

## Twelve banks: The strength of the Federal Reserve

From time to time, the question is raised: “Does the Federal Reserve still need 12 regional banks?”

In a Wall Street Journal article earlier this year, a former vice chair of the Federal Reserve’s Board of Governors suggested the answer to that question is “no,” saying it is “very clear” 12 banks are no longer necessary and that as few as four might be sufficient.

While some might occasionally suggest a reduction in the number of banks is in order, the Federal Reserve believes in its own future as a 12-bank system. The Federal Reserve has invested in new facilities in Minneapolis, Atlanta and most recently Kansas City, where we will be moving into our new headquarters building in 2008.

However, with the changes occurring in the banking industry, it is understandable why some might raise the topic of the number of regional Reserve Banks and efficiency. The banking and economic structure of the United States obviously has changed in the decades since the Federal Reserve was created. Today, while currency remains in wide use, check writing is in decline, and credit and debit card use is becoming the standard payment means. These developments most certainly have affected Federal Reserve operations nationwide.

So, as a particular business changes, it is perhaps anticipated that some would ask whether a 12-Reserve Bank system is necessary. It is, in this narrow context, a fair question.

However, it is a question that fails to appreciate the founding purpose and structure of the Federal Reserve System. It is a question that, by its very asking, reflects a different understanding of value versus cost.

The Federal Reserve’s 12-bank system was not established as simply a check-processing system. It was designed to serve multiple interests across a variety of regions and financial institutions. It was designed to assure broad input to decisions and to provide a mechanism to build national policy consensus across broad regional, economic and cultural differences.

And it was designed as a public-private partnership, accountable to, and yet independent of, the government. To miss these connections is to incorrectly tie the Federal Reserve’s structure to its processing activities rather than to its efforts of assuring trust in the institution.

The 12-bank system reflects the vast economic differences among regions in the United States. It also reflects the need to provide a mechanism for input to banking and our important credit policy activity for each region.

Our nation’s regional differences are illustrated in a variety of forms. For example, some years ago, I spoke with a policy person from another sector of the country making his first visit to the Midwest. During the conversation he quite sincerely noted how impressed he was that the city had such a “full” skyline. Clearly he was surprised. Similarly, an East Coast reporter traveling to Cleveland once phoned and asked us if he could drive by and see the Kansas City Bank during the trip. He apparently thought Kansas City and Cleveland were





closer than the more than 800 miles that separate us. Being from Missouri, I have come to appreciate in a personal sense our regional differences. In my travels through the southern United States, I am often called a Yankee, while, in the north, I might be referred to as a Southerner. Most recently I took notice of a New York Times article pointedly titled “The Not-So United States.”

From an economic perspective, these regional variances can be even more striking. One need only look at the differences in average home prices between any Midwestern community and a similar community on either coast to get some idea of the diversity of our economy. Regional employment and manufacturing can also vary greatly.

The fact is that as homogenous as we like to think we are, we remain a country with large variances in regional perceptions, biases and economies.

The founders of the Federal Reserve were clearly addressing these differences when they created our decentralized system in 1913. Even then, decades before today’s high-speed technology, there was no compelling physical reason for having 12 Reserve Banks.

In fact, the nation previously had not one, but two monolithic central banks, both located in Philadelphia.

The first Central Bank of the United States was established in 1791 and was designed by Treasury Secretary Alexander Hamilton. It was controversial from the start. Some protested its constitutionality. Many were fearful of its influence.

When it came time for Congress to renew the Bank’s charter in 1811, the Bank’s

critics were able to stop it. The proposed renewal lost by a margin of a single vote in each house of Congress.

The issue of a central bank reappeared in 1816. For five years, the country had been without a central bank to regulate banking and credit. Meanwhile, the War of 1812 had thrown American finance into chaos. The Second Bank of the United States was chartered under President James Madison, and once again there was widespread public distrust.

In essence, neither the first nor second central bank of the United States was widely understood by the population at large. In each case, the central bank was structured as a single bank. It was central and I am sure, using today’s jargon, it was efficient—but mostly it was distrusted and even hated by some. Andrew Jackson, a populist president, vetoed the renewal of the Second Bank’s charter, bringing an end to central banking in the United States for the next eight decades.

Regional distrust and dissatisfaction crippled the nation’s first two central banks and contributed to their eventual demise.

Early in the 20th century, as the United States became a growing economic force, it was apparent the banking and financial system needed a “central bank.” During this period, the United States faced numerous instances of financial panic as commercial banks across the country suffered serious liquidity problems. Business credit collapsed, and the public suffered significant financial hardship.

But there were a few hurdles to overcome in chartering this third central bank. Among the most important was the question of whether the United States once again would



have a highly centralized institution with concentrated authority. Or would it be best to create a new system—a decentralized system that would share authority across the nation?

In his memoirs, Paul Warburg, one of the Federal Reserve's founders, lists the main objections to the establishment of the central bank:

First: The danger of political control,

Second: The danger of control by special interests,

Third: Hurtful competition with existing banks.

The debate regarding the structure of the central bank went on for some time, but in the end, "a system of centralized reserves and decentralized banking power is clearly the system that this country requires," Warburg said.

This time the founders better understood that to provide for a more durable institution they needed a structure that shared the institution's responsibilities and power across the country, not just with the central government and in Wall Street. It was concluded our central bank should reflect the value we Americans place in shared control of some of our more important institutions.

Each Reserve Bank has a board of directors from the region where it is located. These directors not only provide oversight of the Reserve Banks, but also information regarding their industries and communities. As was noted to me some time ago, "through these 12 Reserve Banks, the Federal Reserve has roots that run deep within our communities, which enables it to garner broad public knowledge and support, and to function far more effectively than if it was located in only a few places."

The 12 regional banks flanking the Board

of Governors keep the Federal Reserve from becoming insulated from Main Street America.

They interact with the public and financial institutions at a local level. In doing so, the central bank demonstrates it is something other than a cumbersome bureaucracy counting its money. The board offers the public unprecedented direct access to the thinking of policymakers. Each bank is part of the basic fabric of its community, providing a connection between the community and its business and policy roles. This has been a critical element of the Federal Reserve's long-run success.

This structure and these principles are as important today as they were in 1913, perhaps more so. The Federal Reserve System remains a powerful institution. Its ability to gain and hold a broad base of trust and support is fragile, yet crucial to its success and, even more importantly, to the success of our national economy.

In terms of its overall operations and policy, the 12-bank system has consistently shown itself to be efficient and adaptable to change.

During the recent decades, it is hard to name another organization that has been systematically more effective in carrying forward its missions, whether in providing services to the public or conducting day-to-day policy.

Just as important, the 12-bank system has performed superbly across the nation during numerous crisis situations, ranging from the banking crisis of the 1980s, through the Y2K millennium experience, the tragedy of 9/11, and most recently during the aftermath of Hurricane Katrina.

Of course, it may be argued that the issue isn't so much about a centralized or decentralized structure but about whether the System



should have fewer than 12 banks. That debate also occurred at the Federal Reserve's founding. There was considerable, and often heated, discussion regarding the number of Federal Reserve Banks. Some wanted as few as five while others wanted more.

Even after the System was established with 12 banks, the debate continued for a time. It is interesting to recall that within about two years of the formation of the Federal Reserve, there was a serious confrontation among the members of the Board of Governors about reducing the number of Districts. In the end, the Attorney General of the United States wrote an opinion stating, in essence, that the Board did not have the authority to unilaterally reduce the number of operating Reserve Banks. Senator Carter Glass, one of the lawmakers who helped create the Federal Reserve, said those wanting to reduce the number of Banks were ignoring the will of the Senate.

A system of reserve banks was seen as an essential element to building trust in so powerful an institution, one that would have enormous influence over our economic lives.

It was also Paul Warburg who suggested one strength of the Reserve System lies in one of its weaknesses: protection against the dangers of an autocratic central administration. In this respect, the Reserve System was preferred to a more centralized system. There is no doubt that such a system, if enacted, might have been more efficient, but it certainly would have offered easier and more tempting targets for political attacks. This political superiority of the Reserve System was of immense importance, although it is, at the same time, a weakness.

Obviously, many things have changed

during the past eight decades. We have experienced exceptional changes in technology, banking structure, banking products and a greater national and international scope of business and banking. But, the fundamentals that drove the United States toward a 12-bank system are as real today as they were then.

Today, concern for centralized and concentrated financial power understandably remains important in the minds of the American public. The trends in consolidation have only heightened concerns in this regard.

At the same time, although there has been significant consolidation within the financial system, there remain thousands of regional and community banks which continue to play an important role across the nation. Banking activities vary across the nation and are greatly affected by their regional economies.

For example, about 25 percent of New England's banks failed in the early 1990s after local real estate values collapsed. In our own Tenth District, anyone involved in business or banking can recall vividly what happened in this region after the collapse of values in agriculture, energy and real estate. While it would be nonsense to suggest that these crises could not have been addressed in a centralized banking system, it is fair to say they were well addressed in a decentralized, although coordinated, manner.

Knowledgeable working relationships with regional and community banks are critical to understanding change and perhaps even discovering these types of problems in a timely fashion. The 12 Reserve Banks give us a broad distribution of contacts and means of interaction with commercial banking that is crucial



for understanding and responding to local banking markets. Such interaction might be accomplished with fewer than 12 Reserve Banks but, I would argue, not as effectively.

On the justification for having fewer rather than more Reserve Banks as it relates to cost, I would note a couple of points.

The System has been diligent in controlling its costs. Inflation-adjusted expenses for the 12 banks, as reported in the System's budget documents, have increased on average about 1.5 percent a year since 1970, showing actual declines in real terms in recent years.

Moreover, the Federal Reserve has consolidated some of its operations where the opportunity to improve efficiency was apparent. Check processing is one such area. Others include wire transfers, retail electronic payments and support activities. All these actions have served to contain costs.

Yes, there is every reason to pursue cost savings when it makes sense to do so. Certainly repetitive processes often benefit from new technology that simplifies operations.

But there is another side to consolidation where costs can rise and performance can decline. When the consolidation withdraws authority for local decision-making, it can lead to cumbersome bureaucracies, slower decision-making and loss of local incentive and performance.

All consolidations involve cost-benefit trade-offs. Balancing the difficult-to-measure benefits of access, communication, broad regional representation and operational delivery against any hard-dollar savings that might come from having fewer banks requires an understanding of bottom-line accounting and organizational

purpose. In this context, the value over the cost of our 12-bank system is considerable.

Finally, the value of this structure has been recognized by others. In 1998, the 16-bank European Central Bank was established and modeled closely to the Federal Reserve. Like our nation's central bank, the ECB is responsible to a diverse population across a broad region with varying economic and banking conditions. As with the Federal Reserve, a broad base of support is necessary for the ECB to succeed in its mission.

Robert Bremner, in his biography of Chairman William McChesney Martin, referred to a quote which described the Federal Reserve System as "America's greatest contribution to the science of government."

While this may be hyperbole, looking in the past, this structure has served us well. And looking to the future, it is designed to last.

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**TOM HOENIG**, President of the Federal Reserve Bank of Kansas City, delivered this speech September 15 at the annual convention of the Independent Bankers of Colorado.