

H.R. 28; FEDERAL RESERVE

ACCOUNTABILITY ACT OF 1993

RESEARCH CENTER
Federal Reserve Bank
of St. Louis
JUN 23 1994

HEARING

BEFORE THE

**COMMITTEE ON BANKING, FINANCE AND
URBAN AFFAIRS
HOUSE OF REPRESENTATIVES**

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

OCTOBER 27, 1993

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 103-86



U.S. GOVERNMENT PRINTING OFFICE

73-435 CC

WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402

ISBN 0-16-044286-9

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H.R. 28; FEDERAL RESERVE ACCOUNTABILITY ACT OF 1993

WEDNESDAY, OCTOBER 27, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry B. Gonzalez [chairman of the committee] presiding.

Present: Chairman Gonzalez, Representatives Neal, Waters, Klein, Hinchey, Leach, Roukema, McCandless, Nussle, Pryce, Knollenberg, Lazio, Grams, and Huffington.

The CHAIRMAN. The committee will please come to order.

The Banking Committee begins the 4th day of hearings on issues involved in H.R. 28, the Federal Reserve System Accountability Act of 1993.

I welcome Charles Bowsher, the Comptroller General of the General Accounting Office, and look forward to his testimony. He will tell us about the legal limitations the GAO faces in examining Federal Reserve operations.

In testimony during these hearings on October 13, Federal Reserve Chairman Alan Greenspan told us, and I quote, "GAO, in the 1978 act, could audit all aspects of the Federal Reserve System with the exclusion of those which refer to the question of the deliberations related to monetary policy," end of quote.

Was he trying to mislead us?

Let me tell you some areas of Federal Reserve operations that the GAO cannot investigate. Most people do not know that when the Federal Reserve changes the money supply, it does so from its New York Federal Reserve Bank in an auction separate from the U.S. Treasury auctions used to borrow money for government operations.

Each morning, around 10 a.m., the Federal Reserve Bank of New York holds a 30-minute auction with approved bank and nonbank dealers in order to change the monetary base of the United States. By buying or selling securities, usually very short-term repurchase agreements, the Fed takes money out of circulation or puts money back into circulation. There is little information on this auction. We know there is no market clearing price as was recently introduced for Treasury auctions. Thus, accepted bids or offers are transacted at different prices.

Is this the most efficient way to run this market? Why are the bids and offers not published? Is there any possibility of exploiting inside information, especially since participants can meet at the

Federal Reserve Bank shortly before the auctions? Can the GAO send in a team of experts to uncover the answers?

The second example concerns the Federal Reserve's intervention in foreign currency markets. We know from the minutes of the 1962 FOMC meetings that the Federal Reserve gave itself a fund for intervention without adequately notifying the Congress or the public. That fund is now \$30.1 billion. The Treasury, on the other hand, has a fund similar to that of the Fed, called the Exchange Stabilization Fund, but its budget is approved by the Congress.

According to a description published by the Federal Reserve Bank of New York in the 1970's, the Federal Reserve uses commercial banks to initiate some of the transactions involved. For example, an intervention by the Federal Reserve to sell German marks to increase the relative price of U.S. dollars includes the sale of marks to commercial banks, a request for a swap transaction to the Bundesbank, and a 2-day settlement period.

Can the GAO send in a team of experts to discern the propriety of these procedures?

I believe the answer to both situations is, of course, no.

Is it out-of-bounds for the Congress, therefore, the American public, to learn about these transactions?

Again, this has nothing to do with the FOMC deliberations or micromanagement of daily Federal Reserve operations. The Fed just wants to keep the curtains closed and keep any outside eyes from reviewing how well—or how bad—its biggest policies are implemented. Who knows whether the Fed's engine needs a tuneup if no one will let the mechanic look under the hood?

Now, let's discuss another gray area where the GAO would be appropriate. Earlier this year, I was informed that New York Federal Reserve Bank personnel were accepting hospitality at expensive restaurants and gifts from the very banks they have authority to regulate. On May 18, 1993, I received this astounding reply from E. Gerald Corrigan, the former president of the New York Federal Reserve Bank, and I quote:

"Our review indicates that in the limited number of instances where bank officers have been guests at meals hosted by regulated institutions at what would be considered an expensive restaurant, they have been acting within bank guidelines, and their conduct does not call into question the ethical standards of the Federal Reserve Bank of New York," end of quote.

That certainly says something about the ethical standards of the New York Federal Reserve Bank because such gifts would be illegal for government agencies using appropriated funds.

President Corrigan also rationalized the acceptance of tickets for sporting events from regulated banking institutions when he said, and I quote:

"There were a literal handful of instances involving attendance at sporting events in which bank officers were guests of acquaintances who worked at regulated institutions," end of quote.

But with no outside review, we don't know how many cases there were. Maybe this is like the rough notes of FOMC meetings that turned out to be quite extensive tape recordings and transcripts.

The question I have for the Comptroller General is whether the GAO can investigate the receipts of hospitality from regulated

banks by Federal Reserve employees if the employees say, "We were discussing monetary policy during our free meals provided by the XYZ Bank in an expensive restaurant"?

As I understand it, in this case, the Federal Reserve must give its permission for any GAO examination. Doesn't the public have the right to monitor possible conflicts of interest? Are the Fed's employees then invested with infallible comportment, merely because they are sacrosanct officials of the Federal Reserve?

Finally, the reason GAO has such limitations is because the Fed conducted an elaborate campaign to prohibit any audit bill from passing and succeeded for many years. In fact, it was not even approved by the Banking Committee, but by another committee, in 1978.

I am happy to have the Comptroller General here today to discuss the GAO limitations in examining the Federal Reserve.

Mr. Bowsher, please introduce your associates after I have given a chance for our minority leader, Mr. Leach, to say a few words or place his remarks in the record.

Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman. I have a lengthy statement. I would like to read about half of it and place the rest in the record.

The CHAIRMAN. Sure.

Mr. LEACH. Mr. Chairman, as you know, I have previously stated my support for relatively modest reforms to remove certain indefensibly undemocratic elements of the Federal Reserve System. I am also sympathetic to a greater degree of accountability for Fed decisionmaking which might include a somewhat more timely release of FOMC policy directives.

However, I have reservations about the potentially more draconian action of expanding GAO investigation, some call it audit authority, to the monetary policy functions of the Fed.

In this regard, lest there be any misunderstanding, it should be noted that in the government the term "audit" has two distinct meanings. The GAO conducts financial audits—so called dollars and cents audits of balance sheets; and performance audits—or reviews of programs and the implementation of laws. Performance audits are akin to audits of the decisionmaking process.

The issue of GAO audit or review of the Fed's conduct of monetary policy is not an issue of first impression. Indeed, beginning in the early 1950's, the more general issue of GAO audit of the Federal Reserve, including the monetary policy function, was widely debated on Capitol Hill.

The eventual outcome of this 25-year debate was passage of the Federal Banking Agency Audit Act in 1978. That act, for the first time, authorized the GAO to conduct both financial and performance audits of the Fed, exclusive of the monetary policy function.

The monetary policy function was excluded from the purview of GAO review at that time in recognition of the special political vulnerability of a central bank because of the opposition that may be generated, particularly when it imposes monetary restraint.

There was also—and I believe still is—an awareness of the extreme sensitivity of the confidential nature of information provided

by foreign central banks and governments—information critically needed in the formulation and implementation of monetary policy.

It is not unreasonable to assume that public knowledge that an arm of Congress, the GAO, had review powers and access to such information would have a chilling effect on the Fed's relationships with foreign governments and central banks.

Indeed, 2 years ago, when this committee subpoenaed all records held by the Federal Reserve relating to the BCCI scandal—an action I supported—this issue was raised, albeit in the context of bank supervision.

In that case, the covered records included confidential documents supplied to the Fed by the Bank of England. The Bank of England was prohibited by British law from releasing these documents to its own Parliament and indicated that if the Fed were compelled to produce them pursuant to this committee's subpoena, it would decline to share such information with the Fed in the future.

The formulation of monetary policy is a decisionmaking process that involves confidential interchanges with a host of foreign governments and central banks. Just as information sources are not infrequently protected for reasons of political security and certain foreign policy agencies of our government, an analogously compelling argument exists that in a world of economic competition and friction certain financial and economic information provided to the Fed should be protected for reasons of national economic security.

It is conceivable that even the hint of a possibility of the release of such information could jeopardize existing relationships among foreign monetary authorities, the Fed, and the U.S. Treasury, thus, aggravating our Nation's international finance relationships.

Confidentiality may be the best protection for financial economic security and the best protection for taxpayers who would bear the brunt of any losses resulting from the compromise of policies caused by the untimely disclosure.

Let me just conclude by saying, I would like to reemphasize that the fundamental question in the issue of GAO auditing of the Fed's monetary policy function involves an understanding, or misunderstanding, of the word "audit." Unfortunately, the word "audit" carries connotations that are misleading.

The common usage of the term, in everyday life, is an accounting of the income and outflow of dollars. In this sense, there is already 100 percent audit of the Federal Reserve.

But what we are talking about here is a fundamental review of the information and decisionmaking process which raises implications more of data sources and timeliness than it does of dollars and cents.

As this committee well understands, the Fed makes a profit every year, over \$16 billion in 1992, that goes to the Treasury. To the degree that market sensitive information is released in an untimely manner that profit is jeopardized. The greater protection provided the Federal Reserve System, the better off the taxpayer.

I thank the Chairman.

[The prepared statement of Mr. James Leach can be found in the appendix.]

The CHAIRMAN. Thank you very much.

I am going to ask unanimous consent that all members present and absent have an opportunity to place in the record any written preliminary statement they may wish to make at the outset of this hearing to appear in the transcript.

We will proceed and recognize General Bowsher.
If you will, introduce your associates.

STATEMENT OF CHARLES BOWSHER, COMPTROLLER GENERAL OF UNITED STATES, GENERAL ACCOUNTING OFFICE

Mr. BOWSHER. Thank you very much, Mr. Chairman, members of the committee.

I am accompanied today by Mr. Socolar, who is my Deputy; Mr. Bothwell, who is in charge of all our banking and financial institutions work; and Mr. Swaim, who has done most of our work at the Fed in recent years.

We are pleased to be here today to discuss the limits of our audit authority over the Federal Reserve System. My remarks principally will concern the provisions of section 3 of H.R. 28 which would remove all restrictions on our authority to examine Federal Reserve activities.

Currently, we lack audit authority over the Federal Reserve's monetary policy, foreign transactions, and the Federal Open Market Committee operations.

In responding to the committee's request, I will first describe our existing authority and some of the work we have done under this authority. I will then examine the implications of removing all restrictions on our authority, with specific reference to several topics the committee asked us to address. Finally, I will discuss certain safeguards that we feel would be appropriate to adopt if restrictions on our authority are to be removed.

The question of whether to lift the statutory constraints on our authority to audit the Federal Reserve System ultimately depends on what Congress wants us to do. Our access needs to be commensurate with the types of audits that the Congress expects us to perform.

For just a little history here, we derive our Federal Reserve audit authority from the Federal Banking Agency Audit Act of 1978. This act was passed after we did a special congressionally mandated study of the supervisory activities of all of the Federal bank regulatory agencies.

Before the act, our work at the Federal Reserve was mainly limited to audits of the fiscal agent functions performed by the Federal Reserve banks for the Department of the Treasury. We did this work under our authority to audit the Treasury.

Although the act significantly expanded our access to the Federal Reserve System and other bank regulatory agencies, it precluded us from auditing activities related to monetary policy, foreign transactions, and the FOMC. The exact wording of the limitation is set out in appendix 1 of my statement.

The act also prohibited us from disclosing certain information identifying open financial institutions and customers. Appendix 2 describes these prohibitions in greater detail.

The act does not require us to perform any particular type of audit. This means, as is true with most of our work, that our au-

ditions are determined largely by specific congressional requests or by our discretion under our basic legislative authority. As appropriate, of course, we coordinate all of our activities with the Federal Reserve's Office of Inspector General.

Notwithstanding the limitations on our authority, in the last 15 years since the act was passed, we have audited many aspects of the Federal Reserve System in areas in which our access has not been restricted. And we mention several of those studies here. They were basically in the area of bank supervision and regulation, in the payment system activities, and in the government securities activities.

Our current work that involves the Federal Reserve, either exclusively or as part of a study of all bank regulatory agencies includes: One, studies of regulatory burden; two, implementation of major provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991; three, analysis of the risk and benefits of interstate banking; four, the regulation and supervision of derivative products; five, an analysis of the banking industry activities in mutual funds; six, loan loss reserving by banks; seven, review of efforts to ensure a safe and sound international banking system through coordination among national regulators; and, eight, analysis of the expenses and revenues of the Federal Reserve System as they affect the Federal budget.

As I have indicated, section 3 of H.R. 28 would remove all of the restrictions on our authority to examine Federal Reserve activities. This would provide us with full access to FOMC transactions; to transactions for or with foreign central banks, governments, and international financing organizations; and to deliberation, decisions, and actions on monetary policy matters, including discount window operations, member bank reserves, and open market operations.

In considering the implications of removing restrictions, it is useful to look more closely at the types of work we do. Our audit work can be viewed as falling into two broad categories: financial audits and performance audits.

I will just briefly describe financial audits, Mr. Chairman. And I hope my full statement could be put in the record.

Financial audits are basically where the auditor goes in and checks the flow of funds through the organization. You check the internal controls, the systems; and according to the government auditing standards today, we are asking for more review of the controls and the systems to see whether they are adequate or not. And then the auditor gives a report at the end of that work.

Starting on page 10, section 3 of H.R. 28 proposes that all Federal Reserve banks, as well as the Board of Governors, be audited annually by an independent public firm, not the GAO. In other words, the way your legislation is set up, it would be an audit by an outside public accounting firm.

I am inclined to believe that this outside review would be beneficial for both the Federal Reserve and the general public. If the restrictions on our access were removed, we would be better able to assess the quality of those financial controls in auditing the Federal Reserve's system and make recommendations for improvements.

Concerning performance audits, I would like to discuss access issues by referring to the three areas we were asked to address in our testimony. These issues are: One, the daily government securities auctions at the New York Federal Reserve Bank which the Federal Reserve uses to manage the money supply; the Federal Reserve's interventions in foreign currency markets; and safeguards in the auctions, and presumably foreign currency transactions as well, against the Federal Reserve's releasing inside information.

Our access restrictions would be a major limitation to studying any of these issues in a way that required us to analyze data on actual transactions. Although it would be necessary for us to consider the actual scope of a request before reaching a judgment in any particular case, we must recognize that the restrictions in the law are quite explicit. Therefore, with performance audits, as well as with financial audits, the major question is really what Congress wants us to do.

Now, if Congress decides to remove the existing restrictions on our audit authority, we believe certain safeguards should be included in the legislation. These safeguards, which are similar to those that already exist under our present authority should: One, prohibit us from disclosing the identity of foreign central banks or governments; two, prohibit us from disclosing confidential documents and require safe keeping of confidential information; and, three, specify delays in our access to certain types of confidential information.

These safeguards are important because they make clear that removing our audit restrictions will not necessarily jeopardize the Federal Reserve's independence.

I would like to say to the committee that we, in no way, want to jeopardize the Federal Reserve's independence.

For example, with these safeguards, we could not use our expanded audit authority to undertake contemporaneous reviews of the Federal Reserve's monetary policy decisionmaking functions.

Also, immediate disclosure of information about Federal Reserve decisions in a situation such as the stock market break of October 1987, might not be in the public interest because it could disrupt the financial markets. Our role should be to make after the fact assessments of the Federal Reserve's performance, both in general and in problem situations.

In summary, we have been able to do significant audits of the Federal Reserve, despite the existing limitations on our authority. Congress obviously must decide whether our audit authority should be expanded.

However, if our audit authority is expanded, we believe measures should be included to protect against release of confidential documents and to prevent undue interference with the Federal Reserve's ongoing policymaking functions.

This concludes my prepared statement, Mr. Chairman. We would be pleased to answer any questions.

[The prepared statement of Mr. Bowsher can be found in the appendix.]

The CHAIRMAN. Thank you very much.

Is a private accounting firm in the best position to do an annual financial audit of the Federal Reserve? Or is it more desirable for the GAO to conduct the annual audit?

Should the Banking Committee consider allowing the GAO to review any audits of the Federal Reserve by private accounting firms?

Mr. BOWSHER. You could do it either of those ways, I think, and have a satisfactory result.

I think the big accounting firms could do the audit. We could do it, although we are somewhat strapped for people now as we are coming down in size. Just yesterday, the President, in announcing his new National Performance Review, Summary of Government Reform and Savings Act of 1993, called for audited financial statements of 23 key Federal agencies. That is, the 23 largest agencies in the Federal Government, which would comprise about 90 percent of the Federal Government.

So there is going to be a big effort here in all of the Federal Government, if the Congress votes for that legislation. This would be a big effort too. So I would think it might make sense to have the independent CPA firm do the financial audit and then possibly have us do some review of that as we do on many of the government corporations.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. No questions.

I appreciate your perspective, as we do in this committee very often. Thank you.

Mr. BOWSHER. Thank you.

The CHAIRMAN. Mr. Neal.

Mr. NEAL. I think you have expressed these views before over the years. They are not new, and I respect your opinion. And, in fact, as you know, just yesterday in another hearing we were lauding your operations, praising you for the good work that you do.

I don't want to take a long time on this. I am just curious, what is it that, especially in the open market operations, that would trouble you to make you think that we—I guess I put it in terms of sort of a cost benefit view of things. I mean as a clear benefit, you said you don't want to interfere with the independence of the Fed. There is a well understood benefit in keeping the Fed independent from political pressure, so it can try to take the long view of things, which means that it can help keep inflation down, keep interest rates down, and so on, that could be compromised, everyone recognizes, if we do too much political meddling.

Now, the worry—the reason that an audit of the open market operations was specifically prohibited in earlier legislation was that we didn't think that the benefit of getting into that area would outweigh the costs.

What makes you come to a different conclusion?

Mr. BOWSHER. I don't come to a different conclusion, Mr. Neal, other than to say that sometimes having any process reviewed to see whether it is being done fairly, efficiently, and things like that, has some benefit.

But I have no knowledge of how that operation really works. So I have no evidence to put forth to you that there is a big need here.

But in any operation of any large organization, sometimes it is good to have a performance audit as to how well is it working.

Mr. NEAL. I mean as a general principle, I can't disagree with you. I think that makes some sense. Again, I think here—well, let me ask this question: How about our inspector general over there? Is it your impression that—

Mr. BOWSER. Well, you know, I read his last report, and he is raising one issue that you might want to consider, and that is that, according to the government auditing standards, independence is a big issue; and he believes that independence would be enhanced if the Financial Examination Program reported to the Board, whereas now it reports to a division within the Federal Reserve.

And so I would think that the committee might want to look at the issue that he has raised in his most recent report. And it is just really the question of independence that they have in doing their work.

Mr. NEAL. You know, when I was chairman of the subcommittee that had the oversight responsibility for the Fed, we heard from the inspector general once a year; and we always made it very clear, publicly, privately, and in every way, that the discussion off the record was open and we wanted to hear from him, if he had the slightest suspicion of any problem of any kind.

Mr. BOWSER. I think that is very good that you would do that. Now the question is: How open of a door does the Financial Examination Program have to the—

Mr. NEAL. To the Board itself?

Mr. BOWSER. To the Board itself? And that is the issue that he is raising in his report.

Mr. NEAL. That is something that we ought to take a look at?

Mr. BOWSER. Yes.

Mr. NEAL. I guess I am still just a little—my worry is, I have seen what can happen when the Fed does not do its job right. We went through this very costly period in our economy: Huge unemployment, disruption, just incredible suffering that that caused.

Now we are moving in the right direction, got inflation down, interest rates down. I am just worried about doing something to get in there and foul it up.

So really, to me, it is a cost/benefit question. I don't quite know how to get at it. Because, I mean, as a general principle, I couldn't agree with you more, that we should have openness and no one is perfect. You know, the idea of getting in there and taking a look at things sounds very healthy. It is this other worry.

I guess the worry is about sort of going too far, especially if we were to legislate it. Say we started the legislative ball rolling around here and it just seems to me the temptation would be great to just keep it moving in a way that would end up being harmful to us.

Do you have any thoughts on that?

Mr. BOWSER. I don't really have a lot of thoughts on it, Mr. Neal. In other words, we would be willing to do the work as the Congress wants it done. But I think it is up to you gentlemen and ladies to make your policy decision on this issue.

Mr. NEAL. Thank you, sir, very much.

The CHAIRMAN. Mr. Knollenberg.

Mr. KNOLLENBERG. Thank you, Mr. Chairman.

I am a strong believer in the maxim that, if it ain't broke, don't fix it. And I think I have made that clear at previous meetings of this committee.

But could you outline any benefits there might be that may be derived from having the GAO audit the FOMC? And aren't there some potential political risks in this process?

Maybe you have some thoughts that you might want to elaborate on in regard to that.

Mr. BOWSHER. The benefits, basically, would be just having an independent check on the procedures and the systems that are used and the policies that they have laid out being followed. That is basically the way we do these performance audits.

So what you are doing is you are just checking to make sure that things are working the way they should be in a manner that everybody has agreed is what they want done.

The political concerns, I don't have any feeling on that one way or the other. I would leave that up to your judgment.

Mr. KNOLLENBERG. I have no further questions.

Thank you.

The CHAIRMAN. Thank you.

Ms. Waters.

Ms. WATERS. No questions.

The CHAIRMAN. Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

Mr. Bowsheer, you and I have spent quite a bit of time together the last couple of days.

I am going to go back to our discussions yesterday at the Government Operations full committee as to the procedures that are followed by GAO relative to the construction, the review, and the ultimate release of a document, a report on subject X.

It was an interesting discussion, because there were checks and balances through the process, as we discussed it, not only internally between your management reviewing the product, but also in some cases, the product being reviewed by the office or the department, in some cases, prior to release for purposes of maybe refining it.

In the subject here today, we are talking about videotaping the actual proceedings of an action. We are talking about immediate release of a transcript of everything that has taken place and all of the surrounding aspects of making everything public, except I guess when somebody excuses themselves to go to the sand box.

This seems to be a contrary approach to the process of administration of a public office. I would appreciate your thoughts on what appears to me to be a total opposite in terms of how you function.

Mr. BOWSHER. Well, the way we function is we——

Mr. MCCANDLESS. The comparison is what I am interested in.

Go ahead. I am sorry. I didn't mean to interrupt you.

Mr. BOWSHER. The way we function, Mr. McCandless, of course, is two ways. When we do a review, about 50 percent of the time on our major reports, we give a copy of the report to the agency and ask for their official comments and we bind those comments into the back of the report.

The other 50 percent of the time, for various reasons, we don't get official comments, but we always have an exit interview, and we try to take into consideration any of the issues that the audit, you might say, raises in finalizing our report.

Now, as we discussed yesterday, sometimes, unfortunately, some people will leak a report from the agency or sometimes if it gets over here on the Hill—and we run into trouble when sometimes that happens. If that was to happen in the Federal Reserve type situation, it would be, I think, most unfortunate, as it is generally in all of the other cases.

So one of the things we might want to do, if you wanted us to do these kind of reviews, is to set up special processes to safeguard the release of the reports; this would be one thing I might want to consider with you.

Mr. McCANDLESS. Do you feel from your experience and the operation of GAO that it is a good idea to have an agency operating in a fishbowl while it is developing policy?

Mr. BOWSER. We have always generally been, in doing our work, after the fact.

In other words, we have not been auditing, you know, right then and there while a committee is making a decision or while the defense officials are making their decisions on weapons systems or forces.

And generally our process is to go in after the fact and to look and see how it was done and to report on the process, you might say.

Mr. McCANDLESS. Well, what I made reference to here is you are also examining compliance with existing regulations and making comments in your report relative to these issues.

So that is where I was focusing from a policy point of view: Is it good government business to have such an organization operating in a fishbowl environment while in the process of making rather substantial decisions on the future of the country's business?

Mr. BOWSER. Well, I think that is a major policy decision for the Congress to make here. In other words, in some cases Congress has generally come out on the side of openness and sunshine.

Other times you have made the decision that you thought, like with National Security Council decisionmaking and things like that, it was not. So I think that that is a policy decision for you people to make. I think it is a very important one.

Mr. McCANDLESS. Good political answer. Thank you.

My time is up.

The CHAIRMAN. Thank you.

Mr. Grams.

Mr. GRAMS. I have no questions.

The CHAIRMAN. Mr. Huffington.

Mr. HUFFINGTON. No questions. Thank you.

The CHAIRMAN. OK.

Do you have any further questions?

Mr. NEAL. May I ask one?

The CHAIRMAN. Yes. Certainly.

Mr. NEAL. I would just like to ask one more question if I can. I am just trying to get a little clearer fix on what is and what isn't done.

As I understand it, the Fed—all the regional banks are audited internally, and then the Governors have an auditing system in addition to that. They audit the banks. Then the operations of the Federal Reserve System itself are audited.

Other than the transactions between our Fed and foreign banks—and the reason for that is that if we were to make public those relations—the foreign banks simply wouldn't do business with us. I mean they are much more secretive than our banks. And our Fed thinks it is valuable to have that information. And so the practical matter is, if they thought that their relationships with us were made public, then they would simply shut down their operations.

The discount window operations aren't audited because if you make public the transactions between the discount window transactions between the Fed and the bank, that would signal that that bank was in trouble and you might cause a run on the bank.

So there is a pretty good reason for not making all that public.

And then the open market operations aren't audited, and the argument has always been there that you don't want to audit them because that would start to compromise the independence of the Fed and get into the conduct of monetary policy itself, because, as a matter of fact, what they do, they buy and sell; and the only real thing to look at is, I mean, to say, did you buy this on a certain day? Well, sure, you either did or you didn't. I mean there is nothing to hide there. They did or they didn't. So there is really not much to get into except questions of policy.

Mr. BOWSHER. Yes.

Mr. NEAL. So as I understand it, these are the three main areas where we don't have audits, and everything else is well audited, if I understand you correctly. And that is what I would like for you to comment on.

So I don't think that we ought to leave—my point here, to me, is that it seems to me there are probably pretty good reasons that almost anyone would agree to that we shouldn't get into these three areas. And we don't want to leave this impression that somehow this massive operation, all these banks and the regulatory operations and so on, aren't audited, because they are. That is what I want you to comment on.

Mr. BOWSHER. They are audited, Mr. Neal. And you described it basically right. They just don't pull it all together like you would with an external financial audit. And that is the thing.

The one thing I should also say—and my colleague made a note here for me—is that if you are going to have a financial audit, then the outside auditor would have to be able to look at the necessary transactions to give his opinion on the overall operations. But there is no question that today, the Federal Reserve has certain components of their operation, most of the large components, being audited by their internal procedures.

Mr. NEAL. Is there any reason to doubt the adequacy of those procedures?

Mr. BOWSHER. We have not done any work that would answer that.

Mr. NEAL. Do you agree that the reasons I gave for not having auditing—especially auditing that would be made public—of these three areas makes some sense?

Mr. BOWSHER. They do. But I think also some people would want to have those processes checked out every once in a while. I think that is really the other part, to just see how well are they working. After the fact, mostly.

In other words, as you say, when they are in a crisis stage with some big problem, you don't want to have the auditors there at that point in time. But at some point in time, periodically or something like that, it might be good to be checking the processes. That is really your policy question, I think.

Mr. NEAL. Well, you mean maybe with a timeline, 5 years or something. Say you had a bank in trouble and it had to do discount window operations with the Fed and you would say that it would be—possibly could be important to go in and take a second look at that after the fact—not after time—so that you might exacerbate a bad financial situation, but with a time lag of, what? How long a period of time would you say?

Mr. BOWSHER. Some audits of discount window operations that are related to bank supervisory activities we can do now, even with the exclusions that are there.

What we can't look at is the foreign operations and the monetary policy aspects.

The CHAIRMAN. The time of the gentleman has again expired. We have some witnesses following.

Thank you very much, Mr. General and associates. We deeply appreciate your helping. And we will be in sustained communication as we continue to travel along the road of H.R. 28.

Our next and second panel consists of Governor Wayne D. Angell, the Governor of the Federal Reserve Board; and President William J. McDonough, president of the Federal Reserve Bank of New York.

I want to welcome Mr. William J. McDonough, Vice Chairman of the Federal Open Market Committee and the president of the Federal Reserve Bank of New York and Governor Wayne D. Angell, Federal Reserve Board.

I certainly want to hear your views on the GAO audit limitations and whether or not you think they are justified.

Before turning to that, however, I have a very serious matter to address. As you know, in H.R. 28, there are provisions that require the release of any policy change within 1 week and a videotape of FOMC discussions within 60 days.

You both know that I inquired of all of the Federal Reserve Bank presidents and the Governors in my letter of October 22, 1992, about minutes of FOMC meetings. Chairman Greenspan wrote the following to me on December 24, 1992, and I quote:

"Members felt that making a tape or literal transcript public would have an especially restrictive effect in discussions," end of quote.

For the hearing last week on October 19, 1993, I asked each Federal Reserve official to include in his or her testimony any knowledge of notes or records made by others at FOMC meetings.

And even though you didn't appear, Vice Chairman McDonough, you submitted testimony as follows—and I am going to quote from it:

“I have no personal knowledge of any other notes or records that others may have made at FOMC meetings,” end of quote.

Yesterday, I received a letter from Chairman Greenspan saying that there have been tape recordings made at FOMC meetings since 1976, that the FOMC has unedited transcript and staff notes from transcripts existing back to 1983.

In addition, the meeting room for the FOMC has a complete setup for tape recording including, and I quote:

“A green light on top of the meeting table near its head is lit when the recording system is in use,” end of quote.

How could anyone not know what that green light meant and fail to tell the Congress or report that there were no literal translations?

I also must say I have some trouble with Chairman Greenspan's statements, that he knew about the taping when he first assumed office and he forgot when he learned about unedited transcripts.

I am going to quote:

“Indeed, until a staff member jogged my memory in the last few days, I had been under the impression that I first learned only about a year ago that transcripts were being retained,” end of quote.

If I were sitting in front of a green light, as we do here, and it lit up every time I talked, I think I would have been a little bit more inquisitive about what was going on. It would jog my memory. I hope they didn't think that when the green light went on it meant raise interest rates.

Now that we know that Chairman Greenspan initiated a conference call and informed the Governors and presidents about the tape recordings, why did they give the testimony we received last week on October 19?

I want to thank Governor Angell for testifying that he knew about the transcripts several years ago. However, if that is the case, why did you join in the misleading reply sent to me from Chairman Greenspan on October 26, 1993?

This is a time in our Nation's history when the public demands accountability from its government officials. There are many citizens who are losing their trust in government.

The less-than-truthful response to my requests by the senior officials of the Federal Reserve about minutes and their testimony last week raises serious questions. Why all these discrepancies?

We held these hearings to encourage greater accountability of the Federal Reserve. And sincerely believing that, in the end, it would be helpful even to preserving and maintaining the rightful entitlement to independence. The outrageous deception of the last few days shows precisely why greater accountability is needed.

Now, as for the GAO audit, I can paint no better case for a GAO audit than the outcome of the inquiry I made on the acceptance of hospitality and gifts by the Federal Reserve of New York Bank officials from the very banks that they regulate.

Evidently, from the opening statement that you sent us, Mr. McDonough, this practice has not ended. You have yet to establish what you call a, quote, "paper trail," end of quote.

I don't think this is an adequate response when such hospitality is illegal for other government employees. I would certainly expect these practices to be curtailed, to establish an arm's length relationship with those you regulate, just as other regulators have always done.

I don't think the American public, and particularly those that have elected us to represent them as their agents, would be satisfied with less.

If it has seemed, through the years, that maybe they weren't, the impression I had all of these 32 years, is that they just didn't see any choice, they just didn't see any hope that anything they could do would matter, if their agents didn't care enough either.

So, respectfully, I must say that the intent, the purpose of having the agency the Congress has created for that purpose, to give us some accountability of this great institution, is done with that single-minded purpose of accountability.

I think that every one of our branches, whether it has been the legislative—through our history, or the executive or the judiciary, where it has power in accountability—our history shows we have had rather difficult times for the public interests.

None of us, whether it is in the Congress, is exempt from the dictum that if we have power, we must render accountability to the best of the frail human abilities that we can summon. I have never had any satisfaction in seeing anybody's discomfort or anything, and that is not the purpose. And I think my record, whether as chairman of subcommittees that I have chaired all through, or as full committee chairman at any time, reveals that I have, at any time, been abusive or even discourteous to any witness who has been kind enough and respectful enough to answer a request to appear as witnesses.

So thank you very much for your patience at hearing these preliminary remarks.

And if there is no objection, I will introduce you as we listed you and recognize Governor Angell first.

STATEMENT OF WAYNE D. ANGELL, GOVERNOR OF THE FEDERAL RESERVE BOARD

Mr. ANGELL. Mr. Chairman, thank you very much. Mr. McDonough and I, of course, will want to respond directly and fully to any questions you have on these matters that you have raised.

With your permission, I will go through the testimony. I will leave out a few items in my statement so as to provide ample time at the end to respond forthrightly and directly to your questions.

The CHAIRMAN. Certainly, Governor.

In fact, may I say that we want to thank you for submitting your prepared statements. And they will appear, if there is no objection, as you gave them to us in writing, following your oral presentation.

And you may proceed as you deem best, sir.

Mr. ANGELL. Thank you, Mr. Chairman.

I am pleased to have this opportunity to speak on the General Accounting Office's authority to audit Federal Reserve operations

and the changes to that authority that would be made by H.R. 28. President McDonough is addressing the scope of GAO audit authority from the perspective of the Federal Reserve Bank of New York.

At the outset, I would like to dispel the notion I have frequently heard that the Federal Reserve is not subject to GAO audit. In 1978, the Federal Banking Agency Audit Act gave the GAO broad authority to audit most of the operations of both the Federal Reserve Board and the Federal Reserve banks.

Since then, the GAO has completed more than 100 reports on various aspects of System operations, as well as numerous other reports that involved us less directly. At present, the GAO has roughly 25 audits of the Federal Reserve under way and maintains several of its staff in residence at the Board and at selected Reserve banks.

The GAO has free rein to audit the System, subject to explicit exemptions for: Deliberations, decisions, or actions on monetary policy matters including discount window credit operations, reserves of member banks, securities credit, interest on deposits, and open market operations; transactions made under the direction of the FOMC; transactions with, or for, foreign central banks and governmental entities; and discussions or communications among or between members of the Board and of officers and employees of the Federal Reserve System related to these matters and transactions.

By excluding these areas, the act attempts to balance the need for public accountability of the Federal Reserve through GAO audits against the need to insulate the central bank's monetary policy functions from short-term political pressures and the need to ensure that foreign central banks and government entities can transact business in U.S. financial markets through the Federal Reserve on a confidential basis.

The precise line differentiating those Federal Reserve specific operations and activities that are subject to GAO audit under the Banking Agency Audit Act, and those that are exempt from audit is difficult to draw in the abstract.

Over the years, since the passage of the act, the Federal Reserve has worked with the GAO to define those limited areas that are not subject to audit on a case-by-case basis in the context of individual audits. In the future, we will continue to work with the GAO to address its concerns consistent with the mandate of the act.

Expanding the GAO's audit authority over the Federal Reserve into the exempt areas would be contrary to the public interest. Such an expansion could adversely affect Federal Reserve effectiveness in the conduct of monetary policy.

As the Banking Agency Audit Act recognized, such a change could reduce the central bank's insulation from day-to-day political pressures. Even what appears to be a very limited audit of the efficiency of monetary policy operations could, in fact, turn into pressure for a change in monetary policy itself. For example, the question posed to Comptroller Bowsler in connection with these hearings as to whether the magnitude of our open market operations reflects unnecessary buying and selling of government securities are monetary policy questions, not efficiency questions.

The number of transactions that the Open Market Desk completes in carrying out the FOMC's directives correlates directly with the substance of the policy in place.

GAO scrutiny of policy deliberations, discussions, and actions could impede the process of formulating policy. A free discussion of alternative policies and possible outcomes is essential to minimize the chance of policy errors. The prospect of GAO review of formative discussions, background documents, and preliminary conclusions could have an adverse effect on the free interchange and consensus-building that leads to good policy.

Transactions made under the direction of the FOMC include foreign exchange operations. The efficacy of these operations is crucially dependent on confidentiality. Important daily contacts and exchanges of information with foreign monetary authorities are an integral part of these operations. They now take place in a candid and constructive atmosphere.

The possibility of a GAO audit of our foreign exchange operations would reduce the willingness of foreign authorities to share information with us and would thereby reduce the effectiveness and efficiency of our operations which are frequently coordinated with foreign authorities.

This caution also applies to the exemption for transactions that the Federal Reserve carries out as agent for foreign entities; however, there the principal issue is one of sensitive proprietary information about foreign governments, foreign central banks, and international financial organizations.

The benefits, if any, of broadening the GAO's audit authority into the areas of monetary policy and transactions with foreign official entities would be small.

With regard to purely financial audits, the Federal Reserve Act already requires that the Board conduct an annual financial examination of each Reserve bank. The Federal Reserve places great importance on both the Reserve banks internal audit responsibilities and the Board's responsibilities for examination of Federal Reserve Banks, in part because it recognizes that its ability to police Federal Reserve Bank operations is critical to public and congressional confidence in the Federal Reserve System.

The process of conducting annual financial audits is reviewed by a public accounting firm to confirm that the methods and techniques being employed are effective and that the program follows generally accepted auditing standards applicable to the audit of Federal Reserve Banks. These examinations are complemented by extensive Board oversight and supervision of Federal Reserve Bank activities, including Board operations reviews of Reserve bank effectiveness and efficiency, as well as by comprehensive audits conducted by each Reserve Bank's independent internal audit function. Oversight and supervision of Federal Reserve Bank activities include review of Federal Reserve budgets and expenditures as well as personnel and operating policies.

The Board's annual financial examinations of Federal Reserve Banks, operations reviews, and its oversight and supervision of Federal Reserve Bank activities specifically includes examinations, operations reviews, and oversight of open market and foreign transactions.

The annual financial examinations include review of all accounts for accuracy, compliance with internal controls, and confirmation that balances reflected on the books agree with the records of accountholders.

Operations reviews for effectiveness and efficiency of open market and foreign operations are conducted by multidisciplinary teams, including economists familiar with FOMC operations and specialists in data and physical security, automation, communication, accounting, and secondary market trading and settlement. These operations reviews also include the Federal Reserve Bank of New York's internal audit attentions to the open market account.

Further, a private accounting firm audits the Board's balance sheet, and the Board's inspector general audits the effectiveness and efficiency of Board programs and operations under the Inspector General Act of 1978 as amended.

The Board has continually reviewed its procedures for examinations and oversight of Federal Reserve Bank activities. For example, recently the Board has contracted for independent private audits of two Federal Reserve Banks, Kansas City and Cleveland, in order to provide an independent evaluation of the Reserve banks control environments and the Board's examination procedures and to determine the feasibility of substituting, from time to time, outside audits for financial examinations by the Board's examiners.

These audits have indicated that previous financial examinations of these Reserve banks were at least as thorough as the outside audits, that those Reserve banks were well controlled, and that financial controls may be regarded as satisfactory from an audit perspective.

Indeed, these audits have indicated that many policies are uniquely applicable to Federal Reserve Banks and that, in these areas, the Board's examiners have a significant advantage in auditing for Federal Reserve Bank compliance.

The Board is strongly committed to ensuring that its examinations, both internal and external, oversight and supervision of Federal Reserve Banks, as well as its own internal audit function and external audits, are as effective as possible and will continue to review these functions with an eye to ensuring their future effectiveness.

Finally, and more broadly, Congress has, in effect, mandated its own review of monetary policy by requiring semiannual reports to Congress on monetary policy under the Full Employment and Balanced Growth Act of 1978 and by holding hearings on various monetary policy issues as they arise.

In addition, there is a vast and continuously updated body of literature and expert evaluation of U.S. monetary policy. In this environment, the contribution that a GAO audit would make to the active public discussion of the conduct of monetary policy is not likely to outweigh the disadvantages of expanding GAO audit authority in this area.

In sum, we believe that the Board's supervision and oversight of Federal Reserve Bank activities and the Board's own audit functions have served the public interest well, particularly in the area of confidentiality of monetary policy information.

In this regard, Mr. Chairman, you have asked about the security checks on personnel involved in the monetary policy process and incidents of so-called insider trading by Federal Reserve officials.

Attendees at FOMC meetings are now required to have "secret" or higher clearances. And, over the years, there have been only three known incidents where monetary policy information may have been used for private gain.

I have fully explained these incidents in the written testimony, Mr. Chairman. And I will be happy to respond to questions on these incidents as well as on the entire subject matter of these hearings and the particular questions that you posed at the beginning.

We believe that the paucity and nature of the three incidents described over the 80-year history of the Federal Reserve System is strong evidence of the integrity of the Federal Reserve monetary policy process.

Further, it is doubtful that any of these incidents would have been prevented by a broadened GAO audit authority.

For these reasons, and the reasons previously stated, we believe the enactment of the provisions of H.R. 28 that would expand the GAO's audit authority by removing the current exemption from monetary policy matters; transactions made under the direction of the FOMC; and transactions, with or for, foreign official entities would be counter to the public interest.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

[The prepared statement of Mr. Angell can be found in the appendix.]

Mr. McDonough.

**STATEMENT OF WILLIAM J. McDONOUGH, PRESIDENT,
FEDERAL RESERVE BANK OF NEW YORK**

Mr. McDONOUGH. Thank you, Mr. Chairman.

I believe that, as an American citizen, it is always an honor to appear before a congressional committee, and I welcome the opportunity to appear before you today to provide my views on H.R. 28.

I will focus on the implications of the proposal for the actions taken by the Federal Reserve Bank of New York in implementing FOMC decisions and carrying out activities for a foreign account.

I would like to comment on the scope of the current exemption and to make clear to the committee my appreciation and respect for the audit process.

Also, I would like to take this opportunity to note steps that can be taken to ensure further the effectiveness of GAO audits of the bank, within the GAO's current authority.

In my opinion, that authority provides sufficient scope to address many of the concerns you have asked me to discuss today.

I believe that the elimination of the current exemption would interfere with the Fed's ability to formulate and execute an optimal monetary policy. It would introduce the unmistakable potential for political influence; every movement and nuance of policy would then have to be examined in light of that potential.

At the core of my concern is the fact that the process by which we implement monetary policy is inextricably entwined with the

policy itself. For example, questions regarding the volume of open market operations on the surface may appear to be questions of efficiency. In fact, they relate to the policy intent to avoid undue volatility in the markets. The idea that the process of executing open market operations may be audited without imposing judgments about the policy itself is, I believe, simply not realistic. The potential for damage clearly would outweigh any possible benefit to the public from GAO audits of monetary policy operations.

I feel equally strongly, Mr. Chairman, about the impairment of our policy implementation if the exclusion were to be lifted on the foreign side. Foreign exchange intervention is conducted not only in conjunction with the Treasury, through the Exchange Stabilization Fund, which is exempt from GAO audit, but also frequently with or on behalf of foreign central banks and monetary authorities.

We hold a very large amount, over \$300 billion at present, of marketable U.S. Government securities representing dollar reserves of these official foreign entities. I cannot presume to gauge the response of all of these central bank Governors and finance ministers; but I can tell you with absolute certainty that there is some number of them, and perhaps a large number, who would question the appropriateness of their reserve activity being scrutinized by the GAO and the Congress. This would almost certainly be damaging to the relationships that are so central to international monetary cooperation and, perhaps, to the role of the dollar. Certainly, it would impair the ability of the U.S. monetary authorities to conduct their foreign exchange intervention policies on a coordinated basis with the same effectiveness and efficiency we enjoy today.

Having said that, I want to reiterate that I do not have some sort of reflexive distaste for auditors or the audit process. To the contrary, as someone who has had managerial responsibility for large organizations in both the public and private sectors, I have a keen appreciation for the role of auditors and the improvements they bring to the table in the form of operational quality and effectiveness.

A number of years ago, Mr. Chairman, the Board of Directors of the World Bank thought that they would like to create an expert panel to evaluate their use of outside auditors; and my interest in auditing and presumed expertise in the matter led them to select me as the chairman of the panel.

I view auditors as an important asset for management. There is a long tradition at the Fed of recognizing the value of independent oversight. Indeed, I believe we subject ourselves to an extraordinarily rigorous series of performance and operational appraisals. Within each Reserve bank there is an independent audit function that reports directly to the board of directors and performs comprehensive audits of all aspects of that bank's work.

At the New York Fed, we have had a constructive and positive relationship with the GAO for almost 15 years. We supply the GAO permanent space in the bank and have assigned staff as liaison in order to assist them in the orderly completion of their tasks. In addition, we take seriously their findings and are responsive to their suggestions for improvements. While I do not want to wax too po-

etic and imply that we love the result of each and every audit—they probably wouldn't be doing their job very well if we did—I do want to make clear that we have a great appreciation for the role of auditors.

The conduct of bank personnel with responsibility for monetary policy matters is subject to the bank's rules of conduct, stringent standards regarding outside financial interests and potential conflicts stemming from family and other personal relationships.

The GAO always has had full audit authority over Reserve bank's personnel policies and practices, disclosure statements, and the like and, thus, has been able to assure itself and Congress of the ethical standards and practices of all of our employees.

We are not, however, resting on our laurels. There are always ways to enhance the effectiveness of operations, and audits by GAO can contribute significantly to that process. I plan to call Comptroller General Bowsher from time to time—we talked just the other day—to offer suggestions as to how the GAO might be even more useful to the Bank.

I now would like to respond to matters raised in Chairman Gonzalez' October 21 letter to me regarding our policy on meals and entertainment and our ethics officer.

As I have noted, there is no limitation on the GAO that prevents its looking at our meals and entertainment practices or policy. Moreover, we do not impart information on monetary policy or our foreign account relationships to any outsiders, at luncheons or any other time. To the contrary, we use meetings with knowledgeable people to gain information about market conditions, and that is helpful in our monetary policy deliberations.

The chairman asked a question regarding the cost of meals at expensive restaurants hosted by regulated institutions, which was mentioned in a letter which you cited this morning, Mr. Chairman, by Mr. Corrigan to you. Because others paid for these approximately two dozen meals that were identified as having occurred over a period of 1½ years, we do not have that cost information. We are, however, very sensitive to the appearances of such things, and our internal rules specifically caution against accepting inappropriate entertainment, lavish meals, or frequent meals from a particular institution.

Further, we concluded that we do not have an adequate audit trail. Therefore, we are about to issue a policy requiring that all business meals paid by regulated institutions or vendors be documented as to restaurant, purpose, and attendees. The purpose of that is to provide an audit trail for us, the Board of Governors, and the GAO going forward.

Mr. Chairman, I would wish to assure you and the committee that in my days of private life, I don't know of any institution that had such an audit trail. We, in the course of evaluating it, said, how do we know who has been having a meal with whom? So we are creating a form that will require that information.

Finally, as the Chairman noted, we recently named an ethics officer. That does not mean this role was not being performed previously within the bank. That function was fulfilled by the bank's first vice president, its general counsel and the personnel officers.

We concluded that we would focus these responsibilities in a single individual, a senior vice president of the bank. Since his appointment as ethics officer, he has responded to inquiries from members of the bank's staff regarding ethics and conflict of interest questions. He also has participated in redrafting our rules of conduct, which should be concluded by year end, and other documents which will be helpful to the bank's staff in their compliance with these rules. We regard his efforts as a continuation and refinement of the policies we have already put in place.

As far as I am concerned, GAO staff has access to those policies and procedures. And lest I confuse anybody by what I mean by procedures, in other words, what actually happens, not just looking at the policy. And I look forward to receiving GAO's input on them.

I appreciate this opportunity to participate in this hearing, and I look forward to answering any further questions, Mr. Chairman, you or the committee members may have.

Thank you.

[The prepared statement of Mr. McDonough can be found in the appendix.]

The CHAIRMAN. Thank you very much. I appreciate your statement about sensitivity to appearances. That is very true.

Many years ago, in another world, when I grew up and knew such things as melon patches and the like, I learned a lesson from a neighbor, a friend of my grandfather, who came from Kentucky. And there was an incident that somebody had snitched some melons. And I will never forget Mr. Heddy saying, well, if you want to avoid suspicion, don't stoop in the middle of the melon patch to tie your shoestrings. It is so apt. It is true.

And as you referred to, there is a vast difference between the private and the public sector. You have been involved in each one of those sectors. And there is quite a difference. And learning to appreciate a difference sometimes is the biggest challenge an elected or appointed public official learns. It is not as easy as it sounds. The standards of success in the private sector are not quite as acceptable in the public area. So I appreciate that remark.

Now, I gather from that statement that GAO has no restrictions on reviewing such things as the meals.

Mr. MCDONOUGH. No. None whatsoever.

The CHAIRMAN. OK. But then you also say something that kind of troubles me and may give rise to the fact that maybe you are trying to tie a shoestring there, and that is you say to gather information about market conditions, meals with bank personnel.

Now, is it ever necessary to have meals involving that character of discussion paid for by regulated institutions?

I mean, you may have some reason, but I am asking.

Mr. MCDONOUGH. Well, one of the things that we try to do, Mr. Chairman, is, as often as we possibly can—and at some expense to our bottom line—recognizing that, since the days of the campfire, man, as a social animal, tends to perhaps talk more fully when dining or lunching or breakfasting we have them in as frequently as we can to the Federal Reserve Bank itself so the occasion is taking place on our premises.

I do think that, on occasion, if a regulated institution, in a restaurant of appropriate, reasonably modest price level, asks our peo-

ple to perhaps even reciprocate for a meal that they have had at the Federal Reserve Bank of New York, that they may accept that invitation.

It is very important for us to know what is going on in the market so that we can implement monetary policy with the greatest amount of knowledge. I think it is fair to say that we are close to notorious for being very good at listening and very chary in saying anything. I think the ideal sort of person to have a conversation with us is somebody who likes to talk a lot and not to listen much, because we have to be so careful about not inadvertently sharing anything that would be inappropriate in the area of policy, and we tend to be very, very quiet and not forthcoming, deliberately.

So I do think that a reasonable amount of accepting meals is acceptable, we tell the people, you should certainly not do it frequently with the same institution. You should be very careful.

New York City is an area where, as you know, the cost of living is quite high. And so we are very much pointing the people away from restaurants that would appear not to be the kind of place that Federal Reserve officials ought to be appearing, especially as the guests of regulated institutions.

The CHAIRMAN. Well, time is catching up on us. I am a little troubled, though, if you say that you do invite private sector to the Fed for meals, then how is it accounted for? But I am not going to split hairs on that.

I just want to say before I close out, Governor, the 1978 Bank Auditing Act did not come from this committee. This committee was thwarted. As a matter of fact, it wasn't until we had the catastrophe that we have been dealing with since 1988, 1989, that it became obvious that the Congress had done everything to please the unseasoned demands of not only bankers, but S&Ls and everybody else. It did everything they ever asked for, and look where it got.

On the other hand, it was obstruction when 1978 came because Chairman Ben Rosenthal of the Subcommittee on Monetary Affairs over in the Government Operations Committee, was the one that also brought to bear—Nelson Bunker Hunt and his brother, in their failed attempt to corner the silver market, which incidentally used over \$25 billion worth of bank resources and credit. And it took him to do it from a subcommittee of the Government Operations Committee, not the House Banking Committee.

Because every effort was made—I know, because I have been on it for 32 years, and I can go back to the initial attempts in the 1960's, and the Fed came and lobbied. And, in fact, I will place in the record the minutes from one of the Reserve banks in which they were trying to figure out how to obstruct Rosenthal in what turned out to be the Bank Audit Act of 1978.

I just wanted to make that clear, that it didn't come with any help or any encouragement from the Federal Reserve Board.

Mr. Leach.

Mr. LEACH. Well, I thank the Chairman. And I must say that there are several anecdotal instances raised by the Chair and then some larger public policy issues. I think we are all concerned about basic ethics and appearances.

On the food policy of the Fed, though, I think it has to be understood as a very small potatoes issue. We are talking about the monetary policy of the Fed here.

In terms of the instance that the chairman raised on the silver issue, though, my own sense is it is one of the greatest mistakes in terms of individual decisionmaking of the Fed, and the chairman implied coverup or lack of cooperation with an investigation.

I think the basic decisionmaking of a private sector speculator that was, in effect, protected through the banking system with the backup of the Fed was deeply wrong headed.

And having said that, there is no reason that this Congress should not have the right to assess or reassess that kind of policy. But, again, that is a circumstance that I share on both issues with the chairman.

But that means that some portion of the Fed's monetary should be open to pervasive performance audits which, after all, truly leads in the direction of politicizing of the Fed.

And here, I think there are some analogies. Governor Angell mentioned the sensitivity of certain information-gathering from foreign governments, which I think is valid. In this issue of definitions, the word "audit" has a very positive kind of implication. But we are really talking about performance review of policy. And here Congress has a number of techniques at our disposal, including the semiannual requirements that the Chairman appear before Congress and other techniques, many of which are public.

In terms of information-gathering I think there are analogies to the national security front where Congress has always agreed that there are certain kinds of information, for national security reasons, that ought to be confidential, at least for a period of time.

While the Chairman of the Joint Chiefs of Staff needs to know that we have a second strike capacity at sea, he or she doesn't need to know the precise location of any submarine at any point in time. Congress also needs to know the direction of policy but doesn't necessarily need to know all market sensitive information.

Increasingly, market sensitive information is of an insider variety and affects markets for market participants. We will be opening ourselves up to a lot of efforts literally of economic espionage within the Congress if this information is transferred to an arm of the Congress.

By economic espionage, I mean foreign as well as American participants, that could be of a difficult nature.

So I, for one, am not overly inclined toward intrusive performance audits. I think that the review of your policy is what we need to know. With regard to the review of all of the market decision-making of the Fed, I think the country is better protected by a little bit of confidentiality.

In order for that confidentiality to be respected, the Fed does have to recognize that there are times now and again that people will differ with decisions that are made and that the Fed has got to realize that there will be some accountability that will be expected.

But I personally think that Congress ought to approach this issue with a great deal of chariness.

Anyway, I might just briefly ask if that seems relevant to you as an observation or irrelevant?

Governor Angell.

Mr. ANGELL. Mr. Leach, I must say that there are times that I think presidents and other officers and directors of Reserve banks think that the Federal Reserve Board examination process is indeed intrusive. But we have a responsibility to do that, and Reserve banks understand that.

I have no other comments to make on your references.

Mr. LEACH. Mr. McDonough.

Mr. MCDONOUGH. They seem to make a great deal of sense to me, Mr. Leach.

I have no other comment.

Mr. LEACH. All right. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Neal.

Mr. NEAL. Well, again, I must say I wonder why—I think about some of the points I was trying to make earlier; you made them much better and much more thoroughly.

Most anything of any significance that we are dealing with here is being audited, it looks to me like. And the things that are not being audited are not being audited because there are good reasons in terms of the impact on policy to not audit.

I don't know why we—I mean so far in these hearings we have steered away from why we have a Federal Reserve and what the most sensible policy is. I mean, the American public today, the working people of America, are able to buy houses at 7, 7.5 percent interest. They are able to buy cars—I noticed the other day the interest on cars is 6 to 7 percent. The banking system has been saved from a huge catastrophe a couple of years ago. Most people were saying we thought we were going to have to bail out the banking system.

The Federal Government is able to borrow to—at much lower rates than it was a few years ago, but all because the Fed has done the job that we have asked it to do fairly well in recent years. That is, it has brought down the rate of inflation.

Now, that is where the focus ought to be. Is the Fed doing the job that we want it to do, which is to control inflation and, thereby, create the conditions that will most enhance economic growth, jobs for our people, low interest rates, savings, investment, productivity growth, competitiveness in international trade. These are the key questions.

And all this other stuff about whether someone had a meal there—I mean, I don't want you to do anything, frankly, that looks the least bit unseemly, because I think it detracts—it gives—it opens up the opportunity to detract from this primary goal.

So, of course, I wince when I hear the least thing. But, frankly, I have to say I think the Fed has operated in a pristine sort of environment. I am not aware of any hint of any scandal. In fact, I think you have conducted your affairs very appropriately and, on the most important question, have devoted your focus to bringing down inflation; and that has benefited the American people enormously.

Now, I have to point out that that inflation was caused by the Fed, also, a few years ago; and we ought to understand that and not repeat it. We wouldn't have had to go through the pain that grinding inflation out of the system has imposed on the American people if the Fed hadn't created that inflation in the first place.

But the Fed has realized it and has brought it under control, and that has enormously benefited the American people. So that is the main issue.

And this other—of course, to do that and to be able to maintain the independence that is necessary to do that, the Fed must conduct its other business in an exemplary fashion. I think you have done that.

I asked the Comptroller General, a little while ago, if he had any reason to believe that there was anything inappropriate going on over at the Fed. He said he didn't. And we have an inspector general—he may not have been in the room when I said I used to Chair the subcommittee that deals with the Fed. We used to tell the inspector general, we wanted to know anything, just the least thing—and I am still sure that that is the policy. We want to know the least thing that is wrong, everything, anything that possibly is inappropriate going on over there, we want to know about it and we want to stop it.

So I am not aware of there being any such thing. And I commend you for it. And I hope the focus—I hope we are able to put the focus on the key question and not some of this other stuff.

I thank you.

The CHAIRMAN. Mr. Knollenberg.

Mr. KNOLLENBERG. Thank you, Mr. Chairman.

I concur with my colleague who just commented on your effectiveness over those 80 years, with just the three examples, I think, that were given as to problems perhaps that were created for you.

You both have been very clear about your opposition to eliminating the exemption. In fact, of the two, I think, President McDonough, you are maybe a little more pronounced in saying that if we made the elimination, it would introduce the unmistakable potential for political influence—I am just reading your comments from the page—and every movement and nuance of the policy would then have to be examined. And, of course, you mentioned, Governor, that it would be contrary to the public interest.

My question, first for the Governor, would be: Could you provide a couple of specific examples of how a GAO audit would—of the FOMC—would negatively impact monetary policy, something that you seem to have had a pretty good handle on?

Just give me a couple of examples, if you would. And you can share those, if you will.

Mr. ANGELL. Yes. Mr. Congressman, the audit process cannot work well at all if you say, well, you can do this aspect of the open market operations and you can do this aspect of foreign exchange, and yet you can't do that aspect.

We understand that to do a full balance sheet audit requires additional information. The information that would be required would be information dealing with the process of policy formation and the carrying out of the policy and making certain that those that are doing the operations do it precisely as it was developed.

Our monetary policy process is really a strategy that we are developing. Macroeconomics and finance is always a changing study. We never get to the place where we have final answers in regard to how people in the financial marketplace will behave because expectations are involved.

Mr. KNOLLENBERG. It is a dynamic kind of thing.

Mr. ANGELL. It is a dynamic kind of thing.

So the policy process is one in which we are looking at strategies and the Federal Open Market Committee has developed these strategies. To have someone come in and audit that and say, well, are you accountable for that, and knowing precisely what your objective was and how it came out would, we believe, have a quieting, an inhibiting impact upon the policy process.

The Federal Open Market Committee is a very unique kind of engagement. It is one in which all participants understand that ideas are raised. Someone is willing to say at the table: Well, maybe this might happen, and raising such questions about what might happen may have—may not be the most probable event, but the reason we have 12 people involved as voting members is we want to make certain that every perspective is being heard.

The audit process from the GAO reporting directly to you rather than our reporting through the Humphrey-Hawkins hearings to you, in a sense, removes us from the full accountability and can have attention directed elsewhere. What is this going to look like in regard to some auditing procedure? We believe that the importance of policy considerations for this country and, indeed, for the entire world, goes so far that we need to be sure that the process continues to work as best it can.

Mr. KNOLLENBERG. Would you concur in that? Or do you have another idea?

Mr. MCDONOUGH. I do concur in it. And I think that the implementation of policy by the Open Market Desk, which perhaps, as you know, I used to run before I became president of the New York Fed, is so completely intertwined with the policy formulation that I don't think it is possible to divide the two.

What the desk manager is doing in consultation with others when he—now she—decides to enter the market on a certain day and do a certain thing fully reflects all the nuances and the discussions of the last FOMC meeting. The two are just as closely tied as you can imagine.

Mr. KNOLLENBERG. Gentlemen, thank you very kindly. I see my time has expired.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Hinchey.

Mr. HINCHEY. Thank you, Mr. Chairman.

Gentlemen, I think everyone would agree that there is great value in maintaining the independence of the Federal System. But, nevertheless, within that, within the context of that independence, there must also be accountability. I think that our chairman is attempting to establish a new balance between that independence and accountability through the introduction of the Federal Reserve System Accountability Act of 1993. And that is the focus of these hearings, to a large extent.

Now, in the context of that focus and of these hearings particularly, there has been some question about the availability of information and, indeed, the actual accumulation of information that occurs during the meetings of the FOMC.

And I think that some of the members of the committee have been concerned because there seems to be some discrepancies in the messages that we have been getting from various members over the course of the last—over the course of these hearings.

For example, Mr. McDonough, in your written statement that was submitted to the committee, you said as follows: I have no personal knowledge of any other notes or records that others may have made at FOMC meetings.

Now, we have learned that, of course, there are these recordings that are made. Each meeting is tape-recorded and there are also rough notes that are taken.

Now, when you said, I have no personal knowledge of any other notes or records that others may have made at FOMC meetings, what was the relationship between that statement and the fact that actual tape recordings are made?

Mr. McDONOUGH. Thank you, Congressman Hinchey. I am delighted that you asked that question because it gives me an opportunity to answer what was asked by the Chair earlier.

I did not attend, as you perhaps remember, the hearings on October 19 because I was asked by Chairman Greenspan to represent the Federal Reserve at a meeting in Moscow. My going permitted Governor LaWare to be here on the 19th.

When I submitted my written testimony, which I had written and actually finished on the morning of the 15th and dispatched it by fax to the committee, I was not aware at the time that the recordings were ever made or that these rough transcripts existed. Consequently, when I wrote the statement and sent it, it was a completely accurate statement.

In the course of the afternoon of October 15, I learned from Chairman Greenspan that the tapes and the rough transcripts existed. Since he said on that occasion that he was going to acquaint the committee at the meeting on the 19th with the existence of the tape and the rough transcripts, I decided that it was not necessary, as I was literally heading home in order to pack my bags to go to Moscow, to change the testimony—change the submission, because I knew that the record would be established in an accurate manner the following Tuesday.

Mr. HINCHEY. Well, I don't want to be too sharp about this, but I think it is an important question. And I think we ought to try to put it to rest for all time if we can.

Let me ask you this, Mr. McDonough: How long have you been in your present position with the Fed?

Mr. McDONOUGH. Three months.

Mr. HINCHEY. Three months. How many meetings have you attended?

Mr. McDONOUGH. As a member of the Federal Open Market Committee, I have attended two.

Mr. HINCHEY. Just two. Were you aware of that green light that apparently flashes on when the recording system is in operation?

Mr. McDONOUGH. I was aware of the green light. And part of my youth was spent as a naval officer, and I was the chief engineer of a ship. So I ought to ask the question of what is the light about, and I thought that the purpose of the light was to say that the sound system was working. I had no idea that it had any other significance.

Mr. HINCHEY. The sound system meaning the microphones at the various—

Mr. McDONOUGH. Yes. It is a big room, rather as you have here. Governor Angell and I, with our Midwestern and plains States tenors, are easily heard. Some others are not, so we have a system so that people can be heard around the table. That is what I thought it was.

Mr. HINCHEY. These kinds of questions arise for a number of reasons, not the least of which is the fact that Mr. Greenspan has indicated that, although at one point apparently he knew about the recordings when he made a statement that said that he wasn't aware of the recordings, he had forgotten of their existence; and we are trying to rationalize those two statements in the context of particularly of this ocular proof, if you will, that the system is actually working. And that has given rise to some concern about the information that we are receiving in the course of these hearings.

Now, under the Freedom of Information Act, is it your view that those transcripts are available?

Mr. McDONOUGH. Congressman Hinchey, I really don't know. I am not an attorney, and I don't claim sufficient expertise on the Freedom of Information Act. I really can't give a sensible, meaningful answer to your question.

Mr. HINCHEY. Who could answer that question for the FOMC? I think this is a question that you ought to be asking someone who could provide you with that kind of information.

Mr. McDONOUGH. I would assume the general counsel would be. He, being the senior attorney of the Federal Reserve System and of the Board of Governors, would be the appropriate person for the FOMC to ask.

Mr. HINCHEY. Would you be kind enough to instruct the attorney to provide us with the official view with regard to the Freedom of Information Act as it relates to the availability of these transcripts and rough notes?

Mr. McDONOUGH. May I pass that to Governor Angell?

Mr. ANGELL. Yes. The general counsel will be giving the advice. And I see no reason for the general counsel's advice not to be made available. So we will provide you with that information.

[Governor Angell subsequently supplied the following information:]

I am advised by counsel that the deliberative portions of the transcripts, which we believe represent most of each document, would be exempt from public disclosure under exemption 5 of the Freedom of Information Act. That exemption permits, but does not require, an agency to withhold from public disclosure material that reflects the process by which an agency arrives at its decisions or policies. The exemption is based on the belief that disclosure of these deliberative processes would inhibit frank and open discussion to the detriment of the quality of decisionmaking within the government. In this regard, in 1976, the U.S. District Court for the District of Columbia addressed the availability to the public under FOIA of the FOMC's Memoranda of Discussion, which were very detailed records of the discussion at FOMC meetings. In its March 9 opinion, the court ruled that the FOMC was only required

to disclose to the public under FOIA the reasonably segregable factual portions of the Memoranda. Thus, the deliberative portions of these materials were not released.

Mr. ANGELL. May I, however, refer back to what Alan Greenspan said when he said he forgot? He said he forgot about the transcripts. He never forgot about the recording. I mean the Chairman knew from the beginning about the recording, the tape recording going on. And then those are recorded over after the minutes have been completed.

He never forgot—he didn't say he forgot about those recordings, with that green light right in front of him. He just forgot about the fact that there was a rough transcript made up and from which the minutes were prepared. And that is what you see he was referring to.

Mr. HINCHEY. So he didn't forget about the fact that the recording was made, he just forgot about the purpose for which the recording was being made, forgot that the recording was being made in order to bring about transcripts?

Mr. ANGELL. You know, Congressman Hinchey, we at the Federal Reserve, do have sort of a single-minded purposefulness, as Congressman Neal suggested. We—the weight of being the world's reserve currency and doing it exactly right does dominate our thinking—

Mr. HINCHEY. I am sure.

Mr. ANGELL. And you get used to a green light. You get used to—I mean that is there. But certainly, I want you to know that I have never known anyone who is so scrupulous, in regard to what comes out of his mouth and its accuracy—and there are many of those around at Federal Reserve that feel that way.

And I want you to know that in my view, Chairman Greenspan is one of those world's most accurate people; and he would never, ever want someone to believe what wasn't the case.

Mr. HINCHEY. I have no difficulty in believing that whatsoever. In fact, that was my belief prior to this most recent experience. It is just that, in the existence of that belief, we have some evidence which seemed to be to the contrary. And what we are trying to do is to clear it up.

Mr. ANGELL. I understand.

The CHAIRMAN. Thank you, gentlemen, very much, for your time and your cooperation.

We have our third panel—

Mr. ANGELL. Mr. Chairman.

The CHAIRMAN. Yes, Governor.

Mr. ANGELL. I would like to also affirm something that you said. Mr. Chairman, we at the Federal Reserve have opportunities to appear on many occasions. And I agree, and I think everyone at the Federal Reserve that appears before you agrees, that this is a committee in which courteousness does prevail. And I want you to know how much we appreciate the atmosphere that you develop which enables us to be as forthright and forthcoming so that everyone in this Nation has confidence in all we do.

I wanted to give you a particular thanks from one person to another in regard to the courtesy that you provide to us.

The CHAIRMAN. Thank you.

Mr. McDONOUGH. Mr. Chairman, may we make that two persons to another.

The CHAIRMAN. Thank you.

Mr. NEAL. I had also written Chairman Greenspan on this transcript matter, and I got a response back from him which I would like to make a part of the record, if I may.

The CHAIRMAN. Without objection.

Mr. NEAL. Thank you.

The CHAIRMAN. Thank you very much, gentlemen. And thank you for your generous words.

Our third and final panel invited to discuss that part of H.R. 28 that authorizes a reform commission to study a number of topics.

The panel will focus on one of those topics, which is the desirability of further privatizing check clearing now handled by the Federal Reserve.

We have first, Mr. John P. Borden, president of the National Organization of Clearing Houses; Mr. J.D. Carreker, chairman of J.D. Carreker and Associates, Inc.; Mr. Howard P. Wentworth, senior vice president, Philadelphia National Bank; and Mr. James R. Lauffer, chairman, president, and CEO of the First National Bank of Herminie, Pennsylvania, and president of the Independent Bankers Association of America.

Gentlemen, thank you very much for your answering our invitation and taking the time to be with us. Unless there is some time constraint on some of the other panelists, is there any objection to my recognizing you in the order that I introduced you?

If not, Mr. Borden.

STATEMENT OF JOHN P. BORDEN, PRESIDENT, NATIONAL ORGANIZATION OF CLEARING HOUSES

Mr. BORDEN. Good morning, Mr. Chairman and members of the committee.

I am John Borden. I am president of the Greater Kansas City Clearing House Association in Kansas City, Missouri, and president and CEO of the Mid-America Payments Exchange. The Greater Kansas City Clearing House Association provides check-clearing services for approximately 100 financial institutions in the Kansas City area. The Mid-America Payments Exchange is the largest of the 29 automated clearing houses in the United States.

I am here today on behalf of the National Organization of Clearing Houses, which is called NOCH; and I serve as president of that organization.

NOCH was founded in 1989 to promote and support the important role of clearing houses in the U.S. payments system. In addition to serving financial institutions in Kansas City, NOCH's member clearing houses serve the regional check-clearing needs for financial institutions in Arizona, California, Connecticut, Illinois, New York State, Oregon, Pennsylvania, Puerto Rico, and Texas.

Our members also include the two national private check-clearing organizations. With this testimony, NOCH will provide its perspective on the role of the Federal Reserve System in providing check-clearing services. Our sole purpose here today is to promote the goal of a competitive check-clearing system.

I respectfully request, Mr. Chairman, that my written testimony be included in the record.

The CHAIRMAN. Certainly. Without objection.

And likewise, with each one of the witnesses that gave us written testimony.

Mr. BORDEN. Thank you, sir.

NOCH does not believe that it is necessary to establish a congressional commission charged with evaluating the fair market value of the Federal Reserve's check collection operations.

Instead, NOCH believes that Congress should focus its attention on achieving the goal of balanced competition as envisioned by the Monetary Control Act.

NOCH also believes that to pursue this goal properly, a combination of active congressional oversight, through existing means, and greater public involvement in the review of Federal Reserve payments system practices is both appropriate and necessary.

It is clear to NOCH that the current check collection environment does not reflect the intent of Congress as expressed in the Monetary Control Act. The Federal Reserve System accounts for roughly 50 percent of all check-clearing volume, whereas no single competitor of the Federal Reserve accounts for more than about 3 percent.

Complicating the private sector's ability to compete with the Fed, is its dual role as not only competitor but also as regulator. Nonetheless, NOCH believes that the goal of a competitively balanced market in check collection services is obtainable.

Given the unique role of the Federal Reserve System, it is no surprise that there is friction between the private sector and the Federal Reserve. This friction goes back to the establishment of the Fed in 1913 but really blossomed following the passage of the Monetary Control Act in 1980.

With the passage of this act, the Federal Reserve's check collection role changed fundamentally from serving member banks exclusively to that of serving the entire population of financial institutions seeking check services, and it involved competing directly with the private sector.

This change in competitive balance led Congress, largely through the General Accounting Office, to become actively involved in determining whether the act was resulting in the intended level playing field. I refer you to the GAO's May 1989 report to this committee and its counterpart in the Senate, which is titled: "Check Collection: Competitive Fairness is an Elusive Goal."

Since the release of that report, the Federal Reserve has taken some positive steps to address specific recommendations made by GAO. Specifically, the Federal Reserve has amended regulation CC mandating same-day settlement for checks without the imposition of fees.

Until these amendments, only the Federal Reserve could present checks to any depository institution in the United States and demand immediate payment without the payment of presentment fees.

While the Federal Reserve has taken specific steps to address the GAO's recommendations, the current environment strongly suggests that the Federal Reserve has neither thoroughly addressed

the competitive fairness issue, nor has it adequately enforced existing competitiveness policies in its approval of check collection services and prices.

If this posture is allowed to continue, the balancing of competitive opportunities that is promised by such actions as same-day settlement will be lost.

An example: The Federal Reserve recently implemented changes to its Payments System Risk Reduction Program, which included a change in the schedule by which check transactions are posted to a financial institution's reserve account. Because of this change, credits for checks cleared through the Federal Reserve are available to the collecting institution much earlier than was possible—or than is possible with checks collected privately. This is an important distinction since the Federal Reserve is preparing to price for "daylight overdrafts." Since the timing of proceeds of checks and all other payment transactions will be very important, it is imperative that we look at this particular matter.

The impact of this change represents a perfect example as to the Fed's dual role as regulator and payment services provider operating to the detriment of the private sector.

In this case we see that the Federal Reserve is seeing risks in the check collection process which we do not see is there for them; and in their attempt to reduce this risk, they have established a competitive advantage.

No one relying on the U.S. payment system stands to realize any benefit if one group, particularly the Federal Reserve, is perceived as dominant in a strictly one-sided game. Sooner or later in this situation, the private sector simply might decide to stay home.

Therefore, the perception that competition in the payment systems is one sided cannot be permitted to continue. The perception and indeed the reality must be that the competitive playing field is level and that the officiating is fair and just. In NOCH's view, that was the intent of the Monetary Control Act.

Public comment is already required by the Federal Reserve's own policies governing the approval of changes in fees and services that would have significant longer run effects on the Nation's payment system.

Frequently, however, changes to a price or a service by an individual Federal Reserve Bank have received Federal Reserve Board approval without the benefit of public comment. That is that the Federal Reserve's interpretation is that a particular change would have a very limited effect on local providers only. It is true that a particular price or service might, in one region, only have a limited impact on competition in that region with those local service providers.

However, subsequent adoption of that change in other Federal Reserve districts, on a national or multiregional basis, may undermine the competitive position of other service providers. Thus, we believe that all changes to Federal Reserve price services have the potential that might result in significant longer run effects on the Nation's payment system and, therefore, should be issued for public comment.

A good example of this is the controversial service, that was approved without the benefit of public comment, a relatively new

service known as "payer service group sort." This service is now in effect in over 11 Federal Reserve offices and relies on a completely different pricing mechanism than any other Federal Reserve check collection service.

I would like to add that not only does the Federal Reserve approve many controversial services without the benefit of advanced public comment but even when the comment seeks more information about the service and its approval process, the response from the Federal Reserve can be less than forthcoming.

For example, when NOCH filed a request for more information about the approval process for the payer group sort under the Freedom of Information Act, the information received was less than satisfactory.

Mr. Chairman, with your permission, I would like to submit for the record a copy of the Federal Reserve's document of approval for this service which was received in response to our request.

The CHAIRMAN. Without objection, it is so ordered, sir.

[The information referred to can be found in the appendix.]

Mr. BORDEN. Thank you. A quick review of this document would reveal that there is a substantial amount of information that has been deleted as "not for public consumption." I find it extremely difficult to understand how a simple and basic information request can result in a response where the Federal Reserve feels compelled to delete so much information.

The message here should be clear: All proposed changes to Federal Reserve prices and services should be issued for public comment. Providing the public with opportunity to review changes to Federal Reserve prices and services not only elevates the Federal Reserve Board above any reasonable suspicion of conferring competitive advantage upon the Federal Reserve System but also permits the private sector providers the opportunity to respond with potential effects that might be felt in the region or regions which they serve.

Public comment would greatly enhance the ability of the public and the Federal Reserve to fully review the competitive impact of those proposals.

However, numerous questions still continue to surround the Fed in its role, and market dominance in the post-Monetary Control Act environment strongly suggests that this role must be further evaluated by a knowledgeable, nonbiased third party.

Given the GAO's substantial involvement with this issue, NOCH would recommend to this committee that the GAO conduct a thorough reevaluation of the Federal Reserve's role in the payment system. Given changes in the competitive environment that have occurred since the May 1989 report, this would be particularly appropriate.

NOCH also believes that Congress should establish an ongoing process to measure progress toward the ultimate goal of achieving full competitive balance in check collection services.

We recommend that GAO follow up this comprehensive report I have just described with an annual progress report until such time as the Congress may conclude that the competitive environment has reached the stage envisioned by the Monetary Control Act.

Congress may, therefore, assure the public that continuous progress is being made toward this goal. To this end, NOCH offers whatever assistance is requested of it to support GAO's reporting initiative.

Mr. Chairman, on behalf of the National Organization of Clearing Houses, I appreciate this opportunity to share our views and would be happy to answer questions at the appropriate time.

[The prepared statement of Mr. Borden can be found in the appendix.]

The CHAIRMAN. Thank you very much, sir.

Those bells you heard and those two lights indicate we have a recorded vote. But if, Mr. Carreker, you could convey your testimony or message in, I would say, 5 to 7 minutes, we would still have time to go and record our vote and come back and pick up.

Mr. NEAL. Mr. Chairman, would you let me say one thing briefly before we go?

The CHAIRMAN. Yes, sir.

Mr. NEAL. A couple of sentences. I just want to say that I have worked—mostly my staff worked with Mr. Borden earlier on this problem, and I personally found it so complicated that I could not figure out who I thought was right. And I just want to commend you for your bill in this area, because I think you are on the right track. I don't personally think there is any reason why the private sector can't do this. I just don't know exactly how to do it. And I think you are exactly on the right track, and I appreciate your doing it.

The CHAIRMAN. Thank you. I know that you are chairman of the Monetary Subcommittee.

Mr. NEAL. Yes. But he contacted us because of our role there. The Fed has all—they have the power. You know, a guy—he can't deal with them. You know what I mean? And I couldn't.

So anyway, if we are going to get this done, I think something along the lines of your suggestion. Whether this is exactly the right thing, I don't know. Maybe we will learn. But you are certainly on the right track here. And it is a private sector sort of activity, it seems to me; so why not get the private sector to do it.

I thank you very much for letting me say that. I wanted to say that because I am not going to be able to come back. And I thank you very much.

The CHAIRMAN. I understand. Thank you very much.

I tell you what, Mr. Carreker. Why don't we see how you proceed. I am not going to place any limitation on you.

STATEMENT OF J.D. CARREKER, CHAIRMAN, J.D. CARREKER & ASSOCIATES, INC.

Mr. CARREKER. Thank you, Mr. Chairman and members of the committee.

I am Denny Carreker, chairman of J.D. Carreker & Associates. We are a management consulting firm. And for approximately the last 25 years or so, I have been working with the top 250 banks in the United States on matters related to the banking system, and check presentments most recently.

Our client base includes most of the country's top 100 banks, their regional clearing houses, and banking industry associations.

It has also included Federal Reserve Banks and the staff of the Federal Reserve Board of Governors.

It is in my capacity as executive director of ECCHO, the Electronic Check Clearing House Organization, that I have been invited to address the committee.

ECCHO is a nonprofit national organization dedicated to facilitating the private sector's implementation of electronic check presentment. As I will describe later, electronic check presentment is changing the payment systems in the United States and the relative roles of the private sector and the Federal Reserve.

ECCHO now has 58 members who account for more than 60 percent of the total domestic deposits for the largest banks—100 largest banks in the United States.

ECCHO has become the central focus for many of the important changes currently taking place in the Nation's payment system.

The committee has asked me to address two questions. First: Is it feasible to privatize the Federal Reserve's check-clearing functions? And, second: What is the fair market value of the Federal Reserve's check-clearing operation?

First, regarding feasibility, not only is gradual privatization of the Federal Reserve's check-clearing functions feasible and desirable, it is already occurring. It is ECCHO's belief that the Federal Reserve should encourage the prevailing privatization trend and the success of private sector initiatives.

Doing this would involve addressing a fundamental issue and that is the basic conflict of interest in the Federal Reserve's dual role as both regulator of and competitor in the check collection system. In this dual role, the Federal Reserve can unilaterally and without accountability undertake regulatory, service policy, and service pricing initiatives to maintain market share and recover costs in direct competition with the private sector.

There was a time when, thanks to nonpar banking, widespread unit banking, and manual check operations, and uncertain transportation that the Federal Reserve's operating role was necessary. That is not the case today.

Three main changes are contributing to the privatization trend. The first is consolidation of the banking industry; the second is the emergence of electronic check presentment; and the third is the increasing extent to which the payment information needs of banks' customers are directing the payment system.

Collectively, these three changes are changing the relationship between the Federal Reserve and its necessity to play an operating role. I would like to elaborate on each of these briefly.

First, consolidation. As banks consolidate, the nature of check-clearing volumes changes. Intra-bank checks increase while inter-bank checks, or transit checks, decrease. The Federal Reserve's check-clearing role is in transit checks. As a result, consolidation continues to diminish the Federal Reserve's check volumes and, correspondingly, the required role of the Federal Reserve in the check collection system.

The second change I referred to is electronic check presentment or ECP. The essence of electronic check presentment is that it captures the checks' information on the bottom of the check, the MICR [magnetic ink character recognition] data, and transmits that infor-

mation electronically, separating the physical handling requirements of checks from the transmission of the data that is needed to affect most of the payment operation.

It is important to note that the Federal Reserve's role with electronic check presentment will be changing. The private sector has already developed electronic check presentment software, written the rules and agreements designed to implement requirements, develop national standards and formats, definitions, and borne the expense and risk connected with all of these efforts. The private sector is adapting ECP service and delivering mechanisms to serve the thousands of small banks that cannot support their own check-clearing operations and helping these small banks reduce their check risks and the risks of their customers.

On the other hand, the Federal Reserve, while explicitly endorsing the concept of ECP is planning to invest in a different approach to ECP that will compete with the private sector's investment and has already complicated and delayed the private sector's development of electronic check presentment standards.

There is no reason for the Federal Reserve to duplicate the private sector's ECP efforts. Additionally, competitive ECP activity by the Federal Reserve at this juncture will unnecessarily complicate the work of the private sector, potentially introducing new systemic risk and delaying ECP's benefits for banks and their customers.

The third change I referred to is the greater customer responsiveness required of the payment system. During the decades that have led to this point in time that the Federal Reserve played its operating role, the check was pretty much a commodity. Pieces of paper were handed from one group to the next to the next.

With electronic check presentment and the future of the electronic check payment system that will be evolving in this country, it is important to understand the risk exposure of the various customers in the United States that utilize the payment system. The Federal Reserve does not have an awareness of these customer requirements, since it appropriately does not play a role in interfacing directly with corporations and consumers.

The second question I have been asked to address is the fair market value of the Federal Reserve check-clearing operations. The value of the operations are directly tied to the timing in which, and the scope of which, operations would be taken from the Federal Reserve. It is our belief that the operational transition from the predominantly Federal Reserve role to a private sector role should take place over a significant period of time and that the settlement functionality that the Federal Reserve is currently performing should continue to stay with the Federal Reserve.

ECCHO recommends that Congress establish a Payment System Advisory Board, comprised of payment system experts drawn from private sector, Federal Reserve staff and other parties as appropriate.

The Payment System Advisory Board would advise Congress or its agents on new Federal Reserve pricing initiatives, major Federal Reserve investments in check collection, changes in the scope of Federal Reserve services, and Reserve compliance with congressional mandates.

The Payment System Advisory Board would hold an annual meeting and provide Congress with an annual report on these issues. ECCHO believes that the General Accounting Office could play a useful role in this regard.

In summary, the committee's attention to this issue is particularly timely. It comes at a time when the private sector check-clearing banks are particularly well positioned to provide even better check-clearing services more cost-effectively than ever, with greater corporate and consumer value than ever and with even better service for small banks.

Congress can, with little or no impact on the quality or safety of the check collection system, encourage current private sector initiatives, the prevailing trend toward privatization of the check-clearing business and the gradual elimination of the Federal Reserve's conflict of interest.

To ensure the continuity and security of the payment system during this transition and beyond, Congress should form a Payment System Advisory Board consisting of Federal Reserve and private sector parties. ECCHO is pleased to offer its services in any way in the establishment of this Board.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

We will stand in recess until after the vote.

[The prepared statement of Mr. Carreker can be found in the appendix.]

[Recess].

The CHAIRMAN. Mr. Lauffer.

STATEMENT OF JAMES R. LAUFFER, CHAIRMAN, PRESIDENT, AND CEO, THE FIRST NATIONAL BANK OF HERMINIE; PRESIDENT, INDEPENDENT BANKERS OF AMERICA

Mr. LAUFFER. Yes, Mr. Chairman.

Jim Lauffer, chairman and president and CEO of the First National Bank of Herminie in Irwin, Pennsylvania. I am also president of the Independent Bankers Association of America.

We appreciate this opportunity to testify on your bill, the Federal Reserve Accountability Act of 1993. You have asked us to comment on that part of the bill which directs a new commission to study the benefits and efficiencies that would result from reducing or eliminating the Federal Reserve's role in check clearing. While my written statement discusses other issues, I will limit my oral remarks to what you have asked for on the commission.

IBAA believes that the legislation should call for a study that would, or could, ignore crucial factors that must go into consideration of whether the Federal Reserve should divest check-clearing services. It only requires the commission to take into account the economic benefits to be derived from and the efficiencies to be achieved as a result of the divestment. This would or could result in a biased study, since it does not clearly require the commission to consider any of the disadvantages of reducing or eliminating the Federal Reserve's check-clearing role.

The bill should require the commission to consider the indirect cost to the public if reasonably priced check clearing is no longer available to financial institutions serving small and rural commu-

nities; the adverse effects of these communities, if they lose access to prompt and efficient payment services; and the value of having the services retained by the Federal Reserve.

Individuals and small businesses throughout the Nation expect reasonably priced banking services: Checking accounts, interest-bearing checking accounts, and savings accounts. The availability of the Federal Reserve services gives community banks—collectively the largest private sector market for the Federal Reserve settlement and clearing services—access to affordable correspondent services designed to meet the needs of their customers in rural America.

For many community banks, particularly in the rural areas, the Federal Reserve is the only provider offering check-clearing services. The Federal Reserve ensures that all financial institutions, approximately 30,000, have universal access to its services.

In the last 3 to 4 years, several private entities have formed or expanded to provide national correspondent services, including check clearing. Although these services are available on a national basis, they are not universally available to all institutions.

In 1992, Huntington Bancshares and two nonbank partners formed the National Clearinghouse Association, a nationwide check-clearing network. Its membership requirements effectively exclude small institutions by establishing a \$200 million minimum capital level for their participants. That \$200 million would equate to about a \$2 billion asset-sized bank. And there are 10,000 banks in this country that are under \$150 million in assets and under \$15 million in capital. So effectively, in their system, they would be frozen out.

I would like to make a comment that is not in my statement concerning Huntington Bancshares. Lee Hoskins, who was president of the Federal Reserve Bank of Cleveland for a number of years, left about a year ago. Now I would suspect—we are in the Cleveland district, so I know Lee. And he went to Huntington Bancshares, and within months, came up with a decision to spend millions of dollars on this clearing house.

Now, I ask you, Mr. Chairman, a president of the Federal Reserve Bank of Cleveland for a number of years, if he thought that the Federal Reserve pricing system was too low and uncompetitive, why would he go to an institution and form something to compete against the Fed immediately? I would just like to add that to my comments.

The Visa Automated Clearing House has identified the top 100 ACH originators as its niche. Community banks need not apply.

The top 100 banks again. And there are 10,000, 11,000 banks in this country.

Electronic Check Clearing House Organization was formed in 1990 to provide private sector national electronic check presentment. The ECCHO membership includes many of the country's 50 largest banks. I think it was mentioned 58 is what they have.

Late last year, ECCHO added a new associate membership category to attract members that might not otherwise be available to afford regular membership. Unless it has recently changed, the annual cost of associate membership is \$10,000. This effectively excludes smaller banks.

These examples indicate that the private sector has neither the capacity to absorb the Federal Reserve's check volume, about 30 percent of the total—I heard 50, our figures show 30—nor the willingness to provide the services to all segments of the industry.

I have heard it said that you will do it through your correspondent bank. In most major banks, a lot of major banks have gotten out of the correspondent business. In fact, the Independent Bankers Association of America has helped establish 16 bankers' banks, including 1 in your State of Texas, to handle correspondent services because the big banks have gotten out of correspondent services. So unless there is a high-profit margin in check clearing, smaller banks are not going to have access to that service.

If the Federal Reserve abandons these services to the private sector, community banks would likely experience increased operating costs. In today's environment, community banks would have to pass these on to the consumers, or they would have to make less profit.

I think the commission should study that. In other words, if it costs me \$10,000 to get into the clearing house, that will be \$10,000 off my profit; that would be \$3,400, at a 34-percent tax rate, that the government would not receive, unless I pushed the cost on to my customers.

In addition to ensuring that all financial institutions have universal access to check-clearing services, the Federal Reserve is the catalyst for improvements in the payments system, including check-clearing operations.

Unlike any private sector provider, the Federal Reserve has responsibility for regulation and improvement of the payments system. The Expedited Funds Availability Act of 1987 strengthened this requirement. As a result, the Federal Reserve has a nationwide—number one, nationwide, two, long-term perspective, not just a short-term, regional or niche perspective as so many in the private sector do.

The IBAA understands that the Federal Reserve is strongly committed to remaining in the check-clearing business and improving the efficiency of the Nation's check-clearing system. The Federal Reserve's 7-year research and development effort in check image technology and the development of electronic check exchange service are prime examples. The Federal Reserve's leadership role in both of these areas prompted software and hardware vendors to develop systems much sooner than private sector markets would have. The Federal Reserve cannot continue to improve our payments system if it no longer offers services in that system.

Any study must factor in the benefits of the Federal Reserve's dual role as regulator and service provider committed to serve all financial institutions.

Some may contend that community bankers should not worry about this proposed study since, after all, it is just a study. We disagree. Studies, particularly biased studies, can lead to dangerous legislative proposals.

For example, section 1001 of the 1989 savings and loan legislation directed the Treasury to study the Federal deposit insurance system. That section focused on ways to cut back on deposit insurance to reduce loss to the government. It failed to require the

Treasury to study any benefits of keeping deposit insurance, in keeping it where it was.

The result was a Treasury recommendation that deposit insurance coverage be greatly curtailed.

Mr. Chairman, I know you favored those recommendations, and we strongly opposed them. But certainly we can agree that the battle over deposit insurance coverage that grew out of the Treasury study was hard fought and highly significant.

The fact that the 1989 law did not require the Treasury to consider any positive aspects of deposit insurance put a tremendous burden on those of us who opposed deposit insurance cutbacks. Because of that experience, we will continue to closely scrutinize proposals to "just study" topics of concern to community banks and fight to eliminate bias.

We ask, Mr. Chairman, at the least, on your appointment—the appointments to this commission—that there be members from rural America who have an understanding of how these changes in the payments system would impact their banks on main street and rural America.

We thank you for the opportunity to testify, and we would be glad to answer any questions.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Lauffer can be found in the appendix.]

Mr. Wentworth.

**STATEMENT OF HOWARD B. WENTWORTH, SENIOR VICE
PRESIDENT, PHILADELPHIA NATIONAL BANK**

Mr. WENTWORTH. Mr. Chairman and committee members, my name is Howard Wentworth, senior vice president with CoreStates Financial.

CoreStates Financial is a multibank, Philadelphia-based holding company with assets over \$23 billion. We are one of the Nation's largest correspondent banks and, as a result, are in direct competition with the Federal Reserve for priced services. We are also the Federal Reserve Bank of Philadelphia's largest customer.

I would like to thank the committee for the opportunity to comment on the issue of privatization of Federal Reserve price services.

As documented in the 1989 General Accounting Office report, "Check Collection: Competitive Fairness is an Elusive Goal," the Federal Reserve is engaged in almost \$800 million a year business of providing priced services, activities that the Federal Reserve provides for a fee, such as check collection, wire transfer, and so forth, in direct competition with banks and other service providers.

At the same time the Federal Reserve also regulates its competitors. The dual roles of regulator and service provider effectively stifle private sector competition for price services. Competition is curtailed in several ways.

The Federal Reserve enjoys legal advantages that no private sector provider can match. Among these are the ability to present to any paying bank as late as 2 p.m., the ability to compete on a national basis, and the ability to spread costs over a variety of products, including some products where the Federal Reserve enjoys a virtual monopoly position.

As the manager of the payment system, the Federal Reserve exercises its tactical rulemaking abilities, granted under regulation CC, in ways that frequently appear to have, as their primary motivation, improvement of the Federal Reserve's competitive position at the expense of the private sector providers. A recent example would be the establishment, by the Federal Reserve, of a 6:30 p.m. deadline for the settlement of same-day settlement presentments. The late deadline, which applies only to private sector presentments, compares to a deadline as early as 11 a.m. for Federal Reserve presentments. The early deadline reduces Federal Reserve risk, while the late deadline increases private sector risks and costs.

Although the time under which payment can be delayed may appear to be unimportant, the distinction could effectively negate the cost avoidance opportunities for some of the very banks that same-day settlement was supposed to benefit.

Finally, it is important to appreciate that banks view the Federal Reserve primarily as a regulator. As a result, banks frequently are reluctant to challenge Federal Reserve actions related to price services because of their concerns related to the Fed's regulatory role.

The net effect is that the dual powers that Congress has granted to the Federal Reserve sets up a governmental agency with unfair competitive advantages over the private sector. Although it is now seen as a cliché, it is nevertheless true that the FAA doesn't fly airplanes since it would place them in the conflicting roles of regulator and operator. This is a truth that the current Federal Reserve structure does not reflect.

Privatization of the Federal Reserve price services functions is the most effective way to resolve the actual and perceived conflicts of interest which the government has created in allowing the Federal Reserve to function in its dual roles.

Three approaches to privatization of the Federal Reserve's price services functions should be considered.

One, the Federal Reserve should sell their operating units on a regional basis to private sector providers.

Two, priced service activities could be spun off from the Federal Reserve on a local basis. The new charter would be to operate as a private company with profits to be paid to the Treasury. This approach would result in approximately 46 separate companies being created. Each new company would be subject to the same regulations as the private sector providers.

And, three, the Federal Reserve could return to its historic role as a processor of last resort providing those services that the private sector elects not to deliver.

Each of the three alternatives provides benefits and challenges. Additional work would be required to install any one or a combination of the above solutions. However, each would appear to successfully eliminate the conflict in the dual roles of the Federal Reserve without jeopardizing the safety and soundness of the payment system.

Thank you for your attention. I would be pleased to answer any questions.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Wentworth can be found in the appendix.]

The CHAIRMAN. Well, let's see now. Mr. Borden, if I understood correctly, you don't favor the creation of a congressional study committee?

Mr. BORDEN. Mr. Chairman, we feel that a committee approach or a GAO approach would both end up with going for the same goal.

It was our position that the GAO, having had some previous exposure and experience in looking at this question with the Fed, might have a headstart on that process.

The CHAIRMAN. Well, Mr. Lauffer, you heard the other testimony and also Mr. Borden's. As I interpret it, you are suggesting that private enterprise would not satisfactorily provide the check-clearing services, particularly, the smaller and either what you call community or rural.

But now the thrust of your presentation with respect to the study was not so much against the creation of a committee as to what the parameters should be prefixed for that committee to work within.

But I don't interpret yours to be in opposition to an inquiry or a study or the creation of the committee as such.

Am I correct?

Mr. LAUFFER. Well, as long as there were representatives on there that would take into consideration the rural banks.

You see, with the big clearing houses, volume is the name of the game. And they already stated—how much volume do you have now in the total market, 85 percent or something. It doesn't pay them to provide services to the smaller banks with that low volume. And that is why Fed has always been a good provider that we know is going to be there.

Correspondent banks, the issue is, OK, get it through your correspondent. A lot of correspondent banks have gone out of all kind of business. Like I said, we helped 16 bankers' banks around the country in 16 States because the correspondents said to the little banks, forget it, we don't need your business, there is not enough volume in it, whether it has been safekeeping or a number of things.

We have a bank in Pittsburgh that had a data center, that has, I forget how many participants, hundreds, maybe 1,000, that they were always going to be in that business and their correspondent banks joined. Well, they sold it 6 months ago.

And so you have the big banks always moving to where the profit is going to be the greatest, and that is fine. That is what they should be doing in a free enterprise system. But if we do something to take away the rural bank's only way of clearing, or they have to pay a correspondent or pay \$10,000 a year just to belong, because as I said in the statement, the Huntington one, they required \$200 million in capital; thereby, they are not interested in the 10,000 other banks. They are only interested in the top 100 that produce the volume.

That is just how it is going to come down, because that is how a profit margin is going to come down. Sure, they might provide them but at what cost to the individual banks? And what cost to

the consumers? Because it is just like the nationwide banking trend.

As they consolidate, you find them closing branches in rural areas because it doesn't pay them to have one that far—it is too far to move the material. Material can move electronically now, but the cost to a \$10 million bank or a \$30 million bank or a \$50 million bank would be unreal.

My other point that I think is a good point, if Lee Hoskins, who was president of Fed Cleveland for a number of years, thought that the Fed's pricing was noncompetitive in the market, why would you go to a large bank and form this to compete against the Fed?

I can't find a rational reason why that would happen. Because these other three gentlemen are saying that the Fed has a competitive edge, they have a competitive advantage. I mean here is a man who worked for Fed and then started one of the biggest deals that we have in the Nation right now.

Mr. WENTWORTH. Mr. Chairman—

The CHAIRMAN. Either he should have stuck to being the Fed president, or he knows something we don't know. And maybe perhaps we can have some comment from the respective witnesses.

Mr. Wentworth.

Mr. WENTWORTH. Yes. Thank you, sir.

As a point of clarification, CoreStates is not a member of the National Association of Clearing Houses; however, I am familiar with their operations.

I believe the record will indicate that the \$200 million requirement was established by the Federal Reserve as part of the negotiations that went on between Huntington Bank and the other partners in order to get the settlement facilities that were necessary for that organization's operation. So that limiting membership was never an objective of the organization. It was a requirement placed by the Fed.

Second, I think it is interesting that we have heard testimony about the withdrawal of correspondent banks from the marketplace or of major banks from the marketplace.

I think that is absolutely accurate. But the root cause of that withdrawal is the predatory pricing of the Federal Reserve as they move to try to offset the other elements that are happening simultaneously within the marketplace such as the consolidation of banks.

The statements that addressed the reduction in transit activity are exactly right. As transit volume declines, the Federal Reserve has moved to retain its market share by ratcheting down prices, as they have the ability to do that and have exercised their ability to do that.

The profit incentives that are left for banks has been eliminated so that there is a cause and effect here and an interrelationship between all of these activities.

Mr. CARREKER. I would like to make just two points. First, back when the Monetary Control Act came about, the Federal Reserve started losing volume significantly because it, for the first time, was having to price its services; and its volume levels were such that, since the check operations are very volume oriented, its cost of services were too high.

The Federal Reserve, taking advantage of its national delivery system and its ability to regulate implemented something called "noon presentment" which forced all banks across the United States to receive deposits from the Federal Reserve individually until 2 p.m. so it changed the entire structure across the country.

And then it put in place a national transportation system that made it possible for the Federal Reserve to intercept transit checks in remote national locations around the country and to funnel those into the Federal Reserve and out of the private sector.

As a result of that, a number of the clients that we work with that had spent millions of dollars building large correspondent bank operations found their volume going away to the Federal Reserve. As a result, their unit costs went up. As a result, when they started looking at their ability to compete with the Fed, they exited the business, resulting in the problem that Mr. Lauffer is referring to.

It is a perfect example of how the Federal Reserve has, in fact, used its regulatory authority to change the playing field and to compete in a way that disrupts the ability of the private sector to predict the return—reasonable return on investment that it can realize from its check operations. That is the first point I wanted to make.

The second point I wanted to make is that all of our discussions have focused on the check collection system in the United States as we thought of it historically. The check collection system in the United States is undergoing a change like it has not seen since the early sixties when MICR was invented.

Electronic check presentment and the advent of image technologies will position the United States to move forward in dramatically reducing fraud, which is growing exponentially, which will allow it to reduce the processing costs dramatically, which will allow it to compete much more effectively on a global basis around the world.

To do that, the private sector, who is aware of the opportunities to reduce costs, fraud, and deliver improved payment systems services to corporate America, has to take the leadership and make the investment necessary to move our payment system forward.

If the private sector constantly has fear that the Federal Reserve can come in and regulate a playing field that disrupts their ability to predict a return on that investment, they will withdraw. That has occurred in the past, and it will occur again in the future.

This is a crucial time for the private sector to take leadership, even the Fed acknowledged that; and that is why we feel it is so important that a connectivity between the private sector and the Fed, like never before, be established through this advisory board so that the Fed can't unilaterally move to try to optimize its cost recovery market share and those kinds of things.

This is not the time for that kind of behavior.

The CHAIRMAN. Mr. Borden.

Mr. BORDEN. Mr. Chairman, I would like to comment on a few things. And I think maybe an overall comment that while there are several proposals coming from this table, I think that the general spirit is in the same direction that there is something that needs to be addressed. That does not mean that we need to attack the

role of the Fed in providing services to the independent community banks. I don't think that is the intention at all.

I think that the root comment that we are looking at here is that if we have a competitive process that, as Mr. Carreker said, has that level playing field aspect, then you would find a lot of the competitive inequities that maybe are falling at the lap of the community banks removed.

And to take that further, I would like to go into the automated clearing house world where it is a little different than checks; but there you have an organization like VISA who is an operator of an ACH, just as the Fed is an operator of the ACH.

VISA, for years, has been working with the Fed to get a settlement agreement in place. When they finally did get the settlement agreement in place with the Fed, it was less than satisfactory. And it definitely favored, as Mr. Wentworth said, the larger organizations.

So we have the Fed, in effect, set a policy on the use of settlement in several examples—one, a check clearing house and the other an automated clearing house—that is biased toward the larger player.

And in that regard, I think that the IBAA comments are right on target. It is not that these organizations do not want to service the independent or smaller bank at all. It is because they are constrained in what they are dealt by the Fed as to how they can operate that business.

And I would go further to say that in my clearing house and in my ACH we have membership that goes down to the credit unions which open 1 day a week, and you can't get much smaller than that in terms of being a financial institution, so that we have all of these players that are in the same process together.

There are differences between the large ones and the small ones. The small ones cannot afford to have certain kinds of services and activities. They can't afford the capital to buy the equipment. But they have access throughout this process. And it is the access, I think, that we are worried about. And if we have a competitive, level playing field, the access will take care of itself.

Thank you.

The CHAIRMAN. Now, are you saying that Mr. Lauffer's point about the market for banking services and check clearing are not functioning well for small banks, but that is because of Fed policies.

Mr. Lauffer, what do you say about that?

Mr. LAUFFER. I would disagree with that. I contend that the Fed is the only national player across the Nation. If we were close to Kansas City and able to use Mr. Borden's clearing house, that would be one thing. But you have banks in Montana, Wyoming, and parts of Texas, as you well know, that aren't close to a regional situation. And I don't think—I mean I have to rest part of my case on the Huntington Bancshares and go back to what you said. The gentleman must know something more than we know of that because, why would you start a venture and invest millions of dollars and go after this big market if you didn't think that you had a competitive edge against the Federal Reserve from where you came?

It just, to my mind—and I have never asked Lee that question; but since it came up here today, that is a good question to ask. If there is no competitive advantage, I mean, why would you go out and become CEO and go into something that is so unique as this, and only few in the country, if you knew that the Federal Reserve is going to undercut you, you wouldn't make a profit?

You know, I rest with you saying somebody knows something we don't know.

The CHAIRMAN. Mr. Wentworth.

Mr. WENTWORTH. Sir, the National Clearing House Associates, which is the organization that Huntington is linked with, is a not-for-profit corporation. It is an association of banks who have come together without a profit motivation in order to reduce their clearing costs. The Huntington involvement is an element called Chexs, which is a for-profit company that provides settlement services exclusively for the members of the national clearing house.

So to make a comparison of the motivation that Huntington had vis-a-vis traditional correspondent check clearing house activities, I would categorize as being inaccurate. Huntington does not process checks, Huntington provides a settlement service, which is a net settlement service, through the books of the Cleveland Fed.

The CHAIRMAN. Yes, Mr. Carreker.

Mr. CARREKER. Mr. Chairman, relative to the comment that was made about making payment system services available through remote or rural banks. In Canada, the Federal Reserve equivalent there does not perform check operations. Instead, what it has is, in effect, a committee, if you will, that is an ongoing group where the banks that have met certain qualifications to play the role of intermediary bank come together with the policy regulatory authority, which is the Fed equivalent up there, and the Fed, in effect, interacts with those larger banks in Canada to ensure that the payment system is sound, safe, and cost effective.

The banks, then, implement the operations and carry those out, and while the largest banks are involved in that interaction with the Federal Reserve equivalent, there are many banks in more rural locations than we have here in the United States that are served in the Canadian model. Similar models exist in other industrialized countries.

So it is not a direct conclusion that a private sector approach under the regulation and authority of the Federal Reserve cannot deliver cost-effective services. It has in the past and it could do it in the future. There would be many issues that would have to be thought through and dealt with, but given the opportunity, that could be done.

Mr. LAUFFER. Mr. Chairman, I want to put something else in the record here one of my colleagues gave me. We have asked the Fed people a number of times about the \$200 million capital limitation, and they have denied saying that they ever set any capital limitation. I don't know who is right and who is wrong, but that is what they have told us.

The CHAIRMAN. Well, we intend to follow through and we will have another hearing at which time of course we would expect to have the Fed, and that is why it was important for us to hear from

you first so that we would be able to follow through and pinpoint some of these issues.

[The information referred to can be found in the appendix.]

The CHAIRMAN. But coming back, I am going to ask some of the other witnesses, Mr. Carreker and Mr. Wentworth, to respond to Mr. Lauffer's speculation about the venture of this former reserve president going into a business if the Fed is so preemptive in its dual role as regulator and competitor.

Mr. CARREKER. Well, there are many situations, I think, where over time, as various payment systems, innovations have come about where the Federal Reserve has been found to not be the cost-effective solution, and to not be the best price in town. And I think what the national clearing house organization has done is to identify a way for the private sector to come together and to create a structure between banks that is less costly than going through the Federal Reserve. That is innovative and that is a creative thing to do.

I think the point that I really want to drive home, because of the need for investment in the payment system today, is that the Federal Reserve can change the rules. They have done it in the past and they are not some black cloaked outfit out to do damage or anything like that, they simply have a conflict of interest. They are required to maintain a certain market share and a certain cost recovery if they are going to stay in operation, and so they tend to do the things necessary to accomplish that.

If you were an enterprising organization out to get a good return on investment for your investors, you would not invest in things when there was inordinate risk. And in the payment system of the United States, when the Federal Reserve can unilaterally change the rules, that deters investment. And that, to me, given the time period that we are in in this country, is a very, very serious and sad situation to be in. It needs to be dealt with.

The CHAIRMAN. Mr. Wentworth.

Mr. WENTWORTH. If I may, Mr. Chairman. I think representing correspondents in general, which is a mantle I am taking unto myself, our position would be that service enhancements and quality are assured as the result of competition, competition between the private sector and the Federal Reserve.

I think the numbers from our market, the third Federal Reserve district, perhaps are symbolic of the problem. The best numbers that we have is that the Federal Reserve enjoys about a 55 percent market share. We enjoy about a 35 percent market share, meaning that all of the rest of the banks in the districts split up about 10 percent between them.

Should CoreStates decide for profit motivation reasons to withdraw from this business, there will be no competition for price services in the third district, and I cannot imagine any elements of the banking industry that over time would benefit from that situation.

Mr. LAUFFER. Mr. Chairman, I am a little confused. I think I just heard you said that this was an enterprising thing going on and knowing that private enterprise, the private sector, could be more competitive than the Fed on pricing; and then I know I heard that the Fed has a competitive advantage on pricing. So I am not sure what that leads to.

On one hand we are saying here that the private sector can go out and do a better job and cut costs under Fed, and on the other hand, we are hearing everybody say the Fed has competitive advantage now. It cannot go both ways.

I am sure it could go both ways, or in different factors, in different facets of Fed's operation, but it cannot go both ways. You cannot say the private sector will do a better job and cut costs and the reason why you are going to let them do that is because they are going to be able to cut costs, but then on the other hand say we want to do this because the Fed has a competitive advantage.

The CHAIRMAN. It seems to me that the thrust of the statements with respect to the Fed's dual role or capacity, that is as a regulator over the same entities and banks, and also the provider of services was providing a backdrop in which competition could, at any time, be susceptible to elimination. That is what it seems to me.

I don't know what your opinion is as to this very basic argument for privatization or what is labeled here as an even playing field, competitive playing field. Is it your interpretation that the Federal Reserve Board does not indulge at times in a switch role, one from the other, in this clearing process?

Mr. LAUFFER. I am not sure I understand the question. I think you are saying or are you saying that they may have a competitive advantage in one area and they are subsidizing it from another area? Is that what you are—

The CHAIRMAN. Well, I was trying—I think the best thing to do is ask Mr. Carreker and Mr. Wentworth or Mr. Borden because they are from the private sector, to interpret what I was trying to poorly evaluate as the thrust of their main reason for an enhancement or encouragement of privatization based on a competitive and fair playing field. And that is that the Fed, as a prime regulator of banks, does not lose control of that power when it comes to the providing of check-clearing services.

But I think the best thing would be to clarify that by having Mr. Carreker, Mr. Wentworth, or Mr. Borden elaborate or extend a little more on what they have already stated.

Mr. WENTWORTH. Sir, the Monetary Control Act required the Federal Reserve to act as if it were a private sector provider, and to establish a kind of Chinese wall between its regulatory activities and its price services activities. Events have proven that the Chinese wall frequently appears to disappear when it is in the interest of price services volumes.

The Federal Reserve prices are based upon its ability to change payment rules to their exclusive advantage at the expense of all the other alternatives. We can cite a number of examples where the Federal Reserve has unilaterally made major changes in the payment system in conflict with their own pricing policies having to do with such things as competitive impact studies, where they have stated that they would not make a major change in a payment system that would have an adverse effect on the competitive environment without doing an extensive competitive impact study.

The fact is that these studies are frequently not done at all or done in ways which provide no benefit at all to the process.

I think Mr. Carreker said earlier it is not our intention to pass the image of the Federal Reserve as being ill-intended people. I believe that the basic policy that Congress has established which sets up this dual role has left them in an untenable position. You cannot be both a regulator and an operator, it just does not work.

The CHAIRMAN. Do you have any comment, Mr. Lauffer, in view of that explanation?

Mr. LAUFFER. I have a couple of comments. It has worked since 1912 or whatever it has been and, of course, the Constitution of this country has worked a lot longer than that.

But one point I want to make to Mr. Wentworth; how much of the market did you say you have in Philly or eastern Pennsylvania?

Mr. WENTWORTH. We have 35 percent of the market's share.

Mr. LAUFFER. And Fed has 50?

Mr. WENTWORTH. Fifty-five.

Mr. LAUFFER. I submit to you, Mr. Chairman, you take the Fed out of the business in the Philadelphia district and this one bank will have 85 percent of the market share.

Mr. WENTWORTH. And we are not recommending, sir, that that be the result. What we are simply asking for is to have the Federal Reserve operate on the same level playing field, if you will, as the rest of us.

Privatization does not translate into a monopoly of a single provider, which is the end result of the current practices of the Federal Reserve. Privatization gives the opportunity to have multiple players.

Mr. LAUFFER. Mr. Chairman, one other question or one other statement. The Canadian illustration, I think, is a very poor illustration in comparing our system to theirs. They have five or six large banks with branches all over Canada. Very few community banks. We are dealing with 10,000 banks in the United States.

So to compare that to the same system, you know, we get this thrown in our face as community bankers all the time. We do not need all you guys, England only has three banks, Canada only has four. Well, we are serving somebody out there or we would not be there, and all we want to make sure is that we do not get frozen out of the payment system or priced out of the payment system, so that we cannot afford the price, that it ups our cost and ups our cost to our customers.

That is what we want to do, we want to make sure the Commission is not biased; that they are looking at where our banks are and what we have to deal with and will these private sector providers provide us that service at a reasonable cost.

The CHAIRMAN. Yes, Mr. Carreker.

Mr. CARREKER. I just would not, I don't think anything should happen that would in any way place in jeopardy the small banks that serve the communities around the country, and I don't believe anybody here is suggesting that. I don't even believe that anybody on the panel is suggesting that the Federal Reserve be taken completely out of the payment system until such time as their operating role is conspicuously not necessary any more and other rationale has been put in place that makes it cost-effective.

So I don't think that is what we are dealing with. I think what we are dealing with is the fact the Federal Reserve does have a basic conflict of interest. There is a basic issue there that is deterring the ability of the U.S. payment system and the banks that make it up to move forward in a manner that is important for this country.

And I think that an advisory board or some group that can ensure that the initiatives between the Federal Reserve and the private sector are well dealt with in a very visible and open way, before the Fed has a unilateral opportunity to continue to operate in the dual role, is an important thing that needs to occur at this time.

Mr. LAUFFER. I would respond to that, Mr. Chairman, in saying that I don't have any problem with them being a regulatory body plus being in check clearing. In fact, I think there is an advantage there because the Fed's ultimate goal is to keep this country, the economy, and failures, and the whole thing on as even keel as it can. Taking the volume outside their system takes them out of that loop to know that there might be something that should be dealt with.

So I don't look to, and I don't think the community bankers look to that being a problem at the Fed. The Fed regulates them plus providing clearing or whatever services they do. It might be a problem for the big banks but I am not sure it is a problem for us.

The CHAIRMAN. I believe that the issue here is the wisdom or lack thereof of the creation of an evaluative or study commission. And we can conjure all kind of peers, but the basic premise is that this is an area that needs clarification as to policy, where the national policymaking body, the Congress, has a responsibility.

So unless any one of you gentlemen has an additional remark or question to raise, we will proceed on the basis that this has been a most effective presentation and that we are very much in your debt.

This is an issue that does agitate us on this committee. We do not want to do what has happened so often in the immediate past three decades where you have these burgeoning issues coming up and Congress apparently not aware or at least not confronting them. So we do, of course, intend to have the Federal Reserve and others testify on this particular section of this bill.

So thank you very much, gentlemen. You have been most patient. We have gone right through the lunch period.

And I am going to request, as is customary and as I have been asked, unanimous consent that all members, including myself, be provided the privilege of submitting written questions to you; questions that you should receive by the time you get a transcript of the proceedings of today's hearing.

There are so many things going on right now, including business on the House floor. But, more importantly, the quite unexpected visit of the President and his wife this morning and the consequent change in the schedule of the House and its business today, which accounts for so many members being out and a few of those that did come in only having to leave.

But everyone has a copy of your testimony and some will be submitting questions in writing as well as I. But thank you very much, gentlemen.

The committee will stand adjourned until further call of the Chair, which will be tomorrow at 10 o'clock in this hearing room.

[Whereupon, at 1:15 p.m., the hearing was adjourned, to be reconvened 10 a.m., October 28, 1993.]

APPENDIX

October 27, 1993

Opening Statement
Chairman Henry B. Gonzalez
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
October 27, 1993
Fourth Day of Hearings
on the Issues Involved in
the "Federal Reserve System Accountability Act of 1993"
HR 28

Today, the Banking Committee begins the fourth day of hearings on issues involved in HR 28, the "Federal Reserve System Accountability Act of 1993." I welcome Charles Bowsher, the Comptroller General of the General Accounting Office (GAO) and look forward to his testimony. He will tell us about the legal limitations the GAO faces in examining Federal Reserve operations.

In testimony during these hearings on October 13, 1993, Federal Reserve Chairman Alan Greenspan told us, "GAO, in the 1978 Act, could audit all aspects of the Federal Reserve System with the exclusion of those which refer to the question of the deliberations related to monetary policy." Was he trying to mislead us?

Let me tell you some areas of Federal Reserve operations that the GAO cannot investigate. Most people do not know that when the Federal Reserve changes the money supply, it does so from its New York Federal Reserve Bank in an auction separate from the U.S. Treasury auctions used to borrow money for government operations. Each morning around 10 a.m., the Federal Reserve Bank of New York holds a 30-minute auction with approved bank and non-bank dealers in order to change the monetary base of the United States. By buying or selling securities, usually very short-term repurchase agreements, the Fed takes money out of circulation or puts money back into circulation. There is little information on this auction. We know there is no market clearing price as was recently

introduced for Treasury auctions. Thus, accepted bids or offers are transacted at different prices. Is this the most efficient way to run this market? Why are the bids and offers not published? Is there any possibility of exploiting inside information, especially since participants can meet at the Federal Reserve Bank shortly before the auctions? Can the GAO send in a team of experts to uncover the answers?

The second example concerns the Federal Reserve's intervention in foreign currency markets. We know from the minutes of the 1962 FOMC meetings that the Federal Reserve gave itself a fund for intervention without adequately notifying the Congress or the public. That fund is now \$30.1 billion. The Treasury, on the other hand, has a fund similar to that of the FED, called the Exchange Stabilization Fund, but its budget is approved by the Congress.

According to a description published by the Federal Reserve Bank of New York in the 1970s, the Federal Reserve uses commercial banks to initiate some of the transactions involved. For example, an intervention by the Federal Reserve to sell German marks to increase the relative price of U.S. dollars includes the sale of marks to commercial banks, a request for a SWAP transaction to the Bundesbank, and a two-day settlement period. Can the GAO send in a team of experts to discern the propriety of these procedures?

I believe the answer to both situations is "No." Is it out-of-bounds for the American public to learn about these transactions? Again, this has nothing to do with FOMC deliberations or micro-management of daily Federal Reserve operations. The Fed just wants to keep the curtains closed and keep any outside eyes from reviewing how well -- or how bad-- its biggest policies are implemented. Who knows whether the Fed's engine needs a tune-up if no one will let the mechanic look under the hood?

Now let's discuss another grey area where the GAO would be appropriate. Earlier this year, I was informed that New York Federal Reserve Bank personnel were accepting hospitality at expensive restaurants and gifts from the very banks they have authority to regulate. On May 18, 1993, I received this astounding reply from E. Gerald Corrigan, former president of the New York Federal Reserve Bank:

"Our review indicates that in the limited number of instances where Bank officers have been guests at meals hosted by regulated institutions at what would be considered an expensive restaurant, they have been acting within Bank Guidelines and their conduct does not call into question the ethical standards of the Federal Reserve Bank of New York."

That surely says something about the ethical standards of the New York Federal Reserve Banks because such gifts would be illegal for government agencies using appropriated funds. President Corrigan also rationalized the acceptance of tickets for sporting events from regulated banking institutions when he said:

"There were a literal handful of instances involving attendance at sporting events in which bank officers were guests of acquaintances who work at regulated institutions."

But with no outside review, we don't know how many cases there were. Maybe this is like the "rough notes" of FOMC meetings that turned out to be tape recordings and transcripts.

The question I have for the Comptroller General is whether the GAO can investigate the receipt of hospitality from regulated banks by Federal Reserve employees if the employees say, "We were discussing monetary policy during our free meals provided by the XYZ bank in an expensive restaurant"? As I understand it, in this case, the Federal Reserve must give its permission for any GAO examination. Doesn't the public have the right to monitor possible conflict of interest situations?

Finally, the reason GAO has such limitations is because the Fed conducted an elaborate campaign to prohibit any audit bill from passing and succeeded for many years. In fact, it was not even approved by the Banking Committee but by another committee, in 1978.

I am happy to have the Comptroller General here today to discuss the GAO limitations in examining the Federal Reserve. Mr. Bowsher, please introduce your associates who will assist you in your testimony, for the record, and then proceed.

**Statement for Second Panel
Chairman Henry B. Gonzalez
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Fourth Day of Hearings
October 27, 1993
on the Issues Involved in
the "Federal Reserve System Accountability Act of 1993"
HR 28**

I want to welcome William J. McDonough, Vice Chairman of the Federal Open Market Committee (FOMC) and President of the Federal Reserve Bank of New York, and Governor Wayne D. Angell of the Federal Reserve Board. I would like to hear your views on the GAO audit limitations and to know if you think they are justified.

Before turning to that, I have a very serious matter to address. As you know, in my bill, the Federal Reserve System Accountability Act of 1993, HR 28, there are provisions that require the release of any policy change within a week and a videotape of FOMC discussions within 60 days. You both know that I inquired of all the Federal Reserve Bank presidents and the governors in my letter of October 22, 1992 about minutes of FOMC meetings. Chairman Greenspan wrote the following to me on December 24, 1992:

"...Members felt that making a tape or literal transcript public would have an especially restrictive effect in discussions..."

For the hearing last week on October 19, 1993, I asked each Federal Reserve official to include in his or her testimony, any knowledge of notes or records made by others at FOMC meetings. Vice Chairman McDonough, although you did not appear, you submitted testimony as follows:

"I have no personal knowledge of any other notes or records that others may have made at FOMC meetings ..."

Yesterday, I received a letter from Chairman Greenspan saying that there have been tape recordings made at FOMC meetings since 1976, that the FOMC has unedited transcripts, and staff notes from transcripts exist back to 1983. In addition, the meeting room for the FOMC has a complete setup for tape recording including:

"A green light on top of the meeting table near its head is lit when the recording system is in use."

How could anyone not know what that green light meant and fail to tell the Congress or report that there were no literal transcriptions?

I also must say I have some trouble with Chairman Greenspan's statements that he knew about the taping when he first assumed office and he also knew about unedited transcripts, but just forgot.

"Indeed, until a staff member jogged my memory in the last few days, I had been under the impression that I first learned only about a year ago that transcripts were being retained."

If I were sitting in front of a green light lit up every time I talked, I think I would have been a little bit more inquisitive about what was going on. It would jog my memory. I hope they didn't think that when the green light went on it meant "raise interest rates."

Now that we know that Chairman Greenspan initiated a conference call and informed the governors and presidents about the tape recordings, why did they give the testimony we received last week on October 19?

I want to thank Governor Angell for testifying that he knew about the transcripts several years ago. However, if that is the case, why did you join in the misleading reply sent to me from Chairman Greenspan on October 26, 1993?

This is a time in our nation's history when the public demands accountability from its government officials. There are many citizens who are losing their trust in government. The less than truthful response to my requests by the senior officials of the Federal Reserve about minutes and their testimony last week raises serious questions. Why all the discrepancies? We held these hearings to encourage greater accountability of the Federal Reserve. The outrageous deception of the last few days shows precisely why greater accountability is needed.

Now, as for the GAO audit, I can paint no better case for a GAO audit than the outcome of the inquiry I made on the acceptance of hospitality and gifts by the Federal Reserve of New York Bank officials from the very banks they regulate. Evidently, from the opening statement that you sent us, President McDonough, this practice has not ended. You have yet to establish what you call a "paper trail." This is not an adequate response when such hospitality is illegal for other government employees. I expect you to stop these practices and to establish an arms-length relationship with those you regulate just as other regulators have always done. Nothing less will satisfy me or the American public.

STATEMENT OF CONGRESSMAN JAMES A. LEACH
COMMITTEE ON BANKING, FINANCE & URBAN AFFAIRS
October 27, 1993

Mr. Chairman, as you know, I have previously stated my support for relatively modest reforms to remove certain indefensibly undemocratic elements of the Federal Reserve System. I am also sympathetic to a greater degree of accountability for Fed decision making which might include a somewhat more timely release of FOMC policy directives. However, I have reservations about the potentially more draconian action of expanding GAO investigation, some call it audit, authority to the monetary policy functions of the Federal Reserve.

In this regard, lest there be any misunderstanding, it should be noted that in the government the term audit has two distinct meanings. The GAO conducts financial audits -- so-called dollars and cents audits of balance sheets; and performance audits -- or reviews of programs and the implementation of laws. Performance audits are akin to audits of the decision making process.

The issue of GAO audit or review of the Federal Reserve's conduct of monetary policy is not an issue of first impression. Indeed, beginning in the early 1950's the more general issue of GAO audit of the Federal Reserve, including the monetary policy function, was widely debated on Capitol Hill. The eventual outcome of this 25-year debate was passage of the Federal Banking Agency Audit Act in 1978. That act, for the first time, authorized the GAO to conduct both financial and performance audits of the Federal Reserve, exclusive of the monetary policy function. The monetary policy function was excluded from the purview of GAO review at that time in recognition of the special political vulnerability of a central bank because of the opposition that may be generated, particularly when it imposes monetary restraint.

The Congress concluded in 1978 that Congress had a host of very adequate techniques at its disposal, including statutory requirements for semi-annual reports to relevant committees by the Chairman of the Federal Reserve Board, to assess Federal Reserve monetary policy. In this context, it was further concluded, I believe wisely, that frequent congressionally directed performance audits would lead to a greater politicization of the Federal Reserve System and ill-serve the country's economic best interests.

There was also, and I believe still is, an awareness of the extreme sensitivity of the confidential nature of the information provided by foreign central banks and governments -- information critically needed in the formulation and implementation of

monetary policy. It is not unreasonable to assume that public knowledge that an arm of Congress, the GAO, had review powers and access to such information would have a chilling effect on the Fed's relationships with foreign governments and central banks. Indeed, two years ago when this Committee subpoenaed all records held by the Federal Reserve relating to the BCCI scandal, an action I supported, this issue was raised, albeit in the context of bank supervision. In that case, the covered records included confidential documents supplied to the Federal Reserve by the Bank of England. The Bank of England was prohibited by British law from releasing those documents to its own Parliament and indicated that if the Fed were compelled to produce them pursuant to this Committee's subpoena, it would decline to share such information with the Fed in the future.

The formulation of monetary policy is a decision making process that involves confidential interchanges with a host of foreign governments and central banks. Just as information sources are not infrequently protected for reasons of political security in certain foreign policy agencies of our government, an analogously compelling argument exists that in a world of economic competition and friction certain financial and economic information provided to the Federal Reserve should be protected for reasons of national economic security. It is conceivable that even the hint of a possibility of the release of such information could jeopardize existing relationships between foreign monetary authorities, the Federal Reserve and the United States Treasury, thus aggravating our nation's international finance relationships. Confidentiality may be the best protection for national economic security, and the best protection for taxpayers who would bear the brunt of any losses resulting from the compromise of policies caused by untimely disclosure.

Indeed, in a financial world in which huge sums of money are now, in effect, being wagered everyday in currency markets, Congress would be opening itself up to the potential of economic espionage against itself by American as well as foreign nationals if an institution aligned to Congress had timely access to market sensitive information. The relevant question is need to know on a long-term policy basis, not micro-information gathering of a nature not immediately relevant to the legislative process. Here, the analogy is to the Chairman of the Joint Chiefs of Staff. He or she needs to know that an adequate second strike deterrent is at sea. He or she doesn't need to know the precise location of all our submarines at any point in time. That knowledge is very narrowly delegated within the Armed Services. Likewise,

Congress needs to know policy direction; we don't need to know all market sensitive information.

In the end, the Congress has no choice but to say that the Fed must, and indeed is, being audited in a balance sheet way, and that the Fed must be, and indeed is, subject to performance reviews of its implementation of bank supervisory policies. But there is a compelling argument for confidentiality in the conduct of monetary policy. That confidentiality is central to the continued integrity of our central bank and its capacity to exercise independent judgment free from external pressures. It is also central to helping ensure that government resources are not needlessly at risk to insider speculation.

As Arthur Burns said in his valedictory speech before the National Press Club (January 30, 1978): "...substantial independence in exercising power over money creation is not something that Federal Reserve officials have arrogated unto themselves, nor is it something that others have conferred because of a belief that central bankers have unique insight that sets them apart from other people. Rather, the ability of the Federal Reserve to act with some independence from the Executive Branch, and also with immunity from transient Congressional pressures, was deliberately established and has been deliberately maintained by the Congress in the interest of protecting the integrity of our money."

In conclusion, I would like to re-emphasize that the fundamental question in the issue of GAO auditing of the Federal Reserve's monetary policy function involves an understanding or misunderstanding of the word "audit." Unfortunately, the word "audit" carries connotations that are misleading. The common usage of the term in everyday life is an accounting of the income and out-flow of dollars. In this sense, there is already a 100 percent audit of the Federal Reserve. But what we are talking about here is fundamentally a review of the information and decision-making process which raises implications more of data sources and timeliness than it does of dollars and cents. As this Committee well understands, the Federal Reserve makes a profit every year (over \$16 billion in 1992) that goes to the Treasury. To the degree that market sensitive information is released in an untimely manner that profit is jeopardized. The greater protection provided the Federal Reserve System, the better off the taxpayer.

Thank you.

United States General Accounting Office

GAO

Testimony

Before the Committee on Banking, Finance and Urban Affairs
House of Representatives

Release on Delivery
Expected at
10:00 a.m. EDT
Wednesday
October 27, 1993

**FEDERAL RESERVE
SYSTEM AUDITS**

Restrictions on GAO's Access

Statement of Charles A. Bowsher
Comptroller General of the United States



GAO/T-GGD-94-44

Mr. Chairman and Members of the Committee:

We are pleased to be here to discuss the limits of our audit authority over the Federal Reserve System. My remarks principally will concern the provisions of section 3 of H.R. 28 which would remove all restrictions on our authority to examine Federal Reserve activities. Currently, we lack audit authority over the Federal Reserve's monetary policy, foreign transactions, and Federal Open Market Committee (FOMC) operations.

In responding to the Committee's request, I will first describe our existing authority and some of the work we have done under this authority. I will then examine the implications of removing all restrictions on our authority, with specific reference to several topics the Committee asked us to address. Finally, I will discuss certain safeguards that we feel would be appropriate to adopt if restrictions on our authority are to be removed.

The question of whether to lift the statutory constraints on our authority to audit the Federal Reserve System ultimately depends on what Congress wants us to do. Our access needs to be commensurate with the types of audits Congress expects us to perform.

GAO AUTHORITY UNDER THE BANKING AGENCY AUDIT ACT AND WORK AT THE
FEDERAL RESERVE

We derive our Federal Reserve audit authority from the Federal Banking Agency Audit Act of 1978. This act was passed after we did a special congressionally mandated study of the supervisory activities of all of the federal bank regulatory agencies. Before the act, our work at the Federal Reserve was mainly limited to audits of the fiscal agent functions performed by Federal Reserve banks for the Department of the Treasury. We did this work under our authority to audit the Treasury.

Although the act significantly expanded our access to the Federal Reserve System and the other bank regulatory agencies, it precluded us from auditing activities related to monetary policy, foreign transactions, and the FOMC. The exact wording of the limitation is set out in Appendix 1. The act also prohibited us from disclosing certain information identifying open financial institutions and customers. Appendix 2 describes these prohibitions in greater detail.

The act does not require us to perform any particular type of audit. This means, as is true with most of our work, that our audits are determined largely by specific congressional requests, or by our discretion under our basic legislative authority. As

appropriate, we coordinate our activities with the Federal Reserve's Office of Inspector General.

Notwithstanding the limitations on our authority, in the 15 years since the act was passed, we have audited many aspects of the Federal Reserve System in areas in which our access has not been restricted. I would like to mention some of the studies we have done in a few key areas:

-- Bank supervision and regulation. Much of our work in this area has included the Federal Reserve along with the other federal bank regulators. For example, our analysis of bank failures and supervisory efforts to deal with problem banks led to our recommendations that legislative efforts were needed to require prompt corrective action and other regulatory reforms. More recently, our work on examinations of banks and bank holding companies has underscored the need for the Federal Reserve and other regulators to strengthen their efforts to assess the quality of the management systems banks use to monitor and control risk. We have also studied how risk-based capital standards have been implemented in different countries around the world. Work that is unique to the Federal Reserve has included studies documenting the scope of the activities of the securities subsidiaries of bank holding companies that are supervised by the Federal Reserve under section 20 of the Glass-Steagall act. In a recent

study, we pointed out that the Federal Reserve had not yet implemented the mandate in the Foreign Bank Supervision Enforcement Act of 1991 to charge for its examinations of foreign banks operating in the United States.

-- Payment system activities. We have conducted several studies of Federal Reserve pricing of payments services under the Monetary Control Act of 1980. Our recommendations have, I believe, increased the Federal Reserve's awareness of how it competes with private sector banks in providing these services. We have also evaluated the implementation of the legislation on accelerated collection of checks and have made recommendations on ways to improve security procedures in Fed wire transactions.

-- Government securities activities. Work we have done on the government securities market has, I believe, contributed to greater openness in the primary dealer system, particularly concerning the disclosure of price information. Our audits have also contributed to pending legislation that would help protect customers and maintain the integrity of this very important market.

Our current work that involves the Federal Reserve, either exclusively or as part of a study of all bank regulatory agencies, includes (1) studies of regulatory burden, (2)

implementation of major provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991, (3) analysis of the risks and benefits of interstate banking, (4) the regulation and supervision of derivative products, (5) an analysis of the banking industry's activities in mutual funds, (6) loan loss reserving by banks, (7) review of efforts to ensure a safe and sound international banking system through coordination among national regulators, and (8) analyses of the expenses and revenues of the Federal Reserve System as they affect the federal budget.

IMPLICATIONS OF H.R. 28

As I have indicated, section 3 of H.R. 28 would remove all of the restrictions on our authority to examine Federal Reserve activities. This would provide us with full access to FOMC transactions; to transactions for or with foreign central banks, governments, and international financing organizations; and to deliberations, decisions, and actions on monetary policy matters, including discount window operations, member bank reserves, and open market operations.

In considering the implications of removing restrictions, it is useful to look more closely at the types of work we do. Our audit work can be viewed as falling into two broad categories-- financial audits and performance audits. A financial audit

basically sets out to verify the financial reports of an entity, including its balance sheet, income statement, and cash flows. Our financial audits also assess the systems of internal controls established by the audited institution and the institution's compliance with specific financial requirements. Performance audits are designed to assess whether an entity is achieving its stated goals, and include questions of efficiency, effectiveness, and compliance with related laws and regulations. Appendix 3 describes these types of audits in more detail.

Turning first to financial audits, the nature and volume of transactions associated with the day-to-day operations of the Federal Reserve System make financial auditing extremely important. For example, in providing services to the banking system in 1992, the Federal Reserve processed

- 20 billion checks with a value of \$14 trillion;
- 20 billion pieces of currency with a value of \$278 billion;
- 68 million electronic fund transfers for \$199 trillion; and
- 76 million issuances, redemptions, and exchanges of U.S. government securities with a value of \$143 trillion.

In 1992, the FOMC also purchased, sold, or exchanged approximately \$350 billion of securities, engaged in over \$750 billion in repurchase agreements, and conducted almost \$3 trillion in matched transactions.¹ All told, about 90 percent of the \$368 billion in assets on the combined balance sheet of the Federal Reserve banks consist of assets acquired as a result of FOMC or foreign exchange operations.² Passage of H.R. 28 would allow us access to the full range of Federal Reserve System transactions.

The nature and extent of auditing that presently takes place within the Federal Reserve System is a factor that Congress may want to consider in deciding whether to expand our authority. The Board of Governors examines the 12 reserve banks and the FOMC annually. Such examinations, which involve both financial statement audits and compliance reviews that concentrate on financial controls, are conducted by the Division of Federal Reserve Bank Operations. The Board's financial examination

¹Repurchase agreements essentially are transactions by which the Federal Reserve buys or sells securities for specified periods of time, typically overnight or short terms. The agreements are used by the FOMC to adjust the level of reserves in the banking system. According to Federal Reserve officials, in matched transactions the Federal Reserve essentially executes transactions that have no net effects on bank reserves or the balance sheet of the FOMC. Matched transactions are conducted principally with foreign central banks.

²The assets, with amounts as of December 31, 1992, in billions of dollars shown in parentheses, are as follows: U.S. Treasury securities (\$302), federal agency obligations (\$6), and assets denominated in foreign currencies (\$22).

program involves a full-time staff of about 22 people at an annual cost of approximately \$2 million. Each Federal Reserve bank also has an internal audit department, which--in the case of the New York Federal Reserve Bank--includes examination of the activities of the FOMC.

The Board's financial examination program has been subject to some outside scrutiny by public accounting firms. Each year, the Board contracts with an outside accounting firm to review the examination program's operations. In the last letter the Board received, the outside accounting firm said that the financial examination program was effectively meeting its objectives and made some suggestions for improvement.³

The Federal Reserve's Office of Inspector General, which has an annual budget of about \$3 million, is authorized to conduct its own financial and performance audits, although the Inspector General has indicated to Congress that there are some limitations on the office's ability to gain independent access to the reserve banks. The Inspector General has just completed a report on the Board's financial examination program. This report raises some fundamental questions about the comparability of the financial examination program to an outside audit that is geared toward

³Letter to the Federal Reserve Board dated December 27, 1991, from Coopers & Lybrand.

certification of financial statements.⁴ The report also contains recommendations for improving the financial examination program.

For some time, the financial statements of the Board of Governors itself have been audited by an outside public accounting firm. For 1993, the Board also contracted with independent accounting firms for audits at the Kansas City and Cleveland Federal Reserve Banks. As a part of this latter experiment with engaging outside auditors, the firms were asked to comment on those aspects of the Board's financial examination program concerned with both audit of financial statements and of compliance with board policies and controls. We understand that the reports from the outside auditors for 1993 have just recently been presented to the Board.

According to Federal Reserve officials, in the Kansas City and Cleveland Reserve Bank audits, some access issues were negotiated with the accounting firms. Although these audits did not involve a full-scale audit of the System Open Market Account or foreign accounts, we understand that the auditors required some testing of the systems in these areas to determine if the allocations of assets to the particular reserve banks were appropriate.

⁴Office of the Inspector General, Board of Governors of the Federal Reserve System, Report on the Audit of the Board's Financial Examination Program, September 30, 1993.

Section 3 of H.R. 28 proposes that all Federal Reserve banks, as well as the Board of Governors, be audited annually by an independent public accounting firm. I am inclined to believe that this outside review would be beneficial for both the Federal Reserve and the general public. If the restrictions on our access were removed, we would be better able to assess the quality of financial controls and auditing in the Federal Reserve System and make recommendations for improvements.

Concerning performance audits, I would like to discuss access issues by referring to the three areas we were asked to address in our testimony. These issues are

- the daily government securities auctions at the New York Federal Reserve Bank, which the Federal Reserve uses to manage the money supply;
- the Federal Reserve's interventions in foreign currency markets; and
- safeguards in the auctions, and presumably foreign currency transactions as well, against the Federal Reserve's releasing inside information.

Our access restrictions would be a major limitation to studying any of these issues in a way that required us to analyze data on

actual transactions. Although it would be necessary for us to consider the actual scope of a request before reaching a judgement in any particular case, we must recognize that the restrictions in the law are quite explicit. Therefore, with performance audits, as with financial audits, the major question is really what Congress wants us to do.

SAFEGUARDS

If Congress decides to remove the existing restrictions on our audit authority, we believe certain safeguards should be included in the legislation. These safeguards, which are similar to those that already exist under our present authority, should

- (1) prohibit us from disclosing the identity of foreign central banks or governments;
- (2) prohibit us from disclosing confidential documents and require safekeeping of confidential information; and
- (3) specify delays in our access to certain types of confidential information.

These safeguards are important because they make clear that removing our audit restrictions will not necessarily jeopardize the Federal Reserve's independence. For example, with these

safeguards we could not use our expanded authority to undertake contemporaneous reviews of the Federal Reserve's monetary policy decisionmaking functions. Also, immediate disclosure of information about Federal Reserve decisions in a situation such as the stock market break of October, 1987, might not be in the public interest because it could disrupt the financial markets. Our role should be to make after-the-fact assessments of the Federal Reserve's performance, both in general and in problem situations.

SUMMARY

In summary, we have been able to do significant audits of the Federal Reserve, despite the existing limitations of our authority. Congress obviously must decide whether our audit authority should be expanded. However, if our authority is expanded, we believe measures should be included to protect against release of confidential documents and to prevent undue interference with the Federal Reserve's ongoing policymaking functions.

This concludes my prepared statement. My colleagues and I would be pleased to answer questions.

Restrictions on GAO Audits Contained in the Federal Banking
Agency Audit Act⁵

Audits of the Federal Reserve Board and Federal Reserve banks may not include

- (1) transactions for or with a foreign central bank, government of a foreign country, or nonprivate international financing organization;
- (2) deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market operations;
- (3) transactions made under the direction of the Federal Open Market Committee; or
- (4) a part of a discussion or communication among or between members of the Board of Governors and officers and employees of the Federal Reserve System related to items (1), (2), or (3).

⁵31 U.S.C. section 714(b). This section codifies a portion of section 2 of Public Law 95-320, July 21, 1978, which amended section 117 of the Accounting and Auditing Act of 1950.

Provisions in the Federal Banking Agency Audit Act Concerning Disclosure of Information and Safekeeping of Records⁶

Except as provided in this subsection, an officer or employee of the General Accounting Office may not disclose information identifying an open bank, an open bank holding company, or a customer of an open or closed bank or bank holding company. The Comptroller General may disclose information related to the affairs of a closed bank or closed bank holding company identifying a customer of the closed bank or closed bank holding company only if the Comptroller General believes the customer had a controlling influence in the management of the closed bank or closed bank holding company or was related to or affiliated with a person or group having a controlling influence.

Except for the temporary removal of work papers of the Comptroller General that do not identify a customer of an open or closed bank or bank holding company, an open bank, or an open bank holding company, all work papers of the Comptroller General and records and property of or used by an agency that the Comptroller General possesses during an audit, shall remain in the agency. The Comptroller General shall prevent unauthorized access to records or property.

⁶Excerpts from 31 U.S.C. section 714 (c), (d).

Types of GAO Audits⁷FINANCIAL AUDITS

Financial statement audits determine (a) whether the financial statements of an audited entity present fairly the financial position, results of operations, and cash flow or changes in financial position in accordance with generally accepted accounting principles; (b) whether the entity has complied with laws and regulations for those transactions and events that may have a material effect on the financial statements, and (c) whether the internal controls were effective and met standards.

Other financial audits include determining (a) whether financial reports and related items, such as elements, accounts, or funds are fairly presented, (b) whether financial information is presented in accordance with established or stated criteria, and (c) whether the entity has adhered to specific financial compliance requirements.

Financial audits include an assessment of internal control risks related to the scope of the audits. In the internal control phase, the auditor should obtain evidence about the effectiveness of internal controls to (1) form an opinion on internal controls as of the end of the audit period and (2) assess control risk and the effectiveness of budget and compliance controls during the audit period. Control risk is a factor in determining the nature, timing, and extent of substantive procedures for the testing phase.

PERFORMANCE AUDITS

Economy and efficiency audits include determining (a) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (b) the causes of inefficiencies or uneconomical practices, and (c) whether the entity has complied with laws and regulations concerning matters of economy and efficiency.

Program audits include determining (a) the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, (b) the effectiveness

⁷These definitions are taken from Government Auditing Standards, U.S. General Accounting Office, 1988 revision, and the GAO Financial Audit Manual, June 1992.

of organizations, programs, activities, or functions, and (c) whether the entity has complied with laws and regulations applicable to the program.

For Release on Delivery
10:00 A.M. E.D.T.
October 27, 1993

Statement by

Wayne D. Angell

Governor, Board of Governors
of the Federal Reserve System

before the

Committee on Banking, Finance
and Urban Affairs

U.S. House of Representatives

October 27, 1993

I am pleased to have this opportunity to speak on the General Accounting Office's authority to audit Federal Reserve operations and the changes to that authority that would be made by H.R. 28 "The Federal Reserve System Accountability Act of 1993." President McDonough is addressing the scope of GAO audit authority from the perspective of the Federal Reserve Bank of New York.

At the outset, I would like to dispel the notion I have frequently heard that the Federal Reserve is not subject to GAO audit. In 1978 the Federal Banking Agency Audit Act gave the GAO broad authority to audit most of the operations of both the Federal Reserve Board and the Federal Reserve Banks. Since then, the GAO has completed more than 100 reports on various aspects of System operations, as well as numerous other reports that involved us less directly. At present, the GAO has roughly 25 audits of the Federal Reserve under way and maintains several of its staff in residence at the Board and at selected Reserve Banks.

The GAO has free rein to audit the System, subject to explicit exemptions for: deliberations, decisions, or actions on monetary policy matters including discount window credit operations, reserves of member banks, securities credit, interest on deposits, and open market operations; transactions made under the direction of the FOMC; transactions with, or for, foreign central banks and governmental entities; and discussions or communications among or between members of the Board and officers

and employees of the Federal Reserve System related to these matters and transactions. By excluding these areas, the Act attempts to balance the need for public accountability of the Federal Reserve through GAO audits against the need to insulate the central bank's monetary policy functions from short-term political pressures and the need to ensure that foreign central banks and governmental entities can transact business in U.S. financial markets through the Federal Reserve on a confidential basis.

The precise line differentiating those Federal Reserve specific operations and activities that are subject to GAO audit under the Banking Agency Audit Act and those that are exempt from audit is difficult to draw in the abstract. Over the years since the passage of the Act, the Federal Reserve has worked with the GAO to define those limited areas that are not subject to audit on a case by case basis in the context of individual audits. In those cases, the Federal Reserve has worked with the GAO to further the GAO's audit objectives while honoring the statutory exemptions designed to ensure the independent conduct of monetary policy and the confidentiality of foreign transactions. In the future, we will continue to work with the GAO to address its concerns consistent with the mandate of the Act.

Expanding the GAO's audit authority over the Federal Reserve into the exempt areas would be contrary to the public interest. Such an expansion could adversely affect Federal Reserve effectiveness in the conduct of monetary policy. As the

Banking Agency Audit Act recognized, such a change could reduce the central bank's insulation from day-to-day political pressures. Even what appears to be a very limited audit of the efficiency of monetary policy operations could in fact turn into pressure for a change in monetary policy itself. For example, the questions posed to Comptroller Bowsher in connection with these hearings as to whether the magnitude of our open market operations reflects unnecessary buying and selling of government securities are monetary policy questions, not efficiency questions. The number of transactions that the Open Market Desk completes in carrying out the FOMC's directive correlates directly with the substance of the policy in place. Indeed, a comprehensive audit of these operations would likely require a comparison of the actual results of the operations with intended results.

GAO scrutiny of policy deliberations, discussions, and actions also could impede the process of formulating policy. A free discussion of alternative policies and possible outcomes is essential to minimize the chance of policy errors. The prospect of GAO review of formative discussions, background documents, and preliminary conclusions could have an adverse effect on the free interchange and consensus-building that leads to good policy.

Transactions made under the direction of the FOMC include foreign exchange operations. The efficacy of these operations is crucially dependent on confidentiality. Important daily contacts and exchanges of information with foreign monetary

authorities are an integral part of these operations. They now take place in a candid and constructive atmosphere. The possibility of a GAO audit of our foreign exchange operations would reduce the willingness of foreign authorities to share information with us and would thereby reduce the effectiveness and efficiency of our operations which are frequently coordinated with foreign authorities. This caution also applies to the exemption for transactions that the Federal Reserve carries out as agent for foreign entities; however, there the principal issue is one of sensitive proprietary information about foreign governments, foreign central banks, and international financial organizations.

The benefits, if any, of broadening the GAO's authority into the areas of monetary policy and transactions with foreign official entities would be small. With regard to purely financial audits, the Federal Reserve Act already requires that the Board conduct an annual financial examination of each Reserve Bank. The Federal Reserve places great importance on both the Reserve Banks' internal audit responsibilities and the Board's responsibilities for examination of Federal Reserve Banks, in part because it recognizes that its ability to police Federal Reserve Bank operations is critical to public and congressional confidence in the Federal Reserve System.

The process of conducting annual financial audits is reviewed by a public accounting firm to confirm that the methods and techniques being employed are effective and that the program

follows generally accepted auditing standards applicable to the audit of Federal Reserve Banks. These examinations are complemented by extensive Board oversight and supervision of Federal Reserve Bank activities, including Board operations reviews of Reserve Bank effectiveness and efficiency, as well as by comprehensive audits conducted by each Reserve Bank's independent internal audit function. Oversight and supervision of Federal Reserve Bank activities include review of Federal Reserve Bank budgets and expenditures as well as personnel and operating policies.

The Board's annual financial examinations of Federal Reserve Banks, operations reviews, and its oversight and supervision of Federal Reserve Bank activities specifically include examinations, operations reviews and oversight of open market and foreign transactions. The annual financial examinations include review of all accounts for accuracy, compliance with internal controls, and confirmation that balances reflected on the books agree with the records of account holders. Operations reviews for effectiveness and efficiency of open market and foreign operations are conducted by multi-disciplinary teams, including economists familiar with FOMC operations, and specialists in data and physical security, automation, communication, accounting, and secondary market trading and settlement. These operations reviews also include the Federal Reserve Bank of New York's internal audit attentions to the open market account.

Further, a private accounting firm audits the Board's balance sheet, and the Board's Inspector General audits the effectiveness and efficiency of Board programs and operations under the Inspector General Act of 1978 as amended.

The Board has continually reviewed its procedures for examinations and oversight of Federal Reserve activities. For example, recently the Board has contracted for independent private audits of two Federal Reserve Banks (Kansas City and Cleveland) in order to provide an independent evaluation of the Reserve Banks' control environments and the Board's examination procedures and to determine the feasibility of substituting, from time to time, outside audits for financial examinations by the Board's examiners. These audits have indicated that previous financial examinations of these Reserve Banks were at least as thorough as the outside audits, that those Reserve Banks were well controlled, and that financial controls may be regarded as satisfactory from an audit perspective. Indeed these audits have indicated that many policies are uniquely applicable to Federal Reserve Banks and that in these areas the Board's examiners have a significant advantage in auditing for Reserve Bank compliance.

The Board is strongly committed to ensuring that its examinations, both internal and external, oversight and supervision of the Federal Reserve Banks, as well as its own internal audit function and external audits, are as effective as possible and will continue to review these functions with an eye to ensuring their future effectiveness.

Finally, and more broadly, Congress has, in effect, mandated its own review of monetary policy by requiring semiannual reports to Congress on monetary policy under the Full Employment and Balanced Growth Act of 1978 (also known as the Humphrey-Hawkins Act) and by holding hearings on various monetary policy issues as they arise. In addition, there is a vast and continuously updated body of literature and expert evaluation of U.S. monetary policy. In this environment, the contribution that a GAO audit would make to the active public discussion of the conduct of monetary policy is not likely to outweigh the disadvantages of expanding GAO audit authority in this area.

In sum, we believe that the Board's supervision and oversight of Federal Reserve Bank activities and the Board's own audit functions have served the public interest well, particularly in the area of confidentiality of monetary policy information. In this regard, Mr. Chairman, you have asked about the security checks on personnel involved in the monetary policy process and incidents of so-called insider trading by Federal Reserve officials. Attendees at FOMC meetings are now required to have "secret" or higher clearances and, over the years, there have been only three known incidents where monetary policy information may have been used for private gain. In the first instance, in October 1979, there were errors in the deposit data reported by a large New York commercial bank. These errors were technical or clerical and were not intentional on the part of the bank. The Federal Reserve's screening procedures flagged the

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Federal Reserve Bank
of St. Louis

data as possible errors, but the bank stated that the numbers were correct as reported. The data therefore resulted in overstatements of the estimates of the money supply published by the Board. Subsequent data submitted by the bank indicated that the deposit data were indeed incorrect; as a result the bank revised its deposit data and the money supply figures were revised downward correspondingly. At the request of the House Committee on Banking, Finance and Urban Affairs, the Board conducted an investigation to determine if any institution or individual had improperly profited from the errors.

In order to ensure objectivity in the investigation, the Board engaged the services of a private law firm to conduct a complete inquiry and prepare a report. That firm, with the Board's concurrence, in turn engaged a private accounting firm to review trading activity. The report concluded that neither the bank that had made the reporting error nor persons connected with it, the Board, or the Federal Reserve Bank of New York had improperly and knowingly profited from the erroneous estimates or revision of the erroneous money supply estimates. Nor did the report find that any other institution or individual had improperly and knowingly profited from that error.

Nevertheless the report did identify one transaction that gave rise to an appearance of a conflict of interest in which an officer of the Federal Reserve Bank of New York who had knowledge of the impending revision of the money supply data had purchased units of a municipal bond fund immediately after the

revised data had become publicly available. That officer resigned from the Reserve Bank shortly thereafter.

In the second incident, in 1982, an ex-employee of the Board managed to gain telephonic access to confidential money supply data stored in the Board's computer system shortly after the employee had left the Board to work for a private firm. This access was identified quickly and the matter was referred to the Federal Bureau of Investigation promptly. The individual ultimately pleaded guilty to one count of wire fraud and received one year's probation. Subsequently additional security measures were implemented to prevent a recurrence of similar data security violations.

In the third incident, in 1986, in connection with the United States Attorney's investigation of allegations of securities fraud and tax evasion by former principals of a failed government securities dealer, the U.S. Attorney's office contacted the Federal Reserve Bank of New York concerning a former director of that Reserve Bank. After further investigation by both the Reserve Bank and the U.S. Attorney's Office, the U.S. Attorney's Office brought a criminal proceeding against the former director. In 1989, the former director pleaded guilty to charges of bank fraud based on the illegal disclosure of sensitive, non-public information regarding changes in the discount rate and was sentenced to a jail term, probation and community service. Again, Board and Reserve Bank procedures were revised after this event to prevent a recurrence.

We believe that the paucity and nature of the incidents that have occurred over the eighty-year history of the Federal Reserve System is strong evidence of the integrity of the Federal Reserve monetary policy process. Further it is doubtful that any of these incidents would have been prevented by a broadened GAO audit authority.

For these reasons and the reasons stated previously, we believe that enactment of the provisions of H.R. 28 that would expand the GAO's audit authority by removing the current exception for monetary policy matters; transactions made under the direction of the FOMC; and transactions with, or for, foreign official entities would be counter to the public interest.

TESTIMONY BY

WILLIAM J. MCDONOUGH, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK

BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

OF THE

UNITED STATES HOUSE OF REPRESENTATIVES

OCTOBER 27, 1993

I welcome the opportunity to appear before the Committee today to provide my views on the provisions of H.R. 28, the Federal Reserve System Accountability Act of 1993, which relate to the audit of Reserve Banks by the Government Accounting Office. H.R. 28 would eliminate the exemptions in the Federal Banking Agency Audit Act for foreign central banks and government transactions, monetary policy deliberations, decisions, and actions, and Federal Open Market Committee transactions. Governor Angell will be addressing the concerns of the Board of Governors on this legislative proposal. I will focus on the implications of the proposal for the actions taken by the Federal Reserve Bank of New York in implementing FOMC decisions and carrying out activities for our foreign accounts.

I want to comment on the scope of the current exemption and to make clear to the Committee my appreciation and respect for the audit process. Also, I would like to take this opportunity to note steps that can be taken to ensure further the effectiveness of GAO audits of the Bank, within the GAO's current authority. In my opinion, that authority provides sufficient scope to address many of the concerns you have asked me to discuss today.

I believe that the elimination of the current exemption would interfere with the Fed's ability to formulate and execute an optimal monetary policy. It would introduce the unmistakable potential for political influence; every movement and nuance of policy would then have to be examined in light of that potential. At the core of my concern is the fact that the process by which

we implement monetary policy is inextricably entwined with the policy itself. For example, questions regarding the volume of open market operations on the surface may appear to be questions of efficiency. In fact, they relate to the policy intent to avoid undue volatility in the markets. The idea that the process of executing open market operations may be audited without imposing judgments about the policy itself is simply not realistic.

Simply put, optimum monetary policy is achieved only when the public and the markets perceive no short-term political influence. This is not a new issue, nor a new conclusion on my part. I have had plenty of opportunity to consider the import of the exclusion of the GAO from auditing monetary policy in my former role as manager of both the domestic and foreign open market accounts. I have no doubt that the potential for damage to a credible and effective monetary policy would be very real if the exclusion were to be lifted. This potential for damage clearly would outweigh any possible benefit to the public from GAO audits of monetary policy operations.

I feel equally strongly about the impairment of our policy implementation if the exclusion were to be lifted on the foreign side. Foreign exchange intervention is conducted not only in conjunction with the Treasury, through the Exchange Stabilization Fund which is exempt from GAO audit, but also frequently with or on behalf of foreign central banks and monetary authorities.

We hold a very large amount -- over \$300 billion at present -- of marketable U.S. Government securities, representing dollar reserves of these official foreign entities. I cannot presume to gauge the response of all of these central bank governors and finance ministers, but I can tell you with absolute certainty that there is some number of them, and perhaps a large number, who would question the appropriateness of their reserve activity being scrutinized by the GAO and the Congress. This would almost certainly be damaging to the relationships that are so central to international monetary cooperation and, perhaps, to the role of the dollar. Certainly, it would impair the ability of the U.S. monetary authorities to conduct their foreign exchange intervention policies on a coordinated basis with the same effectiveness and efficiency we enjoy today.

Having said that, I want to reiterate that I do not have some sort of reflexive distaste for auditors or the audit process. To the contrary, as someone who has had managerial responsibility for large organizations in both the public and private sectors, I have a keen appreciation for the role of auditors and the improvements they bring to the table in the form of operational quality and effectiveness.

I view auditors as an important asset for management. There is a long tradition at the Fed of recognizing the value of independent oversight. Indeed, I believe we subject ourselves to an extraordinarily rigorous series of performance and operational appraisals. Within each Reserve Bank there is an independent

audit function that reports directly to the board of directors and performs comprehensive audits of all aspects of that Bank's work.

At the New York Fed, we have had a constructive and positive relationship with the GAO for almost 15 years. We supply the GAO permanent space in the Bank and have assigned staff as liaison in order to assist them in the orderly completion of their tasks. In addition, we take seriously their findings and are responsive to their suggestions for improvements. While I do not want to wax too poetic and imply that we love the result of each and every audit, I do want to make clear that we have a great appreciation for the role of auditors.

The conduct of Bank personnel with responsibility for monetary policy matters is subject to the Bank's rules of conduct, stringent standards regarding outside financial interests and potential conflicts stemming from family and other personal relationships. The GAO always has had full audit authority over Reserve Banks' personnel policies and practices, disclosure statements, and the like, and, thus, has been able to assure itself and Congress of the ethical standards and practices of all our employees.

We are not, however, resting on our laurels. There are always ways to enhance the effectiveness of operations, and audits by GAO can contribute significantly to that process. I plan to call Comptroller General Bowsher from time to time to

offer suggestions as to how the GAO might be even more useful to the Bank.

I now would like to respond to matters raised in Chairman Gonzalez' October 21 letter to me regarding our policy on meals and entertainment and our ethics officer. As I have noted, there is no limitation on the GAO that prevents its looking at our meals and entertainment practices or policy. Moreover, we do not impart information on monetary policy or our foreign account relationships to any outsiders, at luncheons or elsewhere. To the contrary, we use meetings with knowledgeable people to gain information about market conditions that is helpful in our monetary policy deliberations.

The Chairman asked a question regarding the cost of meals at expensive restaurants hosted by regulated institutions. Because others paid for these approximately two dozen meals that were identified as having occurred over a period of a year and a half, we do not have that cost information. We are however, very sensitive to the appearances of such things, and our internal rules specifically caution against accepting inappropriate entertainment, lavish meals or frequent meals from a particular institution. Further, we concluded that we do not have an adequate audit trail. Therefore, we are about to issue a policy requiring that all business meals paid by regulated institutions or vendors be documented as to restaurant, purpose, and attendees, to provide an audit trail for us, the Board of Governors, and the GAO going forward.

Finally, as the Chairman noted, we recently named an ethics officer. That does not mean this role was not being performed previously within the Bank. That function was fulfilled by the Bank's First Vice President, its General Counsel and the Personnel officers. We concluded that we would focus those responsibilities in a single individual, a senior vice president of the Bank. Since his appointment as ethics officer, he has responded to inquiries from members of the Bank's staff regarding ethics and conflict of interest questions. He also has participated in redrafting our rules of conduct, which should be concluded by year end, and other documents which will be helpful to the Bank's staff in their compliance with these rules. We regard his efforts as a continuation and refinement of the policies we have already put in place. As far as I am concerned, GAO staff has access to those policies and procedures, and I look forward to receiving GAO's input on them.

I appreciate this opportunity to participate in this hearing and look forward to answering any further questions the Committee members may have.

**STATEMENT OF
JOHN P. BORDEN
PRESIDENT,
GREATER KANSAS CITY CLEARING HOUSE
ON BEHALF OF THE
NATIONAL ORGANIZATION OF CLEARING HOUSES
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS**

OCTOBER 27, 1993

My name is John P. Borden. I serve as President of the Greater Kansas City Clearing House Association in Kansas City, Missouri; and as President and CEO of the Mid-America Payments Exchange (MPX). The Greater Kansas City Clearing House provides check clearing services to over 100 financial institutions in the greater Kansas City area. MPX, which was founded in 1975, is the largest of the 29 regional automated clearing house associations in the United States.

I am here today on behalf of the National Organization of Clearing Houses (NOCH), which I serve as President. NOCH was founded in 1989 to promote and support the important role of check clearing houses in the U.S. payments system. In addition to Kansas City, NOCH's member clearing houses serve the regional check clearing needs of financial institutions in Arizona, California, Connecticut, Illinois, New York State, Oregon, Pennsylvania, Puerto Rico, and Texas. Our members also include the two national private check clearing organizations.¹

With this testimony, NOCH will provide its perspective on the role of the Federal Reserve System in providing check clearing services. Our sole purpose here today is to promote the goal of a competitive payments system.

The Goal is Balanced Competition

NOCH does not believe that it is necessary to establish a congressional commission charged with evaluating the fair market value of the Federal Reserve's check collection operations for the possible purpose of privatizing these operations. We do, however, believe that the concerns NOCH has with the Federal Reserve's competitive role may be reflected in the intent of this provision in Section 8 of H.R. 28, the "Federal Reserve System Accountability Act of 1993."

NOCH believes that Congress should focus its attention on the goal of the Monetary Control Act of balanced competition, and do so with the understanding that the Federal Reserve System's complete withdrawal from check collection is not a precondition to achieving this goal. NOCH also believes that to pursue this goal properly, a combination of active Congressional oversight through existing means and greater public involvement in the review of Federal Reserve System check collection and other payments practices is appropriate and necessary. Unfortunately, many decisions are made by the Federal Reserve that have significant impact on private sector check clearing service providers without the benefit of public comment.

It is clear to NOCH that the current check collection environment does not reflect the competitive environment envisioned by the Monetary Control Act. The Federal Reserve System accounts for roughly 50 percent of all interbank check clearing volume,

¹ The National Clearing House Association (NCHA) and the Electronic Check Clearing House Organization (ECCHO).

whereas no single competitor of the Federal Reserve accounts for more than about 3 percent.²

Much of the Federal Reserve System's dominant market share may be attributable to its ability to take advantage of a nationwide network and the many resultant opportunities for economies of scale. In the current environment, these same economies of scale are unavailable to most private sector providers, which tend to be focused on serving local or regional markets. Even large bank holding companies that might otherwise have access to similar economies of scale are constrained because of interstate branching restrictions.

Complicating the private sector's ability to effectively challenge the Federal Reserve System's market share is the Federal Reserve's dual role as a dominant competitor and regulator. Since the Federal Reserve regulates the payments system in general, its policies as regulator often inadvertently affect the abilities of private sector service providers to compete.

A final complicating factor in the competitive relationship between the Federal Reserve and the private sector is that the very same service providers that choose to compete against the Federal Reserve must rely upon settlement services provided by the Federal Reserve in order to offer their own check collection services. In short, as a private sector clearing organization, perhaps the most important benefit you can offer -- settlement in immediately available funds -- is controlled by your largest competitor.

While the Federal Reserve currently dominates the check collection market, NOCH believes the goal of a more balanced competitive environment is attainable. In this environment, a large number of competitors would operate, with no one competitor -- including the Federal Reserve System -- enjoying more than a modest share of the market. NOCH believes that Congress, in passing the Monetary Control Act, recognized that the market forces operating in such an environment would do a better job of holding down costs, fostering technological enhancements, and contributing to even greater efficiencies than are currently present.

The Competitiveness Issue is as Old as the Federal Reserve Itself

Given the unique role and construction of the Federal Reserve System, it is no surprise that friction exists with the private sector. This friction dates back all the way to the establishment of the Federal Reserve System in 1913, but really began to take hold following passage of the Monetary Control Act in 1980. With the passage of this Act, the Federal Reserve's role in check collection was fundamentally changed from one of serving member

² NOCH's market share figures are derived from Federal Reserve clearing volume and that of the California Bankers Clearing House Association. "On us" checks (checks drawn on the bank at which they are deposited) are factored out of total estimated check volume (1992: 57.7 billion items) to arrive at total estimated interbank volume.

banks exclusively (by law), to one of competing directly with the private sector and serving all depository financial institutions seeking check clearing services.³ This change in the competitive balance led Congress -- largely through the General Accounting Office (GAO) -- to become actively involved in exploring whether the Monetary Control Act was resulting in a level playing field as intended. The most recent work on this issue was the GAO's May 1989 report to this Committee and its counterpart in the Senate entitled *Check Collection: Competitive Fairness is an Elusive Goal*. The purpose of the report was to evaluate private banks' ability to compete with the Federal Reserve Banks in the provision of check collection services as directed by the Competitive Equality Banking Act of 1987.

The May 1989 report does not stand alone, however, with several other studies having been conducted by the GAO and two different Committees of the House of Representatives. The common theme among all these initiatives has been the establishment of a true competitive balance between the Federal Reserve and the private sector as envisioned by the Monetary Control Act. For example, a 1984 report by the House Committee on Government Operations concluded that "the objective of public policy must be, among other things, to strike a balance that provides a fair and full opportunity to compete to both the Fed and the private sector suppliers."⁴

A report by the House Banking Committee's Subcommittee on Domestic Monetary Policy reached similar conclusions:

The Monetary Control Act did not envisage, nor does the Subcommittee accept the creation of a theoretically pure and perfect competitive setting if the result is to drive the Federal Reserve out of the payments system and thus weaken the safety, security, and accessibility of the system. However, the Subcommittee would also not accept, nor did the Monetary Control Act intend, a situation in which the Federal Reserve through its actions drives the private clearing banks out of check clearing.⁵

NOCH shares the views expressed by both reports that the Monetary Control Act does not specifically require the Federal Reserve to leave check collection entirely to the private sector as a measure of compliance with the Act's intent of a balanced competitive environment. On the other hand, we do believe that a single service provider owning fully one-half of the entire check clearing market in the United States is completely inconsistent with any reasonable definition of what constitutes a "balanced competitive environment." In short, we believe the payments system should not be structured so as to promote the interests of the Federal Reserve System as a provider of services at the expense

³ The Monetary Control Act does not mandate that the Federal Reserve System provide check collection services, but that, if it chooses to, it must make such services available to all depository financial institutions.

⁴ H.R. REP. NO. 98-676, 98th Cong., 2nd Sess. 30-31 (1984).

⁵ STAFF OF HOUSE SUBCOMM. ON DOMESTIC MONETARY POLICY, 98TH CONG., 2D SESS., REPORT ON THE ROLE AND ACTIVITIES OF THE FEDERAL RESERVE SYSTEM IN THE NATION'S CHECK CLEARING AND PAYMENTS SYSTEM 34 (Comm. Print 1984).

of the private sector.

At the time it was conducted, the May 1989 GAO report built upon these conclusions and many of the concerns that remained regarding the Federal Reserve's unique competitive advantages. The report concluded with specific recommendations aimed at the Federal Reserve:

[T]o ensure that competitive fairness issues are appropriately considered, the Federal Reserve needs to (1) better define what is meant by its policy commitment to competitive fairness as a means of providing clear decision-making criteria and (2) establish better procedural controls to further payments system changes that promote competitive fairness while providing strengthened safeguards against potential conflicts of interest. It should then apply these policies and procedures to the development of a same-day payment regulation.⁶

Since the release of the GAO's May 1989 report, the Federal Reserve has taken steps to address the specific recommendations of the GAO. Most importantly, the Federal Reserve has amended Regulation CC mandating same-day settlement for checks without the imposition of fees, subject to certain reasonable conditions. Until these amendments were approved, only Federal Reserve Banks were exempt from paying presentment fees.

Also subsequent to the May 1989 report's release, the Federal Reserve revised its policy statement entitled "The Federal Reserve in the Payment System" to require, among other things, that a competitive impact analysis be performed for "proposed changes that would likely have a substantial effect on payments system participants."⁷

Do Federal Reserve Policies and Practices Now Reflect Congressional Intent?

While the Federal Reserve has taken actions to address the GAO's recommendations, at least two questions remain:

1. Have the Federal Reserve's actions thoroughly addressed the issue of competitive fairness, and have they or will they result in a more equitable competitive balance?
2. In addressing the recommendations contained in the GAO report directly, has the Federal Reserve Board also permitted other practices by Reserve Banks that compromise the intent of the GAO recommendations and the Federal Reserve's own responses to those recommendations?

⁶ U.S. General Accounting Office, "CHECK COLLECTION: Competitive Fairness is an Elusive Goal," GAO/GGD-89-61, 61 (1989).

⁷ FEDERAL RESERVE SYSTEM, Policy Statement -- The Federal Reserve in the Payments System 3 (1990).

NOCH believes these important questions must be resolved before full industry confidence in the Federal Reserve's adherence to fair competitive principles can be restored. Furthermore, the evidence to date strongly suggests that the answer to both questions is that the Federal Reserve has neither thoroughly addressed the competitive fairness issue in its payments system policies, nor has it adequately enforced existing competitiveness policies in its approval of Reserve Bank check collection services and prices. If this posture is permitted to continue, the balancing of competitive opportunities promised by actions such as same-day settlement will be lost.

For example, the Federal Reserve recently implemented changes to its Payments System Risk Reduction Program (PSRRP) which included a change in the schedule by which check transactions are posted to a depository institution's reserve account. Because of this change, credits for checks cleared through the Federal Reserve are now available to the collecting institution much earlier in the day than is possible for checks collected privately under same-day settlement. This is an important distinction since, as part of the PSRRP, the Federal Reserve is preparing to price "daylight overdrafts" in a depository institution's reserve account. As such, the timing of proceeds from check and all other payment transactions will be very important to depository institutions as they control their overdraft levels.

The impact of the risk reduction policy changes on the competitive playing field represents a perfect example of how the Federal Reserve's dual role as regulator and payment services provider can operate to the detriment of the private sector. In trying to reduce the Federal Reserve's risk in the payments system, the Federal Reserve has set in motion forces that will specifically discourage migration of check volume under same-day settlement to the private sector.⁸

In addition to the Federal Reserve's compromise of the attractiveness of same-day settlement due to the change in the check posting schedule, allow me to provide another example of what NOCH views as a deviation from the principle of competitive fairness intended by the Monetary Control Act. Recently, the Federal Reserve Board approved a Federal Reserve Bank's request to offer a new check collection service dependent upon a unique pricing mechanism. Known as a "payor service group sort" (PSGS), this service is now being offered by over eleven Federal Reserve offices around the country (more have recently announced that they too will add such a service). The service was approved by the Federal Reserve without the benefit of public review, despite the determination by the Federal Reserve Bank applicant that its proposal should be treated as "non-routine" because the pricing mechanism represented a departure from Federal Reserve pricing policies in place at the time.

This new pricing mechanism relies on revenues received from paying banks to offset

⁸ Checks pose minimal risk to the Federal Reserve and, as such, NOCH has long believed that the check posting change recently implemented by the Federal Reserve was unnecessary.

the prices charged by the Federal Reserve to collecting banks for check deposit services. According to the Federal Reserve Board staff's document approving the new service, the pricing mechanism would "assess a fee to both the depositing bank and the payor bank for deposits of checks in a Payor Service Group Sort."⁹ In short, the paying bank is paying a portion of the collection costs for checks presented to it through this service, allowing the Federal Reserve to offer a corresponding discount to the collecting bank choosing to use the service.

The power of this pricing incentive should not be understated. Typically, a bank's determination of check collection method depends on price more than any other single factor. Therefore, as NOCH sees it, the PSGS service is purposely structured to subsidize collecting banks as an incentive for them to collect checks through the Federal Reserve System, instead of through private banks that do not have the capability to link paying and collecting bank services and prices.

Moreover, until this new pricing mechanism was approved, the Federal Reserve's pricing policies for check collection services had always been to assess fees only on only those banks directly benefitting from the provision of the service. In short, the price borne by the collecting bank for a collection service fully reflected the Federal Reserve's cost of providing the collection service plus a private sector adjustment factor. With the PSGS service, when revenues from paying banks are factored out of the cost recovery equation, NOCH questions whether this pricing mechanism is even recovering the marginal cost of collecting checks through this service.

Between the recently implemented check posting changes under the Payment System Risk Reduction Program and the Payor Service Group Sort pricing mechanism, NOCH fears that the same-day settlement amendments to Regulation CC might be rendered meaningless.

The Solution: More Congressional Oversight and Greater Public Involvement

No one relying on the U.S. payments system stands to realize any benefits if one group of organizations (e.g., the Federal Reserve and its Reserve Banks) is perceived as dominant in a strictly one-sided game. Sooner or later in this situation, the private sector might simply decide to stay home. Therefore, the perception that competition in the payments system is one sided cannot be permitted to continue. The perception -- and indeed the reality -- must be that the competitive playing field is level; the officiating fair and just. This, in NOCH's view, was the intent of the Monetary Control Act.

The Importance of Public Opinion: In evaluating the Federal Reserve System's dual role as

⁹ COMPETITIVE IMPACT ANALYSIS, PRICING PROPOSAL #542; accompanying an approval letter from Mr. William W. Wiles, Secretary of the Board of Governors of the Federal Reserve System, to Mr. William H. Hendricks, First Vice President of the Federal Reserve Bank of Cleveland, (July 11, 1990).

regulator and dominant national payments service provider, NOCH can only state that when public opinion has been sought before the Federal Reserve enters into a new or different service, or a new or different pricing methodology for such a service, the resulting outcome has been to the benefit of the banking industry, its customers, and the national payments system as a whole. When the Federal Reserve has not subjected price or service proposals from Federal Reserve Banks to public review, questions and confusion have all too often been the result. This has particularly been the case when the approved price or service change has ultimately been adopted by other Reserve Banks around the country.

Frequently, proposed changes to a price or service by an individual Reserve Bank have received Federal Reserve approval without the benefit of public comment because the change might only have a limited effect on other local service providers. Meanwhile, subsequent similar changes by Reserve Banks serving other regions are generally subjected to only the most basic review process by Federal Reserve Board staff because, presumably, the Board of Governors and its relevant committees have already reviewed the competitive impact of the original application. The problem that exists is that a particular price or service change in one region may indeed have only a limited impact on competition with local private sector providers, whereas, on a national or multiregional basis, the competitive position of many other private sector service providers might ultimately be undermined by the subsequent adoption of the change in their Federal Reserve districts. Since local changes frequently have national repercussions, NOCH believes that virtually all changes to Federal Reserve priced services should be viewed by the Federal Reserve as potentially having "significant longer run effects on the Nation's payments system" – thus triggering public review requirements under policies adopted by the Federal Reserve pursuant to the Monetary Control Act and the Administrative Procedures Act.

NOCH would like to add that not only does the Federal Reserve approve many controversial services without the benefit of advance public comment, but even when the public seeks more information about a service and its approval process, the response from the Federal Reserve can be less than forthcoming. As an example, I have attached for the record several documents NOCH received from the Federal Reserve in response to a request under the Freedom of Information Act for information regarding approval of the payor service group sort. A quick review of these documents reveals that a substantial amount of information contained within has been deleted as not for public consumption.

The message here should be clear. All proposed changes to Federal Reserve prices and services should be issued for public comment. Providing the public the opportunity to review changes to Federal Reserve prices and services not only elevates the Federal Reserve Board above any reasonable suspicion of conferring competitive advantages upon the Federal Reserve System, but also permits private sector providers of payment services to respond with the potential effects such a service would have in the region or regions they serve. Even if the proposal is generated by an application of a Reserve Bank that is not directly in competition with a particular commenter, as part of the public record, these comments can serve as a guide to the Federal Reserve and its staff when reviewing similar changes

proposed by other Federal Reserve Banks.

Finally, public comments by individuals or organizations actively involved in the issue being subjected to comment frequently suggest beneficial changes to proposals when adopted in the final form. Examples of Federal Reserve proposals that have benefitted in their final form from useful suggestions made during the public comment process include not just rule changes (e.g., same-day settlement and Regulation F), but also check service pricing proposals (e.g., capped fees for interdistrict transportation, and tiered pricing for Federal Reserve check deposit services). It is unwise to think that a single Reserve Bank or Federal Reserve Board staff will always thoroughly develop a proposed price or service change to its full potential without comment from those institutions that would use or compete against the service if offered in their District.

Active Congressional Oversight: Issuing proposed Federal Reserve price and service changes for public comment in advance would greatly enhance the ability of the banking industry and the Federal Reserve Board to fully review the full competitive impact of these types of proposals before they are approved and implemented. However, the numerous questions that continue to surround the Federal Reserve System's role and market dominance in the payments system strongly suggest that this role must be further evaluated by a knowledgeable, non-biased third party.

Given the GAO's substantial involvement in evaluating the Federal Reserve's role in the payments system, NOCH would recommend that the GAO be commissioned to re-evaluate the current competitive role of the Federal Reserve System given changes in the competitive environment since the research for the May 1989 report was compiled. Of particular interest would be the degree to which same-day settlement and changes to Federal Reserve policies have addressed the recommendations in the May 1989 report and the intent of the Monetary Control Act. As it evaluates the effects of recent Federal Reserve actions, the GAO should also review what, if any, changes have been made by the Federal Reserve in either its regulation of, or in its role as provider of services to the payments system that have worked to compromise same-day settlement's levelling of the playing field.

To measure progress towards the ultimate goal of achieving balanced competition, NOCH would like to close its remarks by recommending that the GAO follow up the comprehensive report described above with annual progress reports until such time as the Congress may conclude that the competitive environment has reached the stage of maximum fairness as envisioned by the Monetary Control Act. Congress may therefore assure the public that continuous progress is being made towards this goal. To this end, NOCH offers whatever assistance is requested of us to support any such GAO reporting initiative.

**TESTIMONY BEFORE THE U. S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS**

on

"The Federal Reserve System Accountability Act", HR 28

delivered by

**J. D. Carreker
Chairman, J. D. Carreker and Associates, Inc. and
Executive Director, Electronic Check Clearing House Organization**

October 27, 1993

Introduction Thank you, Mr. Chairman and Members of the Committee.

I am Denny Carreker, Chairman of J. D. Carreker and Associates. We are a management consulting and technology company, serving the banking industry in matters of the payment system, bank operations, check processing, and electronic check presentment.

Our client base includes most of the country's top 100 banks, their regional clearinghouses, and banking industry associations. It has also included Federal Reserve banks and the staff of the Federal Reserve Board of Governors.

ECCHO It is in my capacity as Executive Director of the Electronic Check Clearing House Organization, or ECCHO, that I have been invited to address the Committee. ECCHO is a non-profit national organization dedicated to facilitating the private sector's implementation of electronic check presentment, or ECP (Exhibit 1). As I will describe later, ECP is changing the payment system and the relative roles of the private sector and the Federal Reserve.

ECCHO now has 58 members, who account for more than 60% of the total domestic deposits of the 100 largest banks in the U. S. ECCHO has become a central focus for many of the important changes currently taking place in the nation's check payment system.

Purpose The Committee has asked me to address two questions about the Federal Reserve's payment system role: One, is it feasible to privatize the Federal Reserve's check clearing functions? Two, what is the "fair market value" of the Federal Reserve's check clearing operation?

Introduction First, regarding feasibility. Not only is gradual privatization of the Federal Reserve's check clearing functions feasible and desirable, it is already occurring.

It is ECCHO's belief that the Federal Reserve should encourage the prevailing privatization trend and the success of private sector initiatives.

Doing so would involve addressing a fundamental issue, and that is the basic conflict of interest in the Federal Reserve's dual role as both regulator of and competitor in the check collection system. In this dual role, the Federal Reserve can, unilaterally and without accountability, undertake regulatory, service policy, and service pricing initiatives to maintain market share and recover costs, in direct competition with the private sector.

There was a time when, thanks to non-par banking, unit banking, and uncertain transportation conditions, the Federal Reserve's operating role was necessary. It is not necessary today, as Congress indicated in the Monetary Control Act of 1980, and the private sector is meeting the needs of the check collection system.

To address this conflict of interest, Congress should consider the example of other countries such as Canada, and establish an entity to ensure that the Federal Reserve's conflict of interest is eliminated and the check collection system evolves as Congress intends.

The Privatization Trend

Three main changes are contributing to the privatization trend (Exhibit 2).

- **One**, the continued consolidation of the banking industry.
- **Two**, the emergence of electronic check presentment, or ECP
- **Three**, the increasing extent to which the payment information needs of banks' customers are directing the payment system.

Collectively, these three changes amount to the formation of an "electronic umbrella" (Exhibit 3) covering all parties in payment transactions. And collectively, they serve to diminish the importance of the Federal Reserve's check clearing role and to increase the importance of the private sector's efforts to invest in further improvements without the current fear of unpredictable and disruptive regulatory or pricing changes by the Federal Reserve.

I would like to elaborate on each of these three changes.

1. Consolidation First, consolidation. As banks consolidate, the nature of check clearing volumes changes. Intra-bank checks increase, while inter-bank, or "transit" checks decrease. The Federal Reserve's check clearing role is in transit checks. As a result, consolidation continues to diminish Federal Reserve check volumes, and correspondingly, the required role of the Federal Reserve in the check collection system.

2. Electronic Check Presentment (ECP) The second change I referred to is ECP. The essence of ECP is that it captures checks' payment information for electronic transmission, thus separating checks' most time-critical information from the paper item itself. For the first time, the speed of check processing is not limited to the speed at which a piece of paper can be handled and transported (Exhibit 4). For banks and their customers, ECP represents a tremendous opportunity to reduce check risk and losses.

It is important to note that the private sector formed ECCHO and invested in ECP in order to reduce the risk exacerbated by Regulation CC. Thanks to this private sector initiative, there is less risk and more efficiency in today's check collection system.

ECP has substantial implications for the Federal Reserve's future role in the payment system. For most of this century, the basic check clearing system was a daunting physical sorting and transportation challenge. Banks were unit banks, many in remote or rural locations, and transportation was slow (Exhibit 5).

This situation constituted a clear need for a national entity to provide a standard sorting and transportation service at a reasonable price. It was logical for the Federal Reserve to assume this dual role of regulator and operator, which it performed conscientiously and well, helping to create the world's most efficient check clearing system.

But now that the private sector is implementing ECP, physical transportation and sorting is less time-critical. The private sector has already developed ECP software, written the rules and agreements, designed the implementation requirements, developed national standards, formats, and definitions, and borne the expense and risk connected with all these efforts. The private sector is adapting ECP service and delivery mechanisms to serve the thousands of small banks that cannot support their own check clearing operations, helping these small banks reduce their check risk and that of their customers.

(continued)

FEASIBILITY (continued)**2.
Electronic
Check
Presentment
(continued)**

On the other hand, the Federal Reserve, while explicitly endorsing the ECP concept, is planning to invest in a different approach to ECP that will compete with the private sector's investment and has already complicated and delayed the private sector's development of ECP standards.

There is no reason for the Federal Reserve to duplicate the private sector's ECP efforts. Additional competitive ECP activity by the Federal Reserve at this juncture will unnecessarily complicate the work of the private sector, potentially introducing new systemic risk, and delaying ECP's benefits for small banks and their customers to ECP's benefits.

**3.
Customer
Participation**

The third change I referred to is the greater customer responsiveness required of the payment system (Exhibit 6). During the decades that the Federal Reserve was expanding its role in the check collection system, the system was not especially customer-oriented. Check services were largely commodities, and customers did not demand differentiation.

That situation has changed. Now customers desire extensive payment information along with payment transactions, and now they expect to see services designed with the particular needs of their companies or industries in mind.

For example, studies by J. D. Carreker and Associates and our bank clients have shown that ECP has tremendous potential for providing corporations with better payment handling and information, and reduced payment risk. As a result, corporations are now taking steps toward developing corporate ECP applications.

There are many other such examples that involve both corporate and consumer customers, including electronic data interchange, home banking, telephone bill paying, and ATM services.

In none of these examples is the involvement of the Federal Reserve as a service provider required. As corporations and consumers increasingly demand more responsive payment services, the opportunity for effective participation by the Federal Reserve diminishes. The Federal Reserve, appropriately, does not have customer relationships with these parties, nor does it have the market-driven experience of the private sector.

FAIR MARKET VALUE**Factors**

The second question I've been asked to address is the "fair market value" of the Federal Reserve's check operations. Clearly, if the Federal Reserve were to relinquish its check clearing role, it would forsake a large investment in payment system capacity.

The most important factor affecting the value of the Federal Reserve's check clearing business would be timing. The business is valuable today, but the value will diminish. I have just recounted for you the continuing transition from paper to electronics. The Federal Reserve's check collection system mechanism was designed to support a paper check system, not an electronic one requiring a national data communications network. It was designed before the large-scale nationwide consolidation of the banking industry and before the large-scale responsiveness to corporate and consumer customers.

Thus the value of the Federal Reserve's investment diminishes daily as these trends continue. Its "fair market value", then, is tied to how soon it is extracted.

The value of the business would also be affected by the scope of the functions involved and the scale of the business. The combination of settlement and check collection functions is clearly more valuable than check collection alone, and the national scale of the total Federal Reserve business is more valuable than several regional businesses would be.

FUTURE FEDERAL RESERVE ROLE
Overview

Having asserted that the early rationale for the Federal Reserve's dual role no longer exists, that the private sector is pursuing effective check collection improvements in the form of ECP, and that the Federal Reserve's dual role jeopardizes private sector initiatives, the question remains how the check collection transition should be managed.

ECCHO believes that Congress should encourage the prevailing trend toward privatization by:

- A. Establishing an entity to ensure accountability for Federal Reserve check collection initiatives, and
- B. Taking steps to eliminate the Federal Reserve's conflict of interest, as other countries such as Canada have done.

Recommendation

ECCHO recommends that Congress establish a Payment System Advisory Board, comprised of payment system experts drawn from the private sector, Federal Reserve staff, and other parties as appropriate.

The Payment System Advisory Board (Exhibit 7) would advise Congress or its agents on the following:

- New Federal Reserve pricing initiatives
- Major Federal Reserve investments in check collection
- Changes in the scope of Federal Reserve services
- Federal Reserve compliance with Congressional mandates

The Payment System Advisory Board would hold an annual meeting and provide Congress or its agents with an annual report on these issues. ECCHO believes that the General Accounting Office could play a useful role in this regard.

An additional role of the Payment System Advisory Board would be to provide a forum for discussing issues related to the evolution of the U.S. payment system.

SUMMARY**Summary**

In summary, the Committee's attention to this issue is particularly timely. It comes at a time when the private sector check clearing banks are particularly well positioned to provide even better check clearing services than ever, more cost-effectively than ever, with greater corporate and consumer value than ever, and with even better service for small banks.

In other words, Congress can, with little or no impact on the quality or safety of the check collection system, encourage current private sector initiatives, the prevailing trend toward privatization of the check clearing business, and the gradual elimination of the Federal Reserve's conflict of interest.

To ensure the continuity and security of the payment system during the transition and beyond, Congress should form a Payment System Advisory Board of Federal Reserve and private sector parties. ECCHO is pleased to offer its services in any way in the establishment of this Board.

Thank you for the opportunity to testify on behalf of ECCHO. This concludes my prepared remarks.

The Electronic Check Clearing House Organization

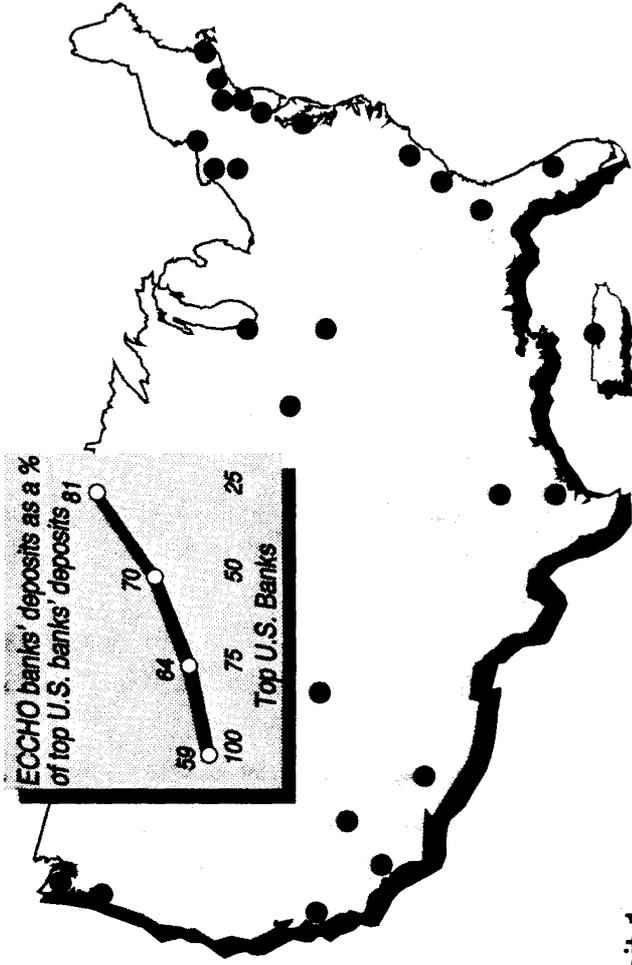


Exhibit 1

Payment System Major Trends

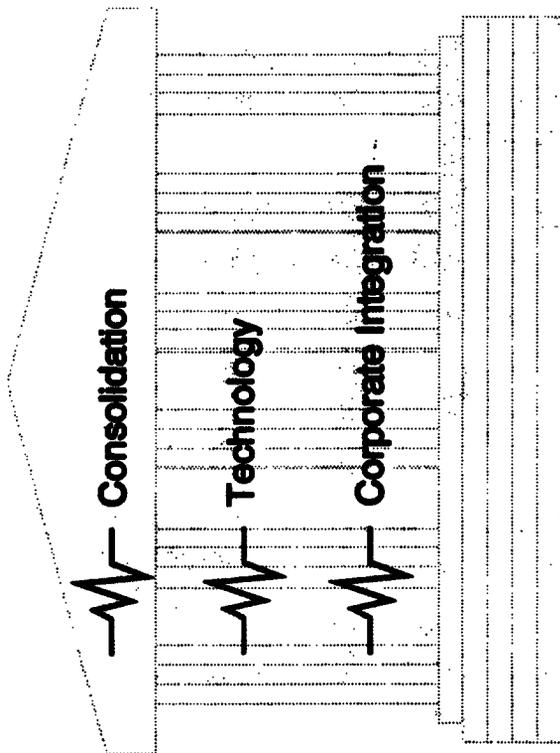


Exhibit 2

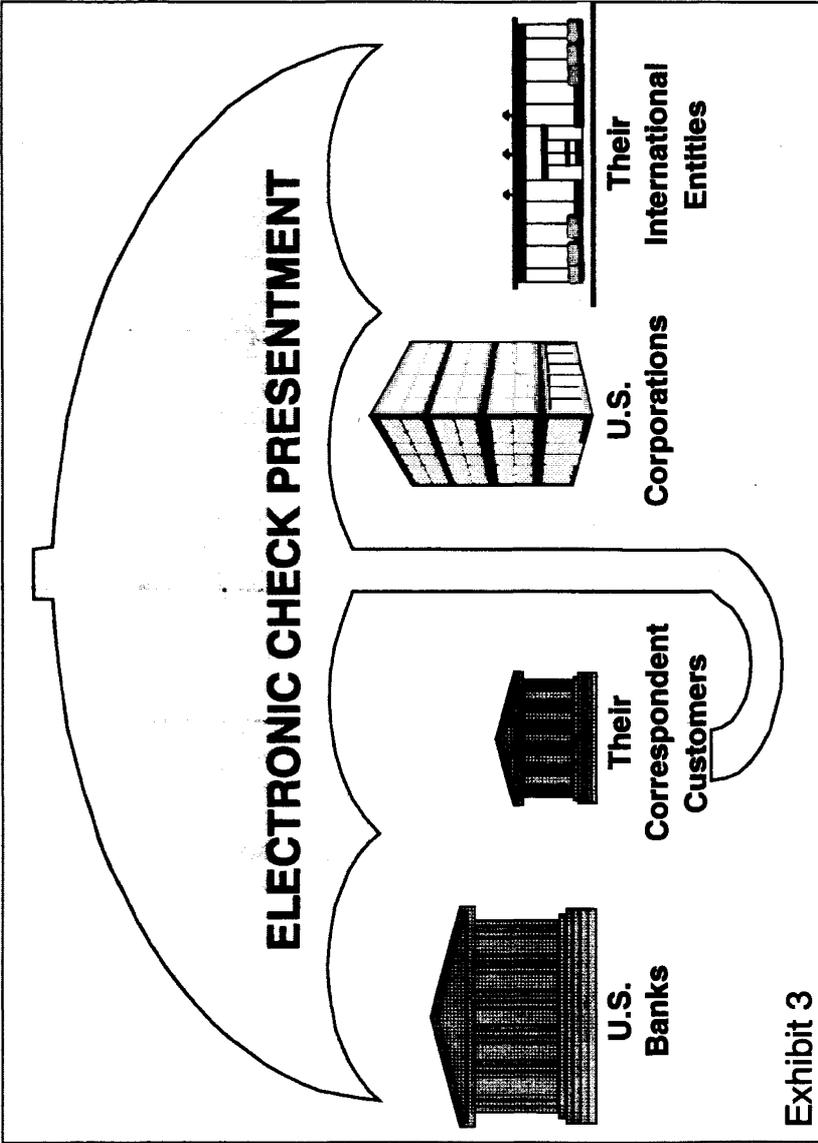
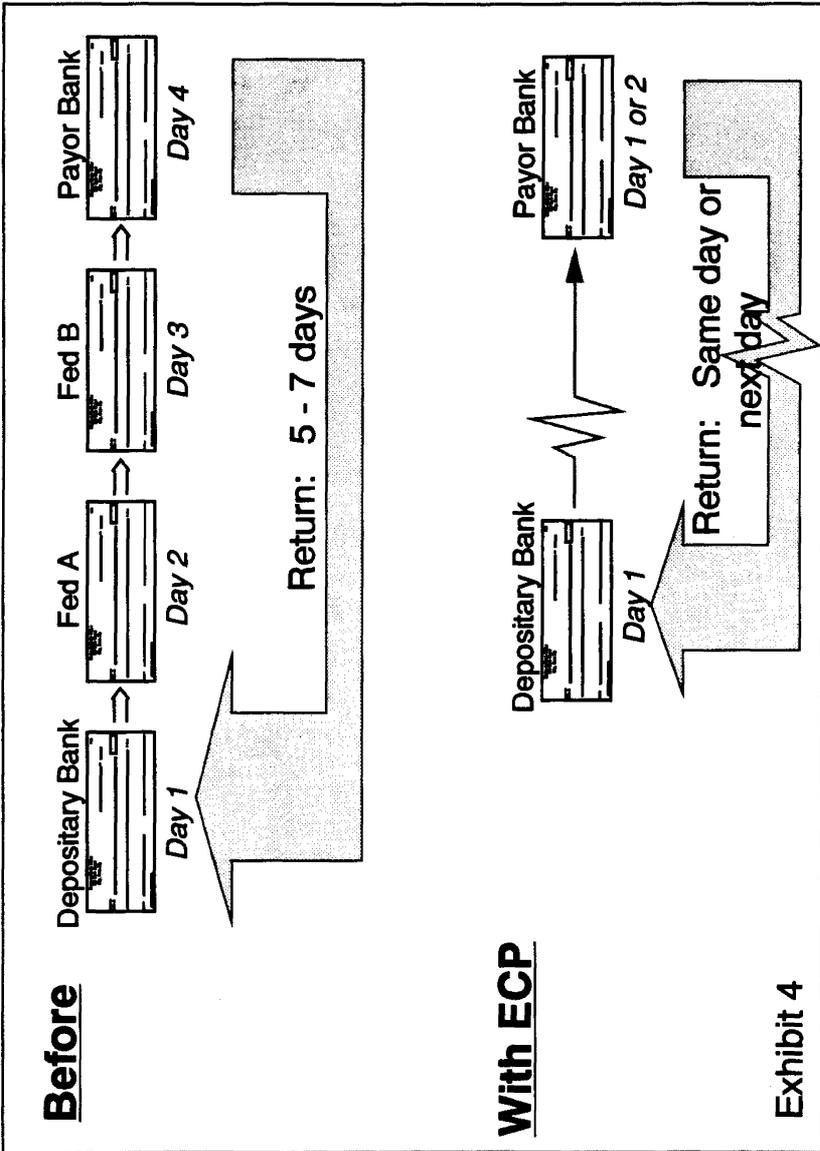


Exhibit 3



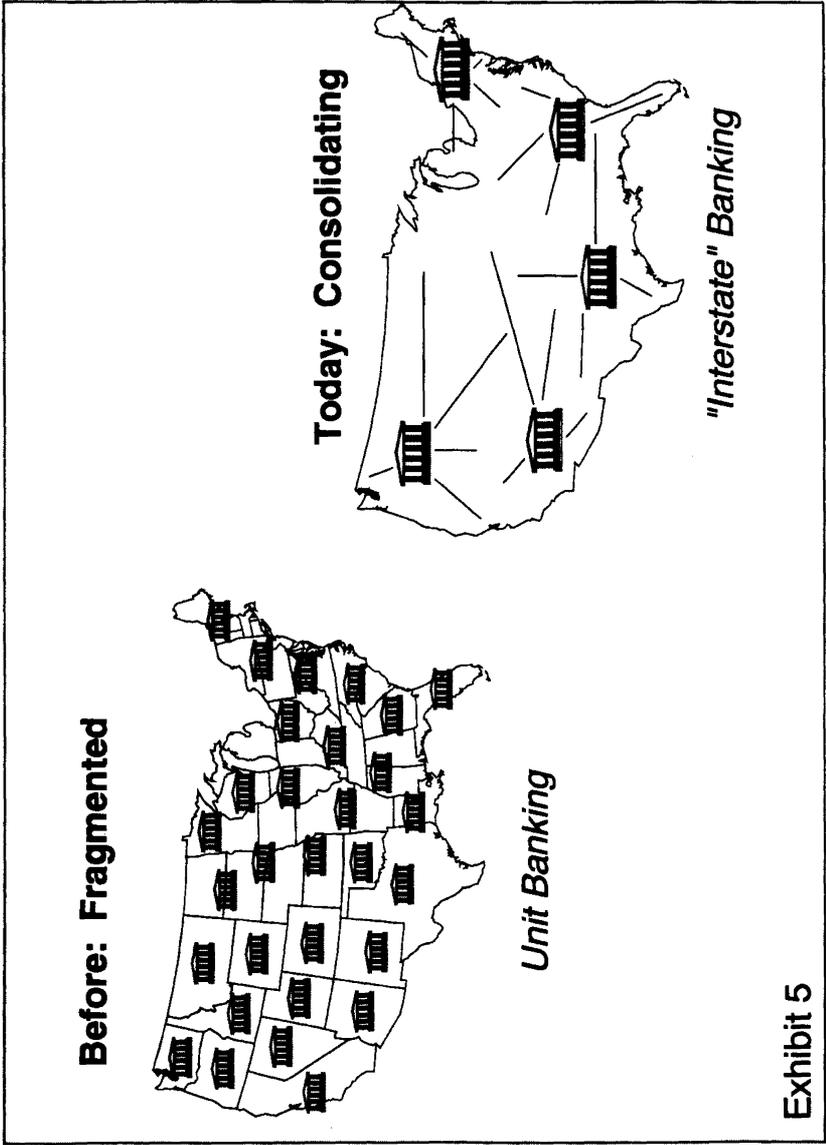
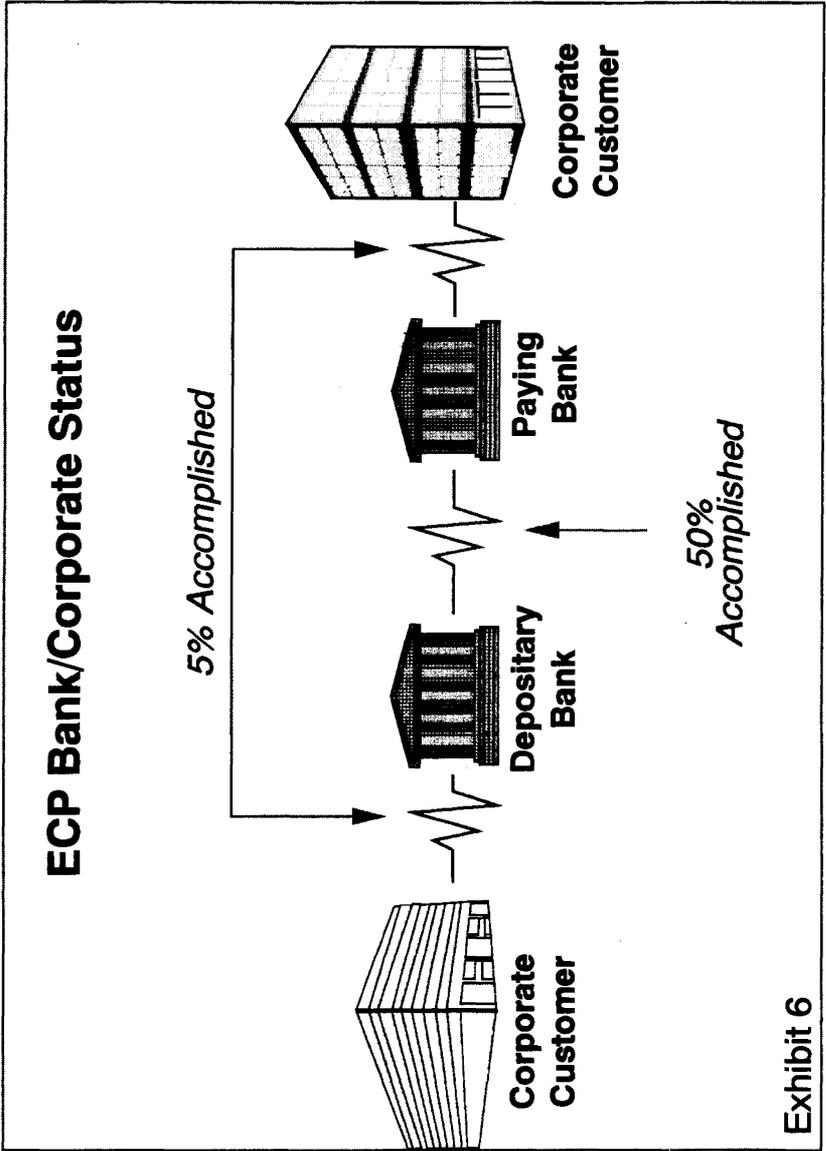


Exhibit 5



**Payment System Advisory Board
advises Congress on:**

New Federal Reserve pricing initiatives

Major Federal Reserve investments in check collection

Changes in the scope of Federal Reserve services

Federal Reserve compliance with Congressional mandates

Exhibit 7

TESTIMONY OF

**JAMES R. LAUFFER
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER
OF THE FIRST NATIONAL BANK OF HERMINIE
AND PRESIDENT**

of the

THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

before the

**UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS**

on the

"FEDERAL RESERVE SYSTEM ACCOUNTABILITY ACT OF 1993"

OCTOBER 26, 1993

Mr. Chairman, my name is James R. Lauffer, and I am Chairman, President and CEO of the First National Bank of Herminie in Irwin Pennsylvania. I am also President of the Independent Bankers Association of America, which is the only national trade association that exclusively represents the interests of community banks.

We appreciate this opportunity to testify on your bill, the Federal Reserve System Accountability Act of 1993 (H.R. 28). You have asked us to comment on the provision of that bill that authorizes the formation of a commission to study, among other subjects, the fair market value of the Federal Reserve's check clearing system and the advisability of further privatizing check clearing. While we have a strong interest in that provision, we also have serious reservations about other aspects of H.R. 28. We believe that this bill would undermine the independence of the Federal Reserve System and politicize its conduct of monetary policy. This statement will outline our views on all of these provisions.

Federal Reserve Accountability Commission

The Study Would Ignore Key Factors

The IBAA believes that section 8(b)(3), as written, calls for a study that would ignore crucial factors that must go into any consideration of whether the Federal Reserve should divest check clearing services. It only requires the commission to take "into account the economic benefits to be derived from, and the efficiencies to be achieved as a result of, the divestment." This would result in a biased study, since it does not clearly require the commission to consider any of the disadvantages of reducing or eliminating the Federal Reserve's check clearing role.

Therefore, section 8 should be expanded to require the commission to consider the indirect cost to the public if reasonably priced check clearing is no longer available to financial institutions serving small and rural communities; the adverse effects on those communities if they lose access to prompt and efficient payment services; and the value of having the services retained by the Federal Reserve.

The Vital Role of Federal Reserve Services

Individuals and small businesses throughout the nation expect reasonably priced banking services -- checking accounts, interest-bearing checking accounts and savings accounts. The availability of Federal Reserve services gives community banks -- collectively the largest private sector market for Federal Reserve settlement and clearing services -- access to affordable correspondent services designed to meet the needs of these customers.

For many community banks, particularly in rural areas, the Federal Reserve is the **only** provider offering check clearing services. The Federal Reserve ensures that all financial institutions, approximately 30,000, have universal access to its services.

Historical Background

Prior to 1916, the Federal Reserve was involved only in a voluntary check collection arrangement in which member banks voluntarily paid checks at par and received immediate credit for checks deposited at a Reserve Bank. This voluntary approach was a failure since most banks gained more by operating outside this system, paying checks on a non-par basis. At that time, paying banks regularly charged "an exchange fee" to the bank presenting the check for payment. Checks often were routed in ways that delayed payment.

The Federal Reserve promulgated its first rules on check collection in July 1916, requiring member banks to send checks for collection directly to the bank on which they were drawn. Member banks were also required to clear at par.

Over the years, the Federal Reserve has endeavored to improve the efficiency of the check collection system, sometimes at the request of the Congress. Most recently, in 1987 the Congress directed the Federal Reserve to implement the Expedited Funds Availability Act to provide depositors with more prompt access to their funds. This new law required the Federal Reserve to implement numerous changes to improve the efficiency of the check collection system. The Federal Reserve had to ensure that checks were collected and returned in a timely manner to help protect banks against the risk that they would pay checks that were drawn against insufficient funds.

Recent Developments

In the last 3 to 4 years several private entities have formed or expanded to provide national correspondent services, including check clearing. Although these services are available on a national basis, they are not universally available to all financial institutions.

In 1992, Huntington Bancshares and two non-bank partners formed the National Clearinghouse Association (NCHA), a nationwide check clearing network. The membership is comprised of large regional banks, including NationsBank. The NCHA membership requirements effectively exclude smaller institutions by establishing a \$200 million minimum capital level for all participants.

Similarly, the Visa Automated Clearing House has identified the top 100 ACH originators as its niche. Community banks need not apply.

The Electronic Check Clearing House Organization (ECCHO) was formed in 1990 to provide private-sector national electronic check presentment. The ECCHO membership includes many of the country's 50 largest banks. Late last year, ECCHO added a new membership category -- associate member -- to attract members that might not otherwise be able to afford regular membership. Unless it has recently changed, the

annual cost of associate membership is over \$10,000. This effectively excludes smaller banks.

The membership requirements or niche strategies of the national private-sector service providers make clear that most smaller institutions will continue to depend on the Federal Reserve. Thus, they will not be able to obtain private sector services that could produce cost savings for their customers.

New technology has emerged that will enable some private-sector entities to offer some services nationwide. One of these entities is represented here today. However, no single entity will provide universal, reasonably priced services to all of the nation's financial institutions.

The private sector has demonstrated neither the capacity to absorb the Federal Reserve's check volume -- about 30 percent of the total volume nor the willingness to provide the services to all segments of the industry. The two private sector initiatives by Visa and Huntington both demonstrate the willingness of the private sector to serve only high-volume users. Capacity and willingness must be key considerations when valuing the Federal Reserve services.

If the Federal Reserve abandons these services and the private sector is the only correspondent service provider, many community banks would likely experience substantially increased operating costs. In today's cost-cutting environment, community banks would be forced to pass related fee increases on to consumers in various forms -- increased or new service charges and/or activity fees and lower rates of interest for interest-bearing accounts. Consumers, small businesses, farmers, and ranchers would bear the brunt of these fee increases.

Under current law, community banks already pay competitive fees. The Monetary Control Act of 1980 requires the Federal Reserve to price its check services as though it was a private sector player. The Federal Reserve calculates its cost for each individual product which also includes a Private Sector Adjustment Factor (PSAF). The Monetary Control Act also mandated that the Federal Reserve System match its costs and revenues in the long run, while giving due consideration to competitive factors and the continuation of an adequate level of services on a nationwide basis.

To date, the Federal Reserve has played a critical role in ensuring that community banks, and their customers, have access to adequate payment systems. The Federal Reserve must remain active in this role, as no other institution appears to be willing or able to replace it. The study commission created by H.R. 28 must take these factors into account.

Improving the Payments System

In addition to ensuring that all financial institutions have universal access to check clearing services, the Federal Reserve is the catalyst for improvements in the payments system, including check clearing operations.

Unlike any private-sector provider, the Federal Reserve has responsibility for regulation and improvement of the payments system. As I indicated earlier, the Expedited Funds Availability Act (EFAA) of 1987 directed the Federal Reserve to improve the payments system. According to section 609(c)(1):

... "The Federal Reserve System shall have the responsibility to regulate:

(A) any aspect of the payment system, including the receipt, payment, collection, or clearing of checks; and

(B) any related function of the payment system with respect to checks."

Given this responsibility, the Federal Reserve has a nationwide, long-term perspective -- not just a short-term, regional or niche perspective characteristic of private-sector providers.

The Federal Reserve's current role enables it to offer services which will assist in executing its regulatory responsibilities. The EFAA, among other things, directed the Federal Reserve to prescribe regulations resulting in an automated system for the return of unpaid or dishonored checks. If the Federal Reserve did not provide a nationally available return item service, this mandate would not have been met. The Federal Reserve's role has greatly improved the return-check process -- a benefit to both depository institutions and most importantly, their customers.

The IBAA understands that the Federal Reserve is strongly committed to remaining in the check clearing business and improving the efficiency of the nation's check clearing system. The Federal Reserve's seven year research and development effort in check image technology and the development of an electronic check exchange service are prime examples. The Federal Reserve's leadership role in both of these areas prompted software and hardware vendors to develop systems much sooner than private-sector market forces would have. The Federal Reserve cannot continue to improve our payments system if it can no longer offer services to facilitate these improvements.

Any study must factor in the benefits of the Federal Reserve's dual role as a regulator and service provider committed to serve all financial institutions.

Role of Studies in Legislation

Some may contend that community bankers should not worry about this provision, since, after all, it is "just a study." I strongly disagree. Studies, particularly biased

studies, can lead to dangerous legislative proposals. For example, section 1001 of the 1989 savings and loan legislation directed the Treasury to conduct a study of the federal deposit insurance system. That provision focused on ways to cut back on deposit insurance coverage or reduce the deposit insurance funds' losses. The section failed to require the Treasury to study any benefits of deposit insurance.

The end result was a Treasury recommendation that deposit insurance coverage be greatly curtailed. Mr. Chairman, I know you favored that recommendation, while we strongly opposed it. But certainly we can agree that the battle over deposit insurance coverage that grew out of the Treasury study was hard-fought and highly significant. The fact that the 1989 law did not require the Treasury to consider any positive aspects of deposit insurance put a tremendous burden on those of us who opposed deposit insurance cutbacks. Because of that experience, we will continue to closely scrutinize proposals to "just study" topics of concern to community banks and fight to eliminate bias.

Other Provisions of H.R. 28

We strongly agree with Federal Reserve Chairman Greenspan's earlier testimony before this committee on the other provisions of H.R. 28. Whatever their stated intent, their effect would be to undermine the independence of the Federal Reserve.

Presidential Appointment of Reserve Bank Presidents

The bill's first major provision would require that Reserve Bank presidents be appointed by the President of the United States and confirmed by the Senate. Chairman Greenspan has effectively outlined a number of very strong arguments in favor of the current system and against the change proposed by H.R. 28. We see no need to repeat those points in this testimony, but do want to add several points.

The Chairman and Vice Chairman of the Board of Directors of the Federal Reserve Banks are not bankers. Second, the banking industry is not monolithic and the non-bank directors represent a diverse constituency. Third, the Board of Directors at any Reserve Bank does not have a carte blanche selection mandate -- in selecting Federal Reserve Bank Presidents there is an interface with the Federal Reserve Chairman and the Board of Governors. The Board holds an effective veto.

We would be remiss if we did not point out that the advise and consent process is not working that well for banking agency appointees. Extending this process to the Reserve Bank presidents could lead not only to the politicization of the selection process but also to serious delays in their appointment. We have not had an FDIC chairman since August, 1992. And, since Director C.C. Hope's death -- which caused a vacancy which has not been filled -- the FDIC has effectively been run by the Comptroller of the

Currency. This has undermined the independence of a key agency. Other high financial posts also remain vacant.

GAO Audit of the Monetary Policy of the Federal Reserve

The GAO is the investigatory arm of the U.S. Congress. Increasing its auditing role at the Federal Reserve increases Congressional power over monetary policy. This will weaken economic and financial confidence. The GAO has been routinely auditing the regulatory and supervisory function of the bank regulatory agencies, including the Federal Reserve, since the late 1970s. After 15 years of experience, there is no evidence that the GAO understands the difference between an audit and a supervisory examination.

The GAO has no expertise in monetary policy -- it does not attract first-rate economists. This is important because monetary policy is an economic specialization, not an accounting function. And even its accounting expertise is suspect. The GAO's accounting projections of the prospective losses of the FDIC-BIF are now widely viewed as having been wrong. Its projections of future losses did not materialize. Ross Perot's projected \$100 billion taxpayer hit was a figment of the imagination that started with the GAO's faulty projections. These faulty projections were used to secure Congressional passage of the FDICIA legislation which many experts, including those at the Federal Reserve, regard as a drag on bank lending and the general economy.

We respectfully invite any member of the Banking Committee to pay a visit on one of the 4,000-plus banks under \$50 million to ascertain whether FDICIA -- which added to previously existing regulations -- has imposed a regulatory burden that threatens its survival. The cumulative regulatory burden is so onerous that government examiners often outnumber these banks' professional staff.

Legislation giving the GAO second-guessing rights over monetary policy decisions serves no useful purpose -- it will only undermine confidence in American economic decision making. Our country's fiscal-policy house has not been in order for at least 20 years and this has put extra-ordinary burdens on monetary policy. Generally, our central bank has acquitted itself well. It does not need the GAO or this committee fine tuning monetary policy.

These issues are not new to the House Banking Committee leadership and its staff nor to the IBAA and its staff. They were last seriously fought in the late 1970s. They were rejected then -- they should be rejected today.

Thank you.

HOWARD B. WENTWORTH

Mr. Chairman and Committee members, my name is Howard Wentworth. I am a Senior Vice President with CoreStates Financial Corp. I would like to thank the committee for the opportunity to comment on the issue of the privatization of Federal Reserve Priced services.

As documented in the 1989 General Accounting Office report "Check Collection Competitive Fairness Is an Elusive Goal", the Federal Reserve is engaged in an almost \$800 million a year business of providing priced services (activities that the Federal Reserve provides for a fee such as check collection, wire transfer, etc.), in direct competition with banks and other service providers. At the same time, the Federal Reserve also regulates its competitors. The dual roles of regulator and service provider effectively stifle private sector competition for priced services. Competition is curtailed in several ways. The Federal Reserve enjoys legal advantages that no private sector provider can match. Among these are the ability to present to any paying bank as late as 2:00 p.m., the ability to compete on a national basis and the ability to spread costs over a variety of products including some products where the Federal Reserve enjoys virtually a monopoly position.

As the manager of the payments system, the Federal Reserve exercises its tactical rule making abilities, granted under Regulation "CC", in ways that frequently appear to have as the primary motivation improvement of the Federal Reserve's competitive position at the expense of the private sector providers. A recent example would be the establishment by the Federal Reserve of a 6:30 p.m. deadline for the settlement of Same Day Settlement presentments. The late deadline, which applies only to private sector presentments, compares to a deadline as early as 11:00 a.m. for Federal Reserve presentments. The early deadline reduces Federal Reserve risk while the late deadline increases private sector risk and costs. Although the time under which payment can be delayed may appear to be unimportant, the distinction could effectively negate the cost avoidance opportunities for some of the very banks that Same Day Settlement was supposed to benefit.

Finally, it is important to appreciate that banks view the Federal Reserve primarily as a regulator. As a result, banks frequently are reluctant to challenge Federal Reserve actions related to priced services because of their concerns related to the Fed's regulatory role. The net effect is that the dual powers that Congress has granted to the Federal Reserve sets up a governmental agency with unfair competitive advantages over the private sector. Although it is now seen as a cliché it is nevertheless true that the FAA doesn't fly airplanes since it would place them in the conflicting roles of regulator and operator. This is a truth that the current Federal Reserve structure does not reflect.

Privatization of the Federal Reserve's priced services function is the most effective way to resolve the actual and perceived conflicts of interest which the government has created in allowing the Federal Reserve to function in its dual roles.

Three approaches to privatization of the Federal Reserve's "Priced Services" functions should be considered.

1. The Federal Reserve could sell their operating units, on a regional basis, to the private sector providers.
2. "Priced services" activities could be spun off from the Federal Reserve on a local basis. The new charter would be to operate as a private company with profits to be paid to the Treasury. This approach would result in approximately 46 separate companies being created. Each new company would be subject to the same regulations as the private sector providers.
3. The Federal Reserve could return to its historic role as a processor of last resort providing those services that the private sector elects not to deliver.

Each of the three alternatives provides benefits and challenges. Additional work would be required to install any one, or a combination of the above solutions. However each would appear to successfully eliminate the conflict in the dual roles of the Federal Reserve without jeopardizing the safety and soundness of the payments system.

Thank you for your attention. I would be pleased to answer any questions.

The official minutes from a meeting on February 19, 1974, with President Frank E. Morris of the Boston Federal Reserve Bank suggesting that the board of directors contact the Members of Congress to promote the Federal Reserve's position on the GAO audit bill.

The official minutes of this meeting state (p. 95 of Federal Reserve Bank of Boston Director's minutes 1972, 1974, 1975, as delivered to the House Banking Committee):

"Mr. Morris also called attention to the fact that H.R. 10265, which would provide for a G.A.O. audit of the Federal Reserve System had not died in the House Rules Committee but was expected to reach the floor of the House of Representatives on or about March 5. He indicated that the System's position was to support an amendment, to be proposed by Rep. Ashley of Ohio, which would limit the scope of the audit so as to exclude monetary policy actions, but to continue to oppose the bill, even if amended, on the final vote. The directors were encouraged to let Members of the House know their views on the bill."

On May 23, 1974, Governor George W. Mitchell, then vice chairman of the Federal Reserve Board of Governors, appeared at the directors meeting of the Chicago Federal Reserve Bank. A description of his remarks is presented in the minutes of that meeting as follows:

"Remarks by Governor Mitchell, (p. 157, Federal Reserve Bank of Chicago Minutes of the Board of Directors for 1974, as delivered to the House Banking Committee):

Governor Mitchell also noted that the GAO audit bill should come up for vote next week on the floor of the House. Reserve bank directors have been helpful in contacting Congressmen and hopefully the bill can be at least amended to restrict the type of audit if chances for outright elimination lessen."

Mr. Robert P. Mayo, President of the Chicago Federal Reserve Bank, then called on the directors, who are primarily private bankers and businessmen, to conduct a lobbying campaign against the GAO audit bill (ibid).

"Mr. Mayo commented further on the GAO audit bill, noting that it is House Bill number 10265 and should be up for consideration on May 29. He then requested each director to make whatever calls seem natural to him in order to encourage support for the Federal Reserve position. Although basically the System would prefer to see the entire bill defeated because of its monetary policy review aspects, if that is not possible then the Ashley amendment, restricting the GAO to a financial audit is favored."

Mr. Mayo followed through on his campaign in the June 27 meeting by thanking the directors who contacted Members of Congress to secure support for the Federal Reserve position. The minutes of this meeting reveal the following (ibid, p. 169):

"The GAO audit bill recently passed the House of Representatives, but was limited to a financial audit. There is no prospect of Senate action this session, however, Mr. Mayo thanked those directors who were able to contact Members of Congress to secure support for the Federal Reserve position."

The pattern of organized Fed lobbying is also seen in connection with attempts to get the Fed totally exempted from the "Government in the Sunshine" bill. On December 11, 1975, the Chicago Fed's President Mayo reported to his directors on this legislation. After noting the alleged consequences of opening directors meetings to the public, he then described the organization of the lobbying effort, indicating that Ward J. Larson (Senior Vice President, General Counsel and Secretary to the Board of the Chicago Fed) would follow up with each director on his lobbying activities (pp. 318-319, Federal Reserve Bank of Chicago, Minutes of the Board of Directors for 1975, as delivered to the House Banking Committee):

"Mr. Mayo reported that a 'Government in Sunshine' bill has already passed the Senate, requiring all federal agencies headed by a body of two or more members appointed by the President to conduct business at meetings open to the public. Even in those instances where a majority of the members vote to close the meeting a verbatim transcript must be made and retained for at least two years.

"While this bill does not appear to apply to the individual reserve banks, it does apply to the Board of Governors and possibly to the FOMC, (Federal Open Market Committee) and this application concerns us directly as a System.

"A similar bill, H.R. 11007, will be voted upon soon by the Government Operations Committee of the House. We would hope that the Federal Reserve System could be totally excluded from the bill -- or at least that it be exempt from the requirement that a verbatim transcript be made of all closed meetings.

"Keeping a verbatim transcript would clearly inhibit discussion and could cause members to speak only for the record. While such a transcript would be subject to court subpoena, even more critical to the system would be the scrutiny of the Congress. As you can see this legislation is particularly sensitive with regard to Board discussions on monetary policy and bank regulatory matters. (emphasis added).

"Mr. Mayo then read a list of Committee members from this district. He asked each director to think about possible contracts to explain Federal Reserve concern and indicated that Mr. Larson would be in touch with each director tomorrow as a follow-up." (emphasis added).



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

August 19, 1993

Mr. Ian W. Macoy
Director, Check Services
National Organization of Clearing Houses
Suite 200
607 Herndon Parkway
Herndon, VA 22070

Dear Mr. Macoy:

This is in response to your letter dated August 3, 1993, received by the Board on August 4, 1993, in which you request, pursuant to the Freedom of Information Act, 5 U.S.C. § 552, copies of the following documents:

1. The FRB's principles, including those pursuant to provisions in the Monetary Control Act of 1980 and all other applicable FRB policies, for reviewing applications for priced services offerings submitted by Federal Reserve banks, branches and offices as in effect at the time when the Fourth Federal Reserve (Cleveland Federal Reserve Bank) District's "Pricing Proposal #542" was reviewed by the FRB and approved.

2. Any additions or changes to the FRB's principles for reviewing applications for priced services offerings submitted by Federal Reserve banks, branches and offices as defined in #1 that are currently in effect.

3. The FRB policy statement entitled "The Federal Reserve in Payments System" as issued in March 1990 and any other FRB policies currently in effect relating to the performance of a "competitive impact analysis" for proposals affecting the Federal Reserve System's offering of priced services and its Reserve Bank operations.

4. Any policy statement that permits a Federal Reserve bank, branch or office to use fees collected from payor institutions to offset costs incurred in the provision of check deposit services to collector institutions.

5. The Cleveland Federal Reserve Bank's application and all supporting documentation resulting in the FRB's approval of Pricing Proposal #542 and the date this application was first received by the FRB.

This FRB
response
attached

6. The FRB's statement of approval of Pricing Proposal #542 and the date it was approved, the competitive impact analysis accompanying this approval and the date it was completed, and all other FRB documentation supporting this approval. This request includes any legal opinions prepared by FRB counsel relevant to this approval and any documentation as to why public comment was not recommended or required before FRB approval.

7. Signed agreements between the Federal Reserve office and each of those depository financial institutions represented as payor institutions for inclusion in the group sort for checks deposited through the type of service represented by Pricing Proposal #542 ("payor service group sort") offered by the following Federal Reserve offices: Charlotte, Cincinnati, Cleveland, Columbus, Dallas, Helena, Indianapolis, Memphis, Milwaukee, Minneapolis and Philadelphia.

8. A list of Federal Reserve offices, if any, approved to offer the payor group sort deposit service not referenced in #6 and all documentation requested in #6 pertaining to these offices.

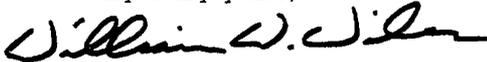
9. Correspondence from any depository financial institutions to the FRB and/or their local Federal Reserve bank, branch or office seeking to be added to or withdrawn from, or seeking more information about a payor service group sort deposit option. Correspondence from the FRB and/or any Federal Reserve bank, branch or office in response to such requests."

In your letter when you request "a detailed statement of the reasons for the withholding or an index or similar statement of the nature of . . . [any] documents withheld," you appear to ask that the Board prepare a "Vaughn index." The right to an index, however, applies only when an agency's decision to withhold documents is made subject to judicial review. Vaughn v. Rosen, 484 F.2d 820 (D.C. Cir. 1973), cert. denied, 415 U.S. 977 (1974). "There is no requirement that administrative responses to FOIA requests contain the same documentation necessary in litigation." Crooker v. CIA, No. 83-1426, slip op. at 3 (D.D.C. September 28, 1984). Based on these and other precedents, the Board's policy is to decline to prepare Vaughn indexes in connection with administrative denials in light of the heavy burden a contrary policy would impose on Board resources.

The staff's search of Board records has revealed a number of documents that are responsive to items (1) through (3), (5), (6), (8) and (9) of your request. Some of those documents will be provided to you in their entirety. We have determined, however, that the remaining documents contain the following kinds of exempt information: commercial or financial information obtained from a person and privileged or confidential; and staff opinions, recommendations, and analyses that would not be available by law to a party other than an agency in litigation with the agency. Such information will be withheld from you under authority of exemptions 4 and 5 of the Act, respectively, 5 U.S.C. §§ 552(b)(4) and (b)(5). The documents containing the exempt information have been reviewed in accordance with the last sentence of subsection (b) of the Act, and all reasonably segregable nonexempt information will be made available to you. With respect to items (4) and (7) of your request, the staff has searched appropriate Board records and made suitable inquiries, but has found no responsive documents. Accordingly, we cannot provide you with any information with respect to those items.

Your request for information, therefore, is partially granted and partially denied with respect to items (1) through (3), (5), (6), (8) and (9) of your request for the reasons stated above. All documents being made available pursuant to this authorization will be sent to you under separate cover. With respect to items (4) and (7) of your request, a determination that no responsive records exist is considered to be an "adverse determination" under the Act. You may appeal these determinations in accordance with section 261.9(d) of the Board's Rules Regarding Availability of Information, a copy of which is enclosed for your information.

Very truly yours,



William W. Wiles
Secretary of the Board

Enclosure

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Excerpts from the Board's Rules
 Regarding Availability of Information
 12 CFR Part 261
 Section 261.9(d)

(d) Appeal of denial of request for records--(1)
 Request for review; time limits. Any person denied access to Board records requested in accordance with this section may file with the Board a written request for review of the denial by the Board or Board member(s) designated to hear such appeal. The request shall be filed within ten working days of the date on which the denial was issued, or, where a request for documents has been partially approved but access to the documents has not been given, within ten working days from the date such documents are transmitted to the requester. The request shall prominently display the word "appeal" on the first page. An initial request for records may not be combined in the same letter with an appeal.

(2) Untimely appeals. The Board may consider an untimely appeal if:

(i) It is accompanied by a written request for leave to file an untimely appeal; and

(ii) The Board or designated Board member(s) determines, in its discretion and for good and substantial cause shown, that the appeal should be considered.

(3) Decision on appeal; time limits. The Board or designated Board member(s) shall make a determination with respect to any appeal within 20 working days of actual receipt of the appeal by the Secretary and shall immediately notify the appealing party of the determination and the right to seek judicial review if the determination upholds, in whole or in part, the denial of the request for records. Such determination is not subject to review under Section 265.3 of this chapter which provides for review of actions taken under delegated authority.

(4) Mootness of appeal. (i) The Board, a Board member, or a staff person designated by the Chairman may declare an appeal wholly or partially moot and instruct the Secretary of the Board to reconsider the previous denial or to release the requested documents, where a determination is made that intervening circumstances or additional facts not known at the time of denial have or may have eliminated any need or justification for withholding the requested documents.

(ii) The Secretary may reconsider a denial being appealed if such intervening circumstances or additional facts come to the attention of the Secretary while an appeal is pending.

Effective July 11, 1988

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD



JUL 11 1990
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LEGAL DEPT
FEDERAL RESERVE BANK
OF CLEVELAND

Mr. William H. Hendricks
First Vice President
Federal Reserve Bank of Cleveland
1455 East Sixth Street
Cleveland, Ohio 44101

Dear Bill:

The Director of the Division of Federal Reserve Bank Operations, acting under delegated authority, has approved your Bank's proposal to implement a Payor Service Group Sort. It is understood that the group sort will incorporate the recently approved fee structure whereby Federal Reserve costs are recovered from fees assessed to both the depositing and payor banks. The Payor Service Group Sort may be implemented after the usual thirty-day announcement period. Please send a copy of your Bank's announcement letter to Ms. Ellen Johnson, Stop 188, at the Board of Governors.

Sincerely yours,

(Signed) William W. Wiles

William W. Wiles
Secretary of the Board

cc: Mr. Robert Eisenmenger
Mr. William Stone
Ms. Joanna Frodin

APPROVED UNDER
DELEGATED AUTHORITY

Charles H. Farnsworth 7/11
DIRECTOR OF
BANK OPERATIONS

The Fourth District proposes to assess a fee to both the depositing bank and the payor bank for checks deposited in the group sort. This pricing scheme represents a new structure for the pricing of Federal Reserve check collection services. No other check product assesses a fee to both the depositor and payor bank for the same process.

Under the proposal, depositors would be charged \$0.010 per item (except for Columbus City checks which would be priced at \$0.007 per item) and the payor service customer would be charged \$0.004 per item.

The attached competitive impact analysis concludes that the proposed product meets the System criteria for new products.

Recommendation

COMPETITIVE IMPACT ANALYSISPRICING PROPOSAL #542

The Fourth District has requested approval by the Director of the Division of Federal Reserve Operations, under delegated authority, to implement a pricing structure that would assess a fee to both the depositing bank and the payor bank for deposits of checks in a Payor Service Group Sort. Payor banks that receive payor bank services could elect to be included in the group sort and would pay the proposed fee for all checks drawn on themselves and deposited via the group sort option.

1. Does the proposed service have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services?

The proposed Payor Service Group Sort does not adversely effect the ability of other service providers to compete effectively with the Federal Reserve in providing similar services. Both the underlying payor bank services and the group sort concept are common Federal Reserve check collection services, and conceptually there is no change in the relationship of services being offered by the Federal Reserve and its competitors. The proposed fee structure,

which is new, could be imitated by competitors wishing to enter the business of providing payor bank services.

The proposal will result in lower Federal Reserve fees for deposit of certain items that could prove to be beneficial to a number of depositors, including some depositors not currently using the fine sort deposit option. It is expected that the major correspondent banks local to the Federal Reserve office will be the primary users of the Payor Bank Group Sort service.

FEDERAL RESERVE BANK
OF CLEVELAND

WILLIAM H. HENDRICKS
FIRST VICE PRESIDENT

CLEVELAND, OHIO 44101
AREA CODE 216-579-2444

February 14, 1990

Mr. Clyde Farnsworth, Jr.
Director, Division of Federal
Reserve Bank Operations
Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

Dear Clyde:

The Fourth District requests approval under delegated authority to implement a new check deposit service. The proposed Payor Service Group Sort product is designed to reduce the processing pressures in our check operations caused by the high growth rates of our payor services and package sort deposits. The proposal uses a new pricing approach for recovering check "floor" costs. Due to this change in pricing methodology, the proposal should be classified as "non-routine".

Within the current Fourth District operations, approximately package sort items each day are reopened and reprocessed for inclusion in Fourth District payor services. Due to the nature of the package deposits, this processing is occurring during our peak operating windows. The proposed Payor Service Group Sort balances the Fourth District operational needs with that of the package sort depositor and payor service customer. By combining revenues from the depositor and payor, the Fourth District "floor" costs are fully recovered.

This proposed Payor Service Group Sort has been supported by both a sample of payor institutions and our largest package sort depositors. Other Federal Reserve Districts with payor service capacity problems have also shown interest in the proposed program.

Please direct any questions that you or your staff may have regarding this proposal to Terrence J. Roth, Assistant Vice President, at (216) 579-2873.

Sincerely,

Bill

William H. Hendricks

Enclosure

cc: Mr. Jack Guynn, Executive Director for Priced Services
Mr. William Stone, System Product Director

PAYOR SERVICE GROUP SORT

FEDERAL RESERVE BANK OF CLEVELAND

February 14, 1990

PAYOR SERVICE GROUP SORT

Action Requested

Each office within the Fourth District requests approval under delegated authority to implement a new group sort deposit option directed at lowering fees and processing costs for the package sort depositor and payor customer. The endpoints included in the group sort will be only those customers which subscribe to the Fourth District's Payor Services Package Sort Option service (Fine Sort Inclusion). The new program is designed to eliminate a major bottleneck in Fourth District operations in reprocessing Package Sort Deposits. Furthermore, the service is designed to pass financial and operational benefits to current package sort depositors and payor service customers. Due to a new approach to pricing the Payor Service Group Sort, the proposal is classified as "non-routine".

Executive Summary

Within the Fourth District, Payor Services (including the Package Sort Option) and Package Sort deposit services continue to experience tremendous success and growth. The exponential growth rates are beginning to impact dispatch times at the Cleveland, Cincinnati and Columbus offices.

The Payor Service Group Sort product is designed to create incentives for package sort customer to deposit the current Package Sort items that are reprocessed for Payor Service capture in a group sort cash letter.

Background

The driving force behind the Payor Service Group Sort is the exponential growth of our Payor Service, Package Sort Option and the Package Sort Deposit services. The following table summarizes the annual 1989 performance compared to annual 1988:

	<u>1988</u>	<u>1989</u>	<u>% Growth</u>
MICR/Truncation Volume			28.3%
Package Sort Option (Payor)			53.6%
Package Sort Deposits			19.5%
Local Processed Deposits			(0.8%)

increased to per day. This represents 23 percent of our package deposits with a growth rate exceeding 50 percent for 1989. Based on current trends, a very high growth rate will continue through 1990.

Discussion

Current Environment

The Federal Reserve System guidelines governing deadlines and the relationship between premium processed, package deposit and dispatch times were developed to insure that all service providers had equal and timely access to local FRS transportation services. The System guidelines stated that the Package Sort deposit program have a cutoff time no earlier than three hours before courier dispatch. During this three hour period, the Fourth District physically sorts package deposits, enters accounting information, and creates/distributes the check supplemental accounting statements.

Statement

To the Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

By: Tom C. Frost

San Antonio, Texas

November 15, 1993

As a career banker whose desire is that my work contribute to the growth and development of the community that my bank serves, I appreciate the opportunity to present to the Committee views on the independence of our central bank within government and on the role of the presidents of the 12 regional banks in the administration of monetary policy.

Lest my vantage point be misconstrued as purely from the vested interest of a commercial banker, let me explain my relationship with the Federal Reserve System. Born into a 125-year banking tradition the Federal Reserve came into my life early on. My grandfather signed the articles of incorporation of the Dallas Federal Reserve Bank. My great uncle lobbied for the establishment of the San Antonio branch and served on the Federal Advisory Council. My father was a director of the San Antonio branch. I will have 15 years of service to the Fed - 6 years on the San Antonio branch board, and 3 years as a member of the Federal Advisory Council. Next month completes my sixth year on the board of the Dallas bank. I ask that my views be accepted as from one with a practical understanding of the workings of our Central Bank. My formal education, the mentoring of my superiors and my direct

experience have been focused on the Federal Reserve's significant role in affecting the well being of each and every individual who participates in economic process in this country.

It is from this conviction that the central bank be an instrument of good for all and not by serving any single sector that I address my remarks to you as you consider changes in the laws governing the Federal Reserve System.

I have been taught and can testify through experience that the independence of our central bank within government is the critical element which allows the effective administration of monetary policy for benefit and good of the entire nation. It is with much satisfaction and great appreciation that the acknowledgement of this independence is not basically questioned by those who propose to change either the method by which the presidents of the regional banks are elected or their participation in the Open Market Committee. It is a fact that the level of inflation in a country is directly related to the independence of the central banking function. The closer a central bank is tied to the political process, the greater the inflation tendencies. Conversely, more independence is associated with less inflation as shown in Exhibit A attached.

It is my opinion that a lessening of the independence of supervision of monetary policy will have negative influence on the standard of living in this country.

The grace of our system lies in the unique, but most effective input of many people directly active and involved in the market-place. The participation of a minority of the Open Market Committee coming from only five who are not named through the political process, who have the daily experience in the "real world" and direct participation in the economic process, is a factor which makes our system responsive to the actual and current needs of the people.

The contribution of the 12 regional bank boards through their presidents is invaluable. If those who reflect that element do not have a vote then their input will not be effective.

Without this direct personified input of experience from the market-place, monetary policy might well be deliberated by a committee whose members are isolated inside the beltway environment reviewing computer printouts of economic trends.

The principle that such a public enterprise as a central bank be controlled by those subject to the democratic process appointed by elected officials is not violated since a clear majority of the Open Market Committee is appointed by the President of the United States and confirmed by the Senate.

The Board of Governors' influence is far more pervasive in the operation of the central bank than just serving as a majority of

the Open Market Committee. Those appointed by an elected official, the President of the United States, form 100% of the governing body in all other matters.

So that the role of the Board of Governors in the naming of the 12 bank presidents not be overlooked, I would like to relate my participation in the election of the president of the Dallas bank. The selection committee of the bank board was named by the chairman of the bank who was appointed by the Board of Governors. The Bank Board Committee consisted of only one banker or person elected by the shareholders (commercial banks). It was understood and agreed that while the board of the regional bank would initiate and manage the selection process that no candidate would be presented to the board of the bank unless that candidate was approved by the Board of Governors of the entire system. This gives practical evidence that the office of the president of a regional bank is not outside the democratic process.

Since its inception, the Federal Reserve System has undergone change and adaptation. The open market function itself was not appreciated or understood at the beginnings in 1914, coming into effective existence later. On its own volition more input from the marketplace has been sought by the Board of Governors. The Federal Advisory Council, set out in the original act to consist of bankers, has been joined by similar groups consisting of consumers

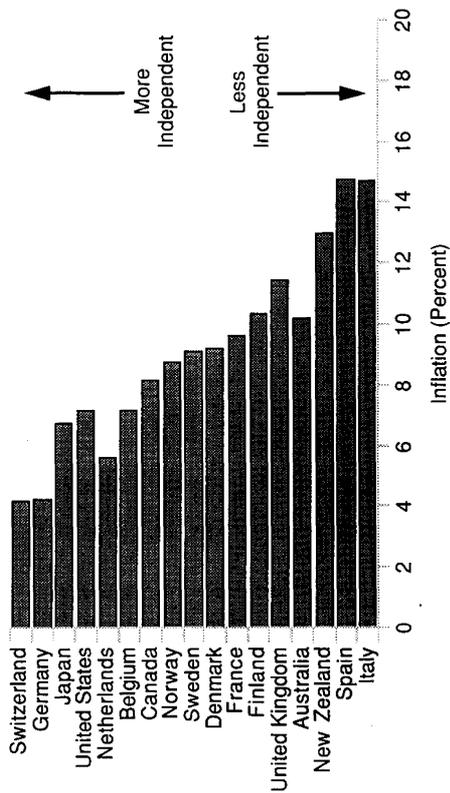
and small business representatives.

The diversity of the 12 banks' boards and the boards of their branches has been expanded significantly through efforts and initiatives of the Board of Governors, the regional bank directors and the commercial banks who are stockholders of the Fed. It has been my privilege to serve with women, members of minority groups, and representatives of non-management such as labor leaders. All have been effective contributors to the work of the central bank and add dimension to the input from the marketplace. The observation that this diversity has not reached the presidencies of the regional banks reflects the historical source of talent pools and not the desire of all who manage and participate in the Federal Reserve process. To recognize and be sensitive to the appropriate elements of various diverse elements is a major goal of all who are part of the central bank.

To close, I ask you not to change the present process of selecting the 12 regional bank presidents or alter their role in the Open Market Committee. To do so would be a mistake for a more politicized central bank leads to additional inflationary tendencies with a negative impact on all. Other nations are moving toward more independence as a result of our example. (See Exhibit B attached). An independent central bank still managed and operated within government will better serve the entire population of this great country.

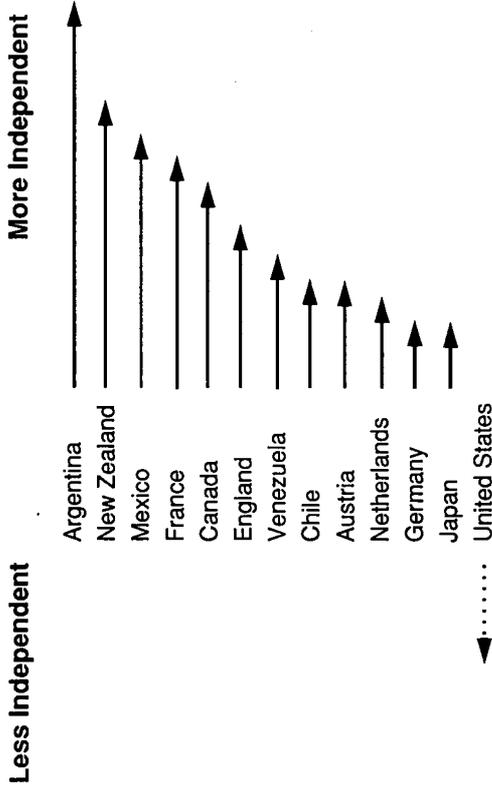
Exhibit A

Average Inflation and Central Bank Independence in Selected Countries



Source: Research Dept., Federal Reserve Bank of Dallas

Worldwide Trends in Central Bank Independence



Source: Research Dept., Federal Reserve Bank of Dallas

RUSSIAN-AMERICAN ENTERPRISE FUND

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E. GERALD CORRIGAN
CHAIRMAN

October 29, 1993

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking, Finance
and Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515-6050

Dear Mr. Chairman:

In accordance with the arrangements worked out with your staff, I am forwarding to you my statement on H.R. 28, "The Federal Reserve System Accountability Act of 1993." As I understand it, the statement will be part of the record with regard to the Committee's deliberations on this subject.

I appreciate very much the opportunity to share my thoughts on this important matter with you and your colleagues on the Committee.

Sincerely,



Attachment

STATEMENT BY
E. GERALD CORRIGAN
FOR THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
OCTOBER 29, 1993

Mr. Chairman, members of the Committee, I am pleased to have this opportunity to share with you my thoughts on H.R. 28 "The Federal Reserve System Accountability Act of 1993". As the members of this Committee know very well, the basic legal framework within which the central bank of any nation operates is a matter of great importance. For that reason, any material change in that framework must be evaluated with great care and with a particular sensitivity to its consequences -- and potential consequences -- over the long term.

From my perspective, a useful point of departure in deliberations that would alter the legal framework of the Fed is to reflect briefly on the track record of the Fed with regard to its basic responsibilities. Those basic responsibilities -- as reflected in the preamble of the Federal Reserve Act -- relate to the Fed's role in the conduct of monetary policy, its efforts to help ensure the stability of the banking and financial system and its efforts to help ensure the efficiency, safety and integrity of the payments system. Because these basic responsibilities are so closely interrelated, I have always viewed them as something of a central banking trilogy in that each element of the trilogy interacts with the other in pursuit of the common theme of financial stability -- including stability in the purchasing power of the dollar.

In looking at these basic responsibilities, I believe most observers would agree that the Fed has a solid record of high quality performance in the nation's interest. There is, for example, no better, no more efficient and no more trusted national payments system in the world than is found in the U.S. -- and that may understate the case. While the marvel of the U.S. payments system is by no means the exclusive product of the Fed, there can be no question that the Fed's operations and its policies have played a major role in the evolution and development of the U.S. payments system. Even the unglamorous nuts and bolts are important in this regard. For example, the fact that millions of households and small businesses -- especially those in more remote areas of the country -- can have their checks and other payments processed with the speed, the low cost and the trust that we witness can be traced, in no small way, to the Fed's efforts.

The second leg of the central bank trilogy relates to the Fed's role in helping to ensure the stability and safety of the banking and financial system. Here, it is interesting to note that many central banks -- including the Federal Reserve -- were established more with a view toward this objective than they were with a view toward what we would regard as contemporary monetary policy. That historical footnote aside, this too, is an area in which I believe most observers would agree that the Fed has played a highly constructive role -- especially in containing the many financial disruptions of the past decade. Indeed, in

many circles -- perhaps especially abroad -- the Fed is seen as having a particularly broad and highly pragmatic base of professionalism and expertise in this area -- a judgment that is conditioned in part from the Fed's working knowledge of financial institutions, financial markets and the "plumbing" of the financial system.

The third -- and central element -- of the trilogy is, of course, monetary policy. Recognizing that price stability is much more a state of mind than a statistic, I believe that the bedrock of any central bank's responsibilities must be the preservation of the purchasing power of the currency of the nation. That, in turn, is the key to sustained economic growth and rising standards of living. It is widely recognized that to achieve those objectives requires -- indeed demands -- an intermediate- and longer-term policy perspective that is insulated from short-term political pressures. That is why, from the very beginning of the history of central banking in the United States, care was exercised in providing the central bank with a significant degree of "independence within government". That is also why we have seen -- and are seeing -- so many countries moving to grant national central banks a greater degree of autonomy and political independence. Indeed, governments in all parts of the world -- in developed and developing nations and even in newly emerging market economies -- seem to increasingly embrace the concept of an autonomous and independent central bank. And, in so doing, they often point to and draw on the

experience of the Fed in the United States. It would be an ironic twist if the United States were seen as moving in the direction of greater political influence over the central bank at just the point in history when so many other countries are moving in the opposite direction.

In suggesting that the Fed has a credible track record with regard to the manner in which it has fulfilled its basic responsibilities I am not suggesting that the Fed is flawless. Human nature and human frailties being what they are, no institution can even begin to make such a claim. Nor am I suggesting that as an abstract principle it would be impossible -- working from a clean slate -- to conceive some alternate structural characteristics that might work as well as those we have. But, we are where we are, and where we are is the result of almost two centuries of debate and deliberation about the structure and functioning of the central bank in a highly pluralistic society.

All of this is not to suggest that we, as a nation, should not pause from time to time in order to satisfy ourselves that the basic structure of important institutions such as the Fed remains in keeping with our national interest and our national heritage. By the same token, as we seek to satisfy ourselves in that regard, we must recognize that the delicate balance that has been struck over the years in the structure of our central banking system, and its relationship to the government as a whole, is just that -- delicate. What may seem

to be modest or even inconsequential change may bring with it the appearance or the reality of major change over time. Thus, while I can understand the sentiments that lie behind H.R. 28 and related proposals, I do not consider these proposals to be modest tinkering. Indeed, I believe that the enactment of H.R. 28 and/or related proposals almost surely will be interpreted both here and abroad as leading to greater political influence over the Fed. In that connection, I would caution against minimizing the international dimension of this concern, keeping in mind that due to our fiscal imbalances we have been and still are importing massive amounts of savings from the rest of the world.

Against that general background allow me to briefly summarize the basis of my concerns. At the most general level, and granting the very best in terms of intentions, I am extremely hard pressed to see how the changes contemplated could be interpreted any other way than to point in the direction of greater political influence over the Fed and/or making it more difficult to formulate and execute monetary policy.

Take, for example, the whole question of the disclosure procedures regarding the deliberations and decisions of the FOMC. Here, I would respectfully submit that the main issue is not one of openness and disclosure but one of practicalities. That is, as a very practical matter, open meetings or verbatim minutes of FOMC meetings would surely stifle debate and discussion but such arrangements also would mean that essential information received from officials abroad could not be introduced into the

deliberations. Indeed, if such information were part of a public record, those foreign officials would simply stop talking to Fed officials about matters that are often highly germane to monetary policy deliberations.

At another level, immediate release of the decisions of the Committee regarding day-to-day tactics of open market operations would, as an entirely practical matter, either result in more market volatility and uncertainty or a less effective policymaking process, or both.

Permit me to elaborate briefly. The nature of open market operations are such that more often than not the directives of the Committee to the trading desk in New York have a contingent element. Indeed, if they did not, the flexibility that is so essential and so central to this tool of monetary policy will be compromised or lost. I would go one step further and say that based on my 13 years of experience as a member of the FOMC, the contingent nature of the Committee's decisions and instructions to the trading desk are an absolutely indispensable part of the policy process as it pertains to open market operations. Therein lies the heart of the dilemma.

That is, if the directive must often be conditional, its immediate release will surely spur more uncertainty and more market volatility, not less. Moreover, in the face of immediate release, it will be much more difficult for the policymakers to reach an orderly and flexible consensus on policy. In other words, immediate disclosure will yield no significant net public

benefits that I can foresee but it will increase uncertainty and financial market volatility and it will work to the detriment of the policymaking process as a whole.

Having said that I should hasten to add that I can see little or no downside risks to a revival of the practice whereby the FOMC -- with an appropriate time lag -- would make public something along the lines of the "Memorandum of Discussion" that was used in the past. If that practice were resumed there would, of course, have to be an understanding to the effect that certain items -- such as references to information relating to discussions with foreign officials and information relating to individual institutions -- would have to be omitted. Subject to those stipulations and recognizing that such an arrangement could be worked out without legislation, I can see merit to an effort on the part of the Fed and the Congress to put in place such an arrangement. Assuming that was done, it would represent a constructive move in the direction of greater disclosure and greater accountability.

The other major provision of H.R. 28 that I wish to address directly relates to its provisions pertaining to the appointment and responsibilities of Federal Reserve Bank presidents. At one level, the issue that arises in this connection is rather straightforward; namely, should "private" individuals be a direct party to the monetary policy decision making process? I am not a lawyer, much less a constitutional lawyer but I am sensitive to history. And, when I look at the

history of central banking in the United States, what I see is that the founding fathers of our nation, who possessed a direct knowledge of the intent of the Constitution, were quite prepared to vest in "private" individuals a major role in the governance of the First Bank of the United States. Perhaps it's an oversimplification, but I'm inclined to the view that if it was good enough for them, it's good enough for me.

Even if that historical argument was legally compelling, it does not, of course, imply that Congress in its wisdom might not opt for some other arrangement, of which at least three are now on the table. One would have the Reserve Bank presidents appointed by the President and confirmed by the Senate; another would remove the presidents from the FOMC leaving them with only advisory responsibilities; the third would have the presidents appointed by the Board of Governors of the Federal Reserve System.

The first of these clearly carries with it the risk of being seen as entailing the threat or, over time, the reality of greater political control over the Fed. The second would, as a practical matter, substantially undercut the regional character of the Fed. Over time, I feel certain that the advisory role of the Reserve Bank presidents would drift into little more than a ceremonial process. Beyond that, it would fundamentally and irreversibly alter the working relationships between the institutional components of the Fed thereby undercutting the

highly constructive interplay between the Reserve Banks and Washington.

Speaking as the only person who has served as the president of two Reserve Banks and has worked at the Fed in Washington, there is no doubt in my mind that over time such arrangements could easily deprive the Fed of important elements of its vitality and diversity that grow out of its regional character. Such a result, in my judgment simply would not be in the public interest.

The third proposal -- having the Reserve Bank presidents appointed by the Board of Governors -- holds no greater attraction for me than the other two approaches. I say that for two primary reasons: First, as a wholly practical matter the Board of Governors now has complete veto authority over the appointment of any Reserve Bank president. Second, and given that absolute veto authority, what the proposal in question would achieve would be to remove from the process of selecting Reserve Bank presidents the formal input of the boards of directors of the Reserve Banks. As I see it, the net result of this also would be to fundamentally alter the regional character of the Fed and the delicate balance of responsibilities and interaction within the Federal Reserve. It would also make it that much harder to attract the high quality men and women that have served the nation with distinction as Reserve Bank directors.

It is never easy to be in a position of rejecting three proposals which are put forward in a serious and thoughtful manner. But, as a matter of utter conviction I cannot see how any of these proposals will work to improve the performance of the Federal Reserve relative to its basic responsibilities but I can see clear dangers that any or all of these proposals could, in subtle but certain ways, alter the character and functioning of the Federal Reserve in ways that would not be in the national interest.

In closing, Mr. Chairman, let me return to the concept of the Fed's "independence within government", a phrase that I believe was originated by William McChesney Martin when he was chairman of the Board of Governors. For me, that seemingly simple phrase has always had a powerful meaning. In its simplicity it recognizes that the Fed cannot be insensitive to, much less indifferent toward, the judgments of elected officials in either the executive or legislative branches. At the same time the phrase also recognizes that the Fed must be in a position where it can make the hard decisions required of any credible central bank free from the vagaries of short-term political pressures. Raising interest rates, for example, is never going to be a popular decision but there are times it must be done. When those inherently unpopular decisions are made, the interplay between the Fed and the executive branch, coupled with the Congressional oversight process, provide ample opportunities and instrumentalities through which accountability can be, and is

being, maintained in a manner that is in keeping with the tradition of central bank "independence within government" in that highly pluralistic society of which I spoke earlier.

Thank you.



ISBN 0-16-044286-9

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