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Statement on

Electronic Funds Transfer Act of 1977 (S. 2293)

and

Right to Financial Privacy Act of 1977 (S. 2096)

Submitted to the

Subcommittee on Financial Institutions of the
Senate Committee on Banking, Housing and
Urban Affairs,
United States Senate

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Mr. Chairman, on behalf of the Federal Deposit Insurance Corporation, I appreciate this opportunity to offer the views of the FDIC regarding the Electronic Funds Transfer Act of 1977 (S. 2293) and the Right to Financial Privacy Act of 1977 (S. 2096). I will provide the Corporation's views on each of these bills in turn.

Electronic Funds Transfer Act of 1977

The efforts of this Subcommittee are both timely and appropriate in light of the recommendations contained in the final report of the National Commission on Electronic Fund Transfers that was issued late last year and in view of the growing involvement of financial institutions in the various aspects of electronic funds transfer (EFT). The FDIC supports the principle adopted by the Commission that the growth of EFT should take place in a competitive environment. The Commission stated its belief that in such an environment:

> ...innovation will be sparked, the largest possible array of alternative EFT services and systems will be placed before users and consumers, and the unfettered choice among these alternatives will produce an EFT environment that is most responsive to the public's needs and desires.

On balance we believe that the Commission's policy recommendations constitute a significant and beneficial step toward a more competitive financial system. The Commission also set forth a number of safeguards for protecting consumers' privacy and for preserving their rights when they use EFT payment techniques.

Senate bill S. 2293 incorporates many of the Commission's recommendations, particularly in the areas of: (1) establishment and use of EFT systems, (2) sharing of such systems, (3) government access to customer financial records, (4) customer rights and responsibilities under applicable law governing EFT transactions, and (5) the provision of services by the Federal Reserve Banks to automated clearing house associations.

In addition, Section 2 of S. 2293 contains a statement of findings and principles. The key principle contained in this Section is that the interests of consumers and the public will be served by promoting competition among financial institutions and other business enterprises using EFT systems and services. Section 2 declares that this principle can be best achieved by keeping government regulation and involvement to a minimum and by removing other impediments to competition, such as geographical restrictions on EFT terminal deployment and service offerings. Although the FDIC strongly endorses the congressional statement of principles in Section 2 and supports the general thrust of S. 2293, I would be less than candid if I did not express reservations about certain aspects of the bill and state the FDIC's views as to preferable policies for achieving those principles.

Before addressing specific Sections of the bill, I would like to discuss in greater detail the basic principles that underpin the FDIC's approach to this bill.

The Corporation endorses the principle of competition and the policy of letting free market forces govern the deployment and sharing of EFT systems. Characteristically, a competitive market should result in the provision of a wider variety of EFT services of higher quality and at lower prices. Competition should also promote technological innovation. It is important to recognize that the kind of technology on which an EFT system is based is a major factor in determining the quality, the security, the convenience, and the cost of an EFT system. Thus, we believe that it is essential to preserve incentives to innovate.

Consumers should be able to choose among a variety of services and technologies, especially while EFT is in its formative stages. Such freedom of choice will lead to the failure of some services and technologies and the development and enhancement of others.

To the extent that barriers to competition exist, such as branching and deployment restrictions and compulsory sharing laws, innovation could be impaired, and the interests of consumers and the public might not be served as well. Although it is possible that unfettered competition could be harmful, it is really much too early in EFT development to determine whether this would occur. Consequently, we believe that reaction to unsupported and unconfirmed fears at this time should be avoided, and the maximum amount of flexibility should be retained.

Thus, for the time being, we believe that the sharing of EFT systems could be governed adequately by the Federal antitrust laws. It would be premature at best -- and possibly detrimental in the long run -- to subject EFT sharing arrangements to special rules. If sharing arrangements should turn out to affect the public interest adversely, for example, by threatening the safety and soundness of the banking system or by restricting consumer access to EFT services, existing antitrust and regulatory remedies might be sufficient to protect the public interest. Only if these tools prove inadequate, and only when we understand what specific types of public injury are generated by the sharing arrangements, should we consider drafting a new special body of law.

Goegraphical restrictions on the deployment of EFT terminals could also hinder innovation and discourage development of services that serve consumers best at the lowest cost. However, it should be noted that at some point geographical deployment restrictions may have little or no adverse impact. The market area probably needs only be large enough to support a sufficient number of systems to ensure effective competition. Enlarging the market beyond this point and adding more systems may have little practical effect on improving competition.

At this time, there is no evidence that open competition will threaten the safety and soundness of the banking system as a whole. The EFT development is proceeding slowly enough that if problems develop for small banks in the future, there will be ample time to take appropriate action. For the time being, we believe that our present review and examination techniques, coupled with our existing enforcement powers, will be adequate to protect the safety and soundness of the banking system.

A. Deployment and Use of Remote EFT Terminals

Section 4 of S. 2293 states that EFT terminals should not constitute "branches" under the Federal laws governing financial institutions. The bill permits the establishment or use of an EFT system by a federally-chartered financial institution anywhere in the United States, but the bank's deposit services are limited to the state in which the bank's home office is located. The institution would also be able to deploy terminals offering deposit services in those states that permit out-of-state institutions to offer such services. In addition, after January 1, 1980, a financial institution would be able to offer deposit services throughout its "natural market area" without regard for state prohibitions, even when the area crosses state lines. The bill defines natural market area as encompassing any standard metropolitan statistical area (SMSA) in which the institution has its head office or any of its branches, plus all contiguous SMSAs, plus any additional area in which, in the opinion of the institution's supervisory agency, the institution could effectively compete.

The FDIC strongly endorses the principle that the rules governing establishment and use of EFT systems should be separate from, and less restrictive than, the rules for branching. We have not yet found any evidence that EFT terminals generate disruptive shifts in market shares, nor that these terminals threaten the viability of smaller institutions. Walker, in his study "Contrasts Among Banks with Retail Electronic Banking Machines and All Insured Banks: 1974 vs. 1976" (FDIC Working Paper No. 77-1), found that smaller banks are quite willing to take advantage of EFT technology. Moreover, Gilbert and Walker, in "The Influence of Electronic Fund Transfer Systems on Changes in Bank Market Shares" (FDIC Working Paper No. 77-2 revised), found that EFT tends to benefit the smaller financial institutions more than it does the larger ones:

> Contrary to the belief of many, the adoption of EFT services does not necessarily confer a competitive advantage to larger institutions.... Improvement in market shares are (sic) actually greater for <u>smaller</u> banks with cash dispensers or point of sale terminals. By the same token, the EFT banks with the smallest absolute market share (those that are the least dominant in their markets) benefit most in terms of market share improvement.

Gilbert and Walker also found that automated teller machines "serve more as an adjunct to business conducted at branch banks rather than as substitutes for brick and mortar branches." Accordingly, there do not appear to be sound reasons to impose the same restrictions on EFT terminals as are imposed on branches.

The FDIC also strongly endorses the principle of establishing uniform rules for the establishment and use of EFT systems. Under present Federal law, EFT terminals that accept deposits qualify as branches for national banks but not for Federal savings and loan associations or for Federal credit unions. Accordingly, a national bank that accepts deposits through an EFT terminal must see that the terminal complies with the state branching laws governing deployment of full-scale, brick-and-mortar branches. The national bank must do so even when the state itself declines to impose its own branching rules on EFT terminals established by state-chartered banks. Federal savings and loan associations and Federal credit unions are not bound by equivalent restrictions. Both the Federal Home Loan Bank Board and the National Credit Union Administration have separate rules governing EFT terminal deployments.

The effect of the limitations on national banks is to push up the overall costs of EFT to the consumer. The existing limitations discourage competitive offerings from national banks. They also impede sharing among national banks and other financial institutions, thereby decreasing the volume of transactions over which large initial costs of establishing an EFT system can be spread. Furthermore, the limitations tend to distort the competitive environment for EFT services in ways that seem to have little relation to the public interest. For example, today we see the anomaly of a national bank, which has created and deployed an EFT system, forced to stand by as the system accepts deposits for other institutions but not for itself. The bank is located in Illinois, a unit banking state, and is thus forbidden to accept deposits through any remote facilities. However, federally-chartered thrift institutions, which are not restricted by the Illinois rules on deposit-taking, are taking full advantage of the system's technical capabilities.

Although the geographic restrictions on deposit-taking set forth in S. 2293 may turn out after further study to be unnecessary, the FDIC believes that it is appropriate at this time to expand deposit-taking powers to the extent prescribed in the bill. Our support includes allowing each institution to accept deposits by means of EFT terminals throughout its natural market area, without regard for whether the area crosses state lines. This is especially important for consumers whose daily lives include trips to work or for shopping across state lines. State boundaries are arbitrary to them. It would be beneficial to these persons to permit depository institutions that operate an office in a natural market area to extend deposit-taking EFT services throughout that area. We also endorse the concept that states should be encouraged through reciprocal agreements to permit financial institutions headquartered in other states to deploy and use an EFT system.

Although we support the essential thrust of Section 4, we believe there are several matters that should be clarified or modified. First, Section 4(b) states that a Federal financial institution may not offer deposit services...at any location outside the state in which its main office is located.... In Section 3(d) "deposit services" is defined as arrangements which enable a customer to have a deposit credited to his account at the financial institution. The Commission recommended making an exception which reads:

> In the case of deposits to merchant accounts that are generated as a result of a customer payment by debit, debit with overdraft, or credit purchase through electronic means at the point of sale, the Commission recommends that merchants should not be limited geographically by statute or regulation in selecting the financial institution to receive such credits.

A modification in S. 2293 along these lines is necessary to avoid disrupting existing relationships between institutions and their corporate clients. Merchants already have the ability to transfer funds electronically among financial institutions and do so to maintain desired deposit levels at given institutions. Therefore, we recommend amending Section 3(d) to exempt merchant credits resulting from electronic point-of-sale transactions from the definition of deposit services.

Second, we believe that the definition of natural market area should be changed. The definition in the bill provides that the natural market area for a given financial institution may be defined by administrative action of the appropriate supervisory agency as an area larger than the SMSA in which the subject institution is located. We recommend that such administrative discretion be limited to adding only areas continguous to the SMSA and to SMSAs continguous thereto.

Third, we recommend that the procedure for determining the boundaries of a natural market area be changed to provide for a panel of Federal state financial institution chartering agencies to make such a decision. Federal members of the panel would include the Comptroller of the Currency, the Federal Home Loan Bank Board, and the Administrator of the National Credit Union Administration. State members would include chartering agencies in the state or states in which the potential natural market area lies. Such an arrangement would give state regulators an opportunity to participate in determining the extent of any interstate activities that go beyond SMSAs and to make the state interests part of the decision-making process. Requiring the chartering authorities to reach common agreement eliminates the possibility present in S. 2293 as drafted that each Federal regulator might draw different natural market areas for the institutions it regulates, a circumstance that could lead to competitive imbalances and that could interfere with sharing arrangements among different types of institutions.

Fourth, although we agree that a cutoff date ought to be set after which Federal institutions may establish and use EFT systems in natural market areas, we believe that the January 1, 1980, date will not give states enough time to enact legislation in response to S. 2293. We believe that it would be preferable to set a date that depends on the date of enactment of the legislation. We suggest that an appropriate time period would be 4 years after the date of enactment.

B. Regulations Governing Establishment and Use of EFT Systems

Section 9 of S. 2293 authorizes the appropriate Federal supervisory agency to review EFT deployments in advance. This procedure represents an improvement over existing review standards. The Federal banking agencies must now review applications for individual terminal deployments, whereas S. 2293 would permit the agencies to consider systems as entire entities. In practice, however, the change in standards would make little difference. The agencies already have developed shortened forms and expedited procedures for dealing with EFT branch applications. In fact, the Federal thrift supervisory agencies have developed procedures for such applications that are independent of their branch review.

Section 9 of S. 2293 does not require the FDIC to review EFT systems in advance because the FDIC is not a chartering agency. The FDIC supports this policy. However, the FDIC needs to oversee and regulate other aspects of EFT terminal deployments. In our role as insurer of commercial bank and mutual savings bank deposits, we need to review the security of EFT systems and the level of commitment to an EFT undertaking in connection with our evaluation of the safety and soundness of bank operations. Nevertheless, neither of these matters necessarily requires the Corporation to review EFT deployments in advance. So long as the EFT terminals and the system as a whole comply with our security rules, and so long as the investment in

EFT does not, on its face, raise questions regarding the soundness of the bank's financial condition, we believe that our existing examination and supervisory powers are adequate to protect the public interest against any risks traceable to imprudent investment in EFT systems. We also support the provision in Section 9(b) of the bill that provides for the automatic approval of an application to operate an EFT system if it is not disapproved by the appropriate supervisory agency within 60 days.

However, we recommend that Section 9 be amended to provide that all insured commercial and mutual savings banks provide a copy of any application to operate or participate in an EFT system to the FDIC. These copies would be for information purposes only and not for approval. The information is needed to conduct our supervisory and examination functions.

C. Sharing of EFT Systems

Section 5 of S. 2293 adopts the procompetitive approach of the National Commission on Electronic Fund Transfers to shared EFT systems. This Section declines to create a special regulatory scheme for overseeing sharing arrangements among financial institutions. Instead, this Section would expose such arrangements to the full force of the Federal antitrust laws. Furthermore, Section 5 provides for the express preemption and nullification of state compulsory sharing laws.

1. EFT and the Antitrust Laws

The antitrust laws are especially well suited to deal with the wide range of problems that mandatory sharing arrangements can create. For example, improper sharing arrangements can pose the following kinds of dangers:

> Exclusion: The danger that a smaller bank will lose a great part of its customer-base, and perhaps fail,

because a rival institution deploys an EFT system in its local market. This danger implies that the smaller bank cannot find any way either to gain admission to the system, or to find an alternative system to join, or to offset the system's competitive advantage by giving better service in other areas.

Discrimination: The danger that the institutions that control an EFT system will use their influence to force other institutions who also use it to pay fees that are unreasonably high or otherwise discriminatory. This danger implies that the other institutions cannot leave the system and join another competing one or form one for themselves.

Monopoly pricing: The danger that the members of an EFT system will charge unreasonably high prices to consumers. This danger implies that consumers have no other system to use, and cannot easily use other payment instruments such as checks or cash.

This catalogue, which is by no means complete, illustrates two points. First, so long as consumers and institutions have ocmpetitive systems from which to choose, the dangers are minimized. Second, no single rule of access to an EFT system -- whether admission or exclusion -- can guarantee against anticompetitive behavior.

The antitrust laws are highly flexible. They do not prescribe any universal course of conduct but instead are designed to cure specific injuries resulting from particular behavior. Very often conduct that would be forbidden in one context may be compulsory in another. For example, in some cases the Department of Justice may seek to dissolve a joint venture that significantly reduces competition among the participants; in others, the Department may compel the venture to accept all competitors who apply for admission. This type of case-by-case analysis is essential to preserve a competitive environment because more general rules of practice are too easily subverted.

The FDIC strongly believes that a competitive environment for EFT is in the best interests of the consumer and of the public as a whole.

Competition encourages EFT systems to operate as efficiently as possible so that services and prices to the consumer can be made more attractive. It encourages systems to take advantage of new technology as soon as innovations become cost effective. It also encourages systems to adapt to the special needs of their customers, which may differ from area to area or from group to group. In this fashion, it encourages experimentation and variety.

Perhaps the most significant effect of a competitive EFT environment is the power of choice it gives to consumers, not only in the initial decision of which EFT system to join (if any), but also in the decision of which system to use in any given case. When consumers have alternative systems from which to choose, they can determine for themselves what standard of security they will insist on, what privacy protection they will require, what levels of accuracy and reliability they are willing to accept, and what prices they are willing to pay. When different systems rely on different technologies, these factors may vary significantly from one system to the next.

It is important to realize that having several independent systems competing in a market does not mean that consumers will suffer any reduction in their access to payment services. They can use the services offered by any or all of the independent systems merely by carrying the appropriate cards. For example, a consumer may carry a debit card for the system that the consumer's bank participates in, plus credit cards from two or three other popular systems, and determine which cards to carry on the basis of which systems are installed in the shops where the consumer trades most often. In addition, of course, the consumer may continue to carry cash or checks for use when trading with a merchant who does not happen to accept any of the consumer's cards.

Moreover, because independent EFT systems must compete for merchant locations as well as for cardholder patronage, the consumer gains additional leverage over the EFT offerings. An individual can take the quality of a merchant's EFT system into account in deciding whether to do business there. If the merchant's system is not functioning properly, or if the quality of the system is poor, the consumer can cross the street to trade with a rival merchant and take advantage of the rival's superior EFT system. If a merchant were to lose a significant portion of business because of poor EFT service, the merchant could change EFT affiliation or insist that the supplier upgrade the service. Accordingly, the consumer could bring the substantial power of the merchant to bear on the supplier by indirect means in a competitive environment.

The pressure of the market place is lost when a joint venture, which is a monopoly, supplies the basic EFT network even when the individual venturers market the EFT services separately. The venturers have little incentive to offer different services from one another or to compete on the basis of improved technology within the framework of a single EFT system.

2. Preemption of State Compulsory Sharing Laws

The second sentence of Section 5(a) would expressly "pre-empt and nullify" state laws that require those institutions which operate EFT systems to share their systems with other institutions which apply for access. Although we believe that state mandatory sharing laws are probably not necessary and are clearly anticompetitive, we believe that express preemption and nullification are not required. The first sentence of Section 5(a) which makes such laws clearly subject to Federal antitrust statutes provides an adequate way, in our opinion, for dealing with those laws. Moreover, the issue of whether federally-chartered institutions are subject to state mandatory sharing laws still remains open. We would expect the Department of Justice to bring a suit testing such laws at an early date to clarify the situation and remove uncertainties about the legality of mandatory sharing arrangements. We prefer this route to that of preemption and nullification because it would provide states an opportunity to present their views and argue their positions.

The general effect of mandatory sharing laws is to inhibit experimentation and variety in EFT systems, to deter the use of advanced technology, and to reduce the intensity of competition among the financial institutions. Moreover, the effect of such laws, particularly when adopted by a state that is dominant in its region, spreads far beyond the state's borders.

Compulsory sharing laws disrupt competition in many ways. For example, they remove the primary incentive to introduce a new service or a new technology into a market. The institution that offers a new technology first must take all the risk of failure; but if the service is a success, every other institution can insist on piggybacking on the first institution's efforts. A dominant institution can use this power to prevent smaller institutions from forming their own joint venture system in competition with the one controlled by the dominant institution.

Compulsory sharing laws also contribute to territorial allocations of markets among competitors. These laws help to freeze the pre-EFT market shares of the participants where competitive EFT offerings might have shifted them somewhat, and thus they help to preserve the dominance of the largest institutions.

Compulsory sharing laws have been advocated because of the present high fixed costs of point-of-sale systems and present low transaction volumes over which these costs may be spread. We have four observations about high fixed costs. First, existing economic analyses have looked at costs associated with a new service that is using new technological principles. It is reasonable to assume that over time these fixed costs will decline as financial institutions learn from the experiences of each other. Second, costs of computer and communications hardware will continue to drop as manufacturers improve their products and as increased sales reduce manufacturer unit costs. Third, it is possible for systems to serve several states and support themselves out of the greater volume provided by a regional level while any single state in the region might not be able to support more than one system. Fourth, the low transaction volumes in point-of-sale systems may reflect poor marketing efforts. The economic incentives necessary to make most consumers prefer a debit card to paper checks seem to be lacking. Such economic incentives may not be forthcoming until financial institutions price explictly for all payment services. The alternatives of paper-based and electronic systems have different advantages and disadvantages to consumers, and consumers should be allowed to choose between them after a price-service analysis.

The FDIC recognizes that some degree of sharing of EFT systems, especially point-of-sale systems, will probably come about. By placing sharing arrangements under the framework of antitrust principles, S. 2293 guards against the development of monopolistic or oligopolistic systems which are not in the best interest of the consumer. The bill also protects smaller institutions from the danger of failure as a result of being excluded from any EFT system that is essential to their survival.

In the hearings conducted by the Commission, many who favored exempting mandatory sharing from antitrust laws did so not because they opposed the principles of the antitrust laws, but because they could not count on those laws for protection due to administrative practices in court systems resulting in lengthy time delays. Section 5 of S. 2293 addresses this issue by providing for expedited court hearings and trials on issues pertaining to system access.

3. Supervisory Agency Participation in Sharing Arrangements

The National Commission on Electronic Fund Transfers recognized that participation by state and Federal financial institution chartering authorities in mediating access disputes to EFT systems could be useful. Section 5(b) of S. 2293 provides that state and Federal chartering authorities may mediate sharing disputes among institutions. The FDIC endorses this approach and agrees that only chartering agencies should act as mediators. Although this policy would exclude the FDIC, we do not believe that S. 2293 precludes the FDIC from ensuring that EFT systems are secure and that participation in EFT arrangement does not constitute an unacceptably risky investment for an insured institution.

D. Customer Rights

Section 7 of S. 2293 requires each financial institution to disclose to each customer for whom it furnishes services through an EFT system information concerning the customer's primary rights and responsibilities under applicable law governing such transactions. Senate bill S. 2293 provides that the Board of Governors of the Federal Reserve System may prescribe regulations pursuant to which such disclosure must be made.

We do not believe that the task of prescribing such disclosure regulations should be given exclusively to the Board of Governors of the Federal Reserve System. It would be preferable to permit the Federal Reserve Board, the Comptroller of the Currency, the Federal Home Loan Bank Board, the National

Credit Union Administration, and the FDIC to have some latitude in determining appropriate regulations. Situations unique to different types of financial institutions could be handled more easily in this way.

As to Section 7(c) which addresses the privacy issues related to disclosure of customer information to third parties, our views on this type of legislation are discussed later in this statement under our comments on S. 2096, the Right to Privacy Act of 1977.

E. Federal Reserve Automated Clearing Houses

Section 8 of S. 2293 adopts the principles that Federal Reserve Banks should continue to operate automated clearing houses (ACHs). However, the bill places a number of restrictions on Federal Reserve operations. This bill requires each Reserve Bank to adopt a schedule of prices for the services it provides in accordance with general rules to be established by the Federal Reserve Board. The bill requires that each service be offered separately and priced separately by each Reserve Bank and that each service fee cover the fully-allocated costs of providing the service, including a rate of return on capital that is commensurate with the risk that a private enterprise would have to accept in providing an equivalent service. In addition, Section 8(a) together with Section 8(c) permit Federal Reserve Banks to provide services only to institutions that belong to automated clearing house associations (ACHAs). To prevent ACHA members from misusing their combined power and their access to the ACH, the bill also requires that an ACHA must admit any depository institution that applies for membership and provide full access to its services on terms that reflect only cost-justified differences, or the ACHA will be ineligible for the Reserve Bank's ACH services.

The FDIC believes that Reserve Bank-operated ACHs, even under the terms of S. 2293, are not the best way of providing automated clearing services. We recognize the great benefits that the Federal Reserve's efforts have conferred in the start-up phase of ACH development. We think, however, that the need for direct Federal Reserve participation has diminished and that the Federal Reserve's continued dominance could choke off innovation in areas related to EFT. Accordingly, we believe that the better course would be to preserve an environment that fosters significant private sector competition in the ACH area.

The Reserve Banks could accept the information they need to perform their traditional net-settlement function from private ACHs, just as they now take information from ACHs they operate themselves. Moreover, the Federal Reserve could establish an open-admissions policy for ACHAs and enforce the policy by refusing to deal with ACHAs that fail to comply with it. This less restrictive program would achieve the purposes of S. 2293 but without the necessity for Reserve Bank operations.

As the Department of Justice has pointed out, private-sector ACHs offer significant advantages over government-operated ones. Unlike the Federal Reserve, bankers must recover the costs of ACH services. They cannot subsidize ACH operations indefinitely out of other revenues as the Federal Reserve does. Nor can they afford simply to determine the cost of providing a service and set a fee that is never subsequently reviewed or changed. They labor under continuing pressure to find the most efficient and least-cost method of clearing financial transactions with one another.

By contrast, Federal Reserve ACH operations do not come under such competitive pressures. When they are subsidized, such as is presently the case, there is a strong disincentive to the growth of alternative arrangements. They also encourage banks to overemphasize services that can take advantage of the subsidized clearing arrangements and to avoid offering services that might be needed but that do not produce the same return on the bank's investment. In fact, the mere threat of subsidization -- which can creep in when the ACH adheres to an obsolete price schedule that ignores inflation -- is a risk that private businessmen must consider when they decide whether or not to invest in an alternative clearing capability. Private sector alternatives that do not rely on the Federal Reserve System are not developing very rapidly because they cannot compete against systems which make no charge for their service.

The problem of pricing could be even worse from the Federal Reserve's point of view. The Board is likely to come under pressure to accommodate a great many special interests in its pricing schedules. Member banks may demand special rates; large institutions may ask for rates that reflect the cost-savings resulting from heavy transaction volumes; smaller or rural institutions may plead for flat per-transaction rates. Accordingly, the Federal Reserve is going to have to establish an administrative mechanism for setting rates, reviewing them, and dealing with complaints about them. The explicit costs of such a bureaucracy should be reflected in the price schedule.

There is also a hidden cost, however, that is harder to quantify and allocate -- the cost of inflexibility imposed on the system as a whole. For example, a group that benefits from one schedule of services and prices could lose ground if the schedule were changed. The interests of such a group would lie in opposing the change by using the bureaucratic process to delay it.

Despite these reservations, the FDIC does not object to the Federal Reserve continuing ACH operations as limited under S. 2293.

Although not addressed in S. 2293, there is a question as to whether the Federal Reserve should refrain from upgrading its ability to service ACH operations from batch processing to the on-line mode. The former Vice Chairman of the Steering Committee of the Commission, Mr. Herb Wegner, raised this question in his letter to the Federal Reserve on March 3, 1978, commenting on the Federal Reserve's proposal to operate an on-line inter-regional switch among ACHs.

Perhaps the greatest drawback to Federal Reserve ACH operations is that, as they grow more powerful, they could begin to perform many of the functions of a central switch for a retail point-of-sale (POS) system. Today, ACHs are generally off-line and are used to process high volume runs of items. In this regard they perform a valuable social service by helping to distribute payroll funds and Social Security payments to a large number of people without interfering with the ability of the recipients to select their institutions. If the Reserve Banks' ACHs become on-line central switches for retail POS systems, the Banks could process individual payment items as easily as they now process batches of items. In addition, financial institutions could avoid investing in separate and competitive systems and could funnel all their transactions through the ACH. In short, financial institutions could create a series of local POS system monopolies tied into ACH operations to perform funds transfer functions.

If POS systems were natural monopolies, or if there were some other reason to insist on full interconnection among POS systems, perhaps the marriage of ACH and POS functions would be advantageous. However, there is no evidence that POS systems can or ought to be formed as local monopolies. Indeed, the evidence presented by the Baxter-Cootner-Scott study, "Retail

Banking in the Electronic Age: The Law and Economics of Electronic Funds Transfer," indicates that several systems can compete with one another in every region of the country, provided only that the systems are allowed to cover enough territory to be self-sustaining.

Accordingly, it would be a grave error to allow the local ACHAs that use Federal Reserve facilities to expand their monopolistic effects into the related but separate area of POS transactions. For this reason, we urge that S. 2293 be amended to provide that, if Federal Reserve ACH operations continue, their scope be limited to batch processing of large volume items. This recommendation is identical to that adopted by the Commission.

F. Study of Effects of EFT Systems on Low-Income Persons

Section 10 of S. 2293 would require the Board of Governors of the Federal Reserve System to conduct a study of the possible effects of EFT on low-income persons. Surveys in the early 1970s indicated that 20 to 25 percent of the nation's households do not use the services of financial institutions; cash and money orders are their primary modes of payment for goods and services. Individuals in these households also have difficulty cashing checks made payable to them as they have no depository account.

If EFT can offer lower costs and greater convenience to consumers in general, then the question is whether innovative systems can be devised to meet the particular needs of low-income persons. For example, the GIRO systems in Europe provide payment services to many households in areas where the number of households that have transaction accounts in depository institutions is extremely low.

The FDIC supports the concept of a study to determine if there are alternative payment systems which can be developed through EFT and which can provide better services to low-income persons.

G. Government Access to Records

Section 6 of S. 2293 provides that no Federal, state, or local government agency may obtain from a financial institution information contained in customer financial records. Our views on the general issues involved in this type of legislation are discussed in the concluding portion of this statement.

Right to Financial Privacy Act of 1977

As you know, up until recent years banks traditionally accorded confidential treatment to information in their files about customer's financial affairs and did not permit unauthorized disclosure of such information. However, in 1970 the so-called Bank Secrecy Act imposed extensive record-keeping procedures on banks to enable law enforcement authorities to obtain evidence needed to prosecute white collar criminals. Then on April 21, 1976, the Supreme Court held in United States v. Miller that a bank customer had no constitutionally protected right of privacy with respect to information about himself in a bank's files. The pendulum began to swing in the other direction later in 1976 when Congress amended the Internal Revenue Code to permit taxpayers whose bank records were supoenaed by the Internal Revenue Service to challenge in court the Service's right to the records before the bank produced them. The purpose of S. 2096 and similar bills in this and previous sessions of Congress is to reverse the cumulative effect of the Bank Secrecy Act and the Miller case and to reestablish generally the confidential relationship between a financial institution and its customers.

To do this, S. 2096 would provide that the financial records of a customer may be disclosed by a financial institution only if the disclosure is authorized by the customer or if it is pursuant to a search warrant or to an administrative summons or judicial subpoena which has been served on the customer as well as the financial institution. The customer could contest the proposed disclosure in a court of competent jurisdiction. Also, under the bill a court could grant an agency a subpoena with a 90-day delay of notice to the customer upon a finding that notification would jeopardize a continuing investigation of a felony. Financial institutions would be reimbursed by the U.S. Government for the cost of producing records required by governmental agencies. The bill would exempt from its disclosure restrictions Internal Revenue Service summonses (because they are now covered by similar procedures under the Internal Revenue Code), grand jury subpoenas, information furnished to financial regulatory agencies, and any information disseminated "under procedures that insure protection of [its] confidentiality." The bill provides both criminal and civil sanctions.

We have supported similar proposals in the past and have recommended a number of amendments to previous bills. As to the amendments we previously suggested, various revisions incorporated in S. 2096 have obviated the need for some of these changes. Our comments herein will focus on those of our earlier suggestions which we still think appropriate in the context of S. 2096.

In our June 8, 1977, letter to Senator Proxmire commenting on a similar bill (S. 1460), we urged that the bill be drafted so as not to impair any existing legal obligations to make disclosures to governmental authorities. For example, under the evolving aiding and abetting doctrine as regards violations of Federal securities laws, it is possible that a material misrepresentation in a customer's offering circular of his loan terms with a bank could impose upon the bank an affirmative duty to disclose the true situation. However, S. 2096 as presently drafted would not seem to permit the bank to voluntarily disclose such information to the Securities and

Exchange Commission or to comparable authorities. We recommend that the bill be amended to ensure that it does not inadvertently relieve banks of any existing obligation to make such disclosures under Federal law. This could be accomplished by an amendment providing that "nothing in this Act shall negate or limit any duty to disclose imposed by applicable state or Federal law."

Also, Section 10(3) of the bill provides that its prohibitions against disclosure do not apply to the examination of financial records by, or disclosure to, any supervisory agency "in the exercise of its supervisory, monetary, or regulatory functions." Although this language would clearly exempt the release of information to the FDIC insofar as its bank regulatory functions are concerned, it is not altogether clear that this language would exempt disclosures to the FDIC in the execution of its insurance and liquidation functions. Because we are certain that the bill is not intended to inhibit the FDIC in carrying out these latter functions, we strongly recommend that this provision of the bill be amended to refer to "supervisory, monetary, regulatory, insuring, or liquidating functions."

One other difficulty we have is that Section 11 might possibly preclude the FDIC and other supervisory agencies from disclosing to appropriate law enforcement authorities information indicating a violation of law which is discovered in the course of their supervisory activities. We strongly recommend amending this section to make clear that the bill is not intended to prevent such disclosures. This could be done by adding the following proviso to Section 11.

> "Provided, further, That any supervisory agency receiving information in the course of discharging its statutory functions which in its judgment tends substantially to indicate a violation of law by any financial institution which it regularly examines, or by any director, officer,

> employee, agent, representative, or customer thereof, may release such information to any governmental entity charged with enforcing such law."

Also, Section 19 provides that government officials must pay the costs incurred by financial institutions in producing records relating to a customer in response to a customer authorization, summons, subpoena, or search warrant. The Federal bank regulatory agencies have authority under Section 10 of the Federal Deposit Insurance Act to issue subpoenas in connection with the examination of insured banks and their affiliates. We do not believe that Section 19 is intended to cover this type of subpoena and we would, therefore, strongly recommend an amendment to make clear that it does not apply to such subpoenas issued for bank regulatory purposes.

Your Subcommittee might also want to consider amending the bill to extend its protection to other financial-type institutions such as nonbank credit card issuers, insurance companies, securities brokers and dealers, investment companies, loan companies, and the like. We believe that the principles underlying the privacy rights accorded by the bill would logically extend to these types of institutions as well.

We would like to emphasize that our support of this type of legislation in the past has been premised on the implicit assumption that it would not cause significant problems for Federal and state law enforcement agencies, particularly with respect to enforcement efforts directed against organized crime and white-collar criminals. We defer to such law enforcement agencies as to the effect of this legislation on their activities and would recommend that great weight be given to their views on its basic provisions prior to enactment.

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