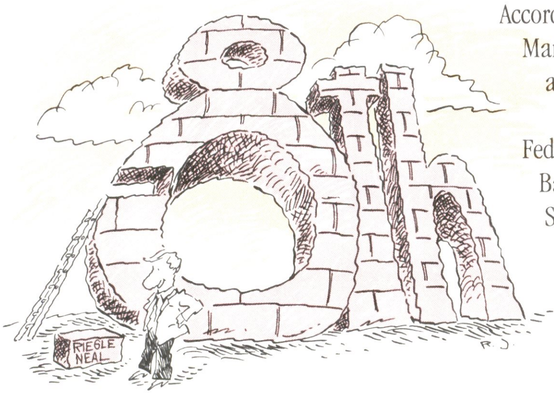
CB CENTRAL BANKER

Summer 1995

News and Views for Eighth District Bankers

Riegle-Neal Impact on Eighth District May Be Small



What impact will the Riegle-Neal Interstate Banking and Branching Act have on banking in Eighth District states? According to Mark Vaughan, an economist at the Federal Reserve Bank of St. Louis, the additional relaxation of interstate branching and banking restrictions by Riegle-Neal probably will not induce significant increases in banking concentration. Such increases are unlikely because District states already have relaxed their *intrastate* branching restrictions.

Between 1985 and 1991, Vaughan observes, banking grew more concentrated in District states as intrastate branching restrictions were relaxed. He points to trends in the percentage of statewide deposits controlled by the five largest banking organizations, a common measure of banking concentration. By this gauge, banking grew more concentrated in all seven District states. Indiana experienced the largest jump. In 1986, the five largest Indiana banking organizations controlled 31.9 percent of statewide banking deposits; by 1992,

(continued on next page)

ECP Helps Detect Check Fraud Earlier

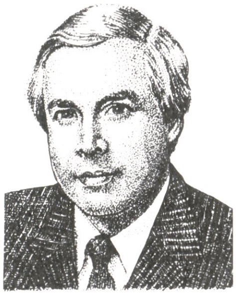
Despite the Expedited Funds Availability Act of 1987, check fraud continues to be a major problem for banks. A recent ABA survey estimates that U.S. commercial banks were defrauded of $815 million in 1993, up from $568 million in 1991, while estimated check fraud cases ballooned from 537,000 to more than 1.2 million. In addition, it's estimated that retailers lose about $5 billion a year because of check fraud.

According to Bruce Brett, chairman of the ABA Check Fraud Task Force, one major factor allowing check fraud cases to rise is the recent availability of check printing and copier technology to the general public. This has enabled more people to produce fabricated checks that appear to be genuine.

The Federal Reserve System encourages electronic check presentment (ECP) as a method of detecting check fraud earlier. By moving check information faster than the typical paper collection and transportation routes, ECP helps detect fraud more rapidly and minimizes the risk of loss. Through ECP, payor banks receive full MICR information well before the actual check arrives. This earlier warning allows payor banks to accelerate return of the fraudulent checks back to the payee.

For more information on ECP, contact Mary Kuni at (314) 444-8715.

Feditorial



Thomas C. Melzer

The Emergence of Nonbank Financial Service Providers

Many of today's headlines herald the emergence of new players getting into the business of processing payments and payment information. Whether it be a credit card company, telephone or cable television company, software vendor or others, the entrance of these non-traditional financial service providers presents new challenges for the Federal Reserve as we fulfill our responsibility for ensuring the integrity, efficiency and accessibility of the nation's payments system.

Historically, the Fed has focused most of its attention on financial institutions because they essentially constituted the nation's payments mechanism. Today, the dynamics of new participants and technology necessitate that we begin developing relationships with a broader constituency. We need to better understand the payments approaches of these new players and be satisfied that any risk associated with such approaches is acceptable.

Building on the relationships we have cultivated within the banking industry, we intend to begin forming new ones with nonbank service providers, bringing all parties together to move toward the best possible payments system for the United States going into the 21st century. With the public's interest foremost, we intend to encourage innovation that takes advantage of new technology and introduces new, convenient payment methods. But we'll never lose sight of how these changes might affect our payments system's safety and reliability.

Thomas C. Melzer is the president and chief executive officer of the Federal Reserve Bank of St. Louis.

Riegle-Neal Impact

(continued from front page)

that percentage had climbed to 47.9 percent.

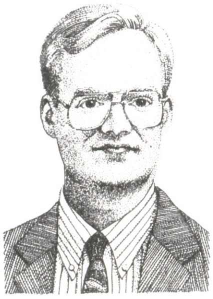
Vaughan also cites trends in the percentage of statewide banking assets held by banking organizations with less than $1 billion in assets, a measure particularly relevant to community bankers who fear the loss of market share to larger banks and holding companies in the post-Riegle-Neal world. Between 1986 and 1992, these relatively small banking organizations lost market share in every state except Missouri. Indiana, again, witnessed the largest change; the percentage of assets held by Indiana banking organizations under $1 billion shrank from 46.1 percent to 35 percent.

"Economic theory will tell you that branching restrictions only impair the ability of a bank to select the size and branch structure that will maximize efficiency and customer satisfaction," Vaughan says. "The removal of intrastate branching restrictions a few years ago increased banking concentration by allowing banking organizations to exploit economies of scale and customers' desire for multi-office banking. Because most obstacles to branching have already been removed, I don't expect the additional relaxation of interstate branching and banking restrictions under Riegle-Neal to increase concentration significantly within District states."

Percentage of Deposits Controlled By Top Five Banking Organizations

State	1986	1992
Arkansas	26.9%	32.7%
Illinois	33.9	36.6
Indiana	31.9	47.9
Kentucky	37.7	40.5
Mississippi	45.3	52.3
Missouri	51.2	54.3
Tennessee	55.3	55.4

Banks' Struggle for Efficiency in the Face of Improved Technology



David C. Wheelock

Banks are not efficient producers of loans and other financial services. At least that is the conclusion reached by many researchers. In some studies, economists have found that the typical commercial bank uses 25 percent to 40 percent more labor, physical plant and borrowed funds than needed to produce loans and other financial services. As an indicator of performance, banks' inefficiency not only suggests that resources are being wasted, but also raises the question: What is the long-term viability of the banking industry?

Because banks supply a myriad of financial services, measuring their efficiency is difficult. When measuring efficiency, researchers are forced to use simplified models of how banks operate. This type of research is in its infancy, but we do know that different measures of bank production can lead to very different estimates of efficiency. Regardless of the model used, however, researchers often find that banks are considerably inefficient.

Paul Wilson, an associate professor of economics at the University of Texas at Austin and a visiting scholar at the Federal Reserve Bank of St. Louis, and I have recently investigated the sources of commercial bank inefficiency. In one study, Wilson and I trace the inefficiency of banks—particularly their seeming lack of improvement over time to technological change.

Over the past 15 years, the banking industry has undergone many changes. Among these, advances in computer and communications technology have revolutionized bank operations, often enabling banks to cut costs while improving service. At the same time, this has increased competition between banks and other financial service providers. Thus, banks have been forced to adapt not only to changing regulations, but also to new technology and increased competition. Many of those that lagged behind either failed or were acquired by other banks.

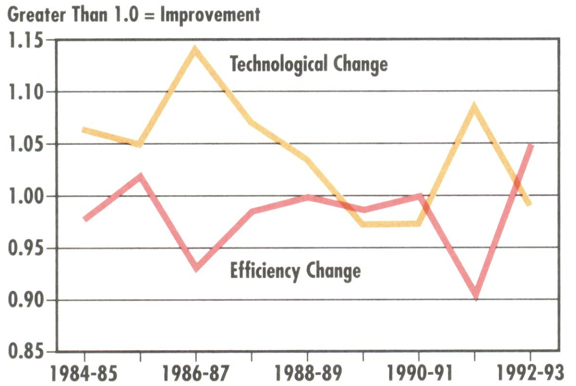
Banks today can produce a given amount of loans and other financial services with less input than they could in 1984. In other words, there has been considerable technological progress in banking among the most efficient banks. Most banks, however, have not adapted as rapidly as the pace of technological progress.

The accompanying chart illustrates the case for banks with more than $1 billion of assets, though the pattern is similar for banks of all sizes. Throughout most of the period depicted, the banking industry experienced technological improvement, but little or no positive change in efficiency. In fact, in 1986-87 and 1991-92, the average bank became considerably less efficient. Failure to keep up with technological progress meant that most banks became less efficient producers than what was possible.

Over the 10 years we study, the apparent declines in efficiency have just about offset the gains in technology in the banking industry as a whole. We find, however, that banks with more than $1 billion of assets are more productive today than they were 10 years ago. Small banks, especially those with fewer than $100 million of assets, are less productive. In other words, the combination of technological improvement and changes in average efficiency has tended to favor larger banks. Thus, the relative disappearance of small banks through failure or acquisition over this period is perhaps not surprising. Further study must be undertaken before decisive conclusions can be made about how efficiency relates to the long-term viability of the banking industry.

David C. Wheelock is a senior economist at the Federal Reserve Bank of St. Louis

Why Are Banks Becoming Less Efficient?
Efficiency Losses and Technological Gains



Regional Roundup

OUT FOR COMMENT

The following are Federal Reserve System proposals currently out for comment:

- **Proposal to simplify the process for reporting suspected crimes and suspicious financial transactions by banking organizations. The new rules would reduce the number of reports that organizations must file and the number of copies that must be submitted. Comments due by Sept. 1, 1995. (Docket No. R-0885)**
- **Proposal to revamp Regulation T to reduce the rules and margin restrictions on certain securities transactions. Comments due by August 28, 1995. (Docket No. R-0772)**

Direct all comments to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

New Data Show Derivatives Usage in District

According to newly expanded call report data, 35 District banks, or 3 percent of the total, reported using off-balance sheet derivatives in the first quarter of 1995, compared with 6 percent of all U.S. commercial banks.

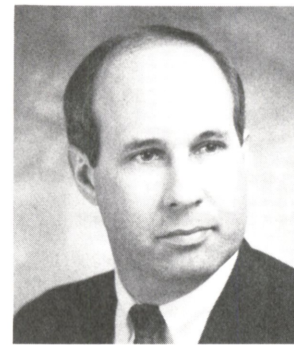
Derivatives usage is concentrated at the largest District banks. Just over two-thirds of District banks with assets of more than $1 billion reported usage, compared with only 1 percent of District banks with assets of less than $300 million.

In contrast, banks of all sizes reported holding structured notes in their securities portfolios. Just over half of all District banks indicated they held these instruments; 51 percent of District banks with assets of less than $300 million reported structured note holdings, compared with 42 percent of banks with assets of more than $300 million.

Bankers' Comments Made Difference in New CRA

As the recently revised CRA regulation illustrates, bankers can influence policy by responding to proposals that are out for comment. Proposals to revise CRA went through two comment periods, with each one receiving more than 6,000 comments. As a result, revisions to CRA have resulted in regulations that are more objective and performance-oriented, and less burdensome on the banks and thrifts that must comply with it.

Bankers are strongly encouraged to take part in the comment process. All responses are read and considered, and a single, well-reasoned argument can have a large effect on the outcome of a proposal. Proposals that are out for comment are listed in every issue of *CB*. Listed with the proposal is the deadline and a contact name and address.



Ashman Appointed Senior Vice President in St. Louis

Karl W. Ashman has been appointed senior vice president at the Federal Reserve Bank of St. Louis with responsibility for the Administration Division, effective Sept. 1, 1995. Ashman currently is the manager of the Little Rock Branch, where he has served for the past five years.

From 1982 to 1990, Ashman was vice president and cashier of operations at Mercantile Bank of St. Louis.

Fed Encourages Positive End-of-day Balances

It is important for account holders to ensure that their end-of-day balances at the Fed will be positive before closing their own accounting systems. To assist in this effort, the Fed has implemented a daily process of alerting institutions that have negative account balances. Every afternoon, Fed officials contact these institutions to inform them of their situation and to facilitate resolution.

Further, the Fed provides several account monitoring tools that institutions can use to supplement their own internal systems. The Monitor Balance and the Daylight Overdraft Inquiry screens on Fedline are particularly helpful in monitoring accounts throughout the day.

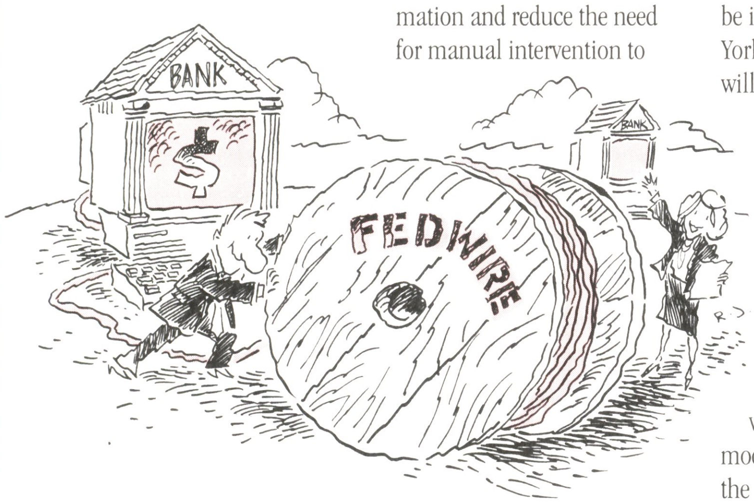
Account holders should remember that transactions can be posted to their Fed accounts as late as 6:30 p.m. Eastern time. Institutions should rely on their own records as the primary source for their account balances. The Fed encourages comparing these totals to those reflected on the Fedline screens throughout the day.

If the two cannot be reconciled, call one of the following numbers for assistance: St. Louis, (314) 444-8917; Little Rock, (501) 324-8247; Louisville, (502) 568-9296; or Memphis, (901) 579-2439.

Fed to Roll Out Expansion of Fedwire Format

Acting on recommendations from an ABA task force, the Federal Reserve Board has approved a proposal to expand the Fedwire funds transfer format. The format will be rolled out gradually and completed by the end of 1997.

The new format will incorporate additional payment information and reduce the need for manual intervention to process and post transfers. The new format will include complete transfer party information to assist in anti-money laundering efforts, a feature specifically requested by the Justice and Treasury departments.



To ensure a smooth transition, depository institutions will first begin receiving Fedwire transfers in the new format before they begin sending new-format transfers. The Federal Reserve viewed this measured conversion method as least likely to cause a serious disruption to the Fedwire system. Federal Reserve Banks will work closely with funds transfer customers to schedule and manage conversions.

Although institutions may face relatively high implementation costs during the rollout, these costs should be offset in the long run through operational gains realized through the improved Fedwire format. To accommodate the new format, new Computer Interface Protocol Specifications (CIPS) will be distributed this summer, and computer interface customers and vendors will be invited to a meeting in New York in October. The Fed will provide enhanced software to banks that access Fedwire through Fedline. Participants, however, will require education and training to become familiar with the new format. In addition, institutions with back-office systems that interface with Fedline may need to modify their systems to support the new format.

In December 1993, the Board issued for public comment a proposal to expand the Fedwire funds format and adopt a more comprehensive set of data elements. Comments received generally were supportive of the expansion. Many indicated that the new format will help to more fully automate their backroom processing and improve compatibility with the Clearing House Interbank Payments System (CHIPS) and the Society for Worldwide Interbank Financial Telecommunication (S.W.I.F.T.) system.

Fed officials will contact District funds transfer customers later this year to develop a conversion schedule (see sidebar for key dates). In the meantime, please call Anne Hoerner at (314) 444-8537 for more information.

Key Dates for Fed "Re-wiring"

Funds transfer customers, mark your calendars now. Listed below are key dates to remember as the new Fedwire format is rolled out.

August 1995—Computer Interface Protocol Specifications (CIPS), which details software and technical requirements, as well as installation and certification guidelines, will be distributed to banks.

April 1996—Testing period begins for funds transfer customers.

July 1996 - May 1997—Phase one of the implementation. Participants convert to receiving Fedwire information under the new format.

May - June 1997—A stabilization period of four weeks will allow any bank that previously has failed to convert the receive side to complete implementation.

June - December 1997—Phase two of the implementation. Participants convert to sending Fedwire information under the new format.

December 29, 1997—Phase two ends. All participants are required to both send and receive the new Fedwire format.

FedFacts

Changes to High Dollar Group Sort Program

The semiannual service changes for the Federal Reserve's High Dollar Group Sort (HDGS) program took effect July 3. In the Eighth District, St. Louis deleted two endpoints and Memphis deleted one endpoint.

As for other districts, 12 offices added HDGS endpoints: Baltimore, Chicago, Denver, Helena, Jacksonville, Kansas City, Lewiston, Milwaukee, Omaha, Philadelphia, San Francisco and Windsor Locks. Six offices deleted endpoints: Cleveland, Los Angeles, Milwaukee, Portland, San Antonio and Windsor Locks.

The program continues to focus on accelerating funds availability by providing improved collection of checks drawn on certain non-city institutions.

For more information on the HDGS program, including a list of fees, deadlines and presentment points, call Rick Johns at (314) 444-8653.

Fed to Offer Seminars on New CRA

The Federal Reserve Bank of St. Louis is planning to hold CRA seminars in late 1995 to inform bankers about the new examination procedures and to discuss compliance with the new regulation.

Stay tuned for more information in the coming months.

Additional Copies of Fed Annual Report Available

Additional copies of the Federal Reserve Bank of St. Louis' 1994 Annual Report now are available. This year's report focused on the case for price stability as the sole goal of the Federal Reserve's monetary policy. To order extra copies, call Debbie Dawe at (314) 444-8809.

1994 HMDA Disclosure Statements Available

The FFIEC has completed distribution of the 1994 individual HMDA Disclosure Statements for mortgage lenders throughout the nation. Upon request, lenders are required to make the statements available at their home office within three business days and at certain branch offices in other metropolitan areas within 10 business days.

Aggregate data for all lenders in each metropolitan area soon will be available. The FFIEC makes HMDA data directly available by calling (202) 452-2016 and selecting menu option 3; or by faxing a request for an order form to (202) 452-6497.

Calendar

Upcoming Fed-sponsored Events for Eighth District Depository Institutions

District Dialogues
Oct. 2 - Evansville, Ind.
Oct. 3 - Mt. Vernon, Ill.

Regional Economic Forums
Oct. 18 - Jackson, Tenn.
Nov. 8 - Columbia, Mo.

Community Affairs Lenders Forum
Oct. 24 - Little Rock, Ark.

For more information on District Dialogues or Economic Forums, call Bernie Berns at (314) 444-8321 or toll-free at 1-800-333-0810, ext. 8321.

For more information on Community Affairs Forums, call Glenda Wilson at (314) 444-8317 or toll-free at 1-800-333-0810, ext. 8317.

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