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BANKING AND THE PAYMENTS MECHANISM

**Remarks of George W. Mitchell
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BANKING AND THE PAYMENTS MECHANISM

The visibility of changes in the evolving payments mechanism has risen sharply in recent months and especially since the Federal Reserve Board on March 28 published for comment its proposal to re-structure reserve requirements and to require payment for cash letters in immediately available funds.

Most bankers know that methods of handling checks are changing, and that as the check becomes economically obsolescent, getting the last ounce of performance from it will require further modifications. Not surprisingly, however, others tend to keep the trend of events in the backs of their minds rather than to look for ways to exploit new technology. So whenever a discrete break in check collection procedures or patterns occurs, there is a measure of surprise and discomfiture at the actual onset of still another change.

I am not sure that the topic I was expected to discuss today -- the Federal Reserve Regional Check Processing Centers (RCPCs) -- is presently uppermost in your concerns about the payments mechanism. For some of you it must have been superseded -- at least temporarily -- by the necessity to rethink rather promptly your own bank's role in the check clearing process as a result of the Regulation J proposal. Given that change in the environment of my topic, it seemed most appropriate today to generalize my remarks somewhat and touch only rather briefly on the specifics of the RCPCs. The discussion period should allow sufficient time for detailed questions.

Over the past few years I have been frequently asked to explain and even justify the Federal Reserve's concern for promoting improvements in the payments mechanism. The question is often intended, I am sure, to probe into a theoretical, legal or functional philosophy of government and private responsibilities in providing money services. But it is easiest to examine the question first by considering it at the practical level.

The foremost practical fact is that the Federal Reserve has had a substantial role and investment in the payments system throughout its history. That role is to expedite, through its clearing facilities, settlement between checking accounts in different banks within a reasonably short period of time. The maximum time period for paying banks for checks presented to the System has been pegged for the past several years at two days. It is supported by a Federal Reserve float subsidy that today exceeds \$3 billion in checks the System has paid for but not collected. While a two-day schedule for the transfer of checks and bank payments was in many instances unattainable when first adopted -- thus giving rise to Federal Reserve float -- it has become increasingly attainable with the evolution of data processing and transportation technology. Today, for all practical purposes, it is entirely feasible.

Universalizing payments in "good money" upon presentment of Federal Reserve cash letters -- as the Regulation J proposal does -- removes the major current barrier to updating our check settlement procedures. Not to move to so expedite settlement under present-day circumstances would, I believe, be a breach of public responsibility

to keep pace with the times and utilize the advantages afforded by technological progress.

But there is more in store for the present system than catching up to the targets in speed of settlement set for accomplishment in the 1960's. Payment on presentment, expanded areas for overnight RCPC operations, and improvements in check transportation arrangements now in prospect will, in fact, put a very high proportion of all check transfer activity on a one-day settlement basis. And this is a goal we intend to push toward. It should be emphasized that as we move toward it and realize earlier collection, the benefits will be passed along in the form of earlier payment. We will not allow such benefits to be, in effect, siphoned off in the form of Federal Reserve credit float.

There is another practical aspect. The existing check clearing system involves a large Federal Reserve expenditure for manpower, equipment and transportation, since about 30 per cent of the total check volume enters into Federal Reserve clearings. Federal Reserve annual direct and overhead costs for check processing activities add up to nearly \$135 million. Operating experience indicates that the flow of checks and money transactions can be greatly improved, reducing these real costs and extending the advantages of earlier availability and convenience. The reduction in the cost of check handling and check transportation will be achieved through the elimination of intermediate handlings and the resultant transportation and processing costs.

The economies from eliminating duplication in processing and circuitous flows extend beyond Federal Reserve facilities to commercial banks and data processing centers. But wherever they are found, the benefits will accrue to the community at large in the form of a faster, cheaper and more certain money service.

Most of the perceptible savings are linked to the expansion of the RCPCs. Even though they initially involve some net additional cost to the Federal Reserve, there is an immediate net saving in total cost to all participants including the public. As the new system shakes down and the trend toward centralized processing of checks continues, it is possible that the volume, the number of sorts and number of end points will be reduced and, if so, RCPC costs should decline or stabilize. Private processing centers on the other hand, whether operated by correspondents, service bureaus, or holding companies, will tend to absorb about the level of costs associated with the volume of "on-us" items attributable to the entire family of banks they service. This could be visualized as the equivalent clearing load a bank with, say, 500 branches takes over from the Federal Reserve because the 500 offices do not function as 500 unit banks.

The role for the Federal Reserve in all this is best visualized as one of transmutation -- the conversion of an inflow of credits into an outflow of debits. The checks an RCPC receives are credits to the bank which sends them into the Center -- when these items have been resorted and rebatched they leave the RCPC transformed into charges on other banks. The process is ideally accomplished when the crediting-debiting effects are simultaneous and when the shipping,

sorting, accounting and processing can be performed between the close of business on one day and the opening of business on the next.

For an overnight operation to be feasible, the check must be a machinable item -- i.e., fully qualified for high speed machine processing when it reaches the RCPC. And the transportation realities must be such that items can be picked up from the depositing bank and moved to the RCPC, processed and then taken to the paying bank within a relatively brief period of time. This is not as difficult as it sounds, as some of you have demonstrated in your own operations, but it is not a schedule with much slack in it. The goal will be accomplished but only as a result of continuing effort at the practical operating level. We expect to supply that effort.

Now let me return for a moment to the legal, theoretical and philosophical bases for Federal Reserve involvement in the payments mechanism and be responsive to the question of whether the Federal Reserve, though acting under its statutory authority, is playing too large a role in the check clearing function.

Historically, there have been eras when governments and bankers have offered competitive money services to the public in terms of both convenience and purchasing power stability. But in the light of modern views of public responsibility, I doubt the Constitution would be construed to permit the growth of a rival non-government-supervised private money system. In our early history, Congress asserted its sovereignty over money, denying the states a money role by placing a prohibitive tax on the notes of State-chartered

banks. It has and continues to assert such control as it has believed necessary over the private institutions which perform money functions. Thus, there seems to be general recognition that there is adequate constitutional authority to enable Congress to enforce its constitutional right "to coin money and regulate value thereof" in both a literal sense and in the sense in which we would interpret the meaning of money today.

The implications of the phrase, "the meaning of money today," need elaboration. While money is conventionally defined as coin, currency and net demand deposits and the statistics on the privately held money supply are derived from these aggregates, some further interpretation of money based on its functions is germane to the problem of who, if anyone, is to have responsibility for managing it. The traditional functions of money are its role as a standard of value, as a transaction vehicle and as a source of liquidity. The latter function has already spread far beyond the narrowly defined money stock -- demand deposits in commercial banks, coin and currency -- and is now performed by a wide variety of instruments and arrangements.

Commercial banks offer instant liquidity in savings accounts and various other liquidity arrangements using certificates of deposit and non-deposit liability instruments such as commercial paper and repurchase agreements. In addition, non-bank intermediaries such as savings and loan associations, credit unions, insurance companies and other institutions provide liquidity services. The Federal Government and large public and private corporations provide short-term marketable instruments

which are convenient sources of liquidity for business, governments and others.

Congressional overview of these liquidity services formerly associated with money has consisted chiefly of the authorization to supervisory agencies to regulate price competition between commercial banks, mutual savings banks, and savings and loan associations for deposit funds. The actual device used has been a schedule of interest rate ceilings which up to the present time has been inoperative except in periods of monetary restraint. In addition, institutional liquidity commitments have been reinforced through deposit insurance and supporting operations of the Federal Reserve and the Home Loan Bank Board.

In consequence of all these arrangements, which have grown in importance and variety in recent years, one important historical money function has been detached in large measure from the other money roles and is quite widely dispersed.

Money as a transaction vehicle is quite a different matter -- at least up to now. Commercial banks are still for all practical purposes exclusive purveyors of checking account service. But mutual savings banks and savings and loan associations are seeking some kind of entry into this activity. Moreover, there are other enterprises who do, or seek to, perform closely related money functions. Some financial markets, for example, do not settle gross transactions among participants in money but use a clearing house arrangement to settle on a net basis. Other enterprises, including banks, are using credit cards to cumulate transactions and later settling a large number of individual transactions with a single money transfer.

The significance of such trends is evident in the gradual decline in money holdings relative to GNP even as the volume of transactions -- particularly those involving short-term debt -- has risen rapidly relative to GNP. The only kind of money supply that has increased in relative terms over the past fifteen years is coin. Because of the development of metering and vending machines, the demand for coins, measured in relationship to consumption expenditures, has increased nearly 40 per cent in the past 15 years.

Currency-in-use, both large and small denominations, on the other hand, has been declining in importance; its role has shrunk by nearly 30 per cent since 1955. Currency is being displaced by credit cards and checks as individual transactions are accumulated in charge accounts and subsequently settled by check. There is no indication this trend is abating; on the contrary, the demand for currency apparently will be shrinking for some time to come.

The major element in the money supply -- demand deposits -- has also declined substantially. Using GNP as a proxy for money demand, deposits declined 40 per cent between 1955 and 1970. The reason in this case is that, even though demand deposits are replacing currency and thus picking up some of that work load, they are also being used much more efficiently. Technology, a changed attitude of corporate treasurers, and the economization of balances made possible by the increased coincidence of depositors' receipts and disbursements have greatly increased money's efficiency as a transactor.

In this evolutionary process, has the sovereign's power over money in some real sense been attenuated?

The question is not easily answered, though with some qualifications and reservations I think the answer is "no." So far as the importance of government coin and currency is concerned, it has been declining in relative terms for some time. So far as the government's influence over the aggregate amount of bankers' money -- demand deposits -- is concerned, control is firm and adequate today. But another dimension of money -- efficiency in transactions -- has become increasingly important. Since 1965 -- earlier data are not entirely comparable -- total transactions by check have almost doubled -- to over \$13,000 billion per year. In this period the demand deposit component of the money supply increased by less than 30 per cent. In the major financial centers turnover rates virtually doubled in those years and in other metropolitan areas, the increase was about 40 per cent.

The evidence from the recent past is clear -- it takes less and less money to accommodate a given volume of transactions. As this trend becomes more and more pervasive monetary control may have increasingly to recognize another dimension than money supply, namely, money efficiency. In the past, gradual changes in money's efficiency could safely be ignored for the short run. But for the electronic transfer future, this is a less comfortable assumption. At the very least there will be continuing attrition of demand deposit money and the substitution of near money. The probable result is that money holdings in the narrow sense will come to have little or nothing to do

with decisions to spend or invest, or not to, but only with the scheduling or timing of payments previously agreed to or contracted for. Thus for monetary policy and liquidity purposes, everyone's horizon will have to be lifted beyond that narrowing money magnitude.

The final points I would like to make have to do with the impact of data processing technology on the banking industry. Until the advent of the computer, the banking business as practiced in the U.S. and elsewhere has been little affected by technological change -- in the way, for example, that rail transport has been affected by trucks on highways, or airlines by the switch from piston-powered aircraft to jets, or as producers of natural fibers have been confronted with the competition of synthetics.

I believe these illustrations are truly suggestive of what lies ahead for the banking industry: banking, as I see it, must undergo a major transformation as an outgrowth of data processing technology. In extent this transformation will affect investment in banking facilities, competitive practices within and without the industry, sources of the industry's loanable funds, and the scope of services provided by banks.

I am aware that these prospects must be disturbing as well as challenging and that there are a variety of attitudes toward them. In my age bracket the usual reaction is, "It can't happen in my time," or "I won't let it happen in my bank while I am there," or just, "Let someone else worry about it." The influence of forward planning is not evident here.

A more reasoned view is that these changes will be gradual enough, creeping, so to speak, through the industry in a pervasive way which will not significantly disturb competitive relationships within the industry. The individual banker and the industry can safely deal with the problems that do arise as they become visible. Add to that an implicit assumption that the industry has nothing to fear from without.

I would have a different judgment on the cumulative effect of data handling technology on banking in the future. So I believe the industry is facing a substantial competitive jolt from both within and without -- something on the figurative order of a megaton bomb! And as the industry has not experienced, except vicariously through its loan customers, the realities and ruthlessness of a massive technological change, and what it can do to established competitive positions, it is not too surprising that its survival and adaptive mechanisms seem inadequate.

If, in fact, they are inadequate, the inadequacy may be related to the sheltered position banks as a regulated industry have had in the past and have come to take, in some degree, for granted. It would not be the first industry to make the mistake of finding regulation cannot exclude competition.

I believe there is general appreciation that while banking regulation has a role in protecting the public interest, but so does competition and the trend of the times is to give greater play and responsibility to competitive forces. This is the very circumstance which makes the new technology so promising as a channel for competitive effort.

The cornerstone of commercial banking is the checking account. Through these accounts flow over 90 per cent of the nation's money payments. This is essentially a public function and a highly prestigious one for those institutions involved. This service attracts customers for other services, funds for lending, and produces an involvement over a wide range of financial participations in the community.

Data processing technology will inevitably change the character of demand deposit services. It may easily open them up to non-bank participation. It will most certainly relax the geographical constraints against branching and broaden the market areas for vigorous banking organizations. It may erode the potential business tributary to money payment as vendors and credit card companies extend more credit and provide more prepayment and postpayment services to individuals and businesses.

I would expect the competition from within the banking industry to surge because of the breaking down of geographical constraints. It will come from hundreds of banks that have attracted computer-oriented personnel into their operating organizations. Some of them will persuade their managements that the potential cost savings will easily justify a switch to one or more types of electronic processing and that a marketing program can sell their customers, and customers of other banks, on the advantages of an electronic system over checks. This is not the kind of competition that is easily overtaken.

The threat from external competition and its modus operandi is harder to visualize. It could be linked to vendors, innovative equipment manufacturers or to the competing depositor institutions.

Let me use a simple illustration to indicate the kind of application which might occur. It would be natural for an innovative bank, association or group to offer, for example, a bill-paying service for home-owners. Under present practices home-owners are accustomed to making a monthly deposit covering mortgage payments, taxes and insurance. This payment might be enlarged to cover utility bills, other insurance, car payments, other installment debt, and other relatively stable items to repetitive payees. The estimated annual total of such items would serve as the basis for uniform monthly or bimonthly installments. The bank or other organization would be the bill payor and the accounts-keeper. In the paper era, this kind of service simply could not be offered, but with electronic accounting it might turn out to be a very attractive package for all concerned.

Electronic data processing will change banking because it goes to the very heart and foundation of banking, touching on the source of customers, the source of funds, and the range of services. Perceiving this fact will lead to many ways of exploiting an opportunity; not perceiving it may lead to being victimized by someone else's innovation and industry.

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