FEDERAL RESERVE SYSTEM

Docket No. OP-1214

Proposal to Withdraw from Noncash Collection Service

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice; Request for comment.

SUMMARY: The Board requests comment on a proposal that the Federal Reserve Banks withdraw from the noncash collection service at year-end 2005. The noncash collection service involves the collection and processing of definitive municipal bonds and coupons issued by state and local governments. The proposal to exit this service is prompted by the declining volume of definitive municipal securities, the expected underrecovery of costs in future years, and the availability of alternate service providers and substitutable services.

DATE: Comments must be received by December 20, 2004.

ADDRESSES: You may submit comments, identified by Docket No. OP-1214, by any of the following methods:

- Agency Web Site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov
- FAX: 202/452-3819 or 202/452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

All public comments are available from the Board's web site at www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, except as necessary for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Kent Owens, Manager (202/728-5848), or Lyndsay Huot, Financial Services Analyst (202/452-5238), Division of Reserve Bank Operations and Payment Systems; for the hearing impaired only: Telecommunications Device for the Deaf, 202/263-4869.

SUPPLEMENTARY INFORMATION

I. Background

The Federal Reserve Banks provide a service to depository institutions for the collection of definitive municipal securities. Definitive municipal securities are registered or bearer bonds that have been issued with interest coupons in certificated, or physical, form by local governments, as well as by states and their political subdivisions and agencies.[1] The Reserve Banks accept deposits of coupons or bonds from depository institutions, identify the appropriate paying agent, and present the items to the paying agent for collection. These services are collectively referred to as the "noncash collection service."

Over the years, the number of outstanding definitive municipal securities has declined as a result of legal and market changes. Municipalities stopped issuing bearer municipal securities in 1983, when the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 removed the tax advantages of bearer municipal securities for investors. Further, the securities industry began issuing and trading municipal securities in book-entry form and began immobilizing existing securities. These changes also had implications for the noncash collection service, because the volume of bonds and coupons presented for collection declines as the number of outstanding definitive municipal securities declines.

In response to these market trends, in the early 1990s the Reserve Banks reviewed their role in the definitive securities business, in both the areas of safekeeping and collection. In 1993, the Reserve Banks withdrew from the priced definitive securities safekeeping service but decided to continue providing the priced noncash collection service.[2] Given the volume declines, the Reserve Banks aggressively pursued cost savings through consolidation and improvements in processing efficiencies. Between 1992 and 1997, the existing twenty-two noncash collection operations sites were consolidated into one site.

II. Discussion

Volume, Customers, and Paying Agents

Since 1995, the Reserve Banks' noncash collection volume has decreased 85 percent. Over the past five years, volume has decreased an average of 20 percent annually and is expected to decline by one-third in 2005. Over the last few years, as interest rates have fallen, issuers have called high-interest-rate bonds, including those in definitive form, and issued bonds in book-entry form with lower rates, thereby accelerating the volume decline. The last bearer municipal bond is expected to mature in 2030.

In addition to declining volume, the Reserve Banks' noncash collection service has also experienced a decline in the number of customers that use the service. In 2003, approximately 1,000 depository institutions used the noncash collection service, 10 percent fewer than in 2002.

[1] Such securities are "noncash" items under Regulation J (12 CFR 210.2(k)).
[2] The Reserve Banks continue to provide safekeeping for collateral pledged to the discount window, the Treasury Department, or federal government agencies.

In addition, use of the service is highly concentrated, as the top twenty-five depository institution customers accounted for 70 percent of total revenue in 2003.

Moreover, the Reserve Banks have been presenting noncash collection items to a declining number of paying agents over the past several years due to the consolidation of paying agents through mergers and acquisitions. Currently, the Reserve Banks present to around 100 paying agents, whereas in the past this number had been as high as 3,500. In addition to the decline in the number of paying agents, there is also a significant degree of concentration in the business, with almost 95 percent of coupon envelope volume being presented to ten paying agents in 2003.

Costs and Revenue

Between 1994 and 2003, the noncash collection service has recovered 109.5 percent of its costs, including imputed expenses and return on equity. In 2004, the Reserve Banks expect the service's cost recovery rate to be 110.4 percent. Given the significant decline in volume and the fixed-cost nature of the service, the Reserve Banks expect a significant underrecovery of costs, beginning in 2005. The Reserve Banks have considered price increases to target full cost recovery, but analysis suggests that price increases may accelerate volume loss and reduce revenue.

In addition, more than one-third of total noncash collection service revenue in 2003 came from return-item fees. A return-item fee is charged to depository institutions for submitting coupons that are returned from the paying agent, primarily due to the deposit and return of coupons from called bonds. In these cases, the institution pays not only the $35 return-item fee, but also the cash-letter and coupon-envelope fee; and it does not receive payment for the returned item.[3] Of the approximately 1,000 customers that used the noncash collection service in 2003, 56 percent were charged a return-item fee at least once. Because the Reserve Banks no longer provide a safekeeping service for municipal securities, there is no readily available way for the noncash collection service to track called bonds.

Alternatives to Using the Reserve Banks' Noncash Collection Service

DTC provides both a securities safekeeping service and an over-the-counter collection service for its participants. The over-the-counter coupon collection service, implemented in 1995 in response to participants' requests, is comparable to the noncash collection service, in that DTC acts as a "pass-through" by collecting securities and then sending them to the appropriate paying agent. In 2003, DTC processed 12,800 coupon envelopes through its over-the-counter coupon collection service. The Reserve Banks charge $4.50 per coupon envelope plus $13.00 for the cash letter that must accompany any deposit of coupon envelopes. DTC charges $21.00 to $23.00 per coupon envelope and does not require an accompanying cash letter.[4] For return items, the Reserve Banks charge $35.00 per envelope, while DTC charges $15.00. In addition, it

[3] Once a bond is called, it must be presented for redemption with all unpaid coupons dated after the call date for early redemption, as these coupons are no longer payable. Coupons with interest dates payable prior to the call date may still be presented separately for redemption.

[4] DTC charges $21.00 per envelope if the CUSIP is noted on the envelope and $23.00 if a customer-assigned identifier is used instead. All Reserve Bank and DTC fees are from the 2004 fee schedules. The Reserve Banks' fee schedule can be found at http://www.frbservices.org/FeeSchedules/CollectionMunicipal2004.html. DTC's fee schedule can be found at http://www.dtc.org/dtcpublic/pdf/rulesandfees/aboutfees.pdf.

is likely that customers would be charged significantly fewer return-item fees if they used DTC. Because DTC provides a safekeeping service for securities, it maintains information on partially and fully called bonds and notifies its customers if they deposit items associated with a called bond before presenting these items to the paying agents, thereby eliminating returns due to called bonds. In addition to the benefits for depositors, paying agents would also benefit from the reduction in return items because they incur costs to handle items received that must be returned to the depositor. DTC's provision of safekeeping services also presents an opportunity to work with depository institutions that use DTC as their alternative to immobilize additional securities.

Correspondent banks also provide services to their customers for the processing of definitive municipal securities. Many of the Reserve Banks' largest noncash collection customers indicated that a significant portion of their transactions are on behalf of other depository institutions. This suggests that many market participants are already using correspondent banks as alternative service providers. Interviews with several of these large banks suggest that they would be able to use DTC or present directly to paying agents if the Reserve Banks were to withdraw from the service. Thus, it appears that these correspondent banks offer a reasonable alternative service to noncash collection customers that are not DTC participants.

Finally, market participants can present directly to the paying agent as a substitute to using the noncash collection service or similar "pass-through" services. Depository institutions that present directly would avoid explicit fees, as paying agents do not charge presenters for the redemption of definitive municipal coupons and bonds; however, they may incur additional internal resource costs to present items directly rather than use a fee-based service provider. To facilitate the identification of paying agents, the Reserve Banks are considering making their paying agent database, current as of the last day of the service, available on the Internet. This database includes securities descriptions and associated paying agents, including phone numbers and addresses. With this and other tools, depository institutions would have a number of ways to identify the paying agents for direct presentment. First, a depository institution would probably start with the paying agent identified in the Reserve Banks' database or with the paying agent information printed on the original bond. Because paying agents sometimes change, a depository institution would next check with the identified paying agent to confirm the information. As an alternative, a depository institution could use an on-line service such as the Bond Buyer or Bloomberg, or it could contact the issuing municipality to determine the current paying agent. Furthermore, it has become easier for depository institutions to identify paying agents as the number of paying agents has declined and the concentration of the business among the top few paying agents has increased. Discussions with several major paying agents indicate that these trends are expected to continue.

III. Analysis of Request to Withdraw

The Board has analyzed the proposal in the context of the factors for evaluating Reserve Banks requests to withdraw from a priced service line.[5] The evaluation against each factor is detailed below.

1. *It is likely that other service providers would supply an adequate level of the same service (i.e. access, price, and quality) in the relevant market(s) if the Federal Reserve withdraws from the service.*

The Board's analysis suggests that depository institutions have a number of options available for the processing of definitive municipal securities. DTC and some correspondent banks provide services similar to the Reserve Banks' noncash collection service. Noncash collection customers that are also participants in DTC would be able to use DTC's coupon collection service as an alternative. If a customer is not already a participant in DTC, the benefits of using DTC for its municipal securities processing may not outweigh the cost of becoming a participant.[6] These customers could use a correspondent bank to obtain noncash collection services. These correspondent institutions may, in turn, use DTC services, if they are participants, or they may present directly to the paying agents. These options should supply an adequate level of the same, or similar, service to customers that want to continue to use a service provider for a fee.

2. *If other service providers are not likely to provide an adequate level of the same service in the relevant market(s), it is likely that users of the service could obtain other substitutable services that could reasonably meet their needs.*

In addition to the alternate service providers available, depository institutions have the option of presenting directly to the paying agent for the redemption of their definitive municipal securities. While depository institutions may incur additional internal resource costs to present directly, paying agents do not charge presenters for the redemption of their coupons or bonds. This option should reasonably meet the needs of customers that want to use their own resources to process definitive municipal securities, rather than use a fee-based service provider.

3. *Withdrawal from the service would not have a material, adverse effect on the Federal Reserve's ability to provide an adequate level of other services.*

Withdrawal from the noncash collection service should have no material, adverse effect on the Federal Reserve's ability to provide an adequate level of any other service. The noncash collection service is a standalone business and is the smallest Reserve Bank priced service, representing less than 0.2 percent of the total budgeted priced financial services costs in 2004. In addition, the proposed withdrawal by the Reserve Banks from the municipal coupon and bond

[5] The factors, adopted in 1992, are described in the Board's policy statement "Factors for Evaluating Reserve Bank Requests to Withdraw from a Priced Service Line," Federal Reserve Regulatory Service 9-1575, 57 FR 53113, Nov. 6, 1992.

[6] The fee for a DTC participant account is $760 per account per month for the first five accounts.

collection process does not include nor have any impact upon the redemption of Treasury coupons, currently handled by the Reserve Banks.

4. *Withdrawal from the service would not have a material, adverse effect on the Federal Reserve's ability to discharge other responsibilities.*

Withdrawal from the noncash collection service should have no material, adverse effect on the Federal Reserve's ability to discharge any other responsibilities. There are no material linkages between this service and any other Federal Reserve responsibilities, with the exception of a small amount of definitive municipal securities being held in safekeeping for the Treasury Tax and Loan and Discount collateral programs. This linkage is minimal and only occurs with coupons that are deposited and collected by the Reserve Banks on behalf of the depository institutions holding collateral for these programs. For example, Reserve Banks deposited only 4 of the 23,787 coupon envelopes processed by the noncash collection service in January 2004, which is historically one of the highest-volume months.

5. *The public benefits of continued Federal Reserve provision of the service do not outweigh the benefits of withdrawing from the service. [The Board would consider whether there was any other public benefit, not addressed under the previous factors, that could be achieved through continued provision of the service.]*

As discussed in detail in this notice, the Reserve Banks expect that the substantial decline in volume and customers for the noncash collection service will make it difficult for the Reserve Banks to recover the costs of the service in the coming years. The availability of other reasonable options for depository institutions to collect definitive municipal securities and coupons is addressed under the previous factors. In addition, the public benefit that the Reserve Banks provide in identifying for customers the appropriate paying agent has diminished commensurate with the decline in the number of paying agents (from 3,500 to 100). The Board has not identified any other public benefits that could be achieved through continued provision of the service that would outweigh the benefits of withdrawing from the service.

IV. Request for Comment

The Board requests comment on the Reserve Banks' proposal to withdraw from the noncash collection service at the end of 2005 and the Board's analysis of the proposal. In addition, the Board requests specific comments in the following areas:

1) Are there alternative service providers or substitutable services, in addition to DTC, correspondent banks, and direct presentment, that have not been identified in this notice?
2) If presenting directly to paying agents, would customers find it useful to have access to the Reserve Banks' paying agent database, which would be current as of the last day of the service? This database includes securities descriptions and associated paying agents, including phone number and address.
3) Are there other tools that customers would find useful to facilitate the transition?

4) Are there any public benefits of continued provision of the service by the Reserve Banks that have not been identified in this notice?

V. Competitive Impact Analysis

The Board has established procedures for assessing the competitive impact of changes that have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services, due to differing legal powers or constraints or due to a dominant market position of the Federal Reserve deriving from such differences.[7] The proposed withdrawal by the Reserve Banks from the noncash collection service will leave the provision of this service to private-sector providers; therefore, it will have no material, adverse effect on the ability of other service providers to compete effectively with the Federal Reserve Banks in providing similar services.

VI. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. ch. 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed the proposal under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the proposal.

By order of the Board of Governors of the Federal Reserve System, October 14, 2004.

Jennifer J. Johnson (signed)
Jennifer J. Johnson
Secretary of the Board

[7] These procedures are described in the Board's policy statement "The Federal Reserve in the Payments System," Federal Reserve Regulatory Service 9-1558.