Spring 1998

CENTRAL Banker
NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS
SPRING ISSUE

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Feditorial: Rivlin Committee Supports Fed's Role

W. LeGrande Rives

The payments environment of the late 20th century is much different from that of 1913, the year the Federal Reserve System was established. Back then, cash was still king, widespread use of checks was in its infancy, and the automated clearing house might as well have referred to the corner saloon instead of an electronic method for transferring funds. As years went by, the Federal Reserve adapted to changing payment methods and a changing landscape for financial institutions. At the brink of a new century, the Fed last year commissioned a review, led by Vice Chair Alice Rivlin, to study what future role, if any, the Fed should have in the payments system.

Governor Rivlin and her committee looked closely at the retail payments system, which has seen dramatic innovations in the commercial sector, as well as technological advances that have led to entirely new payment mechanisms. The committee received input from representatives from more than 450 organizations—including many from the Eighth District—on five hypothetical scenarios, ranging from the Fed exiting check collection and ACH services altogether to adopting a leadership role in spurring innovation and market acceptance of new payment services and products. The committee reached two general conclusions:

1. The Fed should remain a provider of both check collection and ACH services, while ensuring access for all depository institutions; and
2. The Fed should play a more active role in enhancing the efficiency of check and ACH services and helping to evolve strategies for moving to the next generation of payment instruments.

As facilitator at all the forums and meetings held in the Eighth District, I conveyed to the Rivlin Committee valuable input I received from these gatherings. What I learned supported the committee's conclusions. That is, financial institutions believe that the Fed should become more involved in establishing the basic conditions needed to facilitate more widespread adoption of electronic payment instruments.

In many ways, this means continuing the momentum we have built up in several areas of the payments field. In ACH, for example, the Fed has partnered with NACHA and others to promote direct deposit and direct payment to corporations and consumers, as well as bankers. The committee recommended that we further address the technical ACH format-related issues that limit the ability of depository institutions and corporations to receive and process vendor payment information.

In check collection, the committee found that the Fed's withdrawal from the market would result in a short-term disruption, with few long-term benefits. Moreover, Federal Reserve withdrawal could hamper the current migration of paper-based check products to electronic forms, since market participants would need to concentrate on filling the paper collection void left by the Fed. Thus, the Fed will continue efforts to push electronic check presentment and truncation services to meet market demand while continuing to process and clear the substantial paper check volume that remains in the system.

As the banking industry marches into the next generation of payments, no one can say for certain what new issues will emerge. What I can say is that I believe the Federal Reserve is ready to meet the Rivlin Committee's recommendation that it emerge as more of a leader and facilitator in the transition of the financial services industry to a more electronic payments system.

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FHLB System Loans a Hand to District Banks

Michelle Clark Neely

Over the course of the current U.S. economic expansion, commercial banks have prospered by significantly increasing loans to businesses and consumers. Indeed, since mid-1994, loans outstanding at District banks have risen almost 35 percent. And the growth shows little sign of tailing off: Anecdotal reports from bankers around the District indicate that loan demand remains fairly strong.

That said, bankers—especially community bankers—also report that they are having increasing difficulty obtaining deposits, traditionally the major source of loan funding. Indeed, over the last three years, deposits have risen about 19 percent—roughly half the growth of loans—at District banks. Moreover, most of the growth occurred early in the period; deposit growth has been really anemic and even negative for many banks in recent quarters. To meet loan demand in the absence of strong deposit growth, an increasing number of District banks are turning to advances from the Federal Home Loan Bank (FHLB) system.

Banks first became eligible to join this previous thrift-only, government-sponsored enterprise in 1989. In the past several years, commercial bank membership has soared: banks currently make up about two-thirds of the system's 6,000-plus members.

District banks have clearly become big fans of the system, with membership at nearly 50 percent (see table). Within the District's borders, FHLB membership ranges from 37.9 percent in Illinois to 71.9 percent in Indiana. Overall, almost two-thirds of District FHLB-member banks had outstanding FHLB advances as of June 30, 1997, and in Kentucky and Tennessee, all District member banks were borrowing at mid-year 1997.

In several District states, especially Mississippi (34.7 percent) and Indiana (25.7 percent), FHLB advances make up a significant portion of banks' total nondeposit liabilities, indicating how much banks—especially community banks that have experienced actual declines in deposits—have come to rely on other funding sources.

Most of the FHLB advances made to District banks are longer term in nature, with almost three-quarters of total District borrowings carrying maturities of a year or more. These figures, however, vary quite a bit across states. In Missouri and Indiana, for example, more than 50 percent of borrowings are for terms of less than one year, compared with the District-wide average of 27.3 percent. And in Arkansas and Mississippi, about two-thirds of borrowings are for terms of more than five years, compared with the District-wide average of 30.3 percent.

Although FHLB advances have certainly helped banks increase their loan-to-deposit ratios and post record profit levels in recent years, this strategy is not without risks. So far, loans have performed extremely well, and loan losses have been minimal. However, if credit quality deteriorates unexpectedly, and loan portfolio returns start to fall, the burden of interest payments from FHLB advances and other borrowings could pinch earnings significantly.

In a worst-case scenario, a significant downgrading of a bank by supervisors could force it to immediately pay back all FHLB advances and halt all further borrowing, potentially causing a liquidity crisis. Although the industry is exceedingly well-capitalized at this time, and liquidity is readily available, there may be more than a few District banks that will wish they hadn't made that last loan when the next economic downturn arrives.

Table 1

Federal Home Loan Banks Advance in the District

as of June 30, 1997

District Portion of State	FHLB Members as a Percent of Total Banks	FHLB Advances as a Percent of Nondeposit Liabilities
Arkansas	53.2%	15.6%
Illinois	37.9	4.4
Indiana	71.9	25.7
Kentucky	59.5	12.8
Missisippi	45.3	34.7
Missouri	42.6	10.6
Tennessee	56.0	16.3
Total District	49.8	13.8

Sources: Federal Home Loan Banks of Chicago, Cincinnati, Dallas, Des Moines

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A longer version of this article was published in the January 1998 issue of *The Regional Economist*, which is available on the Bank's web site www.stlouisfed.org/publications/regional-economist/.

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https://www.stlouisfed.org/publications/central-banker/spring-1998/payments-campaign-shifts-to-direct-payment

Payments Campaign Shifts to Direct Payment

With the direct deposit campaign coming to a close, the Automated Payments Partnership is prepared to move on to the next phase—direct payment.

The Partnership, composed of the Federal Reserve Banks of St. Louis, Kansas City and Chicago as well as the Mid-America Payment Exchange, was formed last year to increase awareness and use of electronic payments. In January, the Partnership sent a letter to financial institutions in a nine-state territory inviting them to assist in promoting direct payments.

Those who choose to join the Partnership will receive a direct payment marketing kit with sample marketing materials and a direct payment guide for financial institutions. Institutions who are already partners will automatically receive the direct payment kit.

The kit contains a form that financial institutions can complete if they know of utility or service companies in their area who would benefit from receiving a brochure highlighting the benefits of direct payment. The Fed then will provide these companies with a guide to implementing direct payment or tips to increasing direct payment participation.

In April, the Partnership will begin the consumer phase of the campaign when financial institutions and billers promote direct payment to consumers.

For more information, call Carrie Andert at (314) 444-8946.

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St. Louis Fed Names Poole New President

The Federal Reserve Bank of St. Louis has named William Poole as president, effective March 23, 1998.

Poole joins the St. Louis Fed after a 24-year career at Brown University in Providence, R.I., where he was the Herbert H. Goldberger Professor of Economics. He twice has served as chairman of the economics department and was the director of the university's Center for the Study of Financial Markets and Institutions for five years. He also was a member of the Shadow Open Market Committee.

"Bill Poole is a distinguished scholar and respected economist," said John F. McDonnell, chairman of the St. Louis Bank's board of directors. "His views are a great fit with our stance that price stability should be the singular goal of monetary policy, and we are very impressed with the leadership ability he has demonstrated throughout his career."

Poole began his career at the Board of Governors of the Federal Reserve System in 1964 and worked as a senior economist there from 1969 to 1974. He was a member of the Council of Economic Advisers from 1982 to 1985 during the first Reagan Administration. Before joining the St. Louis Fed, he was a member of the Academic Advisory Panels of the Federal Reserve Banks of New York and Boston.

Poole holds Ph.D. and M.B.A. degrees from the University of Chicago and an A.B. degree from Swarthmore College. He replaces Tom Melzer, who resigned in January after more than 12 years as Bank president.

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Interstate Branch Banking Progress Report

It has been nine months since banks were allowed to implement interstate branching, as permitted by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Although interstate branching laws have not significantly affected the majority of Eighth District account holders, there have been a few changes in two areas:

Overall Effect of Merger Activity on the Eighth District

Between June 1, 1997, and Feb. 1, 1998, 10 cross-district mergers involving Eighth District institutions took place. In four of the mergers, the District gained 22 out-of-district banks with $6.4 billion in assets; in the other six, the District lost 35 banks with total assets of 36.4 billion.

Changes in Regulation D and the Introduction of the New Account Structure

As a result of changes in Regulation D and the introduction of a new Federal Reserve account structure on Jan. 1, 1998, institutions may hold only one account with the Fed, regardless of location. Accordingly, the Federal Reserve has been working with institutions to close both separate pass-through accounts kept for reserve maintenance of respondents and secondary accounts held because the institutions have a business presence in multiple Reserve Offices.

By the end of 1998, at least 52 Eighth District separate pass-through or secondary settlement accounts are expected to close, 70 percent of which will merge with master accounts in this District. Also, at least 30 pass-through or secondary settlement accounts that Eighth District institutions hold in other districts will be closed, and the relationships will move to this District.

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Fed's Switch to Triple DES Will Further Ensure Security

To further protect data transmitted electronically between the Federal Reserve and financial institutions, the Fed is preparing to switch to an advanced application of the Data Encryption Standard (DES), known as Triple DES.

The Fed's strategy is to implement Triple DES on all host computers (mainframes), FedLine terminals and link encryptors. Triple DES is based on invoking DES three times. With each iteration, it is possible to use a different encryption key value, which results in a longer overall key value that is more resistant to cryptographic attacks.

This technical direction is based on the importance the Federal Reserve attaches to providing high levels of security, which ensures continuous protection for financial institutions. If you have any questions about Triple DES, call Jean Lovati at (314) 444-8362 or Phil Schlueter at (314) 444-8985.

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Fed Changing Fedline Platform to WindowsNT®

The Federal Reserve System has chosen Microsoft Windows NT® as the exclusive operating system for the new FedLine software after its transition to the Windows Platform.

Because the release of FedLine for Windows NT is still a year away, the Fed suggests that financial institutions maintain their DOS-based hardware for the time being. Institutions should note, however, that as they prepare for the transition to FedLine for Windows NT, they may need to upgrade their PCs to meet new hardware specifications.

The new software for Windows NT will offer several significant improvements over the current DOS-based software, including:

- multitasking capabilities, which enable institutions to use other applications on their PCs without exiting FedLine;
- an in-depth online "help" function; and
- the ability to view and delete queued transactions before sending them to the Fed.

"FedLine for Windows will take advantage of the many changes in PC technology that have occurred since Fedline was introduced in the Eighth District 10 years ago," said Marilyn Corona, vice president of Corporate Accounting and Customer Relations at the St. Louis Fed. "Better utilizing this technology will provide greater flexibility and ease of use in our customers' operating environments."

The St. Louis Fed will assist customers in the transition to the Windows NT platform as the time nears. In the meantime, for questions about the expected hardware configurations or to preview the NT Workstation, please call Gary Auer at (314) 444-8948.

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Regional Roundup

'97 FCA Still Open for Enrollment

Financial Institutions can still enroll to participate in the Fed's Functional Cost and Profit Analysis (FCA) program for the 1997 data year. FCA, a cost accounting program to help measure profitability, is now available in two versions: FCA Basic and FCA Plus.

FCA Basic is for institutions that are unfamiliar with cost accounting. For institutions that have experience with cost accounting or have previously participated in FCA and need more analysis, there is FCA Plus. Both programs create a unique customized report for participants, who use the reports as a tool to analyze income and expense by function and to measure performance against a select group of peers.

For more information, call Dan Horton at (314) 444-8629.

Fed to Eliminate FLASH-Light Support

The Federal Reserve has announced that as of March 31, 1999, it will eliminate all support for its FLASH-Light product. Originally created in 1990 as a receive-only mechanism, FLASH-Light introduced customers with little or no PC knowledge to the benefits of electronic file receipt. The product is limited, however, because it has no capability to originate transactions.

The Fed encourages current FLASH-Light customers to consider a Fedline connection, preferably the new FedLine for Windows product. For more information, call Marilyn Corona at (314) 444-8883.

Collateral Manual to Supplement Circulars

In the coming weeks, the Federal Reserve System will distribute to financial institutions a collateral procedures manual to supplement the following Operating Circulars: 7, 8, 9 and 10. The purpose of the manual is to assist institutions in knowing what to do when depositing, withdrawing or substituting collateral pledged for any purpose.

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FedFacts

Uniform Cash Access Policy Coming in May

On May 4, 1998, the Fed's new Uniform Cash Access Policy (UCAP) will take effect. In general, the policy provides free weekly access for up to 10 endpoints per financial institution per Federal Reserve office. Additional endpoints also will be free if minimum shipment sizes are met. Also, more frequent access may be free depending on shipment size. The St. Louis Fed distributed detailed information to all financial institutions, but for more information contact Gladys Butler at (314) 444-8330.

Greenspan's Testimony Available on the Internet

The full text of Alan Greenspan's semiannual Humphrey-Hawkins testimony before Congress is now available on the Internet. To view this testimony, simply visit the Federal Reserve Board's home page at www.federalreserve.gov.

A summary report of the testimony, entitled Monetary Policy Objectives Summary Report of the Federal Reserve Board, will be available on the Internet at the same address. Printed copies of the summary report are available from the Federal Reserve Bank of St. Louis free of charge.

CDC Financial Institution Testing Begins in July

Beginning July 1, 1998, financial institutions can begin testing their software interfaces for Century Date Change (CDC) compliance with Federal Reserve software like Fedline and Bulkdata.

Most Bulkdata users will want to have a test Bulkdata system available to allow them to test with the Fed during the week. Since much of the Fed's test environment availability will be during the week, a test Bulkdata system will allow users to perform CDC testing while still conducting regular business with their production systems. The Fed encourages Bulkdata users to start working on setting this environment up now if they do not currently have a test Bulkdata capability.

For additional information, please contact Jeff Dale at (314) 444-8400 or your account executive.