Donald L Kohn: The evolving role of the Federal Reserve Banks

Remarks by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the American Bar Association, Banking Law Section, Washington, DC, 3 November 2006.

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I am pleased to have the opportunity to speak to this group of lawyers who practice in the banking area. As banking lawyers are well aware, the Federal Reserve embodies a unique legal structure compared with other central banks around the world. Unlike the Bank of England, for example, the Federal Reserve is a not a single entity, but a decentralized system. The essential components are the Board of Governors, a federal government agency, and the twelve regional Federal Reserve Banks, which are structured essentially as private corporations.

This structure has served the nation exceptionally well over the years. In the past decade or so, however, the emergence of nationwide banking systems, significant changes in the nation's payments systems, technological advances, and other developments have prompted changes in the ways in which we meet our responsibilities, including a geographic consolidation of a number of the functions that historically had been performed by each of the individual Reserve Banks. Today, I will review these trends, and consider some of their practical and legal implications for the Reserve Banks and for the future role of the current decentralized network of Reserve Bank offices around the country.[1]

The existing structure of the Federal Reserve System

The current structure of the Federal Reserve - the combination of a centralized government agency and regional corporate Reserve Banks - is the product of a carefully crafted political compromise. In the early years of our nation, the First and Second Banks of the United States performed many basic central banking services. These were banks that, while chartered by Congress, were owned and managed by private, nongovernmental interests. Their charters, however, were allowed to expire, and their demise has been attributed to deep-seated opposition in some parts of the country to the centralization and concentration of economic power.

As the nation grew through the nineteenth and early twentieth centuries, it lacked any entity that was constituted to carry out the basic roles of a central bank. However, after a financial panic in 1907 forced a number of banks to close, disrupting the economy, a consensus emerged that the nation needed some form of central bank, and Congress created the National Monetary Commission. The commission, chaired by Rhode Island senator Nelson Aldrich, called for one central institution, with fifteen branches across the country, to issue currency and discount commercial paper. However, thirty-nine of the institution's forty-two-member board of directors would be bankers, which aroused the long-standing fear of some about the concentration of economic power in the hands of a few large banks. Agrarian and progressive interests, led by William Jennings Bryan, favored a central bank under public, rather than banker, control. But the vast majority of the nation's bankers, concerned about government intervention in the banking business, opposed a central bank structure directed by political appointees.

The legislation that Congress ultimately adopted in 1913 reflected a hard-fought battle to balance these two competing views and created the hybrid public-private, centralized-decentralized structure that we have today. A centralized governmental Federal Reserve Board, with members appointed by the President and confirmed by the Senate, exercises general oversight over the Federal Reserve System and works with the Reserve Banks to determine policies to fulfill the Federal Reserve's legislative mandates. The Reserve Banks were intended to be "banker's banks" and to carry out the operational functions of a central bank. Additional duties were assigned to them as a result of subsequent developments. Reserve Banks now have broad responsibilities, playing a central role in the nation's payment systems and also in monetary policy through their participation in open market operations and membership on the Federal Open Market Committee. In addition, the Reserve Banks

[1] My remarks today reflect my own thoughts and not necessarily those of the other members of the Federal Reserve Board. Rich Ashton and Yvonne Mizusawa, of the Board's Legal Division, contributed to these remarks.

supervise state-chartered banks that choose to be members of the Federal Reserve System and all bank holding companies, under the overall direction of the Board of Governors.

Each of the Reserve Banks is structured as a separate corporation operating under a charter granted by the Comptroller of the Currency. The stock of each Bank is owned by the member commercial banks within its District; however, the holding of Reserve Bank stock is in the nature of an obligation that goes along with membership and does not carry with it the characteristics of control or financial interest normally attached to stock in a corporation. Each Reserve Bank is supervised by its own board of directors. This board of directors, subject to the approval of the Board of Governors, appoints a president, who serves as the Bank's chief executive officer and has general charge and control over the business of the Bank.

However, in laying out the governance structure for the Reserve Banks, Congress adopted several significant departures from the standard business corporation model. Notably, three of each Bank's nine directors are selected by the Board of Governors, which designates one of its appointees as the Chairman. Three of the directors are elected by the stockholding banks and must represent the public. The remaining three directors are chosen by and represent the member banks. The Board of Governors is also given general oversight authority relating to the Reserve Banks and their activities. These characteristics reflect the fact that the Reserve Banks are structured to carry out public policy objectives set in the Federal Reserve Act, not to advance the interests of their shareholders.

Consolidation of certain Reserve Bank functions

In recent years, in response to major developments in the financial industry and technology, as well as statutory and regulatory changes, a number of Reserve Bank functions have evolved from highly localized operations at individual Reserve Bank offices to more consolidated and centralized functions. This trend is particularly evident in the financial services the Reserve Banks offer to depository institutions.

From the creation of the System, the Federal Reserve has not only been closely involved in overseeing the nation's payment systems but has also been an important operational component of that system. Historically, each Reserve Bank and Branch provided a full range of services to local institutions. In particular, the Federal Reserve Act gave the System the authority to establish a nationwide check-clearing system to minimize inefficiencies and disruptions.

The ongoing transformation of our retail payments system, resulting from shifts in consumer behavior and rapid industry innovation, has directly affected the operations of the Reserve Banks. The number of checks being written has been steadily falling as consumers increasingly take advantage of electronic payments mechanisms. In 2003, for the first time, the number of electronic payments in the United States, such as credit card, debit card, and automated clearinghouse (ACH) payments, exceeded the number of check payments. A range of data indicates that electronic payments have continued to increase and that check payments have continued to decline. Not only are more payments being made electronically, but more check payments are also being processed electronically, in part because of the enactment of the Check Clearing for the Twenty-first Century Act, commonly known as Check 21.[2]

As a result of these trends, the Reserve Banks' check-collection volume has declined. Since 1999, the number of checks collected through the Reserve Banks has fallen by about 30 percent. Consequently, the Reserve Banks have taken major steps to reduce check costs, including reducing the resources devoted to this service by transferring check-processing operations from some offices to more centralized locations. Today, twenty-two offices offer check processing, down from forty-five just three years ago.

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[2] Before Check 21, a bank had to present the original paper check to the paying bank unless the paying bank had agreed to accept electronic presentment of the check. Although Check 21 did not mandate the electronic processing or presentment of checks, it did authorize a new negotiable instrument, called a substitute check, which is the legal equivalent of the original check. By permitting banks to use substitute checks in the check-collection process when the recipient could not or would not accept electronic payment, Check 21 has facilitated the expanded use of electronic technologies in check processing, enabling the banking industry and the Federal Reserve to improve the efficiency and cost-effectiveness of its check-processing operations.

Other Reserve Bank services have been undergoing consolidation as well. At some Branches, cash processing by the Federal Reserve has been replaced by a cash depot operated under contract by armored carriers, who collect currency deposits from and distribute currency to depository institutions. The Federal Reserve System has also consolidated certain other services for banks and the U.S. Treasury, such as automated clearinghouse (ACH), offline Fedwire, and savings bond services. Similar trends are occurring in other areas of Reserve Bank operations. The Reserve Banks have found it more efficient to have a few central offices perform certain internal support and back-office services - such as managing information technology and payroll - rather than having each Bank conduct them individually. This trend toward consolidation of operations has precipitated significant structural changes at the Reserve Banks. Staff levels have been reduced throughout the System. Several Reserve Bank Branch offices now have, or soon will have, no remaining financial services operations. These Branches focus on matters such as community affairs, economic information gathering, economic and financial education, and director recruitment. Some Branches have sold their own buildings and operate in leased space.

In addition to affecting operations, the centralization of some Reserve Bank functions has raised issues related to the governance of the Reserve Banks in accordance with the provisions of the Federal Reserve Act. As mentioned earlier, Congress provided that each Reserve Bank is controlled by its own board of directors and president, subject to the general oversight and approval authority assigned to the Board of Governors by the Federal Reserve Act. Under the act, the directors are required to perform the duties "usually appertaining to the office of directors of banking associations." When Reserve Bank functions are consolidated, operations that once had been performed by a Reserve Bank under the direction of that Bank's board and president are now carried out on its behalf by another Reserve Bank, which has its own governance reporting chain running to its president and board of directors. And some of the operations at each Reserve Bank are being performed for the other Banks. To address these complications, the Reserve Banks have put into place procedures designed to ensure accountability by those Banks that provide services to, or conduct functions for, other Banks on a centralized basis. More generally, as interdependencies have risen, the Reserve Banks have had increasingly to learn to manage processes and control risks across Reserve Banks. This learning process has been challenging at times as individual Reserve Banks have had to give up performing functions they had been providing for many years and as structures to oversee and manage across Reserve Banks were constructed and strengthened. But the challenges are being met.

Payments and operations are not the only areas of responsibility affected by the changes in the structure of our financial system and in technology. In the supervision and regulation of financial institutions, it has become more and more common for Reserve Banks to cooperate, coordinate, and share resources and analysis as the Federal Reserve adapts to oversight of large complex banking organizations and prepares for the implementation of Basel II.

The continued consolidation and adaptation in at least some Reserve Bank functions is likely to continue. For example, check volumes are forecast to continue to decline as more payments are made electronically, and the clearing of paper checks will drop even faster as banks take advantage of Check 21. In response, the Reserve Banks will have to reduce even further the number of offices processing checks. In some other functions too we are likely to find opportunities to operate more efficiently and effectively from fewer locations.

We will be taking advantage of those opportunities. The Monetary Control Act, enacted in 1980, requires the Federal Reserve to set fees for providing certain payment services to depository institutions. These fees must, over the long run, recover all the direct and indirect costs of providing the services, including imputed costs that would have been incurred and imputed profits that would have been earned if the services had been provided by a private firm. And for these types of services, we will simply be following the dictates of a marketplace in which legislative and technological change is driving consolidation. More fundamentally, to protect our independence within the government - the arms-length relationship that provides monetary policy making with a degree of insulation from short-run political pressures - Congress has given us autonomy over our budget. It is incumbent on us to exercise stewardship of our small part of the public purse as responsibly as we can.

The future of a decentralized Federal Reserve System

Given these recent developments, what will the Federal Reserve System of the future look like? Will a decentralized system of twelve Reserve Banks located nationwide continue to make sense?

I think that it will. But my reasons for thinking so have little to do with the delivery of services to depository institutions. Rather, they reflect the attributes of the Reserve Banks that flow from their status as independent, separate entities in close contact with their region's financial institutions, businesses, and communities.

Most important, this status enables the Reserve Banks to bring informed, diverse views to our policy deliberations. Senior management at the Reserve Banks have their own staffs of economists, financial analysts, supervisors, payments system experts, and, yes, even attorneys, to help them formulate their positions in our policy councils. Local offices, where Federal Reserve officials can have direct and frequent contact with the financial institutions and businesses in the immediate region, can gather a wealth of very current information about economic conditions and the financial system within that region that may not be available from other sources. The diversity of perspectives, the analysis backing those views, and the information the Reserve Banks bring from their regional contacts help us reach better policy decisions. The Reserve Banks are also a source of continuity, experience, and institutional memory, especially when, as now, the Board of Governors has experienced rapid turnover.

The contributions of the Reserve Banks are perhaps most visible to the public in the sphere of monetary policy. All twelve presidents attend and participate actively in the meetings of the Federal Open Market Committee. What they tell the Committee about what they are hearing from their contacts helps us recognize shifting economic conditions before they are evident in the data. Their reports often illuminate the reasons for the data we are receiving, thereby helping us anticipate what will come next. Their policy perspectives are informed by the research and analysis of outstanding staffs.

The presidents and other senior Reserve Bank officials bring similar strengths to our discussions of other types of policies. The Banks' active role in payments helps us to design policies and procedures to encourage a safe and efficient payments system. Their daily contacts with depository institutions contributes to shaping our regulatory decisions and is a resource when we are managing crises. Their close relationship to their communities is important as we administer consumer-protection statutes and work to foster fair and open access to credit and greater public understanding of available financial services.

I have stressed the information a Reserve Bank brings from its community to Federal Reserve policymaking, but Reserve Banks also play an increasingly important role in reaching out to convey information to the community. Through extensive education efforts, speeches by their presidents and other officers, and discussions with their boards of directors and other groups, Reserve Banks foster understanding about the System, its policies, and its objectives, as well as about matters of general economic interest.

In addition, because of their many contacts with their communities, local offices of the Reserve Banks play a major role in the Federal Reserve's efforts to improve financial education and financial literacy. In recent years, financial innovations have widened the range of households that have access to opportunities to borrow and lend and have added to the variety and complexity of instruments they can use. The Federal Reserve has responded by putting added emphasis on promoting improved financial literacy among the general public. Greater financial sophistication among consumers will produce a number of economic benefits. Informed consumers place market pressure on financial institutions to offer better products at better prices. Increased financial literacy is also likely to result in better management of personal finances.

In sum, strong, independent Reserve Banks grounded in their regions have been critical to the success of the Federal Reserve. The private-public, centralized-decentralized character of the Federal Reserve System has contributed to policymaking and has been a part of the fabric of our independence within the government. The Reserve Banks will need to continue to adapt to changing circumstances, but their essential characteristics will be preserved and will continue to enable them to help the Federal Reserve pursue the very important public policy objectives we have been entrusted with.