

FEDERAL RESERVE

New Times, New Functions

BY JENNIFER WANG

As the economy changes, so does the role of Federal Reserve Bank branch offices

The Federal Reserve System and its 12 banks owe their existence to the Federal Reserve Act of 1913. This landmark legislation famously reflected the model of so many American institutions: to be at once centralized and decentralized. The Board of Governors sits in Washington, D.C., and formulates U.S. monetary policy in coordination with the Reserve bank presidents. It's a system of geographic checks and balances, with the centralized board relying on the firsthand regional economic knowledge of the decentralized bank chiefs, whose main offices are located in cities around the country. And of course, this knowledge exchange works both ways.

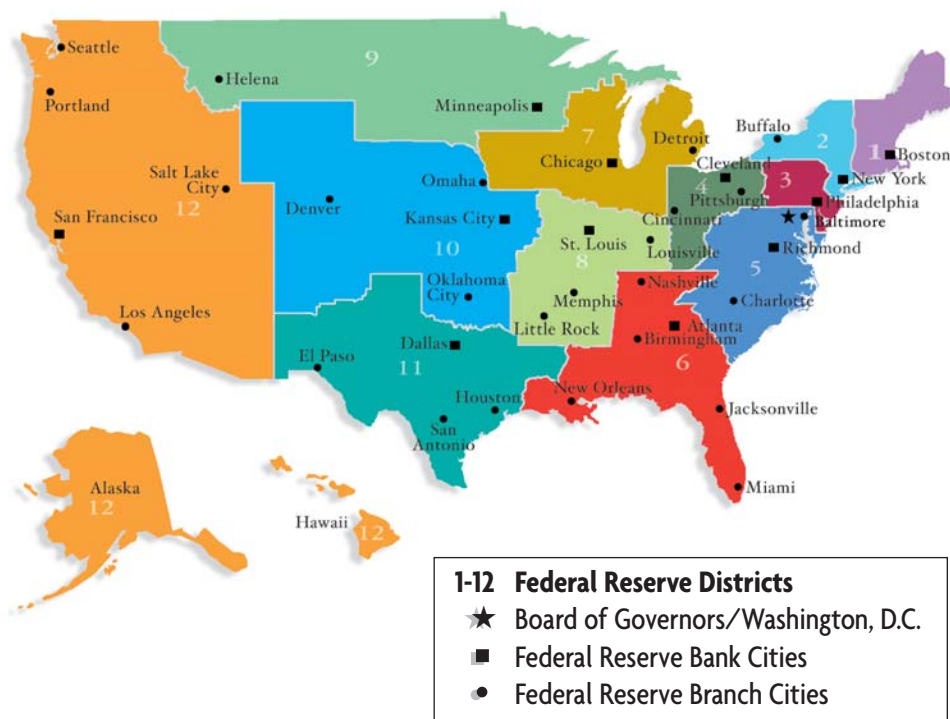
But even divided among 12 Reserve banks, the entire United States is a lot of turf to cover. For this reason, many Reserve banks also keep branch offices. Since the very beginning, the

role of these branches has been in some debate. At first, branches were envisioned as miniature Reserve banks, doing everything the main office could do but on a smaller scale. Then they became more like repositories for specific functions like check clearing. And the discussion has grown more complicated in the past decade with advancing technology and the evolving functions of the Federal Reserve System itself.

The Federal Reserve Act stated that there would be between eight and 12 Reserve banks, and cities eagerly vied for the opportunity to be home to one. But beyond the number of Reserve banks to be created, there was also considerable uncertainty over the nature and scope of the banks' responsibilities — an uncertainty compounded by the speed with which the banks were to be established. In addition, confusion arose during the discussion of Reserve bank branch offices. It was even less clear what powers these branches would have, and what role they would play within the System.

Twenty-five branch offices would eventually emerge, the number varying from district to district, determined by the needs of the individual Reserve banks. The Fifth District (Richmond), for example, maintains two branches — one in Charlotte, another in Baltimore — while the Sixth District (Atlanta) has five branches, and the First and Third Districts (Boston and Philadelphia, respectively) have none. Many districts also are home to regional check-processing centers, though the number of these centers has dropped recently.

Early on, regional branch offices largely supported the main Reserve banks in an operating capacity, providing functions such as check clearing and cash processing. Over the years, the branches have adapted to the evolving needs of their respective



NOTE: Districts 1 and 3 don't have branch offices.
SOURCE: Board of Governors of the Federal Reserve System

Reserve banks. Some, for instance, have seen their role in the payments system decline sharply, while others have taken on new responsibilities in the areas of community affairs and bank supervision and regulation.

Vanishing Checks

The rapid drop in paper checks is the most urgent factor driving change at the branches, and has resulted in a sizeable scaling down of infrastructure. Though checks remain the most popular form of noncash retail payment, from 1995 to 2002 the number of checks written fell by roughly 10 billion. In 2003, the number of electronic payments through credit cards, debit cards, and similar instruments exceeded the number of check payments for the first time — by more than 8 billion — and the gap is expected to widen over time.

Major changes at the Fed also began in 2003. A significant Fed initiative sought to reduce check service operating costs as the market environment signaled a shift in consumer and business preferences from checks to electronic payments. The initiative proposed an annual review of the check processing operations network for consolidation opportunities; nearby offices would be collapsed into one another to take advantage of economies of scale. When the scheduled office moves are completed next year, checks will be processed in 23 locations (down from 45), and the overall check staff will be reduced by about 400 positions.

In the Fifth District, the Richmond bank closed its check processing centers in Charleston, W.Va., and Columbia, S.C. The checks that had been processed in Charleston were sent to the Cleveland Fed's Cincinnati branch, and those processed in Columbia went to Charlotte. In addition, all of the checks processed at the main office in Richmond were moved to the Baltimore branch.

David Beck, vice president and interim branch manager at the Baltimore office, explains the effect of the consolidations. "All of Virginia territory is now in Baltimore, causing

Baltimore's check volume to rise initially by 70 to 80 percent," he says. "But because of an overall decline in volume, that percentage has not held up."

The Eighth District's Response

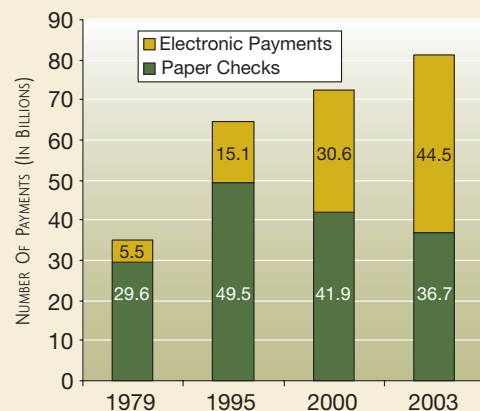
Many of the districts faced substantial challenges when the check restructuring process began. But in the Eighth District, St. Louis Fed President William Poole described the impact as "seismic." With its Louisville branch only 100 miles from Cincinnati, and Little Rock just 120 miles from Memphis, it was difficult to justify maintaining operations at all the branches. It was ultimately decided that operations at the Louisville and Little Rock branches would be completely shut down and the buildings sold. The staff — reduced to fewer than 10 employees at each branch — would work in leased space.

These announcements raised questions concerning the necessity of keeping the Little Rock and Louisville branches at all. But the Eighth District decided that they still served a vital purpose. In the St. Louis Fed's 2003 *Annual Report*, President Poole stated that his district "cannot afford to lose or lessen the importance of the network of economic information-gathering resources we've established, the critical input we get from our branch boards of directors on the regional economy, and the one-on-one relationships we've nurtured among the region's bankers, teachers, community development agencies, and university professors."

Indeed, nearly all Reserve bank presidents cite the vital role of branch offices in providing up-to-date information on the state of the economy, which they use in preparing for Federal Open Market Committee deliberations. That information, though often anecdotal, can provide valuable insights about what is happening around the districts before formal statistical reports are released.

While Poole and his colleagues rely on the branches to provide them with timely reports on economic conditions, the branches are trying to increase their public visibility within the communi-

Electronic Payments Have Increased as Check Volume Has Declined



SOURCE: Federal Reserve System

ties they service. According to Randall Sumner, vice president of public and community affairs at the St. Louis Fed, "One way of doing that is devoting more effort to economic education and regional economic research activities."

Thus far, Sumner believes the transition at the branches has been a smooth one. "This year, we're going to be taking advantage of the skills of the new people we've hired," he says. "The proof will be what it looks like at the end of the year. But we're all very excited and have every confidence in its success."

The Fifth District's Unusual Situation

The Fifth District is relatively unique among Reserve bank districts. Its branch offices are located in much larger metropolitan areas than its main office. This is one reason why, for now at least, check-processing will remain a principal activity in Baltimore and cash operations will continue to be significant in Charlotte. Also, because Charlotte is home to some of the nation's largest financial institutions, banking supervision and regulation has become a crucial function there, as has community outreach.

Beck points out that Baltimore is "one of the largest branches in the system. And the Baltimore-Washington metropolitan area we serve is certainly a lot bigger than, say, Little Rock or

Louisville. So I think checks and cash operations will remain here for a number of years.”

Jeff Kane, senior vice president and head of the Charlotte office, emphasizes the unique status of the Charlotte branch. “I bristle when people talk about branches as generic operations. When you look at the banking presence in the Carolinas, it far outweighs anything else outside of New York.”

In the past, Kane says, “We have thought of our branch as an operational facility. Visitors came in here and we gave them a tour of the checks and cash departments, for instance.” But that’s changing, as the Fed seeks to increase its presence within the local community.

Many of Charlotte’s big commercial banks have important long-standing ties to the region. “There’s not a board of directors of a nonprofit group, charitable organization, or local university that is not touched by those banks in a significant way,” Kane notes. He would like to see the Richmond Fed’s Charlotte office take part in similar activities. Although careful to point out that he doesn’t have the staff to equal the “visibility of a commercial banking organization that employs 250,000 people,” Kane says he is working to increase “the presence of the branch in those circles in which we operate.”

There are obvious reasons for the expanded role of the Charlotte office and of branch offices throughout the Federal Reserve System, Kane says. “What do we all have in common? The answer is we are all tied to the local economy and to the prosperity of the region, and because of that it makes sense for the branches to increase our community outreach activities.”

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A New Leg

One of the most popular metaphors for the Fed is the image of a stool, with three legs representing each of the three main areas traditionally under the Fed’s jurisdiction. There is a monetary policy and research leg, a banking supervision and regulation leg, and a financial services and payments mechanism leg. Recent and forthcoming efforts to increase the Fed’s community outreach activities, though, may lead to the addition of a fourth leg — a type of public education/community outreach leg.

Jeff Lacker, president of the Richmond Fed, says, “If you look at where our head office is and where our branches are across the district, it’s clear that the branches have an important role to play in connecting us to our district.” Besides plans to improve economic education and financial literacy programs in the region, efforts to expand regional economic research also will be strengthened. “We’ve always monitored regional economic conditions out of our head office. But you can only do so much of it from Richmond.

We have a very diverse region, and it’s important to be aware of those differences. So we’re looking to hire regional economists to put into those offices who would be able to focus on the region around the branch.” Additionally, Lacker envisions hosting events in cities throughout the district. “That’s an area where I think the branches can play a role. They have a presence in their regions, and we can use them to reach out to the communities.”

Banking is an area in which the Fed takes a keen interest, of course, and the freeing up of resources once devoted to payment systems operations may help the Fed build and sustain stronger relationships with private banks through its regional offices. “We’ve generally tried to maintain a relationship with banks that goes beyond our supervisory function, which encourages them to feel as if they can communicate with us about any banking issue that’s of concern to them,” Lacker says. “Even if we can’t pass a law for them, we want them to feel as if we understand what’s going on in their industry. We’re going to be looking for ways to foster that dialogue with the banking industry.”

The functions of Reserve bank branch offices have recently undergone significant changes. But their purpose has, in one sense, remained the same: to assist the main office in carrying out its aims and objectives.

Lacker concludes, “If you look at the System from the point of view of the way it was designed in 1913 — as 12 banks as opposed to one big bank — it’s clear Congress meant us to be very well connected to our districts. We need to really know what’s going on and to be responsive, and the branches have an important role to play in helping us achieve that goal.” **RF**

READINGS

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