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Statement by
Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
before the
Committee on Banking, Housing, and Urban Affairs
U S Senate
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I appreciate this opportunity to appear before the Banking Committee today to address certain recent reports on the Federal Reserve's operations. Of most relevance, the GAO has raised some significant issues with respect to the management of the Federal Reserve System. Both the GAO and the Congress deserve our full response.

We are strongly committed to ensuring that the Federal Reserve System is managed efficiently and effectively. It is most important to us at the Federal Reserve Board and the Reserve Banks, not only to run a "tight ship," but to foster the attitudes and processes that will ensure continuous improvement in the effectiveness of the Federal Reserve's operations. We recognize that spending non-appropriated funds places a special obligation on us to be particularly diligent in the use and application of those funds.

Accordingly, even though we may ultimately disagree with some of the specific suggestions of the GAO, we welcome all of them and their insights because they require us to rethink our positions and change them, if appropriate. Certain GAO recommendations for review of specific aspects of our management clearly have merit and reviews of a number of issues highlighted in the GAO's report are currently underway. These reviews may lead to changes in the Federal Reserve's administration that will further enhance our effectiveness.

It is most important for any organization, including the Federal Reserve, periodically to reassess its businesses and how they are carried out.

Strategic planning is particularly critical given our rapidly changing environment, in which technology is advancing at an extraordinary pace and the financial services industry is becoming ever more complex. It is essential that the Federal Reserve adapt to this changing environment with some foresight and as effectively as possible. To that end, in 1995 we formalized our strategic focus by establishing a System Strategic Planning Coordinating Group to assess how the Federal Reserve can most effectively meet its public policy objectives into the next century.

Our strategic focus is also reflected in recent significant changes that the Federal Reserve has made in the way it carries out its major responsibilities. For example, we have undertaken a major redesign and upgrade of our computer systems, communications networks, and critical software applications to improve reliability, respond more quickly to changing business requirements, and improve our disaster recovery capabilities. We have placed an increasing reliance on automation to provide a more flexible approach to bank examinations -- an approach that is risk-oriented, cost-effective, and sensitive to the burden placed on banks. We have also consolidated certain fiscal agency functions that we provide for the government in order to improve cost effectiveness and quality, and a Reserve Bank policy committee has been established to coordinate the provision of Federal Reserve financial services.

In addition, the Federal Reserve already had underway several specific initiatives related to recommendations made by the GAO. For example,

we recently engaged an independent accounting firm to audit and certify the combined financial statements of the Reserve Banks. The firm issued an unqualified opinion on the 1995 financial statements, as prepared in accordance with the financial accounting manual for the Reserve Banks. In addition, we are actively reviewing the appropriate infrastructure for providing certain financial services, taking into consideration both cost efficiency and service quality. One difficult issue that has and will confront the Federal Reserve Board in our oversight of the System is the appropriate degree of consolidation of various activities. Certain Systemwide activities do appear to be more cost effective if consolidated. For example, we anticipate that the consolidation of our critical electronic payment applications will reduce our costs of providing these services. But it is also evident that the element of autonomy that is accorded to the Reserve Banks has created an environment within the Federal Reserve that attracts highly qualified staff who contribute importantly to the effectiveness and efficiency of the Federal Reserve System over the long run. The advantages of this environment must be balanced against the possible savings from consolidation.

Federal Reserve's Role as Service Provider

Many of our resources are devoted to providing priced payment services. The Federal Reserve has played an integral role in the nation's payments system since the System's inception. Indeed, one of Congress' original goals in establishing the Federal Reserve System was to improve the efficiency of check

clearing. Prior to the passage of the Monetary Control Act in 1980, the Federal Reserve provided payment services to its member banks, the banks paid for these services implicitly with non-interest bearing reserves rather than through explicit fees. The MCA fundamentally changed the manner in which the Federal Reserve provided and received payment for these services.

Because the Act expanded reserve requirements to all depository institutions, it also required that the Federal Reserve offer its payment services to all depository institutions. To offset the Act's reduction in the level of required reserves, as well as to broaden and level the competitive market for interbank payment services, Congress required us to price our services at full cost with a rate of return comparable to that of private firms. I believe that the increased competition resulting from the MCA requirements has benefited the payments system.

The GAO has recommended that we review our future role in providing payment services. We are in the process of conducting such a review in the context of our overall strategic plan. In general, we view our role as a payments service provider as crucial in carrying out our overall central bank mission. We believe it is important for the Federal Reserve to foster the integrity, efficiency, and accessibility of the U.S. dollar payments system, which in turn is important to maintain financial stability and maximize sustainable economic growth. The provision of services by the Federal Reserve has contributed directly

to these goals. In addition, the knowledge and operational expertise we have gained as a service provider strengthens our efforts in containing systemic risks and is crucial in managing potential financial crises.

We regard the wholesale payments services we provide, such as Fedwire and net settlement, as essential central bank services and important in limiting payments system risk. Our role in providing these services probably will not change significantly as the marketplace evolves, although the nature of the services themselves might

It is quite possible, if not likely, that as changes occur in the financial services marketplace over time, or owing to other considerations, our role in providing other services, such as check collection, may change as well. In this regard, we must be sensitive to the fact that, as the nation's central bank, we have an unsurpassable credit rating that must not be used to unfairly compete with private-sector providers. We are continually assessing our available means of achieving our payments system goals, including our regulatory authority and our role as a direct participant in the payments system, with our public service role always kept paramount. For example, the Federal Reserve has adopted regulations that have fostered competition and efficiency in the provision of check collection services, even though they resulted in a reduction in the Federal Reserve's direct participation in the check system. At the same time, the Federal Reserve has encouraged other efficiencies in the payments system through

innovations in its service offerings. To the extent that we can achieve our payments system goals most effectively through our direct participation, our continued provision of these services will remain appropriate

Federal Reserve Cost Effectiveness

In considering the cost structure of the Federal Reserve, it is necessary to keep in mind the unique combination of responsibilities that have been assigned to this institution. The Federal Reserve is responsible for conducting monetary policy; supervising and regulating certain financial institutions, promoting the efficiency and integrity of the payments system, and providing fiscal agency services to the Treasury and other government agencies at their direction

Different factors affect the cost structure of each of these functions. For example, priced services are subject to the inherent discipline of the marketplace as the Federal Reserve must control costs in order to meet the statutory directives for cost recovery in the Monetary Control Act. On the other hand, in providing depository and fiscal services to the Treasury, the Federal Reserve must respond to the instructions of the Treasury. We endeavor to carry out Treasury's directives in a cost effective manner, but cannot refuse legitimate requests because of their effect on our costs or because they are inconsistent with other Federal Reserve plans. In the areas of monetary policy and financial institution supervision, there are fewer external constraints on our expenses. Here

we must be particularly vigilant

Given the critical nature of the Federal Reserve's responsibilities, particularly in the areas of monetary policy, financial stability, and financial institution supervision, our major initiatives must be judged not only in terms of cost but also in the context of risk management and the appropriate level of resources to be devoted to each function. For example, Congress, in enacting the Foreign Bank Supervision Enhancement Act in 1991, clearly concluded that the additional costs of expanding the Federal Reserve's supervisory responsibilities for U S operations of foreign banks were justified by the greater financial stability and protection that the enhanced supervision would bring.

We focus our banking examination resources based on risk assessments, with the expectation that areas not covered extensively in the examinations will not become serious problems. Had we devoted more resources to Daiwa, and perhaps less elsewhere, would we have uncovered its wrongdoing at an early stage? We can't know for sure, but the odds would have been higher. But, if we had the foresight to divert these resources from other activities, would we have increased our risk exposure elsewhere?

As another example, the Federal Reserve's recent investment in a major upgrade of our computer systems and personnel to adapt our surveillance and payments technologies to the major changes that have occurred in private financial markets was also driven in large part to improve risk management. While

the costs of these improvements were not trivial, they have enhanced our ability to ensure the smooth functioning of the financial markets, even during periods of financial or operational disruptions. To hold the risk of systemic crises to acceptably low levels in both U.S. markets and U.S. dollar markets abroad requires some redundancy of resources. Given the vast scale of the value of payment transactions that flow through our systems--our Fedwire volume alone averages almost \$1.5 trillion a day--we believe that the benefits of this redundancy far exceed the associated incremental costs.

The risk-management decisions that we make concerning the way we provide payment services to depository institutions are tested directly in the marketplace. These services comprise more than one-third of the Federal Reserve Banks' total budget and the Monetary Control Act requires that, over the long run, we price these services to recover their costs, as well as costs that would be borne by private businesses, such as taxes and a return on equity. If we provide these services inefficiently, we price ourselves out of the market.

Over the past decade, our track record has been good. The Reserve Banks have recovered 101 percent of their total cost of providing priced services, including the targeted return on equity. I should also note that, by recovering not only our actual costs but also the imputed costs that a private firm would incur, the Federal Reserve's priced services have consistently contributed to the amount we have transferred to the Treasury. During the past decade, priced services

revenue has exceed operating costs by almost \$1 billion

Our fiscal agency services, which comprise another one-sixth of the Reserve Banks' total budget, are provided at the direction of the Treasury and other federal government agencies for whom we provide these services and whose reimbursements to us are made primarily with appropriated funds. Here our difficulty has been in obtaining full reimbursement over the years. We understand that, as part of its FY97 funding request, the Treasury sought a permanent indefinite appropriation, similar to that in place for the Bureau of the Public Debt, for services provided to its Financial Management Service. The Federal Reserve and our fiscal principals continue to work closely to identify and implement initiatives that improve further the efficiency of these operations.

With respect to staff compensation and some other aspects of our infrastructure that are necessary to support our varied responsibilities, only indirect market criteria are available to judge the Federal Reserve's costs. For example, we try to set salary structures that can attract and retain the personnel with skills necessary to run the Federal Reserve System in a highly effective manner. In order to acquire and hold such personnel, we strive to provide salaries and benefits competitive with local private and public sector markets, tempered by the willingness of many professionals to accord a nonmonetary premium to Federal Reserve employment. Although the GAO report suggests that the Federal Reserve does not adequately review Federal Reserve employee salary and benefit

levels to determine whether they continue to be justified, I can assure the Committee that these costs are scrutinized regularly to ensure that they are appropriate

We believe that the GAO's comparison of growth in Federal Reserve employee benefits with those of the federal government is incorrect. The problem is that while we accrue such benefits according to generally accepted accounting principles (GAAP), the federal government does not. Were the federal government to use accrual accounting, presumably the comparisons would be straightforward. The federal government, however, employs an outmoded cash accounting system, which makes it difficult for us to reverse our accruals in a manner consistent with it. As best we can judge, when calculated on a comparable basis using federal government accounting principles, the cost of benefits per employee for the Federal Reserve and the federal government increased by approximately the same percentage during the 1988 to 1994 period -- 64 percent and 62 percent, respectively. We believe the GAO significantly overstated the increase in Federal Reserve benefit costs by including the cost of future pension benefits related to Federal Reserve early retirement plans on an accrual basis without considering the associated future savings attributable to those programs. Each of the early retirement programs has a positive net present value, indicating a net cost savings from such plans. Including the present value cost of early retirement plans without considering the present value of cost

savings skews any comparison of the increase in total benefits costs for the Federal Reserve and federal government

Applying peer analysis more broadly, during the 1988 to 1994 period reviewed by the GAO, the increase in Federal Reserve operating costs was slightly less than the 51 percent increase in federal discretionary non-defense spending, which has been subject to increasing Congressional restraint in recent years. The GAO makes this as one of its comparisons. The Federal Reserve effectively contained its costs despite a significant expansion in its mandated responsibilities and expanded resources required to monitor and contain the financial market turmoil of that period. To also compare, however, as the GAO did in its report, the rate of our expense increases with that of total federal discretionary outlays, which are dominated by the major post-cold war retrenchment in defense, is clearly inappropriate. Moreover, with the significant expansion of our computer systems now close to completion and our adjustment to our expanded supervisory mandates reaching fruition, our costs during the past two years and those projected for the immediate future are definitely on a flattening trajectory.

More generally, we believe that the GAO is mistaken in its notion that the Federal Reserve does not regularly assess certain ongoing programs to determine whether they are reasonable and justified. In particular, we do not use a "current services" approach to develop the Board and Reserve Bank budgets. The significant reallocation of System resources among the various responsibility

areas during recent years clearly demonstrates that this is not the case

In summary, although the Board believes that much of the GAO's analysis and recommendations have merit, we take exception to the broad implication of the GAO report that the Federal Reserve has not exercised appropriate budget constraint and that it has not adequately addressed the changing technological and financial environment in which it operates. In my experience, the Federal Reserve is as well run an organization as any with which I have been associated, private or public, over the decades. Is there nonetheless room for improvement? Certainly. I am not aware of any complex organization for which this is not the case. In particular, the Board plans to review several specific areas highlighted by the GAO related to management of health care benefits, Reserve Bank procurement and contracting procedures, and Reserve Bank travel reimbursement policies.

The Federal Reserve Surplus

One area discussed in the GAO report--the elimination or reduction of the Federal Reserve's surplus--has received substantial, and often misleading, media coverage. I agree with the assessment of the Conference Report on the FY97 budget resolution on this matter. The Report concluded that a transfer of the Federal Reserve's surplus to the Treasury would be a "gimmick" that "has no real economic impact on the deficit." While a transfer of Federal Reserve surplus would increase "unified receipts" (because the Federal Reserve, for technical

reasons, is not included in the unified budget), it would nonetheless be an intra-governmental transfer that would not change the government's true economic and financial position with respect to the private sector.

The Federal Reserve holds government securities as the asset counterpart to its surplus, interest on which it returns to the Treasury. If the Federal Reserve decreased its surplus, it would do so by selling government securities and transferring the proceeds to the Treasury. Consequently, the Federal Reserve's future payments to the Treasury would decline permanently by the foregone amount of interest on the surplus funds transferred, exactly offsetting the Treasury's savings on gross interest payments.

The surplus is part of our capital account. In that context, I believe retention by the Federal Reserve of some level of surplus is desirable, but I acknowledge that the appropriate level of the Federal Reserve's surplus is debatable. We would welcome the opportunity to work with Congress to review this issue.

Other Recent Inquiries

I would like to conclude my testimony by commenting on several recent inquiries into certain aspects of the Reserve Banks' operations -- specifically, the management of our Interdistrict Transportation System (ITS) and cash statistical reporting problems experienced by the Los Angeles Branch of the Federal Reserve Bank of San Francisco.

Earlier this year, Representative Henry Gonzalez issued a report on the administration of the Federal Reserve's ITS network. The report asserts that the Federal Reserve may have violated the Monetary Control Act to the extent that it does not fully recover the costs of ITS through revenue attributable to its use. The GAO and the courts reviewed this issue in the mid-1980s and concluded that such cost recovery was not required by the Act.

No integrated company in the private sector (such as one that provides check collection services) prices individual segments of its operation to achieve a uniform rate of return. Optimum profitability, i.e., minimum consolidated costs, is enhanced through transfer pricing flexibility. Even aside from the imprecisions associated with allocating fixed costs, it would not make sense for us to separately recover the costs of each input to a service, such as transportation, data processing, or labor, as implied by Representative Gonzalez. Rather, all of the costs the Reserve Banks incur in providing check services to depository institutions, including ITS costs (which represent less than 5 percent of the costs of our check service), are recovered through fees for their various check products.

Representative Gonzalez's report also alleges that certain contracting practices used by the Boston Reserve Bank in managing ITS were improper and wasteful. Administration of ITS requires Federal Reserve management to make numerous, rapid, and complex business decisions every day, constantly balancing

efforts to improve service, reduce float, and control operating costs. In hindsight, are there some decisions that should have been made differently? Almost surely. But from a broad perspective, ITS has been managed effectively in our judgment.

Finally, I would like to put in context the errors made by the Los Angeles Branch of the Federal Reserve Bank of San Francisco in reporting certain statistical cash information to the Federal Reserve Board. Unfortunately, the press coverage of this matter, in our judgment, has significantly overstated the problem. First, these reports are used for informational purposes only. No taxpayer money has been lost. No key decision-making has been compromised. The errors have not affected the usefulness of the information derived from the Federal Reserve's financial statements, nor have they affected the Federal Reserve's calculation of the money supply, its conduct of monetary policy, or the amount of shipments of currency and coin to or from the Branch.

Second, although there were reports of mistakes amounting to \$178 million, the errors changed the Branch's reported production volume by less than one-half of one percent. If the mistakes had not been discovered, at worst there would have been slight errors in forecasting future currency demand, which could have caused a slight increase to the Federal Reserve's order to the Treasury to print new currency. The cost of this higher currency print order would have been offset, however, by a lower print order in the following year.

Third, the Los Angeles Branch had identified the problems internally.

and was in the process of resolving them before Representative Gonzalez began his inquiry. The Los Angeles Branch is working diligently to ensure that all of the data used to prepare the cash statistical reports transmitted to the Board are accurate.

In closing, let me state that we appreciate the GAO's review in that it assists us in our ongoing evaluation of the Federal Reserve's structure and functions and our efforts to continually improve operations. As I noted, many recommendations are useful and we are pursuing them. In my opinion, however, the general tenor of the report does not reflect the high level of effectiveness with which the Federal Reserve has fulfilled its mission. While, as is likely the case with any organization, the Federal Reserve has opportunities for further improvement, I believe these opportunities should be put in the context of our significant accomplishments.