

FOR RELEASE ON DELIVERY
WEDNESDAY, APRIL 5, 1978
10:15 A.M. C.S.T. (11:15 A.M. E.S.T.)

FEDERAL RESERVE INVOLVEMENT IN EFT

Remarks of

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Board of Governors

of the

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at the

1978 NACHA SurePay Conference

New Orleans
April 5, 1978

FEDERAL RESERVE INVOLVEMENT IN EFT

I am pleased to have the opportunity to speak to this distinguished banking group brought together by a common belief in the future of the automated clearing house program. Before I begin my formal comments, I want to share with you the status of Board plans to provide interregional ACH operations and Bankwire settlement, because I know you are interested.

As you recall, plans were published for comment in December of last year for the Federal Reserve to link together, into a nationwide operation, the automated clearing house arrangements that are now regionally operated around the country. We have received widespread support for these plans, much of it from the National Automated Clearing House Association and its members. I expect that the full Board will consider these plans in the very near future.

Many of us have been disappointed in the growth of the ACH program, although I am not sure a better or more realistic attitude should be one of satisfaction for the basic achievements to date. The lack of acceptance can be attributed partially to inevitable delays in resolving policy issues which discouraged the commitment of resources to market and promote ACH services. There has been uncertainty as to the proper role of the Federal Reserve and uncertainty as to the role of thrift institutions. Thus a true test of public

acceptance of the ACH concept has not been possible. These uncertainties may soon be resolved. My hope is that we will meet the challenge of proving the capability of the ACH mechanism to serve as the major means of effecting several common types of payments.

I do not believe there is anyone in the audience who would question the mechanics of the automated clearing house operations as a means of making payments. These mechanics have been amply tested through the Treasury Department's direct deposit program. It is now time to develop sufficient commercial volume to demonstrate that the ACH mechanism can offer a cost-effective, convenient service to consumers, business, and the financial community.

My remarks today are intended to inform you of the direction which I believe the Federal Reserve System will head in the near term, and also, to review some of the ideas that I have heard discussed around the country--both within and outside of the Federal Reserve--for increasing commercial ACH payment volume. I hope my remarks make a positive contribution toward that goal.

One of the key factors in developing a system that can move large volumes of payments on a timely basis will be the capacity of the telecommunications facilities linking the regional ACH's. Our planning in this area has been influenced by a test that was made between the Dallas office and the Kansas City office. I would like to describe the results of that test because it is indicative of how the requirement for capacity can be met and of the costs of providing the necessary enhancements.

In the test, a low speed 2400 baud line was replaced with a higher speed 56 kilobit line between Kansas City and Dallas. Without changing any of the computers at either office or any of the communication facilities or procedures, a file representing 10,000 ACH payments was transmitted from one office to the other. We were able to transmit that file in 3-1/2 minutes, in contrast to the two hours required for the same transmission on the lower speed line. We are studying linkages in the System to determine which will require the 56KB capability immediately, and which will require the capability in the future. Our current net cost estimates are on the order of \$150,000 this year to connect the required Federal Reserve offices and up to \$400,000 per year for full implementation.

The need to move ACH payments rapidly on an interregional basis also applies to intraregional movement in which payments move between financial institutions and the ACH. Presently, the ACHs rely on the check courier transportation system for intraregional payments. Reliance on the check transportation system has resulted in time schedules that are unattractive to many potential users of ACH services. One solution would be to establish communication linkages among the major processors within a Federal Reserve office territory. Not only would time schedules be improved with such linkages but also reliability would increase. For example, during the severe snowstorms this past winter, check clearings came to a halt in some areas of the

country. By using our wire system, we were able to distribute the Treasury's direct deposit payments with virtually no interruptions.

This leads to my main point, which is that if the ACH mechanism is going to be a viable payments system, the time schedules associated with handling payments must be improved. For debit payments, the availability schedule for checks is better than that for ACH payments. In many cases a corporation can collect funds more rapidly using the paper system than the ACH system. I believe it would be very advantageous to the success of the entire effort if the ACH availability schedule were improved to the point that it would be at least equal, or in some cases superior, to the availability schedule for checks.

For credit payments, the time schedules for income payments are likewise unattractive to many potential ACH users. The requirement for a business to provide payroll information days in advance of the payment date appears to be a constraint to increased volume.

In my view, we should be moving in the direction of providing the public with a superior service to the check in convenience, certainty, and cost. We are working in that direction, and I hope you will assist us in the effort to provide a better service and one that would be more attractive to all users.

As you all know, however, there are problems and potential hazards in the future ACH development, and I do not want to be accused of discussing only one side of the ledger. Among these are the problems of marketing, of consumer and corporate acceptance, and of the role of the Federal Reserve in future payments activities. I would like to spend some time upon this last issue because it impacts upon both of us and may be the most difficult to handle.

The Federal Reserve is being pressured by some of the large banks of the nation to withdraw from future payments mechanism operations and some even want us to get out of present activities. Although, as we indicated on previous occasions, the Federal Reserve is interested in private sector development, it is also interested in promoting a competitive environment that limits the financial power of a few firms and protects against the hazards to the American economic system that over-concentration might pose.

We are especially concerned that the larger financial institutions not be placed in a position of pyramiding correspondents' deposits, which might constitute a threat both to the central bank's control over money and credit and to the stability of the economy. It is apparent that we are having difficulty in communicating this concept to Congress and the American people because there are vocal advocates of Federal Reserve withdrawal among both.

If one merely looks at the check and cash payments system at the time of the creation of the Federal Reserve, one might see why the Federal Reserve Act charges the System with the development of a stable and efficient system of payments. Admittedly, at that time, the country was a collection of regional markets and a nationwide flow of funds was only beginning to develop. Whatever national money market existed employed correspondent balances deposited with banks in the largest cities. But this concentration of correspondent balances at the largest banks proved to be a significant hazard for the financial system and the nation's economy. It is precisely this development which was stopped by the creation of the Federal Reserve and which we hope to avoid in the future. It is of special interest that the largest banks are again attempting to foster the idea of private sector development--which translates, in my view, to private pressure for a return to a large bank correspondent network. We cannot afford such a redevelopment, and I hope you will help us avoid it.

Finally, I should bring to your attention the devious routes by which such centralized power is being advocated. If pricing of Federal Reserve services is pushed as a way of encouraging private sector competition, one might ask with considerable justification if the member banks are not already paying an excessive price by holding sterile reserves. I must point out that the Federal Reserve serves many

uneconomic points with a basic service level that is nearly equal around the country. Who will serve these institutions if the Federal Reserve must eliminate the subsidy now provided and price service to uneconomic points on the basis of cost? I suspect that the large correspondents want the heavy traffic, point-to-point service but may find the smaller remote banks a burden to serve.

If pricing is being urged to force competitive equality between various payments mechanisms, you and I know that a research and development effort such as ACH must have a period of time to develop volumes needed to perform most efficiently. If subsidies are not granted in the early phases, the development may be stalled and perhaps even lost.

If pricing is being advocated as a means of reducing the level of payments mechanism services provided by Reserve Banks, several questions may be asked. Why do those advocating pricing wish to reduce the benefits and increase the burden of Federal Reserve membership? What political gains can be achieved by reducing the role of the Federal Reserve?

Finally, and most importantly, one must wonder who will look after the broader public interest in the certainty, speed, and solvency of the payments mechanism if the Federal Reserve withdraws or is forced to price on a full cost basis without reference to the public interest. Will those advocating withdrawal of the Federal Reserve accept the disciplines of a rigid regulatory program to insure low float, certainty of payments, and protection of the nation's money supply?

None of my remarks should be construed as a refusal to consider pricing but only as a strong caution as to the methods and potential hazards of moving in that direction.

You may think I am seeing an Indian behind every tree or that I am questioning the motives of some of the advocates of Federal Reserve withdrawal and pricing. As to the latter, you are right. I am suspicious of the push for withdrawal, which will eliminate a major competitor and I am suspicious of the self-righteous statements which cloak these activities under the banner of private enterprise. Maybe you should be questioning these positions too.

In summary, my message concerning Federal Reserve activities is clear. First, we have announced plans to provide interregional ACH operations. Second, we are very much interested in pursuing, with your help, means of substantially improving the availability schedules for ACH payments. Third, in my view, the automated clearing house arrangement may develop along the lines of the check system with the Federal Reserve providing a basic level of service to the public. As you all know, there are many private entrepreneurs now operating in the check system, and I would expect that there will also be many private firms operating in the ACH mode.

Now let me turn your attention to some ideas I have heard about increasing ACH payment volume.

Early in its development, the ACH mechanism was viewed as a vehicle to clear recurring payments initiated by corporations. More recently, the mechanism has been suggested as the clearing vehicle for a broad range of consumer initiated payments. As telephone bill payment volume has increased, financial institutions have considered the use of the ACH to replace paper drafts as the form of payment. Some institutions in the Baltimore area are currently clearing telephone bill payments through the ACH. A bill payment system operated by an S & L in Florida shortly will begin using the ACH for its payments. In Minneapolis, the ACH is being used to clear automated teller terminal transactions. In other areas of the country financial institutions participating in shared ATM systems are considering using the ACH to clear and settle for ATM transactions, thus eliminating the need to exchange paper. The U.S. Postal Service is now piloting use of the ACH for concentrating the deposits of its many post offices.

One other area should be mentioned. The Symposium on Payments Systems of other countries, sponsored by the National Commission on Electronic Funds Transfer last year, focused on the success of GIRO-type payment systems in European countries. The ACH presents an opportunity for the development of similar payment systems in our country. Many of the GIRO payment systems had their beginning as paper-based systems and are either now evolving or have already made the transition to extensive use of automated technology.

I encourage consideration of the ACH in all areas in which it can replace the use of paper for clearing and settlement. It is time, I believe, to view the ACH as a system to be employed whenever and wherever improved service, convenience, and reduced costs can be provided to consumers, businesses, and financial institutions.

The areas that I have mentioned above will take some time to develop as additional sources of volume. In the near-term, I believe it would be very beneficial to the entire ACH effort if some national corporations would handle their payrolls in the ACH mechanism. Examples are the best testimonial.

I suggest to you that the volume is there, although it requires some innovative and creative promotion to convert it to the ACH. The national and local ACH associations can assist in this effort, but individual financial institutions must take the lead and begin to market ACH services.

It seems to me that we are now entering a very critical period--one in which a true test of the viability of the ACH mechanism will occur--and one which will require the dedication of every financial institution participating in the ACH program.

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