What is the Federal Reserve banks' imputed cost of equity capital?

Author

Listed:
- Michelle L. Barnes
- Jose A. Lopez

Registered:
- Michelle L. Barnes ?
- Jose A. Lopez

Abstract

The Federal Reserve System is an important participant in the nation's payments system, which is the infrastructure used for transmitting and settling payments between individuals, firms, and government entities. For example, as reported in the Federal Reserve System's 2004 annual report, the twelve Federal Reserve Banks processed about 16 billion checks, or about 45%, of the 37 billion checks written in 2003. In addition, the Federal Reserve provides fully electronic payments services, such as automated clearing house services. Since the Federal Reserve is required to charge fees for these services, they are known collectively as \\"priced services.\\" Private sector firms, including some large banking organizations, also provide certain of these priced services, such as check processing. ; To promote efficiency and competition in the national payments system for these priced services, Congress passed the Monetary Control Act (MCA) of 1980, which requires the Federal Reserve Banks to set fees that, over the long run, recover all the direct and indirect costs of providing those services. In addition, the MCA requires that those fees recover imputed costs, such as taxes and a cost of capital, that would be incurred if the services were provided by a private firm. These imputed costs are known collectively within the Federal Reserve System as the private sector adjustment factor (PSAF). ; The methodology underlying the computation of the PSAF is reviewed periodically to ensure that it is appropriate and relevant in light of Reserve Banks' price services activities as well as current accounting standards, finance theory, and regulatory and business practices. Such a review was conducted and changes implemented in 2005 starting with the 2006 PSAF calculations; see Board of Governors (2005). In this Economic Letter, we focus specifically on the current decision to set the Reserve Banks' imputed cost of equity equal to that of the overall stock market. Our research shows that while many other methods exist for calculating this cost of equity measure, the choice made by the Federal Reserve is quite reasonable.

Suggested Citation

Michelle L. Barnes & Jose A. Lopez, 2006. "**What is the Federal Reserve banks' imputed cost of equity capital?**," FRBSF Economic Letter, Federal Reserve Bank of San Francisco, issue apr7.

Handle: *RePEc:fip:fedfel:y:2006:i:apr7:n:2006-06*