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CURRENT ISSUES IN THE DEVELOPMENT OF THE PAYMENTS SYSTEM

Remarks of

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My interest in payments technology goes back twenty years or more but my first recorded speech on the subject was at the annual meeting of the American Economic Association in New York City in 1965. I recall the subject matter was indeed novel for economists then, many of whom were deeply interested in the rate of growth of money but hardly at all in how it was transferred, or, to put it in their terms, in the rate of growth in the efficiency of money use.

Since that time, I am sure to have made a fortnightly payments talk on some occasion or other. You can understand, therefore, that if I have some difficulty in listening to what I have to say today, others may have a similar problem. One of my banking friends says listening to me talk about the banking system and the payments mechanism is like being kicked in the shins. "But," he adds, "it is a useful though painful reminder."

While the subject is, perhaps, "old hat" to some, the developments taking place are fresh enough to make trade and general news and to occupy a considerable amount of Congressional and industry attention. Payments matters, which at one time were the exclusive concern of the commercial banking system, the Treasury and the Federal Reserve, have aroused the entrepreneurial interest of others. The thrift industry, the data processing and communications industries, the credit card companies and national and area vendors are all involved. Profit opportunities are apparent to technology sophisticates who see numerous practicable applications of their expertise. The thrift industry visualizes a change-over in payments technology as an opportunity to enter the payments business without the operating handicap of having to use paper checks processed through commercial bank channels.

Competition and Innovation in the Payments System

Both commercial banks and thrifts are continuously and sometimes aggressively seeking assistance from State legislatures and Congress to enhance their market positions. Each seeks, at the expense of the other, to reduce or remove differential statutory constraints that are disadvantaging or, if circumstances are in their favor, to maintain or increase those that are not. In their zeal to limit each other's competitive effectiveness by statutory or regulatory action, banks and thrifts are overlooking the fact that the real competitive challenge is coming from another direction--from unregulated enterprises. The sheer volume of money transfer today (over 100 million daily, by check alone) has overtaxed the conventional labor-intensive technology still widely used by commercial banks and has thus created an opportunity for more innovative-conditioned enterprises to move in.

I would not want to leave the impression that I believe innovation in our regulated depository institutions is entirely absent or is utterly stifled by regulators acting either on their own initiative or through the proddings of the regulated. There are numerous instances where the relaxation of regulatory constraints has been followed by the introduction of new financial services which the public has eagerly accepted. The New England NOW account experiment, which is aimed at ameliorating a long-standing discrimination against small savers, is a good illustration. Initially confined geographically and by name, and approved by Congress as an experiment, a service offering to link or combine an interest-earning savings account to a money transfer account--as the NOW account does--has given rise to a whole series of possibilities of great value to individuals, small business and many local governments.

The average depositor can use his savings account for money transfer or as a back-up for his checking account. By doing so he earns a return on what he doesn't spend and he avoids the costly penalties incurred on account of insufficient funds items. The number of these is not inconsequential and as a consequence the banks and the Federal Reserve get an incidental bonus in their processing cost by virtue of a reduced level in the costly backwater of return item adjustment.

It is proposed to make savings accounts available to corporate enterprises and to simplify further the transfer of funds between savings and checking accounts. Few of the changes made or contemplated bear the name of NOW accounts and they are not confined to New England but their origin can be traced to that original innovative step.

The entry of non-depository institutions into the handling of money payments is possible by fractionating the operating steps of moving money from payor to payee. The breaking up of the payments function evolved from the introduction of the credit card and the removal of check processing from a back room operation to centralized processing factories. Today, funds transfer, data handling, data transmission and the extension of short-term credit can be segregated operationally and all can be performed outside of the banking system except for funds transfer. Even that process can be attenuated by massive combinations of individual transactions.

Perhaps I should make clear what I mean by fractionating or breaking down various steps in the payments process and how vendors, for example, can participate in the payments mechanism as a result of this process. The growing practice of using data processing contractors for demand deposit accounting work and the handling of transit items makes it clear that these operations need not be done by or on the premises of a commercial bank. But the way in which the linkage between banking and settlement or money transfer operations is attenuated and the way in which consumer or merchant credit impinges on bank deposits may not be so obvious.

A credit card system operated by a bank, a non-bank or a retailer generates daily payments to merchant vendors, affiliates or to its operator entity. The card-issuing institution may finance these payments internally or through the commercial banking system. At the same time, the system generates credits from its card holders for their purchases. These money flows to merchants and from card holders do not match and that mismatch in debit and credit flows creates the opportunity for the card issuer to become, in effect, a consumer banker if he chooses. If he elects to finance his card holders' purchases, he makes it possible for them to manage their bank demand deposit accounts in a different manner and more closely in relationship to their income flows.

Thus the retailer is competitive, in fact, for two banking functions: he directly supplies consumer convenience or extended credit and he indirectly impacts the deposit relationship in the banking system by making it more practicable for consumers to reduce their holdings of demand deposits.

Whether or not the card operator extends credit, he cumulates a large volume of payments to accounts in a number of banks. This operation displaces cash and check processing at a bank by performing the accounting that would go with each such transaction internally. For example, a card issuer might internally process a million individual transactions in some given period which would have been settled otherwise by cash or check. His settlement procedure--the actual movement of funds--would be on a consolidated basis, and the number of such settlements would be small in comparison to the number of original transactions. And if he were able to settle with the banks serving merchants and card holders on a net basis and enjoyed a significant level of market concentration, the net amount of funds transfered could also be small.

Obviously, such systems are far too complicated for non-electronic technology but that gate has long since been opened.

Fair Billing Practices and Payments Technology

Another focus on the breaking up of payments processing was evident at a recent hearing at the Federal Reserve Board on fair billing practices. As a consumer protection measure, Congress has directed the Board to adopt regulations applicable to vendors, card companies and their agents to establish standards for the identification of purchases made with credit cards and the conditions of timely notice of amounts owing and of remittances. This hearing explored in detail the billing and payment techniques of vendors and card companies.

A decade ago, I thought the banking system had an opportunity to use its primacy in effecting money transfers to become the "community's accounts keeper." It might have been a good idea but it did not strike much response among banking managements. Such a service would have been aimed at the small business and consumer market. In those years banks were enamoured with liability management and market sources of funds; few of them were interested in attracting individuals as customers because the underlying stability of a consumer deposit base did not seem important at the time. Thus banks made little attempt to innovate their customer accounting in order to retain or attract consumer deposits. The need to displace the return of checks to customers (the equivalent of "country club" billing) with descriptive monthly statements was not recognized as a necessary cost reduction measure if banks were to compete in the consumer market.

Meantime, national retailers and the card companies, bank and non-bank, saw the diseconomies of country club billing in their operations and in light of their customers' need for information. They undertook the development of descriptive billing and timely input of such information into their data processing systems. Today, many of them have and are exercising the capability of avoiding costly, inefficient, labor-intensive operations of returning basic documents to the customer. Although planning for the retrieval of essential information on checks has gone forward, implementation of descriptive bank statements seems far in the future.

Bank managements with doubts about descriptive statements should examine the progress vendors have made in automated descriptive systems which can meet their own and their customers' needs. These systems are proprietary in a sense but are also extensible and adaptable to others directly or through processing contractors.

The three-party card issuers appear to be hard pressed to offer comparable billing disclosure to that available from retailers but one must be impressed with their efforts to narrow that gap and come up with roughly equivalent results. In contrast, banks who have faced a similar problem and for a much longer time have made little use of contemporary technology for achieving descriptive check statements.

Participation of Thrift Industry in Payments System

Turning to another issue of the payments problem, I believe the banking industry has made vital and sustainable progress in dealing with a realistic participation of the thrift industry in the payments system. But progress has been slow. In some sectors of the thrift industry, enthusiasm for participation has been and still is boundless--it reminds me of an earlier enthusiasm shown by the banking industry for Caribbean branches and for managing and advising REITs. If thrifts should penetrate the payments operation to the extent some contemplate, they are most likely to find the deposits generated to be a more costly source of funds than do banks. The non-earning assets levels (cash and balances) to which they are accustomed in the operation of a savings business, which is about 1 per cent of total assets, will far from suffice for a money transfer function.

At the end of 1974, non-earning assets, i.e., cash, reserves at Federal Reserve Banks, correspondent balances and items in the process of collection, were over 13 per cent of total assets at insured commercial banks. The comparable ratio for non-member banks who are not required to keep reserves with the Federal Reserve System was 9 per cent.

A demand for full participation in the payments mechanism on the part of the thrifts will, in my opinion, necessarily involve a full participation in its costs as well as benefits. I see at present only limited evidence that any of the thrift groups are prepared to assume costs of the order the banking industry now bears. It is possible, however, that their anticipated penetration of this market is on a much more limited basis than their demands for access to it imply. In that event, it seems to me they have already achieved a satisfactory arrangement.

There is, of course, the possibility that the thrift industry or some sector of it could adopt an industry-wide electronic transfer program which would be cost-effective in a broad sense--i.e., in reducing processing and transmission cost and in holding clearing balances to very low levels. But the same forces that have impeded banks in the United States--in contrast to banks in some other countries--from taking such action also operate within the thrift industry. The principal one is the existence of a large number of independent, uncoordinated institutions which have varying judgments as to the desirability of any change in their present operations, to say nothing of a uniform system which would reduce their own management flexibility.

Equality of opportunity in providing a money service, it appears today, will be decided in some degree by Congressional action in determining who can participate in providing money services, what their role should be, what investment and deposit powers they should have and the interest rate ceilings and reserve requirements to which they should be subject. But Congress cannot legislate the resourcefulness of entrepreneurial response to any type of competitive climate it can create or modify, including one which involves handicaps for some participants and not for others.

Cost of Money Service

It is clear that for some time to come money transfer will involve currency, checks, electronic tapes and direct electronic communication. During this period, transfers will be in mixed media starting out with one type of input and ending up with another. For example, the planned Social Security System payments will start as tape or direct electronic input but many will be delivered to the recipients' bank or thrift as hard copy.

The transformation from one to another payments media affects so many transactions that it greatly complicates the orderly transition to the more efficient exclusively electronic mode. At some point customers must be given the opportunity of realizing financial or convenience advantages from the present method of payment or being paid. If payment in cash is demanded and that cost is X and the cost of payment by check is one-half of X and by electronic means one-tenth of X, a reflection of these costs is urgently needed to shift the payments system as quickly as is feasible into the optimum media.

While the Federal Reserve's share of the cost of operating the payments system is comparatively small, it is not an inconsiderable sum to us and we have a direct and continuing interest in reducing such costs by making full use of the most effective technology. Our cost studies have demonstrated to us that we and others can save a major share of present costs per transfer by shifting to a fully electronic operation.

We cannot shift our technology in any truly cost-effective way unless banks do so too as we do not deal directly with any initiators of payments other than the Treasury. Our facilities must have the capability of handling payments flowing from one bank to another in any form, and, as I have indicated, the vehicle for transmitting payments information may change en route to its destination.

Despite our secondary role, we have tried continuously to encourage progress toward a more efficient payments system and quite naturally have encountered opposition on all sides, some saying we have gone too far and others contending we have not gone far enough. Judged by the results achieved to date, we cannot expect high marks for what has been accomplished. I would not give banking managements high marks either even though I believe I understand their thinking and "hang-ups."

The essence of my comments today is that the opportunity of the commercial banking system to serve its individual and small business customers is being eroded and slipping into the orbit of competitors who are more innovative and more perceptive in detecting the profit potential in this market. These competitors may be in error and your customers may be entirely content with a "Model T" payments system. However, the consumer-small business market in our economy is too large not to be served imaginatively and I can't believe it won't be served profitably. If this is so, the cost of performing that service must come down because available technology makes it possible to do so and I would think that fact should be evident to everyone.

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