

Federal Reserve Check Processing: “The Perfect Storm”

Cathy E. Minehan
President and Chief Executive Officer
Federal Reserve Bank of Boston

Presented to the Sloan School of Management Fellows Program
November 17, 2003

Why was the Federal Reserve created?

Preamble to the Federal Reserve Act
signed December 13, 1913

*“To furnish an elastic currency, to afford a means of
rediscounting commercial paper, to establish a more
effective supervision of banking in the United States...”*

Elastic currency = Reliable, resilient Payments System

Federal Reserve Payments System Activities

Daily Average for 2002

	Volume (000)	Value
Funds Transfer	458	1.6 trillion
Securities Transfer	70	912 million
ACH	23,400	63.1 million
Check	68,750	61.9 million
Total	92,678	2.7 trillion

12 Banks • 24 Branches • 9 Regional Check Processing Centers

Check Clearing Chronology

1913-1950

1960's Formation of RCPC's

1970's ACH "The Checkless Society"

1980's Monetary Control Act

1990's Industry consolidation and check volume declines

1996 The Rivlin Committee

2003 "Check 21"

2000-2003 "The Perfect Storm"

Monetary Control Act

Among other things:

- Provided access to FR payment services to all depository institutions, whether members or not
- Reduced reserve requirements
- Payment services must be priced in a way that is competitive with the private sector

Monetary Control Act cont'd

Initial Results

- Check volumes at Reserve Banks drop initially
- Banks meet challenge of “cost-recovery” by 1984

Longer-term Results

- Full cost-recovery from 1984 - 2000

Industry Consolidation

1973 14,709 commercial and savings banks
 35% of total assets held by top 25

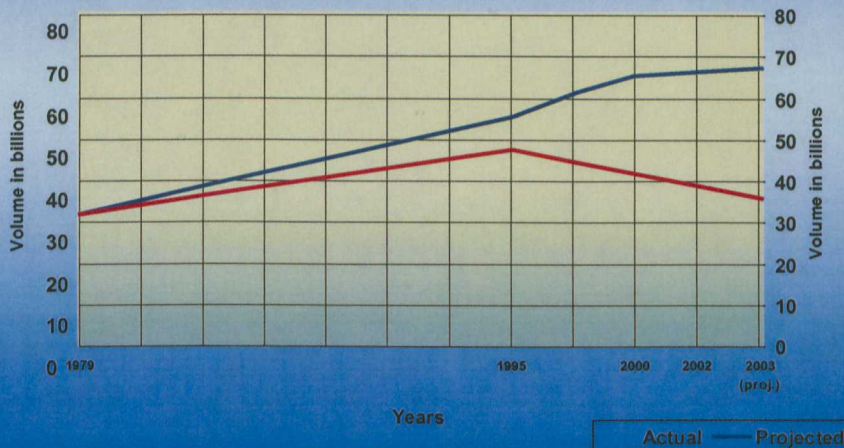
2002 8,369 commercial and savings banks
 60% of total assets held by top 25

- All have capability to operate nationally
- All can bypass Reserve Banks
- Industry changes and so do Reserve Banks

- automation consolidation
- Product offices
 mail consolidated management
- Check Modernization

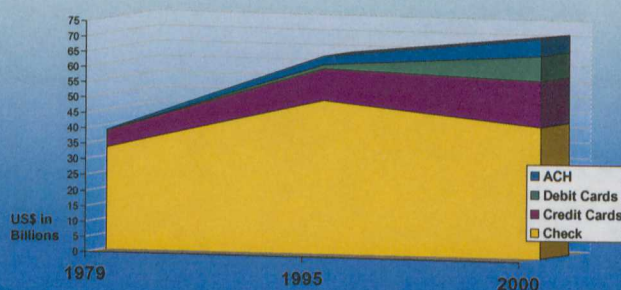
Check Volumes

Projected Vs. Actual Volumes
 (in billions)



Check Volumes

- Check volumes have been declining since the mid-1990's
- Growth in number of electronic payments has accelerated
- In 2000, checks still accounted for 85% of value of retail transactions



The Rivlin Committee

5 Scenarios (liquidation to leading) discussed at 52 National and Regional Forums

Two conclusions:

- Federal Reserve remains a provider of both check and ACH services with explicit goal of “enhancing the efficiency, effectiveness and convenience and of both systems, while ensuring access for all depository institutions.”
- The Federal Reserve should play a more active role to “enhance the efficiency of check and ACH services and evolve strategies for moving to the next generation of payment instruments” (all electronic).

“The Perfect Storm” 2000 - 2003

	<u>Costs</u>	<u>Revenues</u>
Recession and stock market decline		-\$100m
Check modernization	+\$300m	
Check volume decline		-\$ 60m

Negative swing of over \$450 million in 3 years for a \$900 million business

Options

I. Get out of the business

- Large operation - not so easy to do
- Political implications

II. Downsize

- 13 offices to close operations in 2004
- Focused effort to cut costs
- Likely won't be enough

Options cont'd

III. Legislative Relief

- Payment System would be harmed without Federal Reserve in check
- Full costs would hurt small banks
- Agree to get out by *date*; until then manage costs and revenue without requirement to match

What do you think?