

FEDERAL RESERVE SYSTEM

Docket No. OP-1214

Reserve Bank Withdrawal from Noncash Collection Service

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board has approved the withdrawal of the Federal Reserve Banks from the noncash collection service. The noncash collection service involves the collection and processing of definitive municipal bonds and coupons issued by state and local governments. The withdrawal from 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.

DATES: Items for deposit will be accepted until September 30, 2005, and withdrawal will be completed on December 30, 2005.

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 currently provide a service to depository institutions for the collection of matured or called definitive municipal securities.¹ 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.² The Reserve Banks currently accept deposits of matured or called bonds and coupons 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.”

On October 19, 2004, the Board requested comment on a proposal for the Reserve Banks to withdraw from the noncash collection service (69 FR 61496). Several factors support the Reserve Banks’ proposal to withdraw from this service: 1) the volume, customers, and paying agents in the market for noncash collection services are in decline, 2) the Reserve Bank service is facing future cost-recovery challenges, and 3) the private sector can provide an adequate level of similar or substitutable services to the market.

¹ The Reserve Banks will accept deposits of securities up to 30 days prior to maturity.

² Such securities are “noncash” items under Regulation J (12 CFR 210.2(k)).

Municipal bond and coupon volume has been declining since the passage of the Tax Equity and Fiscal Responsibility Act of 1982, which effectively eliminated the issuance of municipal bearer bonds. In recent years, the decline in volume has accelerated due to the increase in called bonds in the low-interest rate environment. In fact, over the past five years volume has decreased by an average of 20 percent annually and is expected to decline by a further one-third in 2005. The noncash collection service has also experienced a decline in customers, and, currently, there are only about 1,000 depository institutions that use the Reserve Banks' service. In addition, consolidation in the market has reduced the number of paying agents to which the Reserve Banks present noncash collection items from roughly 3,500 to about 100.

Although the Reserve Banks have recovered the costs of their noncash collection service over the long run, they project a significant underrecovery of costs beginning in 2005. The declines in volume and customers, described above, have led to a general decline in service revenue. Because the noncash collection service is subject to strict custody control requirements for handling physical securities, its costs are largely fixed. The Reserve Banks believe that the interaction of these factors will lead to underrecovery in 2005 and beyond even if they raise fees significantly.

Depository institutions have a number of options available for the processing of definitive municipal securities. The Depository Trust Company (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.³ 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, services to customers that want to continue to use a service provider for a fee.

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. To facilitate the identification of paying agents, the Reserve Banks will make their paying agent database available on the Federal Reserve Financial Services website at www.frbfinancialservices.org. This database will include securities descriptions and contact information for the associated paying agents, including phone numbers and addresses. 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 Based on the published 2004 fee schedule, the fee for a DTC participant account is \$760 per account per month for the first five accounts.

II. Summary of Comments and Analysis

The Board has received four comments in response to this proposal – two from bank trade associations, one from a commercial bank, and one from a Federal Reserve Bank. None of the commenters raised any objection to the proposal. One commenter requested the development of a transition plan for customers of the noncash collection service, including transition planning tools, a paying agent database, and a timeline for withdrawal. One commenter requested that the Reserve Banks begin providing customers with paying agent information on all collected items as they are processed and provide a listing of institutions that offer correspondent municipal coupon and bond collection services.

In response to the request for a transition plan, the Board agrees with the need to provide information to customers to facilitate an orderly transition, and the Reserve Banks plan to provide transition information to their customers via the Federal Reserve Financial Services website at www.frbservices.org. The Reserve Banks will make their existing paying agent database available, in searchable form, to the public via the website by approximately midyear 2005 and will also coordinate opportunities for customers to receive training on how to use this database. The Reserve Banks will periodically update the database until they complete withdrawal, at which time the database will remain current as of the last day of the service. Additionally, the Board has specified the final date for acceptance of deposits, September 30, 2005, and the final date of the service, December 30, 2005, to allow depository institutions to begin planning accordingly. The earlier cutoff date for deposits is necessary to allow the Reserve Banks sufficient time to process all items, including any items returned from paying agents, before completing withdrawal.

In response to the request that the Reserve Banks provide customers information on paying agents with each processed item, the Board believes that the midyear availability of the paying agent database will allow customers sufficient time to plan to process their own items and, therefore, does not find it necessary to incur the cost of adjusting business processes in the short term. In response to the request for a listing of correspondent banks that offer a noncash collection service, the Board notes that the Reserve Banks do not have information on the full range of institutions that currently provide this service or those that may choose to enter the market. Therefore, the Board has concluded that it would not be appropriate to provide a partial list, which would discriminate among potential service providers. DTC is identified because of its unique role as a market utility that both processes and safekeeps municipal securities.

III. 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.⁴ The withdrawal by the Reserve Banks from the noncash collection service will

⁴ These procedures are described in the Board's policy statement "The Federal Reserve in the Payments System," Federal Reserve Regulatory Service 9-1558.

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 provide similar services.

IV. 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 notice 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 notice.

By order of the Board of Governors of the Federal Reserve System, February 28, 2005.

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