

Corrigan, E. Gerald.

For Rel: [The role of the Federal Reserve in the
Expecte: payments mechanism] / statement of E.
Thursda: Gerald Corrigan, President, Federal Reserve

Statement of

E. Gerald Corrigan, President
Federal Reserve Bank of Minneapolis
Minneapolis, Minnesota

Before the

Subcommittee on Domestic Monetary Policy
of the Committee on Banking, Finance and Urban Affairs

and the

Subcommittee on Commerce, Consumer and Monetary Affairs
of the Committee on Government Operations,

U.S. House of Representatives

June 16, 1983

Mr. Chairmen, I greatly appreciate the opportunity to appear before these Subcommittees to review developments with regard to the pricing of services by the Federal Reserve under the Monetary Control Act (MCA) of 1980 and to comment on some larger issues regarding the role of the Federal Reserve in the payments mechanism. The issues before the Subcommittees are technically complex--complex to the point where the maze of detail can overshadow the public interest considerations associated with a safe, efficient, and trusted payments mechanism for the effective workings of our financial institutions, financial markets, and the economy at large. Indeed, even those of us who are close to the day-to-day operation of the payments mechanism often lose sight of its size and complexity and, more importantly, the financial interdependencies that arise in a system in which hundreds of billions of dollars change hands daily. The smooth functioning of the payments mechanism and the demonstrated public confidence in its operation are not to be taken for granted even though we all exhibit an almost blind trust that the system will, in fact, work and work well.

The public interest aspects of the operation of the payments mechanism are not new; they can be traced to the very origins of the Federal Reserve as the nation's central bank. The controversy as to what role the Fed should play in the operation of the payments mechanism is not new either. Indeed, a review of the legislative history of the Federal Reserve Act and its earliest amendments suggests that the debate as to the role of the Fed versus the role of correspondent banks in the operation of the payments mechanism was, if anything, more contentious 70 years ago than it is today. That earlier debate was, in effect, decided on the side of granting to the

Federal Reserve an operational role in the payments mechanism as the best means of insuring that the interest of the public at large would be well served. For 70 years, therefore, the Federal Reserve has functioned side-by-side with private correspondent banks and others in the provision of payments services. Far more often than not, that side-by-side relationship functioned as a loose partnership in which often competing particular interests have been melded together in a manner which promoted the public interest as well as the legitimate interests of private suppliers of payments services.

The pricing provisions of the Monetary Control Act of 1980 have altered substantially the roles and relationships of both users and suppliers of payments services to depository institutions. For member banks, it meant that implicit costs for Fed services--in the form of reserves that bore no interest--suddenly became explicit hard-dollar charges in a setting in which deregulation, high interest rates, and the effects of subpar economic performance were already pinching operating spreads and profits. For nonmember banks, thrifts, and credit unions the MCA resulted in an alternative source of payments services and therefore reshaped the competitive environment in which large correspondent banks had been accustomed to operating. For the Federal Reserve, it meant having to make the virtually unprecedented shift from an environment of providing "free" services to a limited number of depository institutions to an environment of providing priced services to a potential population of almost 40,000 depository institutions.

Considering the scope and magnitude of these changes, it is not surprising that there have been a few rough spots along the way for all--the Federal Reserve included. Those rough spots notwithstanding, I would

suggest that the most surprising and gratifying aspect of the transition lies not with the problems that have been encountered, but rather with how much has been achieved in the relatively short time span of a little more than two years.

In that connection, Mr. Chairmen, I would like, in the balance of my statement, to summarize three major areas which seem to me to go to the heart of these oversight hearings. They are: first, the achievements of the Federal Reserve in implementing the provisions of the MCA; second, the issues surrounding the role of the Fed as a regulatory agency and a provider of payments services to depository institutions; and finally, the larger question of what role the Fed should play in the operation of the payments mechanism. In the course of these remarks and in the detailed material submitted to the Subcommittees, I believe I have fully answered all of the questions raised in your letter requesting my testimony before you today.

I. Implementation of the Monetary Control Act

In summary, the MCA instructed the Federal Reserve to: (1) provide all depository institutions access to Fed services; (2) price a specified group of services and any new services to recover full costs plus the private sector adjustment factor (PSAF); (3) achieve a balance of costs (including the PSAF) and revenues over the long-run, while giving due regard to competitive forces and the need to provide an adequate level of services nationwide; (4) price or eliminate Federal Reserve float; and (5) adjust resources in line with any volume declines. That Act further specified that the Fed should begin pricing its services by September 1981.

Despite the size and complexity of the task and the inevitable problems encountered along the way, I believe the Federal Reserve has made remarkable progress in complying with the spirit and the letter of the MCA in the relatively short time since pricing began.

The Federal Reserve Banks were well positioned to cope with the pricing provisions of the MCA in part because dating back to the mid-1970s, rigorous cost containment and operations improvement efforts had been undertaken. For example, inflation-adjusted total Federal Reserve expenditures declined by more than 1 percent per annum between 1974 and 1979 despite substantial growth in volume and substantial additions to the Banks' various duties and responsibilities over that period. Similarly, pronounced staff reductions and very sharp rises in worker productivity--particularly in the areas that would later become priced services--were a hallmark of Reserve Bank operations long before the passage of the Monetary Control Act.

With the advent of pricing, the volume of activity in each of the Fed service lines (except those involving electronic payments) declined. While some declines were to be expected, it was impossible to foresee the timing, magnitude, and exact service mix of these volume drops. In any event, within a few months after the commencement of pricing of each service line, volume declines ranged from 15 to 30 percent depending on the particular service in question. In the check area, for example, processed volume at all Federal Reserve Banks in the first quarter of 1983 was about 30 percent below what it would have been had the growth trend in volume prior to pricing persisted until early 1983. By another measure, the Fed's so-called

"share" of check processing has dropped by about 10 percentage points since the start of pricing. In and of themselves, these declines in volume are not the slightest bit bothersome to the Federal Reserve in part because they suggest that the particular payments in question are being made more efficiently.

Faced with these volume declines, the Federal Reserve moved immediately to adjust its resource base in line with resulting lower levels of activities--recognizing, of course, that in the relatively short run it is not possible, to adjust large fixed cost components. Indeed, in the relatively short run, labor is the only variable cost element of size that can be adjusted and in this area, very sharp and prompt adjustments were made. For example, in the post-pricing environment, staff reductions carrying an aggregate hard dollar cost savings of almost \$23 million--\$18 million in check processing alone--were effected by the Reserve Banks. In percentage terms, the post-pricing staff reductions were almost exactly in line with the declines in volume. It should also be emphasized that the Federal Reserve Banks went to great efforts to bring about these staff reductions in as painless a manner as possible relying largely on turnover and retirements.

Obviously, the uncertainties associated with the initial pricing efforts, the volume declines, and the large fixed costs associated with these activities made the task of achieving full cost recovery very difficult in the short-run. However, by strenuous efforts to cut costs, improve ser-

services, and restructure prices and fees, steady progress has been made toward the goal of cost-revenue matching. Indeed, as of the spring of 1983, all individual service lines (except definitive securities and noncash collection which account for less than five percent of the total priced service expenditures and will be repriced this summer) are, for all practical purposes, achieving or exceeding the cost-revenue matching objective. For the March-April, 1983 period, all services combined produced a total revenue flow of \$520 million at an annual rate compared with total annualized costs of \$494 million, including the PSAF. Preliminary data for May suggest these trends continued into that month. Having said this, I don't want to make too much of two or three months' data. As we have seen, things can change quickly, but as of this reading, the overall cost recovery situation looks good.

With regard to float, major progress has also been made. Float reductions achieved through operations improvements have been dramatic such that check float has dropped from \$6.3 billion in 1979 to a relatively modest \$2.1 billion in 1982. The trend is even lower in that for the last quarter of 1982 and the first quarter of 1983 check float was \$1.8 billion. With regard to that remaining float, firm plans are now in place to eliminate or price the balance of float over the July through October, 1983 period. Those steps entail a three-pronged effort of operational improvements, changed crediting procedures, and the addition of the value of those elements of float that cannot be squeezed out of the system in a cost-effective fashion to the cost base subject to recovery through pricing.

The suggestion has been made from time to time that the Fed has been too slow in dealing with float via its strategy of seeking to squeeze out float through operational improvements. In fact, meaningful steps to reduce float were already underway when the MCA was passed. The emphasis on operational improvements has been welcomed by the vast majority of depository institutions. However, the stress on operational improvements grew primarily out of the fact that such an approach was more likely to produce results that would add to the efficiency of the payments mechanism. Simply to price all check float by adding its value, across the board, to check costs would raise significant issues of equity and incentives. For example, if the Fed were to add the value of interterritory transportation float to all check prices, the writers of small checks would heavily subsidize the writers of large checks. Indeed, such an approach would preserve the irresistible incentives to create float because most of its cost would be borne by someone else. Such an approach is not in the public interest.

There is one other point I would stress with regard to float. At the current federal funds rate of about 8.5 percent, the remaining check float has a value of about \$150 million which represents about 40 percent of current check costs. However, it does not follow that Federal Reserve check prices will have to increase, on average, by that 40 percent because operational improvements and changed crediting procedures that will be introduced this summer will, in effect, eliminate the bulk of the remaining float. Recognizing that individual depository institutions have options as to which methods of dealing with float they wish to use--my best guess is that at least \$1 billion of the \$1.8 billion will be eliminated such that no more than the value of

\$800 million will need to be priced. Other things being equal, this would imply a change in our cost base of about 18 percent.

II. The Fed as a Service Provider and a Regulator

It seems to me that the issue of the Federal Reserve as a so-called "competitor" and "regulator" boils down to two separate but related issues. First, are there inherent competitive advantages that accrue to the Federal Reserve that stand in the way of achieving fair and equitable competition between the Federal Reserve and private suppliers of payments services? Second, is there a potential conflict of interest between the Fed's operational role in the payments mechanism and its role as a regulator/supervisor of banks and, if so, are there adequate safeguards to insure that any potential conflict of interest will not become an actual conflict?

I think it is important to note at the outset that wherever one comes out on the question of whether the Federal Reserve has inherent competitive advantages, it is very clear that correspondent banks have important competitive advantages relative to the Federal Reserve Banks. Correspondent banks can pick and choose with whom they do business; they have more flexibility in varying the terms and conditions of a business relationship; they have vastly more pricing flexibility; they can serve all of the banking needs of their respondents; and perhaps most importantly of all, they do not have to balance, in the public interest and under close public scrutiny, the often conflicting points of view of thousands of depository institutions, and dozens of trade associations at the state and national level.

As I have listened to comments about the Fed's "inherent" advantages, it seems to me that the major points that are made fall into several areas; the Fed does not pay (and is precluded in law from paying) presentment fees; Fed clearing balances are not subject to reserve requirements and thus provide a competitive edge over compensating balances at correspondent banks; the PSAF is too low; and, more generally, the facts of universal reserve balances and a nationwide network of offices places the Fed in a competitively superior position. The materials submitted to the subcommittees deal with most of these issues in some detail. However, I would like to make a few summary comments in each of these areas:

- With regard to presentment fees--at least those levied before the 2:00 p.m. Uniform Commercial Code cut-off hour--I simply cannot find any rationale to support the point of view that says the Fed should pay such fees. If anything, I would go in the exact opposite direction and suggest that presentment fees should be banned altogether.
- With regard to clearing balances there are a number of self-imposed constraints on the effective utility of such balances that may--at times--be overlooked. In fact, the only case I can see in which such balances with the Fed are more advantageous relative to a compensating balance at a correspondent bank is the case where such a balance is held by a small institution that satisfies all of its required reserves with vault cash. However, even here the fact that the Fed does not permit the use of earnings credits on excess clearing balances would seem, on average, to more than compensate for this difference.

-- With regard to the PSAF, the conceptual framework for determining it has generally been viewed as reasonable. The debate, as I see it, surrounds the values assigned to the variables that are part of the mathematical calculation used to determine the PSAF. To be sure, there are elements of judgment involved in assigning values to these parameters. Indeed, it has been precisely for this reason that the Federal Reserve, in establishing the PSAF, has in some important respects, given the benefit of the doubt in the direction of assigning values to the variables that have had the effect of shading the resulting PSAF higher rather than lower. As a related matter, the dynamics of the PSAF calculation are such that it takes rather substantial changes in the already conservative estimates of the variables in the calculation to produce significant changes in the PSAF itself and/or in the absolute amount of dollars that the Fed must recover via its service fees. In short, there are elements of judgment involved in determining the PSAF but it seems to me that the approach taken by the Fed and the resulting value assigned to the PSAF are reasonable.

The universality of reserve balances and the nationwide presence of Fed offices were both an explicit and essential part of the initial design of the Federal Reserve by the Congress for the explicit purpose of facilitating a safer and more efficient payments mechanism. Whether the position of large correspondent banks in this respect, would, in fact, be materially different from what it is today in a framework in which McFadden or Douglas were amended or eliminated is difficult to judge. That is something we

will know for certain only if and when we have interstate banking on a national level. The limited evidence available today from situations involving grandfathered interstate bank holding companies or multi-state processing subsidiaries of large bank holding companies simply does not tell us very much. On the other hand, I think it is fair to assume that full-scale interstate banking could have important implications for the manner in which the payments system operates.

In the case of the costs associated with reserve balances some reasonable quantitative judgments can be made as to the extent to which these elements may influence the competitive position of correspondent banks. Before turning to that question, however, a more general observation should be made. The suggestion is often made that required reserves are sterile balances which, in effect, are nothing more than a cost of doing business. In a proximate sense, that is true but to suggest that banks--especially large banks--receive no value in exchange for maintaining such balances would be quite erroneous. Within the day and even on a day-to-day basis, reserves are the working balances which are essential to the smooth functioning of contemporary banking organizations. The fact that some large banks turnover their total reserve position dozens of times daily illustrates the utility of these balances. This is not to suggest that the foregone income associated with reserve balances is not a consideration, but it is to suggest that--monetary policy considerations aside--reserve balances are not a sterile lump of idle cash wasting away in the vaults of the Federal Reserve Banks.

All of that notwithstanding, the question at hand is whether the costs of reserves incurred by correspondent banks are such to place them at a competitive disadvantage relative to the Fed in the provision of payments services to other depository institutions. Viewed at this perspective, it would seem that to the extent the argument is valid, it would be so only insofar as it pertains to the reserves held by correspondent banks on "due to" deposits. However, for the sake of illustration, even if we were to look at the opportunity cost of all required reserves for the sample of large banks used to estimate the variables in the PSAF calculation, the implications for the value of the PSAF are quite modest. For example, taking account of the cost of reserves would raise the cost of shortterm capital by about 8 percent to 14.2 percent and thereby raise the PSAF from 16.0 to 16.3 percent.

There is one other point I wish to comment on briefly in this regard and that pertains to the suggestion that Fed's cost allocations to priced services are somehow inappropriate or that the allocation problems faced by the Fed are somehow more insurmountable than the allocation problems faced by correspondent banks. Cost accounting systems are never perfect. But we have been careful and methodical in allocating costs and the process is under constant review by the Reserve Banks, their auditors and by the examiners of the Board of Governors. At present, the GAO is taking a fresh look at this matter and the Fed has engaged an outside accounting firm to do more of the same. Obviously, to the extent any of these entities have suggestions or comments as to our methods, we will carefully evaluate such

comments and, where appropriate, take necessary actions. We will certainly keep the Congress informed of any developments in this regard.

Turning now to the so-called regulator-competitor issue, I will readily concede that there could be a potential conflict of interest between the Fed's overall role and its specific role as a provider of payments services in a competitive environment. I will also concede that this dual role is not a typical situation for a public body but I would hasten to add that the public interest aspects of the payments mechanism are far greater than is the case with other activities that are vested with a public interest. Moreover, insofar as potential conflicts of the Fed are concerned, there are powerful forces which seem to me to more than adequately insure that potential conflicts will not become actual conflicts. These powerful countervailing forces include the generalized public scrutiny of Fed actions, the oversight and general supervisory role of the Board of Governors, the public comment process, the activities of the GAO, and the oversight of the Congress itself. Moreover, I think the point should be stressed that removal of the Fed from an operational role in the payments system would put the payments system entirely in the hands of private suppliers who legitimately look first to their customers' and their shareholders' interests in determining the operational posture they will take in providing such services. That is wholly appropriate but at times it may not yield results that are in the public interest. The payments process is, inevitably, one that entails collisions of interests; payors want to slow it down; collectors want to speed it up; large economic agents have more clout and flexibility than do the small ones. These potential conflicts are subtle and often hidden and thus not

easy to detect or resolve. The potential conflict associated with Fed activities is one--that to the extent it is real--is highly visible and therefore subject to remedy by the Federal Reserve Board or the Congress.

The Federal Reserve is, and has been, sensitive to these concerns and, working with the Congress and others, will seek to insure that all factors bearing of these considerations will be carefully weighed such that fairness and equity continue to be an integral and essential aspect of the Fed's actions.

III. The Role of the Federal Reserve in the Payments Mechanism

The questions I have discussed earlier concerning achievements of the Fed in implementing the pricing provisions of the MCA and the very difficult questions of competitive parity between the Fed and private correspondent banks are important. However, they do not get to the very essence of the most fundamental issue that is before these subcommittees, namely, what ongoing role, if any, the Federal Reserve should have in the operation of payments mechanism?

As I see it, there is virtually unanimous agreement that the Federal Reserve, as the nation's central bank, has a natural and continuing interest in the efficient and safe functioning of the payments mechanism. In part, that natural interest arises from the fact that disruptions in the payments mechanism--regardless of their origins--can threaten the safety and soundness

of financial institutions, financial markets more generally and, in the extreme, the smooth functioning of the economy at large. Indeed, however great those concerns may have been 70 years ago, a strong case can be made that they take on even greater importance in the context of today's highly interdependent domestic and international banking and financial system.

The point should also be made that transactions balances at depository institutions and the required reserves that are associated with such balances are, at one and the same time, the vehicles through which most payments are made, the bedrock upon which all other financial flows rest, and the mechanism through which monetary policy is conducted. This trilogy of unique functions is one of the reasons that banks (operating with the Federal Reserve) have, in effect, had an exclusive franchise on the operation of the payments mechanism and it is one of the reasons why I believe that franchise should be preserved. More to the point, that trilogy points, in my judgment, to the imperatives of strong banks, strong financial markets, and a strong and efficient clearing system. Stated differently, the payments system demands--indeed requires--the highest degree of public confidence. It simply would not be possible to make hundreds of billions of dollars in payments daily if public confidence in the certainty of payments were shaken or undermined.

The question, therefore, is not whether the central bank has a responsibility to insure the safety and efficiency of the payment mechanism, but rather it is one of how that responsibility can be most effectively discharged. More particularly, should the Fed seek to achieve these public

policy objectives by regulation alone; should it act as a processor of last resort, taking on only those functions that others are unwilling to provide or unable to provide at reasonable prices and conditions; or should it maintain a viable operational presence in the payments mechanism along the general lines that have prevailed for the past 70 years? From my perspective, the dictates of public policy point strongly in the direction of preserving the viable operational presence of the Fed in the payments mechanism--recognizing, of course, that the exact configuration of that presence need not, and probably will not, remain as it is today. In saying this I should also stress that an operational presence for the central bank along the general lines of the Fed's current activities is not unique or even unusual among the industrialized countries of the world.

The processor of last resort concept is deceptively appealing but, in fact, is not workable. The Federal Reserve Banks could not maintain the standby facilities, equipment and personnel that would be needed to function on an on-again-off-again basis or to step into those situations in which an adequate level of payments services might not be available nationwide at reasonable costs and terms. Moreover, even the simplest aspects of the payments mechanism requires a continuity of expertise and working knowledge that would be very difficult to maintain in such an environment. Therefore, assigning to the Fed a role as processor of last resort is simply not viable. Stated differently, the processor of last resort must be a processor.

In my opinion the United States has--taking account of the size of our economy--the most efficient payments system in the world. That fact cannot be attributed to technological superiority; it surely cannot be attributed to geography or the presence of a neat and clean banking and financial structure. While many factors may be involved, I would suggest that the side-by-side presence of the Federal Reserve and the private banking system has been one of the primary factors--if not the primary factor--that has permitted--indeed encouraged--the payments system in the United States to achieve this status. One can speculate as to whether the result would have been different had the historic role of the Fed been confined to that of a regulator. That speculation--however interesting--cannot alter 70 years of experience and it cannot alter the fact of where we are today. Let me cite a few contemporary examples that may help to illustrate my point.

- Is it reasonable to conclude that the book-entry system for U.S. government securities would have been developed as quickly as it was--if at all--if the Fed had been only a regulator rather than a participant in the payments mechanism?
- Is it reasonable to assume that one or more private entities could, or would even want to, displace the Fed's funds transfer network?
- On the other side of the coin, as late as 1979, the Federal Reserve attempted, in the form of a Board policy statement, to put a halt to remote disbursement of checks. But we probably

have more remotely disbursed checks today than we did in 1979 and the Federal Reserve is now seeking to achieve through its operations what it could not achieve through the policy statement.

The point, of course, is that the payments mechanism is so complex, legally and operationally, that it is far from clear that public policy objectives could be achieved simply by writing regulations. Moreover, it is quite possible that absent the "hands on" working knowledge gained through operations, regulatory efforts would quickly take on an ivory tower character that would be ineffective or impair the efficiency of the payments mechanism or both. There is no doubt in my mind the Fed's operational presence in the payments mechanism is a better alternative than what otherwise would be a cumbersome and very costly regulatory apparatus.

While I am skeptical that regulation alone could provide a cost-effective and efficient method of ensuring that the public policy objectives associated with the operation of the payments mechanism, there are other aspects of the Fed's operational presence that would be very difficult to duplicate if it were simply a regulator of the payments system. For example, the Fed can be thought of as something of a neutral and trusted intermediary in the payments process. Its only interest is bringing together collectors and payors in the fastest and safest manner possible. It has no particular interest in whether a check is large or small, whether the collecting or paying institution is large or small, or whether the payor is an otherwise

good customer. Indeed, the fact that the Reserve Banks have no relationships with bank customers is a feature that makes it an attractive source of payments services for many depository institutions. This role as a trusted and neutral intermediary is re-inforced by the fact that the Fed is also the bankers' bank whose solvency is never in question. This feature permits the Fed to prudentially assume risks such as the intra-day credit exposure on Fedwire or acting as a correspondent for problem banks that others may be unable or unwilling to accept. In tandem, the neutral intermediary and the ever-solvent bankers' bank are aspects of the Fed's role in the payments mechanism which contributes, in no small way, to that essential public confidence in the payments system.

None of the above should be construed to mean that the Fed's operational presence should remain exactly what it is today. Technological developments, the advent of interstate banking, the creative efforts of individual banks and a host of other factors, no doubt, will change that role over time. Indeed, on the basis of these hearings and subsequent hearings in the Senate, the Congress may wish to provide different or more specific guidance to the Federal Reserve although I would suggest that any such move would be premature at this time.

The bottom line, as I see it, Mr. Chairmen, is that the financial system, the business community and the public at large have been the clear beneficiaries of the Fed's role--in partnership with the banking community--in promoting the highly efficient and safe payments system that we enjoy

in the United States. The MCA, it seems to me, has produced the result envisioned by the Congress in that it has--the transitional problems notwithstanding--fostered still further strides in the direction of greater efficiencies in the payments mechanism. Our continuing goal should be to see to it that those achievements are not compromised and that we move forward in adapting our payments system to the needs of the future in a way that ensures that the public confidence in the payments system is solidified even further.

Thank you.