The Fed's Role in the Financial System

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I'd like to begin by thanking Frank Pinto for the invitation to be with you this morning. I have known Frank for a long time. In a sense, I have known the Pennsylvania Association of Community Bankers for a long time--long enough to know at least one of your parent organizations. Back in the 1980s, I did some work on lending practices with the Community Bankers of Pennsylvania, one of the organizations that united to form PACB in 1992.

I welcome this opportunity to address your annual convention this year in my new role as president of the Federal Reserve Bank of Philadelphia, and to share with you some of my thoughts about the Fed's role in the financial system.

As most of you know, I just assumed my new responsibilities this summer - July 10 - replacing Ed Boehne, who had been president for some 19 years and whom I am sure many of you know well.

It has been a hectic couple of months, and I still have a lot to learn, but my sense of the Fed's mission and my vision of our Reserve Bank's role are clear to me.

As the central bank, the Fed has the essential mission of providing a financial environment that fosters sustained growth and full employment for the U.S. economy. That environment includes a monetary policy geared to low inflation, a sound banking system, and a reliable payments system that is accessible to all.

In the Fed's decentralized structure, Reserve Banks fully participate in the pursuit of that mission, and my focus is on making sure that we at the Philadelphia Fed continue to make significant contributions to its achievement. In the process, we will make a significant contribution to the vitality of the District we serve, which includes most of Pennsylvania, south Jersey, and the state of Delaware.

First, a word on monetary policy. I think the Fed can rightly be proud of the contribution its interest rate policy has made to the current economic expansion--the longest in U.S. history. The challenge, of course, is to keep it going. I attended my first Federal Open Market Committee meeting on August 22nd and fully enjoyed participating in the discussions with Chairman Greenspan, the other Fed Governors, and my fellow Reserve Bank presidents. I have heard it said many times that making monetary policy is an art, not a science. My own view is that it is part art and part science.

As for our role in bank supervision, I need not tell anyone in this room that the Fed has long been intimately involved in the supervision, regulation, and examination of the banking industry. For today I will simply note that as the financial structure of the United States has evolved, so has our oversight role -- and the process continues.

For some time, the financial services industry has been evolving toward a universal banking model. The Financial Modernization Act of 1999 acknowledged that reality, establishing the entity called the financial holding company and assigning the Fed the role of umbrella supervisor of the financial holding companies.

We are just coming to grips with our role as the umbrella supervisor of these financial holding companies. While this role is similar to our role in supervising bank holding companies, it will require that we achieve greater levels of communication, cooperation, and coordination with other financial supervisors. We also must address the fact that the FHC structure will expose insured deposits to a broader array of risks. I do not believe that these new activities are inherently good or bad, only that our responsibility is to see that the associated risks are properly managed.

Now let me turn from monetary policy and bank supervision to the Fed's third role, as the core of the nation's payments and clearing system.

From its inception in 1913, the Fed has been charged with a central role in the payments system of the United States. In fact, the Fed was created primarily to establish the basic infrastructure for an efficient national payments system: a check clearing network that would establish acceptance of checks at face value and a national distribution system for currency. We also moved quickly to establish a reliable infrastructure for electronic payments. We established Fedwire in 1918.

The Fed is still very much in the payments business, and don't let the geographic size of the Third District fool you - the Philadelphia Fed handles a good share of that payments activity.

Philadelphia is the Fed's single largest check processing site. We handled more than one billion checks last year with a monetary value of over $1.7 trillion. We also processed over $1/2 trillion in ACH transactions and almost $23 trillion in funds transfers. These rather staggering numbers are partly the result of the vibrant Third District economy - we are fully participating in the national economic expansion across the whole range of manufacturing, construction, and technology activities. They are also due to some of the unique features of the District. A disproportionate share of national payments pass through our Bank as a result of the concentration of cash management services and credit card payments within our District boundaries.

Philadelphia's cash distribution volume is also considerable - we processed $30 billion in cash last year -- and it continues to grow. One reason is that the coin and currency we receive and distribute is coming and going to more places. As the banking industry consolidates, our Bank's shipments now move beyond Pennsylvania, New Jersey and Delaware. So bags and bundles of cash with our logo routinely arrive at banks up north in New England and far south into Dixie. And here again, the statistics are only part of the story, because the Philadelphia Fed actually serves as the headquarters of the System's national cash distribution network.

In this age of smaller government and greater reliance on the private sector, some have asked whether the Fed's involvement in the payments system still makes sense. Not long ago, the Fed asked itself that very question. In 1997, Chairman Greenspan asked then Vice-Chair Alice Rivlin to conduct a thorough evaluation of the role of the Federal Reserve in payments and come back with some recommendations.

The Rivlin Committee, as it became known, conducted extensive interviews and discussions with various stakeholders. As Pennsylvania bankers, you may have participated in the forums the committee held at the Feds in Philadelphia or Cleveland. I myself participated in a forum in Philadelphia that included representatives from two major payments system "customers": cable TV retailer QVC and telecom provider Bell Atlantic, now Verizon.

The Rivlin Committee's conclusion, supported by virtually all quarters from which the committee heard, was that the Fed had a vital role to play in ensuring the reliability, efficiency, and accessibility of the U.S. payments system and in facilitating the evolution into new forms of payment.

With that charge, the Federal Reserve has been quite active in its efforts to increase the efficiency of the U.S. payments system, without compromising either its reliability or its accessibility. We are standardizing our product offerings in order to improve service to our national customers and keep our costs (and prices) low. At the same time, each Reserve Bank's Business Development office - including ours in Philadelphia -- continues to tailor offerings and improve service to all District customers. For example, as correspondent banks have retracted their check processing services, we have continued to provide economical check collection. At the same time, we are keeping our eye on the quality of our service. As I am sure many of you know, we've established a new customer call center at the Bank, and it seems to be working well. Customers tell us they are very satisfied with our products and our service.

But taking a broader view, our present predominantly paper-based clearing system is still too costly. The total cost of originating and processing a payment by paper check is two to three times higher than the cost of making that payment by ACH. Clearly, to conserve society's resources and to maintain the competitive position of U.S. financial institutions our payments system must change.

Looking ahead, the Fed recognizes and accepts the challenge of moving the country beyond its current payments technology. Both as payments provider and as regulator, the Fed must facilitate the movement toward electronics and away from paper.

Thus far, both the Fed and NACHA have made great strides in this direction by encouraging ACH transactions in lieu of checks. For example, over the past three years, Fed ACH volumes have grown by 40 percent. But the facts remain that the volume of checks continues to rise, and the volumes for the other major alternate medium of exchange - credit cards - continue to rise as well. This suggests that we need to introduce even more innovative ideas and new products into the payments system. These new approaches must deliver to users of the payments system greater convenience at lower prices, without compromising their confidence in the integrity of the transactions system.

Technological innovations that improve today's payments system - like image technology and electronic presentment of checks-- are steps in the right direction. But they are not enough.

Others are experimenting with quantum jumps in technology -- jumps that would transform the payments system radically. Some of them would move payments not only out of paper checks but out of the banking system itself. Prepaid cards, closed architecture payment systems, and other money substitutes are attempts to make inroads in the historically bank-based clearing and payments system.

As many of us know, experiments using payment methods like the electronic purse have not been very successful thus far. I also realize that, to paraphrase Mark Twain, the reports of the death of checks and cash "have been greatly exaggerated" by the pundits. Nonetheless, make no mistake about it: new technologies will change the very foundations of the payments system of the United States. We in the banking community must embrace this technological imperative if we are to prove the forecasts made by some leaders in the technology industry incorrect and show we are not dinosaurs.

The Fed is committed to enabling a broad array of technological innovation, and we are actively trying to eliminate unnecessary barriers to more widespread use of electronic payment methods. As a "wholesale" provider of payments services to banks, the Fed is moving to an open system architecture for all of its national services. We will begin providing access to some of our financial services through the Internet next month. As the payments system regulator, the Fed has established a high-level internal group, known as the Payments System Development Committee, charged with identifying and addressing the full range of issues surrounding emerging payments and e-commerce. Right now they are preparing a proposal for legislation by the next Congress that would allow the digital images of checks to be used for collection, with appropriate allowances for consumers who prefer paper.

We have a long road ahead of us. We are still a long way from a payments system that delivers the access and convenience that new technologies offer. Yet that is where we must go. Moreover, we must maintain public confidence in the fundamental integrity of the payments system all along the way. This is a journey we must make.

And it is a journey we must make together. For while the Fed seeks to facilitate the evolution of the payments system, it is not for us to choose particular products or services that will survive and succeed. That is for payments providers like you to sort out with your customers in the competitive arena of the marketplace.

Let me conclude with this thought: At the beginning of the last century, the Fed was given the responsibility to establish and maintain the basic infrastructure for a sound payments system. Now as we begin this new century, that mission has not changed, but technology and the financial environment have. I believe that the Fed will adapt accordingly and find new ways to fulfill that responsibility. Likewise, I encourage you to find new and better ways to serve the people who live and work in your communities.

Thank you. I look forward to working with you.