2
Derivation of the 2001 and 2000 PSAF
(millions of dollars)

	2001			2000		
A. Assets to be financed [1]						
Short-term [2]		$18.9			$99.0	
Long-term [3]		1,143.5			1,017.5	
		$1,162.4			$1,116.5	
B. Weighted average cost						
1. Capital Structure [4]						
Short-term debt		1.6%			8.9%	
Long-term debt		41.2%			35.9%	
Equity		57.2%			55.2%	
2. Financing rates/costs [4]						
Short-term debt		4.7%			5.1%	
Long-term debt		6.5%			6.6%	
Pre-tax equity		24.0%			23.3%	
3. Elements of capital costs						
Short-term debt	$ 18.9 x	4.7%=	$0.9	$ 99.0 x	5.1%=	$5.0
Long-term debt	479.1 x	6.5%=	31.1	400.9 x	6.6%=	26.5
Equity [5]	664.4 x	24.0%=	159.5	616.6 x	23.3%=	143.7
			$191.5			$175.2
C. Other required PSAF recoveries						
Sales taxes		$10.5			$10.4	
Federal Deposit Insurance assessment		0.0			2.9	
Board of Governors expenses		4.9			4.2	
			15.4			17.5
D. Total PSAF recoveries			$206.9			$192.6
As a percent of assets			17.8%			17.3%
As a percent of expenses [6]			24.5%			28.5%
E. Tax rate			31.5%			31.5%

NOTE: Details may not add to totals due to rounding.

[1] Priced service assets are based on the direct determination of assets method.
[2] For 2001, short-term assets consist only of those short-term assets that are not financed with short-term payables.
[3] Consists of total priced long-term assets less postretirement/postemployment benefit liabilities.
[4] For 2001, net short-term assets are assumed to be financed with short-term debt, for 2000 all short-term assets are assumed to be financed with short-term debt. Of the total long-term assets for 2001, 41.9% are assumed to be financed with long-term debt and 58.1% with equity.
[5] The pre-tax rate of return on equity is based on the average after-tax rate of return on equity, adjusted by the effective tax rate to yield the pre-tax rate of return on equity for each bank holding company for each year. These data are then averaged over five years to yield the pre-tax return on equity for use in the PSAF.
[6] System 2001 budgeted priced service expenses less shipping are $842.8 million.

Table 3
Computation of Proposed 2001 Capital Adequacy
For Federal Reserve Priced Services
(millions of dollars)

	Assets	Risk Weight	Weighted Assets
Imputed reserve requirement on clearing balances	$742.4	0.0	$0.0
Investment in marketable securities	6,681.9	0.0	0.0
Receivables	77.3	0.2	15.5
Materials and supplies	3.6	1.0	3.6
Prepaid expenses	23.4	1.0	23.4
Items in process of collection	3,606.7	0.2	721.3
Premises	417.5	1.0	417.5
Furniture and equipment	185.5	1.0	185.5
Leases, leasehold improvements & long-term prepayments	73.9	1.0	73.9
Prepaid Pension Costs	718.5	1.0	718.5
Total	$12,530.7		$2,159.2

Imputed Equity for 2001	$664.4
Capital to Risk-Weighted Assets	30.8%
Capital to Total Assets	5.3%

NOTE: Details may not add to totals due to rounding.