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The Federal Reserve Role in The Payments Mechanism

Testimony

of

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I am pleased to be able to discuss with this distinguished Committee the role that the Federal Reserve System plays in the nation's payments mechanism. My testimony today will describe the scope of Federal Reserve participation in the payments mechanism, and how that participation serves the public interest. In addition, I shall address the issues of pricing and access and their relationship to the deepening problem of member bank withdrawal from the Reserve System.

The Federal Reserve System provides a public alternative to private check collection arrangements that ensures the safety, solvency, and certainty of the national check collection system. This operational role exerts a public regulatory presence that protects the interests of the general public in using checks. Private arrangements cleared all checks and drafts before the Federal Reserve System was established, but these arrangements were judged by Congress and by the designers of the Reserve System to be inefficient and a burden on commerce. These clearing arrangements also were inextricably intertwined with the pyramiding of balances at correspondent banks that was a primary contributing factor to recurring money panics like the one that occurred in 1907. The National Monetary Commission set up in 1910 to study solutions to the problem of money panics recommended that an association of banks be organized that would provide a nationwide, centralized clearing union supported by the Federal Government.

The Federal Reserve Act was passed in 1913 at least partly to accomplish this objective, although Congress substantially altered this original proposal -- principally to require membership by national banks and to increase governmental oversight. Later, the Act was amended to assign to the Federal Reserve many of the payments functions that were then performed by the Subtreasuries. As a result, one major role of the System is that of providing a largely voluntary, nationwide, governmentally-controlled clearingbank of unquestionable solvency. The other major payments role of the System is to carry on functions of the Subtreasuries, such as issuing Federal Reserve notes and serving as Fiscal Agent of the United States. The Federal Reserve Act has been amended on several occasions since the System's role in the payments mechanism was defined, but those sections dealing with the payments role have hardly been altered.

As a consequence of carrying out its charter, the Reserve System exerts a pervasive and beneficial influence on the nation's payments mechanism. This influence is exerted through four payments activities: cash, check processing, wire transfers of funds, and automated clearinghouses. I should like to describe each activity briefly.

The cash operations of the Reserve Banks involve the distribution of the supply of currency and coin for the economy. Since 1920 when the functions of the Assistant Treasurers of the United States were transferred to the Reserve Banks, the System has been authorized and directed by the Treasury to distribute available supplies of currency and coin directly to commercial banks. Important public service activities of the System's cash operations include counterfeit detection and maintenance of a high quality of money in circulation.

Currently, 37 Federal Reserve offices provide cash services to approximately 25,000 banking offices served by armored carrier for currency and coin pickup and delivery. During 1976, 7.0 billion pieces of currency and 12.6 billion pieces of coin were processed, and 2.6 billion pieces of unfit currency were destroyed. Including the cost of printing Federal Reserve Notes, amounting to $45.3 million, System direct expenses for cash operations were approximately $113 million during 1976.

Check collection operations comprise the largest single activity of the Reserve Banks. Although the Federal Reserve actually processes less than 40% of all checks written, the System is the major participant in check clearing, having worked in cooperation with the banking industry over the years, through its operations and regulations, to provide a smoothly functioning and efficient check clearing system. Last year the public and private check collection systems handled an estimated 28 billion checks, drawn on approximately 106 million accounts.

Each day some 50 million checks are transported in timely fashion by contract courier and U.S. Postal Service facilities from Federal Reserve processing sites to the institutions upon which they are drawn or the payor banks' designated processing centers. Fully 95% of the checks processed by the System are deposited by member banks; the remaining 5% are received from non-member banks depositing at Federal Reserve Regional Check Processing Centers. Because some 40 percent of the checks processed by the System are deposited originally in banks outside the Federal Reserve territory in which they are payable, the System also employs an extensive air charter network to move checks among Federal Reserve offices. During 1976 the 48 Federal Reserve offices which process checks handled over 12 billion items; processed approximately 2.8 million adjustment cases; and returned almost 143 million dishonored or uncollectible checks to the banks depositing them with the Federal Reserve. In 1976 check collection direct expense to the Federal Reserve totalled $131.1 million.

The third major payments mechanism activity is the Federal Reserve Communications System. The need to move financial and administrative data rapidly between offices has existed since the early days of the Federal Reserve System. To meet that need, the System operates communications facilities interconnecting Federal Reserve offices, the Board of Governors, member banks, the Treasury Department and other government agencies. The speed and sophistication of these facilities have improved through the years as communication technology has advanced. Three types of messages are handled through the communications facilities: transfer of reserve account balances between member banks, transfer of U.S. Government and Federal agency securities, and administrative and monetary policy-related information.

Reserve balances are transferred by member banks to purchase or sell Federal funds, to move correspondent bank balances from one bank to another, and to shift funds to other members on behalf of customers. The communications network is used by the Treasury Department and government agencies to disburse and collect monies and to transfer Treasury and government agency securities. In 1976, 21 million such reserve balance transfers took place, amounting in the aggregate to about $35.6 trillion. In the same year 2.3 million securities transfers for $7 trillion were processed. Direct expense of transfers of reserve account balances between member banks totalled $5.7 million.

The fourth payments mechanism activity of the Federal Reserve System is operation of automated clearinghouses. The automated clearinghouse (ACH) concept was originated by the banking industry to utilize new technology to slow or even to reverse the growing volume and increased cost of processing paper checks. Over the past five years bankers and thrift industry representatives have formed associations to implement the ACH concept in their regions. All but two of the twenty-nine ACH associations have requested Federal Reserve assistance (use of clearing and settlement facilities) in processing payments contained on magnetic tapes. The two privately operated ACH facilities use the transportation network and reserve account settlement facilities of the Federal Reserve. Currently the volume of commercial payments processed by Federal Reserve ACH operations approximates 800,000 items per month. Federal Reserve operation of automated clearinghouses has been endorsed by the National Commission on Electronic Fund Transfers.

The Treasury Department uses the electronic payments processing capabilities of the Federal Reserve, including the same general procedures and computer systems used for commercial ACH processing, for its program of direct deposit of federal recurring payments. Currently the volume of payments made under the Government's direct deposit program is approximately 7.3 million items monthly. By 1980 it is estimated that this program will save the Treasury approximately $25 million annually in reduced disbursement costs. The total direct expense to the Federal Reserve to provide both commercial ACH and Government direct deposit processing was $1.6 million during 1976.

System participation in the payments mechanism provides significant benefits to consumers and to business. For example, the acceptability of consumers' checks is greatly enhanced by the nation-wide network of Federal Reserve offices and the speed with which those offices process checks. In addition, the System grants uniform availability of credit for checks drawn on similarily situated banks. These facets of system participation in and regulation of the payments mechanism reduce the impact of the geographic location of the banks on which the checks are drawn. Furthermore, obligations of all sizes can be settled by check because the System collects all items, large or small, at par on the same terms. By reducing the time required to collect funds, by passing credit on a uniform schedule, and by collecting at par, the System reduces the risk taken by merchants that accept checks. Expeditious clearing also improves the functioning of financial markets generally by ensuring that funds in the clearing process are immobilized for a relatively short time.

Finally, the presence of the System as a major factor in the check-clearing process permits the nation's clearing arrangements to be regulated in the public interest. The Uniform Commercial Code permits the regulations of the Board and the operating circulars of the Federal Reserve Banks to govern many of the terms and conditions for collection of checks. By this mechanism, the System can readily make desirable changes in the check clearing process . In the past decade many of the innovations in the check collection mechanism, such as the Regional Check Processing Centers--which have reduced the time required to collect checks--have been sponsored or implemented by the Federal Reserve System. Similarly, establishment of the automated clearinghouses was achieved partly by Federal Reserve involvement and assistance.

The presence of the Reserve Banks in the payments mechanism also benefits commercial banks, particularly smaller and more remote ones, because the System stands ready to collect checks at par for any member bank on the same terms. The Reserve Banks provide an alternative to the services provided by the correspondent banks. The private clearing network processes 60 percent of the checks written in the country. But the existence of the public alternative which will clear all checks on equal terms has eliminated some of the abuses that existed prior to 1914.

The Board holds the view that the difficulties characterizing the check clearing system prior to 1914 are inherent in the nature of the clearing process, and that a valuable discipline is imposed by a centralized nationwide clearing authority--public or quasi-public--performing a par clearing role similar to that now assumed by the Reserve Banks. There does not appear to be any essential difference in this respect between paper and electronic clearing systems. Traditionally, enterprises of such a centralized nature either are operated by the government or are governmentally regulated.

Federal Reserve participation ensures that the entire nation has the benefit of a uniform, basic level of payments mechanism services. Banks that are remote from the financial centers or that have low volume are afforded very nearly the same payments services by the System that are available to the large city banks. Only a centralized nationwide clearinghouse can provide for such uniformity of service in check collection.

In recent years changes in law and regulation have broadened the classes of institutions capable of offering third-party payments accounts to their customers and have authorized new types of payments instruments, such as NOW drafts and credit union share drafts. Many of these institutions can offer electronic payments services as well. The emergence of thrift institutions as participants in third-party payments mechanisms has created a demand for broadened access to Federal

Reserve payments services.

In the past the question of access was not pressing. If a bank wanted direct access to System services, it could simply become a member bank. However, this option is by law not available to most of the new participants in the payments mechanism. With the exception of mutual savings banks, thrift institutions cannot become members of the System. At least partly to circumvent this prohibition, we have recently seen groups of credit unions purchasing banks, thereby obtaining access to Federal Reserve services. Similarly, a group of mutual savings banks in the State of Washington formed a bank and applied for membership. A group of non-member commercial banks in Minnesota has done the same thing. Thrift institutions also have sought direct access to Federal Reserve-operated automated clearinghouse facilities, and the Board has responded with its "interim" access policy of January 1976, granting such access.

We previously have supplied the Committee with a description of the current access arrangements for the System's payments services. We believe these access arrangements are equitable, and we do not believe that any depository institution has suffered serious competitive disadvantage because of this access policy.

The policy attempts to balance a number of conflicting considerations. First, services produced by a quasi-public organization should be available to all depository institutions on the same terms. But because most thrift institutions cannot become members, access cannot be provided on cost and benefit terms equal to those afforded members. Institutions that are not eligible for membership cannot receive the full benefits or bear all of the costs of membership.

Second, if the System were to charge for its services, and to equalize other terms of access between members and non-members, any inequities in costs and benefits arising solely from usage of payments mechanism services could be eliminated. However, charging for services would inequitably impose another cost on member banks over and above that of maintaining interest-free reserves. Overall terms for use of the services would still not be the same.

Finally, the System could charge for its services in order to encourage private competition. But even assuming that private competition could develop, it is by no means evident that the outcome--including the effect on the efficiency of the payments mechanism on the whole, on the service-level available to individual consumers and businesses, and on the erosion of membership in the System--would be in the public interest.

Recognizing the possibility that charging for payments mechanism services might have beneficial effects under some circumstances, the Board stated in conjunction with the "interim" access policy, that it intended to publish a pricing schedule for comment.

Since that time the problem of establishing charges has been investigated in much greater detail, and the benefits of charging have come under considerable question. One cannot know for certain the ramifications of charges by the Federal Reserve upon the present level of services provided by correspondent banks, the potentially differing impact on institutions of different size, volume, and location, or the competitive effects of the significant shifts in payment flows that might result from imposing charges. Furthermore, the administrative costs of operating a system of charges would lessen any possible benefits.

Our studies show that the benefits of charging would be minimal if charges were not imposed upon all users of the services. Because the overwhelming majority of the System's volume is deposited by member banks, any approach omitting the member banks from such charges would have very little impact on improving efficiency, would quite probably be inequitable, and would probably not induce private sector competition. Member banks already pay indirectly for the payments services they receive, and imposing additional charges upon them would be inequitable.

The compensation member banks provide to the System for these and other services they receive takes the form of earnings foregone on required reserve balances held on deposit with the Reserve Banks. These reserves are partly analogous to the balances that correspondent banks require from their respondents. Reserve balances total well in excess of $25 billion. Our studies have shown that these balances are larger than necessary to compensate the System for the services member banks receive, and they also are larger than the compensating balances that would be required if all these services could be and were provided by the correspondent banking system. Of course, the balances required of members serve many other functions, including those related to monetary policy.

Imposition of additional charges related to System services would have the effect of increasing the operating costs of members by comparison with the costs of non-member institutions. The relationship between the value of services received by members from the System and the earnings foregone on member reserve balances would become further distorted. Thus, the erosion of System membership that has been underway in recent years would likely accelerate.

The Board believes that its responsibility to the public interest under the Federal Reserve Act does not permit us to take actions which aggravate the loss of membership. For that reason, the Board is not inclined to change its present access and pricing policy unless and until the special costs of belonging to the nation's central banking system are recognized and offset. If S. 2055 is enacted, the Board has stated that it will make provision for equitable access to System clearing services for all institutions holding NOW reserves. However, the Board does not believe that it would be prudent to impose upon depository institutions another major change, such as the introduction of additional charges for System services, until the transition costs arising from the introduction of NOW accounts have been largely assimilated.

Once the burden of membership has been eliminated and the transition to nationwide NOW accounts is well underway, the Board could consider introduction of full access and pricing based upon three principles. First, all depository institutions could be permitted direct access to payments services. Second, institutions could be charged for the services used, either by holding compensating balances at the Reserve Banks or by fees paid in cash. Third, any depository institution could be permitted to open a clearing account at Federal Reserve Banks for use in settling transactions with the Reserve Banks. The balance required in such an account (in addition to any compensating balances the institution may choose to hold) would have to be sufficient to pay for the amount of the checks and other items the Reserve Bank would charge to the account each day. Otherwise, overdrafts on the reserve account might occur.

As to the schedule of charges to be imposed under these principles, many difficult policy issues as well as some complex accounting questions must be dealt with before the schedule can be determined. It may appear easy to compute prices for the services: theoretically one need only add up the total cost of providing the service, divide by the amount of service provided, and add whatever markup is appropriate for the situation. In practice, there are many unresolved questions. To what service should we assign a specific portion of costs incurred to carry out multiple functions? Should long-run or short-run costs be employed? Over what geographic area--local or national--should prices be uniform? Other technical questions involve our cost accounting. The expense data we collect are adequate for auditing and expenditure control purposes; and they suffice for management information about the efficiency of Reserve Bank operations; but for purposes of charging, they may not be comparable with cost information collected by private industry. Further examples of questions to be resolved include: should System prices include a return on the capital employed, and if so, at what rate? Should capital be valued at historical or replacement cost? How should taxes be treated? A myriad of such issues have been identified and are being studied prior to consideration by the Board. These difficulties are technical, but the Reserve System could resolve them in one way or another. They are not the principal impediment to introduction of charges for System services. The main impediment is the fact that charging would exacerbate the membership problem.

Congress created the Reserve System to be a largely voluntary association of banks, attracting membership broadly from the entire industry. In this way the widest variety of viewpoints, interests, and needs could be brought to the attention of the Board in the formulation of monetary policy, discount and loan policy, and operating policy toward the payments mechanism. Continuing erosion of membership threatens to alter the very nature of the System, cutting off this broad interaction with the banking industry, and through the industry, with its customers. Because the burden of membership falls more heavily on smaller banks, the erosion of membership is most pronounced among those institutions. There is a very real danger that if the erosion continues, the nation's central bank will become an organization to which only the larger banks belong. I hope we can all agree that such an outcome is not in the best interests of monetary policy formation nor of the public generally.

There are other cogent reasons in the public interest to prefer the Reserve System to have as many members as possible. One of these reasons is the part that the member banks play in monetary management. Balances held at the Reserve Banks serve as the fulcrum for the economic stabilization actions of the central bank. Required reserve balances enable the Federal Reserve to gauge the likely effect of its monetary management actions on the supply of money and of bank credit. As more and more transactions balances are held by the public at institutions that are not subject to reserve requirements, monetary policy inevitably becomes less precise, and prediction of the effect of particular policy alternatives more uncertain.

Furthermore, the implementation of monetary policy is critically dependent upon timely and accuracte data flowing to the System's money managers. At the present time, only member banks provide the needed data in the time frame to make it most useful. Cooperative efforts with the FDIC are just beginning to provide a flow of data from a sample of non-member banks. As thrift institutions take on bank-like payments powers, their actions will have an increasing impact upon monetary management.

With respect to balances providing such bank-like transactions services, thrift institutions should provide the same data and be subject to the same reserve requirements as commercial banks. Perhaps an equally important aspect of membership is its relationship to the safety and soundness of the banking system. Only member banks have ready access to the discount window and to the Federal Reserve counsel and assistance that accompany use of the window. Ready access to adjustment credit cannot be guaranteed by the correspondent banking system--especially in times of stress in financial markets. Access to the discount window may be a major benefit to member banks; but more important, it is the ultimate guardian of our banking system against liquidity crisis. Less obviously, the mere holding of deposits at Reserve Banks increases the soundness of the banking system. Reserve balances are essentially demand deposits held in riskfree form. The same balances held at correspondent banks would be subject to some risk, however small. Therefore, the greater the portion of the banking system's assets that is held at Reserve Banks, the lower the riskiness of the banking system as a whole.

I have dwelt at length this morning on the reasons that broad membership in the Federal Reserve is in the public interest. It is for those reasons that the Board is so concerned about the accelerating erosion of membership. Basically the cause of the loss of members is the burden of earnings foregone by members on the sterile reserves that they hold at the Reserve Banks.

There are a number of techniques that could be employed to equalize the costs of reserve requirements between member and nonmember depository institutions. Uniform reserve requirements would be the best and most simple solution. It would impose the costs of sterile reserves equally on all depository institutions and provide significant benefits for monetary management. And it could do so without weakening our dual banking system or independent thrift institutions. However, the Congress has not been convinced of the ultimate need for such complete coverage. Another way to equalize costs is to lower reserve requirements to the degree necessary to offset the costs of the excess of reserves over the value of services received. Such action would require lowering of the legal limits for reserve requirements. This solution has the disadvantage that the "insurance" value of reserves would be reduced because a smaller proportion of the total assets of the banking system would be held in risk-free reserve balances. Yet another way in which benefits could be equated with costs is by increasing the type, quantity, and quality of services provided by the Reserve Banks. Providing additional services, particulary to smaller banks, could upset traditional banking patterns; and in any case, the System might not be able to provide attractive services in sufficient quantity to offset the earnings lost on the sterile reserves. Finally, this lost income could be offset by the payment of interest on reserve balances. Interest on reserves affords the greatest flexibility, while interfering least with the existing institutional arrangements in the banking industry. Furthermore, it makes explicit the fact that the System is offsetting the special costs of membership.

The Board believes that Title II of S. 2055 is the best presently available alternative for resolving the membership problem, and we trust that it will be enacted. If nationwide NOW accounts are authorized, the banks offering such accounts will face immediate cost increases which will reduce net earnings and force further consideration of the costs of a sterile reserve requirement. Moreover, with new competition for transaction accounts, banks may feel it necessary to protect against a loss of deposits. These forces could bring even greater pressure on membership, and the provisions of Title II will be essential to prevent an acceleration of withdrawals. Whether or not NOW accounts are extended nationwide, however, the Board believes that the case for relief of the burden of membership is overwhelming and urges the adoption of Title II of S. 2055.

My testimony today has been lengthy and somewhat technical. I apologize for both of these shortcomings. But the issue of the Federal Reserve's role in the payments mechanism is a complex and technical one. Because the System's role is justified by the benefits provided to the public interest, costs arising from that role should not be imposed mostly upon the minority of banks that are members of the System. I hope I have been able to convey to this Committee some of the sense of urgency that the Board feels about the risks posed by the decline in System membership.

Thank you for your time and attention. I shall be pleased to answer any questions the Committee may have.