CHANGING FINANCIAL CLIMATE

REMARKS BY

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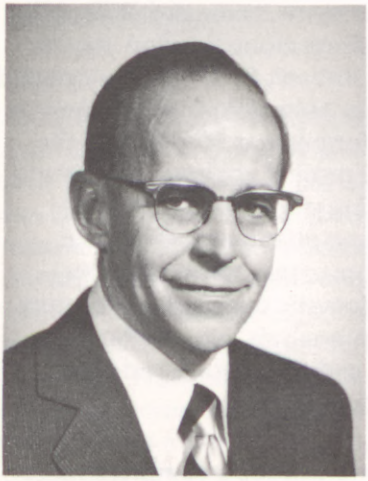

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It is a pleasure for me to participate in the program of the Assembly of Bank Directors. I hope that neither my remarks nor inclement weather will put a damper on your stay in San Francisco. I would like to play the role of financial meteorologist, as it were, and share with you my thoughts regarding a number of developments that can reshape the competitive climate in which you will be operating in future years. In particular, I am thinking of developments —partly technological, partly regulatory— which can eventually transform the financial-payments system.

What Kind of System?

What sort of payments system will finally evolve? Very likely, there will be a single, integrated, nationwide mechanism for the transfer of funds. This will embrace the widest possible gamut of transactions— from the automatic deposit of wages, salaries, dividends, social security and

other receipts, to the pre-authorized debiting of regularly recurring payments and current transactions, such as loan and insurance payments, taxes and utility bills. Pioneering efforts along this line may be seen in the 150-bank California Automated Clearinghouse Association, now known as CACHA but formerly as SCOPE, and the similar COPE project underway in Atlanta. The developing payments system will permit banks to offer many additional services to consumers and businesses—including automatic overdrafts, inventory and cash-flow analysis, income-tax preparation, and accounting and other financial-data services.

Eventually, you will see a comprehensive system of computer-directed communication networks, linking commercial banks and other financial institutions to computers in business firms, to point-of-sale terminals in retail establishments, and even to terminal devices in homes. (The "In-Touch" telephone-computer system now being offered to Seattle area families is a major step in this direction.) Through the use of a card to initiate transactions, the vendor's account will be credited at precisely the same time a debit is made to the payor's account.

Such networks at the local level will be linked to regional, national and even international networks, thus making possible the immediate transfer of funds virtually anywhere. In the process, we will see a significantly reduced volume of paper transactions, involving checks, deposit slips, sales receipts and verification documents. The Federal Reserve probably will maintain the interface or basic links among financial institutions. In fact, Regional Check Processing Centers (RCPC's) and automated clearing-houses,

together with the Fed's new high-speed wire, may become the nuclei of the interconnecting regional networks for handling electronic transfers.

Why a Change?

By now you undoubtedly recognize why we must adopt a new system of money transfers. Very simply, the paper check, which has been a highly efficient, convenient and inexpensive device for effecting financial transactions, will become less efficient, less convenient and more expensive in a rapidly growing and progressively more complex economy. This year, households, businesses and governments will draw some 27 billion checks on 94 million accounts, requiring the processing of nearly 500 million paper items each week. With implementation of the RCPCs, we will achieve a greatly increased efficiency in the handling of these paper checks. Yet at recent rates of growth, check usage will double by the end of the decade.

Consequently, we must implement a more efficient mechanism for effecting transfers, simply to keep the financial system from choking in a flood of paper. This does not mean that the check, like the horse-drawn carriage, will simply disappear. Indeed, the speed of acceptance of an electronic-transfer system will depend on a number of legal and regulatory questions, as well as the effectiveness of commercial-bank marketing efforts. However, the increasing difficulties—and increasing costs—involved in handling a fast-growing volume of checks should hasten public acceptance of an alternative system.

Progress to Date

To date, banks have made little progress in implementing preauthorized debits, partly because of their failure to overcome cus-

tomers' traditional reluctance to "surrender control" over the timing of payments. Nevertheless, I believe that a breakthrough may soon occur through developments centering upon the point-of-sale. These developments involve the major bank credit-card systems, which now count over 10,000 participating banks, 1.3 million merchants and 30 million cardholders among their clientele. Specifically, they plan to activate electronic networks which will provide for the authorization and verification of credit-card purchases nationwide, on a 24-hour basis. One of the systems also is working on the electronic interchange of information now carried on credit-card sales drafts. When implemented, this procedure will materially reduce the costs of interchanging drafts and bring closer the on-line processing of the entire interchange transaction.

In addition, more and more retail stores are now installing credit-authorization terminals. By doing this, they are linking the consumer, the merchant and the banks at the point which best demonstrates to the consumer the advantages of a full electronic-payments system. After all, a large proportion of all household checks, along with an overwhelming share of credit-card purchases, are written at the point-of-sale. Because authorization at the point-of-sale entails the use of some sort of card, the volume of card-related transactions should rise correspondingly. In the process, the card should increasingly assume the attributes associated with "traditional" money, including convenience, safety and efficiency as a medium of exchange. In the electronic era, the plastic card—whether to facilitate "cash" or credit transactions—may eventually become the dominant means of money transfers.

Role for Nonbanks

This brings me to a basic question—namely, what role should nonbank financial institutions play in the developing payments system? In spite of the slow progress made by CACHA and COPE in marketing pre-authorized debits, the S&L's and mutual savings banks apparently believe that an electronic-payments system represents the wave of the future—on the crest of which they, too, must ride.

Looking ahead to the time when all of an individual's financial needs may be combined in a single card-accessed package, thrift institutions are now developing their own cards. These cards are designed, however, to interface eventually with other cards. One example is the "Prestige" card, which has been offered by California's (and the nation's) largest association to those customers who have signed up for a plan of pre-authorized deposit withdrawals from commercial banks. The card was initially designed as a cash card to facilitate deposits and withdrawals, as well as loan payments, but it will also provide its holders with instant access to hundreds of automatic cash-vending machines and, eventually, to retail-sales outlets. Further in the future, the plan would permit electronic funds transfers as well.

Another example is the "MINTS" card offered by an affiliate of the National Association of Mutual Savings Banks. A money-transfer device with the capability of becoming a credit device, the "MINTS" card represents a two-fold effort on the part of the mutuals—first, to achieve some degree of parity with commercial banks, and secondly, to gain entry into an electronic-payments system. In this connection, I consider it highly significant that National Bankamericard, Inc. has announced that it

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will permit mutual savings banks to apply for membership. This move has been welcomed by the mutuals' trade association as evidence that the bank-card organization "is willing to embrace competition in the field of credit-card services".

Legal and Regulatory Problems

As you no doubt are aware, a number of California S&L's also have applied for full membership in CACHA. Already, they can receive paper paychecks and execute pre-authorized drafts on commercial-bank demand deposits to effect fund transfers. But presumably, full membership in CACHA would enable the S&L's to credit and debit savings accounts of their customers, in much the same way that banks credit and debit their customers' checking accounts.

The Federal Reserve System believes that, under certain conditions, some form of thrift-institution participation in automated clearing arrangements is consistent with the System's overall objective of implementing a single, integrated, nation-wide payments system. However, the conditions under which thrift institutions participate are important. First, equitable arrangements must be made, so that the thrifts contribute a fair share of support to the overhead and operating costs of the automated clearing facilities. Secondly, any and all institutions offering the same money-transfer services must share the same regulatory burdens and responsibilities, so as not to impair the implementation of monetary policy.

The legal problems also are complex. Speaking for the Anti-trust Division of the Justice Department, Donald I. Baker recently commented that thrift institutions "probably are entitled to access to automated clearinghouse arrangements, if they

can show that they would be significantly injured by exclusion in competing for time-and-savings deposits." By extension, of course, all types of financially-oriented companies might demand inclusion in such a system—data processing firms, specialized service bureaus, large retail firms, communications companies, and so on. Moreover, given a basic agreement between payee and payor, there is no reason why payments cannot be made simply by direct transfers of balances on the books of the parties concerned, without any commercial-bank participation whatsoever.

In any event, the present CACHA members believe that full participation by the S&L's would entail their de facto administration of a transfer device extremely close to the present payments mechanism—money—and that such participation would therefore require prior Congressional authorization. Also under the Hunt Commission and Administration proposals, thrift institutions would be given broad authority to offer full third-party services, including checking accounts and credit cards. This, of course, raises very vital questions regarding the ground rules for the various institutions participating in money transfers, including such matters as reserve requirements, tax treatment and interest rate ceilings.

Recommendations for Change

For its part, the savings-and-loan industry has rejected the Administration's proposals as a package. Nevertheless, it views certain of those recommendations with considerable favor—most notably, those which would confer consumer-lending authority and a fuller range of third-party services. Indeed, the thrifts may not require broadened lending and investment powers to participate effectively in an electronic-payments system. George Oram, Jr., an

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official of the Federal Home Loan Bank Board, recently commented, "The thought process seems to be moving . . . much more towards a housing and consumer orientation for thrift institutions from the original (Hunt Commission) recommendations." In short, the industry apparently now believes that a full range of third-party payment services for households, including perhaps only modest overdraft privileges rather than full consumer-lending powers, will strengthen the S&L's ability to finance housing.

The Bank Board itself has urged the industry repeatedly to "lay the groundwork for conversion to an electronic funds-transfer system at the opportune moment." Also, in Mr. Oram's words, "Any financial institution which cannot offer its customers the ability to draw on their accounts through a point-of-sale terminal in order to make a third-party payment will not be able to maintain effective competition with those that can." Indeed, the S&L's failure to implement existing third-party payment authority may be explained by their effort to circumvent the paper-check process by direct entry into an electronic funds-transfer system.

In this connection, there is some significance to the NOW accounts (negotiable orders of withdrawal), which presently are offered only in Massachusetts and New Hampshire. For one thing, the NOW's represent a further step in blurring the increasingly fuzzy distinction between demand and savings accounts. But more than that, by offering consumers a new combination of convenience **and** interest, they may help compensate the consumer for his loss of ability to play the float, which is inherent to the check-payment system. The NOW accounts thus may help win consumer acceptance for a system of electronic funds transfers.

Basic Implications

Now, what are the more significant implications of a developing electronic-payments system? First, such a system will mean a breakdown of both institutional and geographical barriers to the flow of funds. In the process, it will render obsolete many existing legal barriers to competition, such as restrictions on branching. Secondly, implementation of an electronic funds- and data-transfer system, in conjunction with expanded functions for financial institutions, would probably increase the potential for realizing economies of scale. The result may be a tendency towards fewer and larger-sized firms.

For the small bank, this means that its very survival may depend upon its ability to work out—perhaps through joint ventures, pooled facilities or leasing arrangements—some means of participating in the new services and markets offered by an electronic system. This approach would obviate the need for very costly investments in hardware and personnel for an independent system.

An electronic-payments system also may result in the obsolescence of many functions now performed by branch offices of financial institutions. Because of the nature of the expanded services that will be tied to an electronic-payment system, customers will find it less necessary to actually visit these offices in their capacity as either borrowers or depositors. Moreover, with the growing variety of computer-oriented financial services, the very concept of what constitutes a market is likely to change in both the geographical and product sense. This shift is certain to have significant implications for both regulatory and anti-trust policies and will keep alive the on-going issue of what types of firms should be confined to what types of market.

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Facilities-sharing, for example, is a proper technological solution to the problem of tieing-in financial institutions electronically. But much will depend upon how the regulatory authorities evaluate competition. Should competition be measured simply by the number of competitors, including the number of offices or pieces of equipment which they employ? Or, alternatively, should it be measured by the scope, variety, and pricing of services offered, at cost savings, through a joint use of facilities?

Next comes the question of the implications for monetary policy of a more efficient payments system. Since 1950, the ratio of GNP to the narrowly defined money supply has doubled—from 2.5 to 5.0. If further efficiencies in the use of money come about as a by-product of an electronic funds-transfer system, progressively smaller increments in the money supply may then suffice to finance a given growth in income and output. And I don't need to remind you that the principal component of the money stock—demand deposits—constitutes a major source of your loanable funds.

Policy implications also will depend upon the extent to which similar ground rules govern all participants in the developing payments system. If the same ground rules hold, in terms of fiscal levies, reserve requirements and other regulatory treatment, this could increase the institutional interdependence of financial and "real" markets, and thereby increase the effectiveness of monetary control. On the other hand, unequal ground rules could impair the process by which monetary policy objectives are transmitted. Any erosion of the institutional control base very much concerns the Federal Reserve System, particularly as the source of money transfers broadens.

Concluding Remarks

In conclusion, I should first note that the full sweep of changes which is likely to accompany the development of a new financial-payments system will occur only over a couple of decades, or even longer. Nonetheless, these developments are certain to alter the competitive financial climate. Whether this is for better or worse —to you as bankers, and to the public you serve—will largely depend upon your response.

The opportunities for new services which the developing payments system will enable you to offer your customers are very great. Your competitors recognize this, and I hope you do too. Those banks that have the vision and the determination to play a role in the payments system of the future will be around to reap its rewards. Those who do not—those who are too tradition-bound to get in on the action—are likely to find the changing climate rather inhospitable.

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