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Reserve Requirements and Monetary Policy
Robert H. Rasche

Reserve requirements are enshrined in introductory economics textbooks as one of the "tools," albeit a crude one, of monetary policy. Such regulations are understood to affect the banking system, and, ultimately, the economy by influencing the proportion of total assets that depositories hold as cash assets (either vault cash or balances with the Federal Reserve).

In recent years, different trends have emerged across industrial economies. The Bank of Canada has abolished reserve requirements. The new System of European Central Banks, in contrast, has established a 2-percent reserve requirement on almost all liabilities. In December 1990 and January 1991, the Federal Reserve reduced reserve requirements on non-personal time deposits to zero. Then, in April 1992, marginal reserve requirements on transactions deposits for the largest class of depositories were reduced from 12 percent to 10 percent.

In the absence of reserve requirements, depository institutions would continue to hold cash assets. Such assets are required to satisfy normal business operations, including settlement of interbank transactions (such as wire transfers and check clearing) and the exchange of retail deposits for currency on request. This represents a transactions demand for cash assets.

The evidence from recent U.S. data strongly suggests that the amount of cash assets demanded by most depositories now is determined by institutions' transaction demands. Under the legal reserve requirement ratios that were established in December 1990 and April 1992, and the "home-brewed" ratios allowed via the implementation of retail deposit "sweep" programs since 1994, reserve requirement regulations no longer are binding constraints on the portfolios of most depository institutions.

An environment in which the demand for cash assets by depositories is determined by transactions demands rather than regulatory constraints has several implications:

1. On March 26, 1998, the Board of Governors announced the return to a lagged reserve requirement structure, beginning July 30, 1998 (Federal Reserve Bulletin, May 1998, p. 337). Under the new system, the reserve computation ends two weeks before the beginning of the reserve maintenance period. Hence, depository institutions can know with certainty their level of required reserves before the maintenance period begins, and, similarly, the Federal Reserve can know the level of aggregate required reserves. In the near future, it is unlikely that this regulatory change will have any substantive effect on depository behavior, or on the conduct of the Fed's Open Market Operations.

2. It is important to distinguish between the concept of a reserve requirement as a pure tax (in exchange for which depositories receive no services) and as an implicit user charge for which the depositories receive clearing services from the Fed that are not explicitly priced. When legal reserve requirements are not binding constraints, the forgone interest from holding Federal Reserve deposits to meet a transactions demand should be viewed as a normal operating expense. Under these circumstances,
payment of explicit interest on Federal Reserve balances would constitute a subsidy to the depository industry.

3. A number of recent studies conclude that funds rate volatility has not increased in recent years. This suggests that the evolution from an environment in which demand by depositories for cash assets is dominated by reserve requirements to one in which this demand is determined by patterns of payments activity does not introduce any fundamental problems for the current Federal Reserve operating procedures that are focused on federal funds rate objectives.

Changes in reserve requirements in the U.S. over the past decade are consistent with reducing the regulatory burden on depository institutions, but have not had a significant impact on the ability of the Federal Reserve to conduct monetary policy.

A longer version of this article will be published in the Jan./Feb. issue of the St. Louis Fed's Review.
Fed Forms Financial Services Advisory Group

The St. Louis Fed has established a District-wide Financial Services Advisory Group to facilitate the exchange of ideas relative to payments system issues. The group will encourage a dialogue between the Fed and financial institutions about product development, service improvements, marketing strategies and emerging issues.

Participating financial institutions will serve staggered two-year terms and will meet two or three times a year at Federal Reserve offices within the Eighth District.

"This initiative will provide valuable feedback from our customers," said Hank Bourgaux, senior vice president at the St. Louis Fed. "We look forward to hearing their views about our services and marketing, and using this information when developing our future strategies."

The members who will be serving three-year terms beginning this year include: Rowe W. Belcher Jr. of Trust One Bank in Germantown, Tenn.; Camden R. Fine of Midwest Independent Bank in Jefferson City, Mo.; Carolyn E. Hudson of Bank of Benton in Benton, Ky.; Don Hughes of Farmers Bank and Capital Trust Co. in Frankfort, Ky.; and Phil Porter of Bank of Bentonville in Bentonville, Ark.

Serving two-year terms are: Thomas Bangert of First Banks Inc. in St. Louis; James Clayton of Planters Bank and Trust Co. in Indianola, Miss.; Judy R. Loving of The Bank of Yellville in Yellville, Ark.; and Reynie Rutledge of First Security Bank in Searcy, Ark. The first meeting was held Feb. 10 at the St. Louis Fed. For more information, call Ronda Sauget at (314) 444-8698.
Editorial: Preparation + Communication = Extermination of CDC Bug

W. LeGrande Rives

With the clock ticking closer and closer to the end of the century, many of us are quickly reaching Century Date Change (CDC) saturation. Airwaves, newsprint and web sites are cluttered with dire warnings about the potential for Year 2000 computer failures. We in banking have an opportunity and obligation to send a positive message regarding our industry's CDC readiness. Indeed, besides solving a computer problem, financial institutions must also deal with a perception problem among their customers. Overcoming this obstacle will take a great deal of work. I believe the industry must take two steps to meet this challenge.

First, we must make sure that our systems are thoroughly tested. You are, no doubt, aware of the emphasis the Federal Reserve has placed on the CDC issue because of the potential impact on the financial services industry. We are executing an extensive Century Date Change initiative to prepare our own internal systems. But the continued strength of our industry depends on financial institutions proactively renovating and testing their own internal systems and external interfaces. Since June 27, 1998, we have been testing with our customers and will continue to test into late 1999. We strongly encourage customers who have electronic connections with the Federal Reserve to test with us. It is promising to note that we have had no CDC problems reported by our customers as a result of these tests.

Our other important task is to diminish public anxiety by communicating frequently and concisely with our customers. The Fed is continuing to keep you informed regarding our progress. Because you are on the front line with your customers, it is essential that you, in turn, inform them about your organization's sense of readiness. Your effort in sending a positive message or calming a nervous customer reduces the likelihood of a perception problem as we approach Jan. 1, 2000.

I urge you to keep in touch with your CDC coordinators to ensure all preparations are proceeding on schedule. Thorough testing and effective communication will eliminate the CDC bug and your customers' concerns.
Fed Issues Report Summarizing Attitudes on Direct Deposit and Direct Payment

On the heels of a Federal Reserve-sponsored comprehensive study on attitudes toward electronic payments, the Fed recently published a summary report that captures the results in a briefer format. The report was mailed to financial institutions across the nation last month.

Through text, charts and graphs, the 23-page booklet provides a synopsis of consumer and business attitudes on direct deposit and direct payment. The question-and-answer format allows readers to quickly skim the findings.

In addition, the summary also reveals how the researchers broke down the population into five segments and how each of these segments perceives direct deposit and direct payment. By analyzing these results, financial institutions can better understand the most logical directions to target their marketing of electronic payments.

For additional copies, call Cheryl McCarthy at (314) 444-8459. The complete results of the study are available at http://frbservices.org/communications/payment_system_research.html.
Century Date Change Readiness Hits Critical Strength

With just under nine months remaining until the new millennium, Century Date Change (CDC) testing and readiness is of the highest importance in the banking industry. In terms of internal readiness, the Federal Reserve System has tested nearly all of its 105 mission-critical systems. More than 5,000 of the Fed's customers, including the Treasury, have conducted tests with Federal Reserve Banks. Although these figures are encouraging, financial institutions still must take key steps to ensure that all of their systems are CDC compliant. By March 31, 1999, financial institutions should have:

- substantially completed testing with service providers; and
- begun testing with their material data exchange partners.

By June 30, 1999, financial institutions should have:

- completed testing of mission-critical systems; and
- substantially completed implementation of renovated mission-critical systems.

This issue of Central Banker examines some of the most important aspects of CDC preparation for financial institutions (see checklist). For additional information, please call Jeff Dale at (314) 444-8400.
Fed Asks Institutions to Review CDC Contingency Funding

As part of preparations for Century Date Change (CDC) compliance, the Federal Reserve is asking financial institutions to establish contingency funding arrangements. Institutions may wish to consider making the Fed's Discount Window one of their liquidity sources. The Fed encourages credit unions to contact their corporate credit unions first.

Most depository institutions are eligible to borrow from the Discount Window. Although loans must be fully secured, the Fed accepts a variety of assets as collateral. A small discount is applied to the assets pledged to determine collateral value. Most pledged assets can be held in book-entry form or remain in the borrower's possession.

Institutions that already have the required borrowing documentation in place should review the amount of collateral pledged in comparison to their potential needs. Those institutions that would like to borrow from the Discount Window must have an account with the Fed or with a correspondent that does. In addition, they will need to submit a letter of agreement, authorizing board resolution and certified copy of the minutes documenting approval of the resolution. For more information, call the Fed's Credit staff at (314) 444-8316 or (314) 444-8622.
Fed Monitoring International Preparation for Century Date Change

U.S. offices of foreign banks lag behind U.S. financial institutions in planning and testing for the Year 2000. These banks, however, have made good progress in recent months, according to Federal Reserve supervisory reviews. The Federal Reserve is working closely with international bank supervisors to better understand the level of Century Date Change readiness worldwide.

Although the Federal Reserve cannot be responsible for CDC preparations among foreign institutions, it is involved in a number of initiatives with the President's Council on Year 2000 Conversion to develop accurate perspectives. The Fed's direct supervisory authority over foreign banks is limited to the offices of those banks operating in the United States, but the Fed will receive information on foreign bank Year 2000 readiness through its participation in several exchanges with international supervisory bodies and private sector forums.

The Fed has been involved with the Basle Committee on Banking Supervision to survey international CDC readiness. This committee has issued guidance for examiners to use in assessing bank readiness. In addition, Fed Governor Roger Ferguson chairs the Joint Year 2000 Council, which is working to promote awareness and information about the CDC issues.

The New York Fed is taking special steps to address CDC issues with the largest institutions in New York that comprise the infrastructure for the U.S. financial and global markets.
Fed to Increase Cash Inventory for Year 2000

Toward the end of the year, the Federal Reserve plans to increase the amount of currency in circulation by about 14 percent over current levels. The increase is in anticipation that some financial institution customers will decide to withdraw greater sums of cash as a result of Year 2000 uncertainty.

Consumers who are concerned that alternative payment methods will not work next Jan. 1 may choose to withdraw more cash than usual for routine household purchases, such as groceries, medicine and gas. But the Fed expects only a small percentage of individuals to significantly increase cash demands toward the end of 1999.

The level of increase in the currency in circulation was determined after the Fed reviewed high currency-demand periods (such as holidays), assessed household spending patterns, and reviewed potential international demand. The currency order does not reflect a Fed recommendation, or even a projection for cash demand in the rollover period. If necessary, the Fed may choose to adjust the increase as it continues to assess the situation throughout the year.

Also throughout 1999, the Fed will work to communicate a positive message to the media and general public concerning the safety of the banking system during the century date change. For additional information about cash inventories, call Jerry McGunnigle at (314) 444-8732.
Regional Roundup

St. Louis Fed Names Rasche Director of Research

On Jan. 4, 1999, Robert H. Rasche assumed the position of senior vice president and director of Research at the Federal Reserve Bank of St. Louis.

Rasche joined the Fed from Michigan State University, where he most recently was an economics professor. Rasche, who joined the Michigan State faculty in 1972, also chaired the university’s economics department from 1980 to 1984. He has been a visiting scholar at the St. Louis and San Francisco Federal Reserve Banks and at the Bank of Japan. He was a member of the Michigan governor’s Council of Economic Advisers and a consultant to several business organizations.


Fed Public Information Catalog Online

Publications, periodicals and videos from all Federal Reserve Banks now can be ordered online from one central site: www.newyorkfed.org/publications. Categories are arranged by individual Reserve Banks and publication topics. The site also indicates which publications are available online.

Fed Tells Its Story In Plain English

The St. Louis Fed has published an educational booklet about the Federal Reserve, written and illustrated to appeal to the general public. The booklet, called In Plain English: Making Sense of the Federal Reserve, describes, in straightforward language, the history, components and functions of the Federal Reserve, including the roles of the Board of Governors, the regional Reserve Banks and the Federal Open Market Committee.

Financial institutions may want to keep copies of the booklet in their lobbies for customers. To request copies, free of charge, call Debbie Dawe at (314) 444-8809.
FedFacts

Year 2000 Teleconference Videos Available

More than 200 bankers participated in a Year 2000 teleconference Dec. 14 at the St. Louis Fed and its three branches. Approximately 100 additional bankers viewed the teleconference through down-link sites at universities and banks around the Eighth District.

Last month, the Fed sent a video of the teleconference, including the question-and-answer session, to those financial institutions that registered to attend. Additional copies are available, free of charge, by calling Bernie Berns at (314) 444-8321.

Fed Working to Upgrade Data Security

To upgrade the security and integrity of data transmitted between the Federal Reserve and financial institutions, the Fed is evaluating several alternative encryption methods. The Fed is pursuing a retrofit solution for existing encryption boards through software modifications.

The Fed currently is working with its encryption suppliers to finalize and test the retrofit solution for roll-out to financial institutions later this year. Additional information on this new encryption standard will be available in the next few months.