COMMUNITY BANKERS ASSOCIATION OF INDIANA

September 14, 1998

I. Introduction

A. Good morning. I'm pleased to be here and appreciate the invitation.

1. Conferences like this provide me with a chance to discuss some issues related to the Fed, but more importantly they give me a chance to hear your ideas and questions.

2. The importance of soliciting and, more importantly, responding to feedback from our customers and stakeholders is something we're stressing at the Chicago Fed.

B. Bankers, of course, are one of our key constituencies.

1. As part of our effort to increase communication between the Chicago Fed and bankers we recently established the Community Bank Council.

2. The Indiana members of the Council are:

   - Calvin Bellamy, president and chief executive officer of Bank Calumet in Hammond;
   - John W. Corey, president and chief executive officer of Lafayette Savings Bank in Lafayette;
   - Cathy McHenry, president, chief executive officer and director of Fairmount State Bank in Fairmount; and
   - James L. Saner (SAY-NER), president and chief executive officer of Peoples Trust Company in Brookville.

3. The first meeting of the Council was very successful, and we appreciate the willingness of the members to dedicate their time to this effort.

C. Clearly, Indiana banks have a great deal of expertise that they can share with others.

1. Indiana banks had an average ROA of 1.37 percent during the first half of 1998—higher than the average for the U.S. and the Seventh Federal Reserve District.

2. The success of Indiana banks is due in part to the fact that they have the best efficiency ratio in the Seventh District.

3. I think we can all learn something from a group of bankers that is performing at this level.

D. To begin, let me give you a little background about the Federal Reserve as a reminder.

1. As the nation's central bank, of course, our mission is to foster a safe and sound financial system and a healthy, growing economy.

2. We have three main responsibilities— providing financial services to banks and the U.S. government; supervising and regulating state member banks and bank holding companies; and formulating national monetary policy.

3. The Chicago Fed is one of 12 regional Reserve Banks and serves a five-state area consisting of most of Indiana, Illinois, Michigan, and Wisconsin, and all of Iowa.

4. We have a head office in Chicago as well as offices in Detroit, Des Moines, Milwaukee, Peoria, and Indianapolis.

E. Given the Fed's main responsibilities, I'd like to touch on three areas today—financial services; bank regulation; and the economy.

II. Electronic Banking

A. First, financial services. More specifically, I'd like to discuss electronic payments. Let me read you a prediction.

1. "In banking….the advances of yesterday are merely a faint prologue to the marvels of tomorrow. In our lifetime we may see electronic transactions virtually eliminate the need for cash."

2. A lot of people would agree with that statement today. However, that prediction was made back in the 1965, by Thomas J. Watson, then president of IBM.

B. We're still not close to a paperless or even a checkless society. But there *is* growing momentum in the electronic payments area. Electronic payments seem to be tantalizingly close to achieving critical mass. Consider the following statistics:

- The dollar value of ACH transactions last year was more than $11 trillion — almost a 10 [9.9] percent increase from 1996.

- Over 200 million debit cards were issued by U.S financial institutions last year.
- On-line business transactions totaled an estimated $7.5 billion in the U.S. last year. Many project a dramatic increase during the next four years.
- A very small percentage of U.S. households used Internet banking last year — no more that 1 or 2 percent. But some estimate usage will accelerate quickly in the next two years.

C. But Americans still wrote about 63 billion checks last year. According to one study, the average American signs about 270 checks each year; the average German signs 10.

D. Why is it important to use electronic payments?

1. I firmly believe our financial system is enhanced by the use of more efficient, cost-effective electronic payments.

2. So a shift to electronics is very much in keeping with the Fed's mission to foster a healthy economy and a stable financial system.

E. I say that even though check services provide the Fed's main source of service revenue. Ideally, I'd like to see our check service evaporate as electronic payments become more popular. But, as I said, we don't expect that any time soon.

1. According to one estimate at a recent Chicago Fed conference, the share of noncash transactions that are electronic is expected to rise from 23 percent in 1995 to nearly 50 percent by 2010.

2. That's a dramatic increase in electronics, but we'll still have a lot of checks.

F. So why do checks remain so popular?

1. From a commercial bank's perspective, checks can have a significant impact on profits.

2. The check product can add to a bank's revenue stream by encouraging the use of other services and can actually be a cash cow.

G. There's also the network problem.

1. The value of signing on to a new electronic payment network depends on a lot of people and businesses being able and willing to accept the payment.

2. At the same time, people and businesses are unwilling to invest in new payment processing equipment unless they are sure a lot of payors will use it.

H. From the perspective of customers, checks are a good deal since banks tend to bundle checks with other services.

1. As a result, customers don't always pay the actual costs of processing. This has reduced the incentive to move to a more efficient alternative.

2. The experience in Norway offers an interesting example. After unbundling its prices ten years ago, Norway went from having only 10 percent of noncash payments in electronic form to 60 percent today.

I. The Federal Reserve is working with bankers to encourage the use of electronic payments.

1. As you may know, a committee of Fed officials, headed by Alice Rivlin, Vice Chair of the Federal Reserve, examined the role of the Fed in the payments system.

2. One of their key recommendations was that the Fed work closely with bankers on ways to expand electronics.

3. For example, we're exploring ways to encourage greater use of the ACH network to reduce the total number of checks and improve the efficiency of the payments system.

J. Can community banks play a role in encouraging electronic payments? Yes.

1. One example that was highlighted in the Chicago Fed's annual report was the Mechanicsville Trust & Savings Bank in Mechanicsville, Iowa, an agricultural community with about 1,100 residents.

2. Mechanicsville Bank acted as a catalyst in the town, working with customers to switch to direct deposit and electronic bill payment.

3. The bank even worked with the local phone company and city government to encourage direct bill payment.

4. The small town of Mechanicsville has emerged as an example of best practices in encouraging electronic payments.

5. So without the expense of elaborate new networks, community banks can make a significant impact on their communities.

III. Risk-focused Supervision

A. Let me move now to my second topic — reducing regulatory burden.

1. Bank supervisors used to be the "regulatory cop on the beat," who would punish banks that weren't in compliance with laws and regulations.

2. Problems that developed were addressed after the fact.

B. Clearly this had to change if bank regulators were to keep up with the vast changes in the industry.

1. One key change is the use of risk-focused examination techniques.

2. The dynamics of the rapidly changing banking industry dictate that supervisors understand each bank's risk profile, the risk appetite of bank management, and how well management understands and manages these risks.

C. Bank supervisors now are more flexible and responsive since there's greater emphasis on managing future risks, rather than reacting to past events.

1. Regulatory burden is reduced for well managed banks.

2. Today, supervisors develop a tailored exam targeting high risk activities or areas that have been problems in the past.

3. The bottom line is more effective supervision that is less burdensome for bankers.

IV. Year 2000

A. One area that we're working closely with bankers is Y2K. By now all of you know that Y2K is not a droid in the new Star Wars movie, but a computer problem we're all facing.

B. The main responsibility rests with individual banks, including us. We're giving the highest priority to preparing all our computer systems. What has the Federal Reserve done so far? A lot.

1. We've completed an assessment of our applications and updated our computer programs and are now in the process of testing them and putting contingency plans in place.

2. We're coordinating with vendors and manufacturers to make sure their hardware and software are ready. Our most significant systems have already been renovated, testing is underway and should be completed by year-end.

3. And we've begun testing interfaces with customers and vendors.

a. All banking institutions that have electronic data interchanges with us are expected to test their ability to send, receive, and process data between their automated systems and ours.

b. These tests have been available 19 hours a day since July and run through 1999.

c. If you need to test with us, I urge you to schedule your test as soon as possible. We'd all like to avoid a last-minute rush during the 4th quarter of 1999.

C. In addition to preparing our own systems, the Fed and the other supervisors are working to help the financial community prepare.

D. First, it's important to clarify that banking supervisors can't solve the problem for the industry. Each institution must complete its own program, test its own applications, and manage the additional risk.

1. Ultimately, each bank's board of directors and senior management is responsible for assuring their institution is compliant.

2. For this reason, the Fed and the other federal regulators strongly encourage regular reporting to the board of directors on Year 2000.

E. The Fed and the other supervisors have taken a two pronged approach: education and guidance, on the one hand, and strong incentives on the other.

1. The education program consists of coordinated advisory statements from all federal regulators, supervisory letters from the Federal Reserve, and an extensive series of seminars and conferences sponsored by regulators.

   a. At the Chicago Fed we've had over 60 seminars attended by a cross section of the financial community. We have 30 more sessions planned through November.

   b. In addition, the supervisory agencies have web sites and the FFIEC has a fax back line …all devoted to Year 2000 issues.

2. On the incentive side, the Fed and other banking supervisors are monitoring and enforcing Year 2000 readiness for banks.

   a. We're examining the readiness of each bank and establishing milestones for meeting our ultimate goal—compliance before January 1, 2000.

F. What are we looking for? Each banking institution must have a written testing strategy and plan in place by now and should be in the process of testing its interfaces. And by June 30, 1999, each must complete its mission-critical testing and be well on the way toward making sure its systems are compliant.

G. In this regard, there are several areas of particular concern.

1. One is whether hardware and software products from third-party vendors are Year 2000 compliant.

2. More than 90 percent of banks use service providers or vendor software to process critical information.

3. Banks can't take the vendors word that products are compliant. They need to verify for themselves.

H. Another area of focus is whether a bank's customers are compliant.

1. Even if a bank is a model of Year 2000 preparedness, it may be exposed to risks such as credit and liquidity risks if its customers are not compliant.

2. Banks should encourage customers to be compliant.

3. However, if they don't extend credit to qualified borrowers with manageable Year 2000 risks, they could subject themselves to lender liability litigation.

4. The key is to monitor the progress of borrowers and avoid making arbitrary credit decisions.

I. It's also essential to ensure that any Y2K risk from customers is well-controlled.

1. All banks were required to implement a risk management process to assess the Year 2000 risks posed by customers by June 30th of this year.

2. The emphasis here is on controlling risk, not managing the borrower's compliance of Y2K. Our goal is to help avoid business interruption.

J. Another issue I'd like to mention is liquidity. The Federal Reserve is prepared to meet any unusual demands.

1. Banks can check their balances with us, through regular channels any time during the day.

2. The Fed's discount window is available as an alternative to market funding. We're prepared to lend to institutions with adequate collateral and under appropriate circumstances.

3. The Fed will also be prepared to meet any increased demands for currency.

4. As always, we will work with financial institutions to ensure that they have enough currency on hand to meet customer demands.

V. Economy

A. Finally, I'd like to take a few minutes to discuss the economy.

1. There's been a lot of good news about the economy in recent years.

2. 1997 in particular was an extraordinary year with a remarkable combination of strong growth, high employment, and low inflation.

B. What was the most unexpected feature of our economic performance in recent years? I'd have to say the continued mild inflation in the face of very low unemployment rates.

1. Over the past five months, the unemployment rate has been at or below 4½ percent.

2. The last time unemployment rates were this consistently low was nearly three decades ago.

3. Labor markets are especially tight here in the Midwest.

C. At the same time, measured inflation has been low.

1. Last year, core CPI, which excludes volatile food and energy prices, came in at 2¼ percent—the lowest since 1965.

2. The overall CPI increased only 1.9 percent last year—the lowest since 1986.

3. Through the first seven months of 1998, the overall CPI has risen at a 1.5 percent annual rate.

D. Historically, of course, inflation usually accelerated when labor markets were so tight. What's different this time? The change is due in part to temporary factors.

   1. Oil import prices have dropped and the strong dollar has contributed to a fall in other import prices, which has helped to keep inflation down.

   2. And there's been slower growth in benefit costs, particularly health care costs, although we have seen increases in this area recently.

E. Another factor may not be temporary—trend productivity growth may have risen to a higher level as a result of strong investment in computers and high-tech equipment. We finally may be seeing the return on that investment.

   1. The official statistics show some increase in productivity growth from the 1.1 percent annual average increase over the past 25 years.

   2. Last year, productivity increased 1.4 percent.

   3. And during the first two quarters of 1998, the productivity increase averaged about 1¾ percent.

   4. But we won't know for some time if the productivity improvement is temporary—a cyclical phenomenon—or a permanent change.

   5. So we still face a risk that our progress on inflation could be endangered, especially if the economy grows at an unsustainable pace.

F. During the past two years we've seen strong growth in real GDP—3.9 percent in 1996 and 3.8 percent in 1997. That growth simply wasn't sustainable over the long term.

   1. More recently, we have seen some slowing in the economy.

      a. Real GDP expanded at a very robust 5.5 percent annual rate in the first quarter, but slowed sharply to 1.6 percent in the second quarter.

   2. In terms of final sales to domestic consumers, businesses and the government, however, there was little slowdown.

      a. This measure of domestic spending increased 6.6 percent in the first quarter and 6.5 percent in the second.

G. The real GDP slowdown in the second quarter was largely due to three factors:

   1. the strikes at General Motors;

   2. a marked slowing in inventory accumulation;

   3. and a further increase in the gap between imports and exports.

H. The GM strikes are behind us. And the sharp slowdown in inventory accumulation suggests that stocks should be near their desired levels so that any further inventory adjustments should be modest.

I. The third factor is the deterioration in our net exports. Here the outlook is more uncertain.

   1. As expected, U.S. export growth slowed due to lower demand in Asian countries and a strong dollar against Asian currencies.

   2. Last year, the U.S. shipped 28 percent of its exports to Asia.

   3. That figure dropped to 24 percent during the first half of 1998.

J. On the import side, we've seen an increase in Asian imports, although the increase hasn't been as strong as some expected.

   1. Asian imports are up about 6 percent in dollar terms compared to a year ago.

   2. The prices of these imports are well below year-ago levels. Import prices on goods from newly industrialized Asian countries are down 9.3 percent from a year ago.

   3. So the developments in Asia have helped to dampen inflationary pressures.

K. How overseas developments will affect the U.S. economy is a key question for the future. Will the economy continue to surge forward even though other countries are faltering?

   1. One factor that will bear close watching is consumer and business spending.

   2. Last year's strong GDP growth was driven by robust consumer spending and business investment and that trend has continued this year. It can be argued that the Asian crisis has actually boosted domestic spending.

   3. The flow of international capital seeking a safe haven in the U.S. has contributed to a decline in medium- and long-term interest rates, and the low rates have helped fuel buying of homes, consumer durables and business equipment.

L. However, the developments overseas certainly add to the risks to our economy.

   1. We don't know how much longer the problems in East Asia will continue.

   2. The more recent problems in Russia and other countries only add to the uncertainty.

   3. A key factor will be Japan's success in strengthening its economy and reforming its financial system.

M. This uncertainty has undoubtedly contributed to the recent fall in U.S. stock markets. And the volatility in stock markets may affect consumer confidence and impact their willingness to spend. But we don't have a clear picture at this point how it will ultimately affect spending and the overall economy.

N. Today we're seeing a dichotomy in our economic picture.

1. On the one hand, the fundamentals remain strong in our domestic economy. Employment is high and measured inflation remains low. But we continue to see tight labor markets and there's still a very real risk of inflationary pressures emerging.

2. On the other hand, the volatility in the stock market may trim the growth in consumer and business spending to some degree.

3. In addition, the Asian situation and problems in other parts of the world have reduced foreign demand for our goods and services. This has offset some of the potential inflationary consequences from tight labor markets and strong domestic demand.

O. Just a few months ago it seemed that the risks of inflationary pressures generated by our domestic economy outweighed the risks presented by developments overseas. More recently, however, these risks seem to have moved into closer balance even as the level of uncertainty increased.

P. At this point, you're probably sympathizing with Harry Truman who asked to talk to a one-armed economist who wouldn't say on the one hand this and on the other hand that.

1. Unfortunately, with so many cross-currents in the economy, a one-armed economist is about as useful as a car that's missing wheels on one side.

Q. The Fed, of course, is closely watching developments in keeping with our goal of fostering a healthy, growing economy with price stability.

R. In conclusion, I'd like to stress the Chicago Fed's commitment in being responsive to the needs and concerns of our customers and stakeholders. I hope that was a recurring theme in each of the areas that I covered.

1. Whether it's working with bankers to develop more efficient electronic services and more effective regulation, or formulating monetary policy that fosters long-term sustainable growth, the Fed can profit by soliciting and responding to our stakeholders.

2. One of the advantages of a regional central banking system is the increased opportunity to hear directly from people affected by monetary policy, financial regulations, and the services we provide.

3. So I thank you for your attention and I look forward to hearing your comments and suggestions.