FOR immediate release

THE CHECK

Remarks of

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BOARD OF GOVERNORS

Federal Reserve System

at the

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T H E C H E C K

I appreciate your invitation to address the Annual Meeting of the Bank Stationers Association, and I appreciate especially the frank expression of your interest by your Program Chairman. Your concern, as with any group of businessmen is: what is the future of our product?

It is a question that elicits sympathetic consideration from any thoughtful observer, because your product -- mainly the paper check -- is a good one, a product that has been vastly improved in the past decade because you have made every effort to make it compatible with advancing technology, and it is a product that your principal users -- the family and the small business -- have come, rightly, to regard as an inexpensive, highly efficient and convenient means for effecting the bulk of their financial transactions.

Why should there be any doubts about the future of such a paragon of a product? Ironically, the answer is that its very attractiveness must in the end be its undoing. It is so good a product that its usage, unless something is done to the contrary, will grow to unmanageable and damaging proportions. The check stands today in somewhat the same position as the telephone in the years prior to the general switchover to dialing -- the telephone had proved itself so useful and desirable a tool that without change from human to

electronic handling of calls, the potential for its increased usage was bound to make it a high-cost frankenstein.

That, in one sense, is the answer to your question about the future of your product: in the public interest of continuing to have at the heart of a growing and ever higher income society, requiring an ever larger and more complex payments mechanism, we must move away from dependence upon paper payments instruments and towards more and more nearly complete reliance upon electronic transfer of funds and electronic accounting for those transfers.

That is the answer that you must have in mind as you look ahead and do your long range planning.

But in a shorter term sense, the answer is quite different, with very different implications. Taking the next decade as an approximate time horizon, the answer to the question, what is the future of the paper check, has the following elements:

--There is at present no practical indication that check usage will soon decline absolutely.

--There are strong reasons for believing that check usage may grow in absolute terms, although the rate of growth can be expected to decline, even if it does not level off.

I should add to that the following caveats in the interest of giving you as frank an assessment as present information affords:

First: All estimates for check usage over the next decade, or decade and a half, are vulnerable, because they are, in fact, guesses

built on estimates of how fast -- or how slowly -- already existing electronic transfer systems, now in experimental usage, will take hold and spread. There are at least three unknowns affecting such guesses: first and basically, to what extent will the tendency for check usage to increase raise the cost of check services and thereby hasten public acceptance of electronic handling of funds transfers; second, assuming public acceptance of general electronic funds transfer and accounting, how decisive -- or how manageable -- are the cost, and the technical and legal problems of installing electronic equipment so as to make substantial inroads on check usage; and, finally, how decisive are certain business factors -- such as the ballooning problem of check verification -- that may put growing weight on the side of moving away from the check?

Second: In our view, and, I believe, increasingly in the view of many commercial bankers, substantial further increases in check usage is a danger to continued effective and low cost financial payments, while the benefits to the public -- and to the nation's economy as a whole -- in switching to electronic payments and accounting are potentially very great. Consequently, we at the Federal Reserve are bound to do all in our power to break through problems standing in the way of general use of electronic transfer, and to shorten as much as possible the time when the great majority of payments in the United States will be made and accounted for electronically.

A Few Background
Pointers

That is a rather bare-bones summary. While it addresses, I believe, your principal interest in a frontal way, it leaves out a number of background and underlying factors that are important for a better rounded assessment of the future of the check.

The Federal Reserve Board has adopted a very firm policy stance with respect to the development of an electronic payments system. As far back as September of 1968 the Board announced a contract to computerize the Federal Reserve System's communications network as "a major preparatory step toward an electronic transfer system for bank deposits and financial data in the 1970's. . . ." Two years later, the Board announced completion of the first phase of the new communications network "that will result ultimately in the transfer of money, securities and economic statistics" at much greater wire speeds, through a new computerized switching center at Culpeper, Virginia. This switching center now links the Board, the 12 Federal Reserve Banks, the 24 Federal Reserve Branch Banks, other Federal Reserve facilities and the U.S. Treasury Department.

On June 17, 1971, the Board issued a policy statement calling for "basic changes in the nation's system for handling money payments" as "transitional steps toward replacing the use of checks with electronic transfer of funds."

The statement said that modernization of the nation's means of making financial transactions through the banking system "is becoming a mater of urgency" due to the rapidity of the growth of check usage, estimated at about 7 per cent a year. That implied at least doubling check traffic by the end of this decade, to something near 45 billion checks a year. It is now estimated that by the end of 1973, check volume will have grown to some 27 billion pieces, from the 22 billion a year estimated for 1971 at the time the Board issued its policy statement. It is our current estimate -- based on new observations giving a conservative estimate of a 6 per cent growth projection -- that, unless steps are taken meanwhile to alter the growth of check volume, it will amount to about 54 billion pieces by 1985. As I have already indicated, estimates as to how much that increase might be reduced by the growth of electronic funds transfer over the next decade is a riddle of uncertainties. And I want to emphasize our commitment to making inroads, and to making them as fast and far as we find possible.

In its June 1971 policy statement on the payments mechanism, the Board asked for the achievement, across the nation, "as soon as possible, of an accelerated flow of funds along more optimal routing patterns" in two initial ways. One was structural change, most of it now accomplished or soon to be in place. This involved, chiefly, increasing the viability of the check payments system by the establishment, in existing Federal Reserve offices, or outside them where

warranted, of regional centers for the overnight clearing of checks. Completion of a network of such high efficiency check centers that -- together with commercial clearing houses -- will bring most checks into same-day clearance, is only months away. I should note that when guidelines were issued for the operation of these centers, in February 1972, one provision was that each center should be designed with the idea of converting it, eventually, to function as a node in a national electronic funds transfer system, together with its local electronic or other clearing functions.

The Board stated its second objective -- operational changes -- in the following language:

> ". . .reducing dependence upon checks by encouraging banks and their customers to make greater use of the expanded capabilities of the Federal Reserve System's communications network."

The Board added that its policy statement

> ". . .confirmed the Federal Reserve System's commitment to a nationwide direct, fast and economical system for the transfer of funds and settlement of balances."

We remain firmly attached to that commitment because there has been no change in the basic reasons for it: (1) rapid growth of check volume due to growth of the economy, and growth in the number of

families and small businesses making use of checks, and (2) the labor intensive nature of the check payments system. Despite all technological advances in check handling, such as magnetic ink encoding, and maximum application of machine handling, the fact is that an inordinate amount of expensive human hand manipulation, and physical transfers of paper, is still part of check clearance. The only significant change meanwhile has been the fast development of Federal Reserve extended zones of overnight clearance.

It is clear, in a nation such as ours where the pool of clerical labor is not rising fast, if banks engage increasingly in the labor intensive business of building up check payments, banking will soon be competing with other businesses for clerical help. This is a process that must raise the unit cost of handling checks to a point at which banks will have to cost out this service much more carefully than at present. The end result is that the housewife and the small businessman will find that the checking account that is now free, or that they look upon as a service that is both highly useful and inexpensive, will grow in cost to the point where it can only be regarded as an expensive necessity, from which users will seek relief. In such a situation, banks too would be seeking relief from continued provision of a service that it would be difficult, if not impossible on any realistic cost basis, to make profitable.

Meanwhile, if there is a spread of the currently budding system of using interest bearing savings deposits as the basis for a new type of checking services for families, the cost of paying interest on funds against which negotiable withdrawals are permitted will make nonsense of the idea of providing checking services at no or nominal cost.

In one way or another, consequently, the days when both banks and their customers have enjoyed the illusion that they can have a vast check payments system at little or no cost appear to be drawing to a close. To the extent this occurs, resistance in the public to change from paper to electronically recorded payments transfers can be expected to change to pressure from the public to bring about such change quickly and on a general scale.

Another factor that I think you will want to keep in mind in considering the future of the check is widespread public acceptance of the credit card. It is a transactions device for accumulating a number of debits, and paying for these debits with a single check per month instead of the half a dozen or more checks that would have been required, in many cases, if the card holder's monthly purchases were paid for individually.

Some On-Going Changes
to Electronic Transfer

In California, as you probably know, banks and clearing-house associations in San Francisco and Los Angeles, with the backing, encouragement and assistance of the Federal Reserve, have brought into being an electronic funds transfer system known as the California Automated Clearing House Association. CACHA permits individual bank customers in the state to authorize their employers to deposit their pay into their checking accounts automatically each payday.

Individuals will also be able -- and are encouraged -- to switch from paper to paperless transfers by authorizing payment by their banks of their recurring, predictable bills, such as mortgage payments, utility bills, insurance premiums and loan payments. Instructions for making such transactions are recorded on electronic computer tape. The Federal Reserve supplies automated clearing houses where the tape recorded transactions can be cleared by computer, and eventual balances can be shifted in reserve accounts on our books.

Private banks in Atlanta, Georgia, have put together a different type of pioneering electronic funds transfer system with emphasis upon the kind of service that has the greatest potential for making a really big dent in the use of checks: point of sale electronic payments.

The Atlanta project also includes what may be a significant innovation in terms of hastening public acceptance of preauthorized, electronic payments. This is called the "billcheck." The customer of a large transactions volume company, such as a utility, receives his bill. If he has agreed to it in advance, attached to the bill is an authorization stub. Say the bill is for $18. The customer can write on the stub $18, authorizing payment of the whole amount of the bill. He can authorize payment of any part of it. Or he can put it in the well-known hat, maybe to be drawn out next month. In other words, the customer retains all the options he has today in writing a check, or ignoring a bill. But the system is unburdened of a lot of paper.

The elimination of paper transfers that occurs with the billcheck is due to the fact that the company receives the stub and transfers the authorization directly from the billcheck to an electronic tape, together with the customer's bank account identification. The company sends a tape with this -- and thousands of other payments -- to the Fed's automated clearing house at Atlanta, for payment. No check or other paper enters the payments mechanism.

The Atlanta project aims at early introduction of point of sale electronic payments. Two such experiments in electronic payments have already been made, one near Columbus, Ohio, and the other at Syosset, New York. In these limited experiments, customers have seemed well

pleased to make their transactions in this way, although preliminary studies at Atlanta indicated that there is a considerable job of education to be done to sell the idea to the housewife, businessman, employees, and bankers. This does not excuse the Federal Reserve, or the commercial banking system, from pressing forward with preparations against the day when the time bomb represented by the potential glut of paper in our payments system will take its toll in the form of suddenly rising user and purveyor costs, sharply reduced productivity in our system for making financial transactions, mistakes and delays due to overloading, and rising customer dissatisfaction.

There are at least two dozen other cities where banks are getting together to launch local electronic funds transfer systems of various types. The Federal Reserve is ready to assist such programs with advice, technical help, and, ultimately, with automated clearing houses. Eventually, our communications system will be prepared to connect local systems in a nation network.

Like all probes into the unknown, electronic funds transfer systems face many problems and uncertainties. Some of these include, in addition to the problem of customer acceptance, the fact that many millions -- according to one estimate I have seen[1/] some 11 million -- business accounting and control systems must be modified. Further, a system must be developed that gives a high degree of accurate customer identification and check verification. The requirement of millions of terminals, in homes as well as stores and other businesses, indicates the need for development of cheap terminals, perhaps little more complicated than the standard telephone, or cash register. And there may be legal problems to be solved, including any anti-trust considerations, as well as the question of the legal standing of a memory bit in a computer, not evidenced by a piece of paper, with respect to good and sufficient records of deposit or debit, or of a transaction, or ownership.

With respect to this last point, it is interesting to note that Treasury regulations with the force of law now permit the elimination of definitive paper government securities and storage of records of their issuance, purchase and transfer, and credit of interest on them, by electronic "book entry" in computers operated by the Federal Reserve. About 71 per cent of the entire Federal public debt is now held in such book entry form, free of paper.

1/ M.A. Schapiro & Co., in Bank Stock Quarterly

Similar developments are taking place in the private securities market. Three large scale depositories for equities have been set up, in San Francisco, Chicago and New York, with the aim of converting to electronic book entry, and of handling electronically all transactions in the securities held by the depositories. Before they can dispense with paper records, however, changes in the Uniform Commercial Code must be ratified by the requisite number of states.

One further point before I close. I suggested earlier that the really big potential for reducing check usage will very likely not be reached until point of sale electronic payments become widespread. Let me back this up with just a few figures. We estimate that individuals write just over half of all checks, businesses write 43 per cent of all checks, and that Federal, state and local governments account for no more than 5 per cent of check volume. Obviously, checks written by individuals to pay for goods and services is the biggest game to be sought, in reducing check usage, although it is also obvious from the number of business checks written that capturing payroll, pension, dividend, interest and like business payments through prearranged deposits will also be a major factor. Nevertheless, the largest growth potential in check usage lies in the use of checks to pay for increasing numbers of private purchases in shops and stores as the economy grows and more people make more purchases and out of higher incomes. So to the future, as well as the present the finger points

to point of sale electronic payments as the area in which most is to be gained in terms of holding down, or reducing, check volume and keeping the payments system operating smoothly and cheaply.

I have already indicated some of the constellation of problems that must be surmounted to make point of sale paperless transactions the usual thing. Possibly the biggest of all is customer acceptance. But there are factors that will work in favor of acceptance. One, as I have previously suggested is the effect of rising costs of using checks that can be expected if volume increases substantially. Such rising costs will be an inducement to families, especially, to accept change to electronic payment. Convenience will also be an inducement. For the merchant, probably the greatest inducement is better, quicker and surer means of verifying the identity of the purchaser, and verifying that he possesses funds or credit with which to pay. The bad check problem is already a major problem in check usage, and can only get worse as check volume grows.

The Future of the Check

I hope that this look at the payment mechanism is helpful to you in considering the future of your industry. While it gives you what I believe is reliable assurance of continued high demand for your product for a reasonably long time ahead, it also, I hope, makes it clear that the well being of the economy, and the convenience of the public for which you

make checks, will, within a measurable time span require reduction and, in the end, virtual elimination of your product. But the picture, as I see it, gives you adequate time to plan for the reallocation of your capital, when that eventually becomes necessary.

Although, like all things in this world, the check printing industry, as you presently know it, is not immortal, your outlook for the future will surely be colored by the fact that there is no reason to believe you are going to lose the ingenuity and ability to keep up with the technological times that has made you, not a failing industry, but one that is succeeding itself out of a job.

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