

NICSA East Coast Regional Meeting

Keynote Address

by

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It's a pleasure to be with you this evening. As many of you know, I spent a good deal of my career in the management of operations, and I know how valuable meetings like this can be for assessing trends, and sharing best practices. I hope my comments can help you by providing an assessment of the overall economy, some perspectives on the challenges for the financial services industry, and a few thoughts on how Reserve Bank supervisory and operational staff are viewing and addressing those challenges.

The national economy's performance last year was exceptional. In the first three quarters of 1996, real GDP grew at an almost three percent rate. Through all of 1996, well over two million new jobs were created. Reflecting this, the unemployment rate has been hovering around the low point reached during the peak of the 1980s expansion. Even with this pressure on resources, core inflation, that is inflation excluding the volatile food and energy components, remained at or around a level the U.S. has not seen since the mid 1960s. Moreover, the national budget deficit exerted the smallest drag on savings in over a decade, though trade deficits continued to be worrisome. All in all an impressive year, and made even more so by the fact that it reflects a continuation of a three-year period of really very favorable economic trends.

Can the economy continue this performance? Most forecasters believe it can. Data on the fourth quarter are still coming in, but it appears that the economy continued to grow at a rate close to or a bit better than its long-run sustainable pace. Job creation averaged better than 200,000 for the quarter, and unemployment remained at the relatively low rates achieved recently. Consumption at the end of the year apparently bounced back from its low rate of growth in the third quarter as retail sales increased in the automotive, department store, and apparel categories. The external sector continued to be a drag, but interest sensitive sectors were sources of strength. The most recent data on housing starts, building permits and overall construction spending suggest a pace of overall construction activity that remains at a relatively high level and shows no signs of weakening. Business fixed investment was also a positive factor, showing some moderation in growth rates but a continuation of its multi-year strength.

The fourth quarter, and for that matter, all of 1996, is history; obviously future prospects are of much more interest. The best guess of most forecasters is that real GDP will continue to expand near its long-run sustainable pace of 2 to 2.5 percent. As a consequence, the unemployment rate will remain relatively stable at or near its recent low levels. High levels of consumer confidence and continued employment growth suggest that consumption should remain healthy, even though the growth in residential investment has moderated. Business cash flows, together with the continuing drive to increase efficiency and

competitiveness, suggest that business investment may remain relatively strong. On the other hand, government spending and net exports could act as drags on the economy, given the prospects for laudable efforts on the national scene to achieve a balanced budget, and the effects of a stronger dollar and prospects for only moderate growth in many of our trading partners. As we expect when the economy grows at its potential, sectors of strength should mitigate those of weakness.

However, even with this balanced growth forecast, inflation risk cannot be overlooked. Our labor resources are strained, at least by most conventional measures. Since the middle of last year the unemployment rate has remained below 5.5%. In the late 1980s when the economy reached today's levels of unemployment, both wage and price inflation accelerated. Although we have seen no hint of an increase in core inflation, wages over a longer period have shown some signs of accelerating. Over the last two years, the growth in average hourly earnings rose about half a percentage point. A better measure of wage inflation, contained in the Employment Cost Index, also edged up slightly.

However, these minor wage increases were not translated into price increases, and most forecasters expect that inflation will remain relatively mild, despite historical experience suggesting the opposite. Various reasons are given for this rather surprisingly subdued inflation forecast, some of which have been characterized as basic changes in the way our economy works. In my view, none of these is completely satisfying, and we would be wise to continue to be vigilant about inflationary prospects.

Now you probably all are thinking "Here's another Federal Reserve worry wart concerned about inflation that doesn't exist. The real problem is growth--why don't they do something about that?" In my view, the Federal Reserve's pursuit of low, stable rates of inflation over the last 15 years or so has been a key factor in supporting economic growth. Low inflation creates an environment in which it is possible for both consumers and investors to pursue investment opportunities, rather than speculative excess. Since the last recession, which was mild for most of the U.S. except New England, the recovery has been dominated by business fixed investment and by consumer durable spending. Broadly speaking, businesses and consumers--despite assertions about job uncertainty--seem to have faith in continued economic growth; they are willing to spend, and increasingly willing to save and invest for their futures. Consumer debt burdens are an issue, but, by and large, consumer, banking, and corporate balance sheets are healthy, and U.S. business is competitive in world markets to a degree we could only imagine a decade or so ago. The trade deficit clearly is an issue, but the prospect for even lower federal deficits is certainly a positive. Low inflation is not the whole reason why all of this has happened, but it is a vital part of the picture.

Looking forward, I, for one, would be loathe to give up on the success on the inflation front that has been achieved to date. I recognize that in the short run inflation control can have its costs, but higher rates of inflation surely have their costs--very large costs--as well. We must be especially sensitive to these costs as we address the important goals of national economic policy--those of fostering growth and rising standards of living.

In some senses, however, the way in which the Federal Reserve System affects national rates of growth is indirect--monetary policy creates an environment but it is businesses, consumers, and fiscal policy that create the actual sources of growth. In this process, there is no more valuable participant than the financial services industry. Banks and other financial service providers perform the vital task of acting as conduits for funds to move from savers to investment. Banks and others perform the maturity transformation of the nation's balance sheet by accepting relatively short-term savings or investments desired by consumers and transforming them into the long-term loans and investments desired by businesses. This transformation process is vital to economic growth, and it is equally vital that the economy have a healthy financial services sector.

Arguably, here the United States has never been in better shape. Just looking at the banking industry as an example, the third quarter of 1996 was among the best ever recorded. Bank earnings exceeded \$13 billion, and banks had an average return on assets of 1.26 percent. Bank profits for all of 1996 are projected to exceed \$50 billion. Moreover, the banking industry is better capitalized than at any other time in recent history, with an equity to asset ratio of 8.3 percent.

Even here in New England, banks are healthy, after a very rough period in the early 90's. New England has roughly one-third fewer banks and thrifts as a result of failures, forced consolidations and mergers, but the remaining organizations are healthy, strongly capitalized, with low levels of non-performing assets, high returns and strong efficiency ratios.

But just as the macro-economy faces risks in the midst of the best performance ever, so too does the financial services industry face a set of considerable challenges. Just to name a few--the drive to consolidate, the impact of increased national and global competition, and rapid technological change. Assets and transaction levels are now concentrated among fewer, ever larger players, and these players understand their futures depend on high rates of both innovation and efficiency. Nationally, barriers to geographic and product expansion in the banking industry are coming down, and internationally, U.S. financial service providers in general are competing as never before.

Rapid advances in information technology and telecommunications have increased trading activity and heightened the emphasis on money management performance. Such advances have also enabled the first large-scale back-office consolidations to occur, enhancing efficiency, but multiplying the costs of software and hardware failure. At the same time, the growing complexity of financial products has made it more difficult to understand the true nature of risks undertaken by financial institutions and the speed with which on and off balance sheet positions can change has rendered valueless moment-in-time assessments of risk. New products have increased the links between markets, and arguably increased the speed with which shocks, however infrequently they may occur, are transmitted between markets for different assets and in different countries. Technological change has eroded the distinctions among the traditional forms of financial institutions, and each of these now compete in markets traditionally served by others. Risks abound, and risk management is the mantra of both industry professionals and regulators alike.

As a financial service regulator and service provider, the Federal Reserve System has recognized that as the industry broadly speaking, and banks more narrowly, evolve to deal with the current challenges, our processes and services have to evolve as well. You in the financial services industry have been buffeted by change, and many of you in this audience wouldn't be here tonight if you weren't successful at managing, and ultimately thriving on, change. Reserve Banks as regulators and providers of services are not immune from the broad sources of change which affect you. We have had to rethink approaches, streamline processes, provide new services, and adjust to a more competitive and innovative environment. In the rest of my talk tonight, I'd like to share some of our experiences with you.

Major changes are being made in the way we supervise banks. The examination process has evolved from a transaction-based, uniform process to a customized focus on the particular risk profile of each institution, its specific businesses, and its strategic plans. To reduce burden, but improve oversight, all the bank examining agencies are working on developing new technology which will be used to download data directly from an institution's information systems. This technology will allow us to focus more attention on identifying and evaluating risks, on performing more off-site analysis, and on using internal risk models and risk management reports to a greater extent.

We are relying more on market discipline in the regulatory process. Examiners realize that they must rely on the increasing sophistication of bank management, and on the discipline inherent in the markets, as the final bulwark in ensuring bank health. To that end, the System has first focused considerable effort on disseminating information defining sound practices for bankers

concerned about controlling risks. Second, to ensure market discipline, an increased level of disclosure by banking institutions is being advocated, not just focused narrowly on financial conditions at a point in time, but also on management's philosophy for managing and controlling risk, particularly in the area of derivatives use and market risks.

But many would argue that the problem with U.S. bank oversight lies not so much in the examination process, but more in the amount of regulatory overhead, bureaucracy, and sheer inertia.

Here we're making significant change as well--guided by four major principles. The first principle is that well-run bank holding companies that meet objective criteria related to their financial health should be able to expect prompt action on expansion proposals. The second is that the application process should focus on specific transactions and not be used to comprehensively evaluate and address supervisory and compliance issues. The third principle is that bank holding companies should be able to conduct nonbanking activities to the fullest extent allowed under the Bank Holding Company Act. Finally, marketplace evolution, especially in nonbanking activities and in the way products and services are bundled for consumers, should be recognized and accommodated with minimal burden.

Reflecting these principles, I would like to highlight several recent Federal Reserve actions. First, last month the Board of Governors relaxed certain constraints on bank holding company subsidiaries' ability to generate revenue from underwriting and dealing in corporate debt and equity securities, and, more recently, proposed to reduce the firewall restrictions that apply to such subsidiaries. These actions will go a long way toward reducing Glass-Steagall burdens, at the same time as nationwide banking will be finally fully in place.

In the area of applications processing, bank holding companies with satisfactory supervisory ratings and transactions of suitable size are proposed to be qualified for a greatly truncated processing window. Assuming these proposals become final, application processing time for better than half of current applications could be reduced by more than 50 percent.

Other proposals include streamlining the overall application process, eliminating restrictions on non-banking activities, by expanding the laundry list of permissible nonbanking activities, and reducing many anti-tying restrictions. In short, the Federal Reserve has begun the process of both changing its supervisory process to reflect both the risks and the realities of the new banking and financial service industry, and its regulatory focus to broaden the activities available to healthy institutions and minimize regulatory burden. This is only a start, but it is a

direction that the System has a commitment to follow. The Federal Reserve's response to the challenges facing the financial services industry also can be seen in its oversight of, and participation in, the payments system. We are committed to the belief that the payments system must not only operate effectively and efficiently, but also continually evolve to support innovations in the financial services industry and the economy as a whole. Of course, neither the financial services industry nor the payments system are ends in and of themselves. They are the means to the larger ends of the efficient allocation of economic resources within our society. They are important, if not vital, to economic growth, but it is that growth itself that is the end game.

In recent years, the Fed has taken several steps to improve its internal operations supporting the payments system. We have consolidated critical payments system data processing operations and significantly improved contingency processing support. In conjunction with this consolidation, all critical payments applications have been rewritten and enhanced. Each of the critical national electronic payments services -- Fedwire funds transfer, ACH, and Fedwire book-entry securities transfer -- will be supported by its own centralized application operating at a single data center--a far more reliable, efficient, and cost-effective process than our previous use of 36 applications operating in 12 data centers.

To complement this consolidated operating infrastructure, we have streamlined our management structure for both technical activities and policy initiatives. Single teams of Reserve Bank staff now manage day-to-day nationwide software systems, while product offices that function for the System as a whole develop new product and strategic plans. As part of the development of payments system improvements, we actively seek interaction with and input from private sector payments system users and financial services providers, with a real sense that they are our partners in improving the payment system. At the Boston Fed we have learned a lot in recent years by working with NICS, attending your programs, participating in the activities of the Custody Committee, and talking with transfer agents. We would like to have more dialogue with you about how to improve the national payments system.

The most important aspect of this management approach is that it embodies our commitment to thinking and acting strategically. A prime example is our focus on electronic payments. Check processing -- the clearing, settlement and physical transportation of checks -- is far and away the Fed's largest payments system operation in terms of resources employed and revenue received. Increasing our check business is NOT one of our strategic objectives. Rather, we are consciously fostering development of electronic alternatives to check

payments - even though doing so will ultimately reduce our check volume and associated revenue. The simple fact is that checks are an economically inefficient means of making payments compared to electronic alternatives. By some estimates, the total cost of processing checks in this country consumes between $\frac{1}{2}$ and 1% of GDP on an annual basis. Widespread use of more efficient electronic payments in this country will free up economic resources that can be put to more productive use and contribute to economic growth.

We are beginning to see the fruits of our efforts. After an initial transition cost bubble, we are seeing reductions in our automation support costs for financial services. These cost reductions have enabled us to reduce the fees we charge to banks for Fedwire funds transfer and ACH transactions. Similar reductions in Fedwire book-entry transfer fees are anticipated in the coming years.

We are piloting image technology to accelerate delivery of returned checks and other alternatives to convert check payments into electronic form to accelerate settlement. We are working closely with industry groups such as the Financial Services Technology Consortium to understand more about Internet-based payment technologies. We have created an advisory group of banking industry representatives to help foster increased Electronic Check Presentment. We still have a great deal to do - after all, recent estimates claim check volume is still growing, albeit somewhat more slowly, with some 63 billion checks written in 1996, compared to 4 billion ACH payments. Nevertheless, I am confident that the actions we have taken will allow us to continue to make progress in the right direction.

These payments system improvements are not unlike the continuing improvements in the securities clearing and settlement process. With a great deal of effort, and not a little trepidation, T+3 has been successfully implemented. The dust has hardly settled on the T+3 initiatives and already now, further improvements are being contemplated. SEC Chairman Levitt and others have suggested T+1, or even T+0, is the goal. The potential economic benefits and reduction of settlement risk will move the industry inexorably toward this goal. However, it is clear to me that further improvements to the payments system (not to mention changes to securities industry back room systems) will be essential pre-requisites to further acceleration of the securities clearing and settlement process. It sounds like we all have our work cut out for us!

In closing, let me say that now is not the time to be complacent either about the health of the overall economy or about the health of the financial system. It is the time for both financial institutions and for the Federal Reserve to look

forward, work together, and to plan and act strategically for the future.

Formal legislative changes may or may not occur in this Congress, but regulatory and market changes already occurring can alter the financial services landscape significantly. The Federal Reserve is committed to a strong financial system. To that end we look forward to continuing to work with you and others in the industry to make our financial system as effective and efficient as possible.