Roger W Ferguson, Jr: A few thoughts on financial sector and payments activities

Remarks by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, before the Independent Community Bankers of America, Washington, DC, 21 May 2001.

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I am pleased to be here with you this morning, and I thank Ken Guenther and the ICBA for inviting me to speak. Ken suggested that I share my thoughts with you about two initiatives that I have been working on recently. The first, published early this year, analyzed global financial sector consolidation in the G-10 countries. Today, I will add a few observations about consolidation in the United States. The second initiative is ongoing and involves the work of the Federal Reserve's Payments System Development Committee with the private sector to improve the U.S. retail payment system. One particularly promising aspect of this latter effort is a potential change in federal law to enhance the market prospects for check truncation and electronic check presentment. Another aspect involves a data collection and research effort we now have under way, for the first time in more than twenty years, to measure accurately the aggregate number of checks paid in the United States.

G-10 Study of Financial Sector Consolidation

I will turn first to financial consolidation at the international level. Consolidation of many types of business activities has been a prominent feature of the global economic landscape for at least the past decade, and the financial sector has participated in this trend. Indeed, we have witnessed accelerating consolidation among financial institutions over the past few years. In September 1999, the finance ministers and central bank governors of the Group of Ten countries commissioned a major study of the possible effects of financial consolidation. This study, which I was privileged to direct, was released to the public in January 2001.

The G-10 study had two primary objectives. First, it attempted to isolate the effects of consolidation from those of other powerful forces transforming financial systems. Second, it sought to identify key areas in which financial consolidation requires new policies. The diversity of the economies involved and the interdependent nature of many of the forces affecting financial systems made achieving these objectives difficult, to say the least. However, I believe the study was a success.

With a study of the depth, breadth, and quite frankly, the length of this one, there is always the potential to mislead by summarizing the key points in only a few words. Nonetheless, I would like to highlight for you what are, in my judgment, the study's key findings and policy implications. These key findings cover thirteen nations (the G-10 plus Australia and Spain).

The study documents high levels of merger and acquisition activity among financial firms during the 1990s and an increasing pace of consolidation, including a noticeable acceleration in the last three years of the decade. Most of the consolidation has been within countries and within segments of the financial sector. Cross-border and cross-sector consolidations have been less frequent. Our research shows that financial consolidation substantially decreased the number of banking firms during the 1990s in almost every country studied and that national concentration of the banking industry tended to increase. Financial consolidation has helped to create a significant number of large and, in some cases, increasingly complex, financial institutions. These firms increasingly operate across national borders and are subject to a wide range of regulatory regimes.

As for the causes of all this merger and acquisition activity, overall, it appears that the most important forces encouraging financial consolidation are globalization of financial and nonfinancial markets, financial deregulation, improvements in information technology, and increased shareholder pressure for financial performance. Because these forces are likely to continue, financial consolidation is likely to continue as well, although the pace may be interrupted by fluctuations in the macroeconomic cycle and other factors. The study considered possible future scenarios but concluded that the likelihood of specific future developments is impossible to assess with confidence. My own guess is that various patterns will emerge. Globally active universal financial service providers will continue to develop. We should also see the further development of firms specialized in the production of particular components of financial services or in the distribution to end-users of products obtained from

specialized providers – providers that may exist within or outside the traditional financial services industry. I fully expect a large number of efficient and profitable small and medium-sized financial institutions to remain important players in the United States. I would guess this will also be the case in many other nations. In addition, the uncertainties of successful post-merger integration may well favor more use of looser forms of consolidation, such as joint ventures and strategic alliances.

The data that we collected suggested a number of conclusions. For example, financial consolidation has increased the concentration of payment and settlement flows among fewer parties. The risk implications of consolidation in payment and settlement systems deserve close monitoring. In addition, the study found that although consolidation has some potential to improve the operating efficiency of the combined financial institutions, and has done so in some cases, the overall evidence in favor of efficiency gains is weak. The study also found that the effects of consolidation on competition and credit flows are very case-specific and depend on the nature of markets for specific products and services.

As I noted, this study was commissioned by finance ministers and central bank governors, so we investigated the implications of consolidation for central bank policies. The study found that financial consolidation has not significantly affected either the conduct or the effectiveness of monetary policy. However, it also suggests that central banks should remain alert to the implications of future consolidation-induced reductions in the competitiveness of the markets most important for monetary policy implementation. Similarly, central banks ought to monitor potential future changes in the transmission mechanisms for monetary policy.

Importantly, the study also concluded that existing policies appear adequate to address individual firm and systemic risks now and in the intermediate term. However, going forward, the study identifies a number of areas that deserve careful attention by policymakers. For example, enhanced contingency planning could reduce the risks to individual firms and the broader financial system, should a large and complex financial institution become seriously distressed. Because no institution is too big to fail, I believe that regulators should develop a clearer understanding of several key factors. These factors include the administration of bankruptcy laws and conventions across borders; the coordination of supervisory policies within and across borders; the treatment of over-the-counter derivatives, foreign exchange, and other "market" activities in distress situations; the roles and responsibilities of managers and boards of directors; and the administration of the lender-of-last-resort function. Our study helped to clarify the need for international attention to contingency planning. In general, both crisis prevention and crisis management could be improved by additional communication and cooperation among central banks, finance ministries, and other financial supervisors, both domestically and internationally.

Consolidation in the US

Against this international background, I would like to look at what has been occurring in the United States. In the U.S., more than 4,000 commercial banking and thrift organizations were acquired between 1990 and 2000. The pace of merger activity generally increased between 1990 and 1998, peaking at more than 500 deals in 1998. In 1999 and 2000, the number of mergers and acquisitions returned to the levels experienced at the start of the decade. Partly offsetting this trend, more than 1,400 charters for new banks and thrifts were issued during the 1990s.

1998 was also the standout year in terms of transaction size. Deals completed in that year accounted for roughly one-third of all bank and thrift assets acquired during the 1990-2000 period. In particular, a handful of these deals were extremely large and substantially influenced the structure of the banking industry. These transactions included Travelers-Citicorp, NationsBank-BankAmerica, Banc One-First Chicago NBD, and Norwest-Wells Fargo. Merger size dropped somewhat in 1999 and 2000, but the average size remained large by historical standards.

Over the past decade, consolidation has had a profound effect on the structure of the banking and thrift industries. Between 1990 and 2000, the number of commercial banking and thrift organizations decreased by one-third, from roughly 12,000 to 8,000. This decline was driven by a sharp reduction in the number of banking and thrift organizations in the smaller asset-size categories. For example, during this period, the number of organizations with total assets of less than $100 million fell by nearly one-half, while the number of organizations with more than $100 million in assets increased slightly. While part of this change can be attributed to the effects of inflation on the value of firms' assets, even

after controlling for inflation the number of small banking and thrift organizations declined compared with the number of larger organizations.

Mergers have also significantly influenced deposit concentration at the national level. For example, the share of nationwide deposits managed by the 100 largest organizations grew from approximately one-half in 1990 to about two-thirds in 2000. In spite of this increase in concentration at the national level, the typical local banking market did not experience a significant increase in concentration. Regardless of whether we measure concentration using the share of market deposits controlled by the three largest bank or thrift organizations or using the broader Herfindahl-Hirschmann Index, we find that, on average, concentration in rural banking markets did not change and concentration in urban banking markets increased only modestly between 1990 and 2000.

The minimal effect of consolidation on local market concentration may be attributable to several factors. First, much of the consolidation that has taken place in the U.S. over the past decade has been between banking organizations that served different geographic markets. Second, in those instances where the merging parties did serve the same local markets, antitrust scrutiny by the Federal Reserve and the Department of Justice has limited the extent of increases in local market concentration. Third, merging entities typically have experienced some degree of deposit runoff following merger consummation. Finally, in many cases, new entry has helped to offset the effects of consolidation on local market concentration.

In addition to acquiring other depository institutions, banks and thrifts have engaged, to a limited extent, in cross-sector acquisitions. In 1999, the Gramm-Leach-Bliley Act relaxed many of the restrictions on the financial activities of banking organizations by permitting the formation of financial holding companies-firms that could engage in a wide variety of financial activities, including commercial banking, securities underwriting, and insurance. Contrary to many observers' expectations, the ensuing cross-sector consolidation activity has been modest so far. Indeed, the largest cross-sector banking deal, the combination of Travelers and Citicorp, took place in 1998, before Gramm-Leach-Bliley was passed.

Check Truncation Act

Now I would like to take a few minutes to talk about some of our efforts to improve the efficiency of the U.S. payments system, which is a subject of concern for all banks.

You may know that I co-chair the Payments System Development Committee with Cathy Minehan, president of the Federal Reserve Bank of Boston. The PSDC was formed in mid-1999 to (1) identify strategies for enhancing the long-term efficiency of the retail payment systems, (2) identify barriers to innovation and work to eliminate or reduce those barriers where desirable or appropriate, (3) monitor developments in payments markets, and (4) conduct workshops and forums that encourage focused discussions on payments system improvements with the private sector.

It is my view that we need to approach payment system innovations with an open mind and a willingness to learn. In a dynamic economy, markets need to play a key role in guiding the development of infrastructure. This means that innovation and competition will be central to the future development of the payments system – as they are in other areas of the economy. Policymakers for their part should strive to remove barriers to innovations that do not conflict with important public policies. They should resist calls to limit competition, but rather should take every opportunity to foster competition.

Similarly, public policy should exercise restraint and resist calls for premature or short-sighted regulation. Even well-intentioned actions may create perverse outcomes, may not effectively address longer-term public policy concerns, or may short-circuit creative innovations. On the other hand, public policy will have to confront genuine and significant problems when these become clear and are not self-correcting.

Now let me tell you about a particularly interesting project that we have undertaken to foster payment system innovation. Federal Reserve Board staff has been working with the financial services industry, including the ICBA, consumer representatives, and others on draft legislation to facilitate increased check truncation by reducing some of the legal impediments that exist under current law. We hope to refer the proposal to Congress for its consideration once the draft achieves a fair balance between the interests of banks and their customers. Under current law, the original instrument is required for presentment or return of a check, unless the parties agree to accept check information electronically.

This requirement often limits the adoption of electronic check presentment because of the difficulties of obtaining large numbers of agreements among banks and with maintaining dual processing streams for paper checks and electronic replacements.

To address these issues, a draft "Check Truncation Act" is being developed under which banks would have the option of truncating some or all of the checks they process. The hope is that such a law would facilitate the use of electronics in the check collection and return process by empowering banks to truncate checks when cost savings or other benefits can be identified. The truncating bank could collect or return checks by exchanging them electronically by agreement, as they can do today, or by substituting machine-readable copies of checks ("substitute checks") for the original checks. A substitute check would consist of a printed image of the check that could be processed through check sorting equipment as though it were the original check.

The most significant aspect of the draft Check Truncation Act is its requirement that a substitute check be considered the legal equivalent of the original check for all purposes and for all parties and that banks accept the substitute check in lieu of the original check. In particular, banks would no longer be able to demand the original check because the substitute check would be valid not only as proof of payment but also as a negotiable instrument. The draft law would not mandate that banks truncate checks, or present checks electronically, or receive checks electronically. Those decisions would be left to the discretion of individual banks. As I mentioned earlier, however, the goal of the draft law would be to facilitate the use of electronics in the check collection and return process by empowering banks to truncate checks if cost savings or other benefits can be identified – in other words, when there is a good business case. Banks that choose not to receive checks electronically would be able to continue processing checks as they do today because any substitute checks they receive would be processed like any paper check processed today.

Now, I certainly recognize the irony of the proposed act creating a new paper document – a substitute check – to promote electronics. The legal equivalence granted to substitute checks under the draft Check Truncation Act, however, would remove the barrier to expanded electronic check processing resulting from the requirement that banks enter into extensive bilateral and multilateral agreements with other banks for electronic processing. The draft law would allow banks greater operational flexibility and likely increase the number of banks that accept electronic checks for collection and presentment.

Our discussions with banking industry representatives have identified a number of possible operational efficiencies that banks might be able to achieve if Congress enacted this law. For example, a depositary bank could truncate checks at the point of deposit – such as at an ATM or a remote branch – transmit the check images to a central operations center, and create substitute checks to send for collection. This process would eliminate the cost of transporting checks daily from the points of deposit and could allow for later deposit cut-off times for their customers. A bank could also transmit check images to an intermediary that could print substitute checks and deliver them to banks that do not accept checks electronically. This could substantially reduce transportation costs and speed the collection or return of some checks, particularly for checks destined to geographically remote locations or for large-dollar checks.

At the other end of the check processing cycle, a paying bank could run its returned check file against its check image file to create substitute returned checks. This process would eliminate the need for a bank to run its entire presentment from the previous day through its sorters to pull the small number of checks that need to be returned unpaid. We believe that image-supported check truncation will become more cost effective for a growing proportion of banks as technology improves and the cost of electronic transmission declines relative to the cost of physical transportation.

Beyond operational efficiencies, the draft Act could lower the hurdles that banks now face in moving from physical to electronic processing of checks. Today, electronic check presentment generally relies on electronic receipt of payment data contained in the MICR line of a check. Because the MICR line includes much less information than the original check, in most cases the original paper checks follow the electronic transmission. Collecting banks, which bear the lion's share of check collection costs are, therefore, limited in their ability to reduce costs. Improvements in image technology, continued declines in telecommunications costs, and continued reengineering of banks' back-office processes have the potential to alter current processes.

Introducing an intermediate step of creating a substitute check that is the legal equivalent of the original check may help create conditions that are conducive to expanding the network of banks agreeing to electronic collection. Let me emphasize again, however, that each bank must weigh its

own costs and benefits and decide whether to invest in image technology, to retain a service provider to provide image-based capture and data processing services, or to stay with traditional paper processing.

Federal Reserve payments research

I have spent the past few minutes talking about ways to reduce the cost of processing checks. You might infer from that discussion that we have a solid idea of the total number of checks being collected. Well, I am certain that it is a large number-our rough guess is in the range of 70 billion checks with a value well over $80 trillion per year. But the truth is that we really do not know how many checks are written in the U.S. each year. And, as I mentioned, the most recent survey data are more than twenty years old.

The Federal Reserve Banks have recently begun a series of surveys to address this gap and to improve their understanding of payment choices and payments processing from the perspectives of consumers, businesses, and financial institutions. Earlier this year, the Reserve Banks engaged several research firms to conduct three surveys aimed at collecting some initial, quantitative data. The first survey collects the volume and value of checks paid by a relatively large sample of depository institutions from which we hope to estimate the total volume and value of check payments in the U.S. A second survey will collect check-payment data from which to estimate the use of checks by broad categories of payment types. The third survey will quantify aggregate volume and value data for various types of electronic payments.

This spring, the check surveys were sent to a sample of banks, thrift institutions, and credit unions. Some of your institutions received a survey questionnaire. If you have completed and returned the survey, we thank you for your help. If you have received but not yet returned the survey, I encourage you to do so. I believe that the estimates based on this survey data will help all of us to better understand the U.S. payment system and to better plan for the future.

Conclusion

Today I have talked about several types of changes – the changes in markets for financial services due to consolidation, a possible legal change to facilitate the greater use of technology, and the changing patterns of payment instrument use over the past few decades that we hope to document through some new surveys. Clearly, these changes will continue and even accelerate, driven by the evolution in technology and, more fundamentally, by the evolution of ideas. Our greatest challenge may be to sort through the promises of the future and find practical ways to improve the present.

Again, thank you for inviting me to speak here with you today. I look forward to continuing to talk with banks and their representatives about banking issues.