The Federal Reserve Banks' Imputed Cost of Equity Capital

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According to the Monetary Control Act of 1980, the Federal Reserve Banks must establish fees for their priced services to recover all operating costs as well as imputed costs of capital and taxes that would be incurred by a profit-making firm. The calculations required to establish these imputed costs are referred to collectively as the Private Sector Adjustment Factor (PSAF). In this paper, we propose a new approach for calculating the cost of equity capital used in the PSAF. The proposed approach is based on a simple average of three methods as applied to a peer group of bank holding companies. The three methods estimate the cost of equity capital from three different perspectives – the historical average of comparable accounting earnings, the discounted value of expected future cashflows, and the equilibrium price of investment risk as per the capital asset pricing model. We show that the proposed approach would have provided stable and sensible estimates of the cost of equity capital for the PSAF from 1981 through 1998.

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