FOR RELEASE ON DELIVERY
THURSDAY, SEPTEMBER 13, 1979
9:00 A.M. (E.D.T.)

THE FED'S ROLE IN DEFINING THE PAYMENTS SYSTEM

(An Update on Payments System Developments)

Remarks by

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at the

Bank Administration Institute Conference

on

"Contemporary Issues in Cash Management"

September 13, 1979
New Orleans, Louisiana

I am delighted to have the opportunity to address this group. You, as bankers involved in the delivery of cash management services to corporate customers, certainly have a great interest in the nation's payments system. We all have an ongoing role in the development and shaping of the payments mechanism. From the Federal Reserve perspective my comments today will provide both background information on the Federal Reserve role, and some operational and policy changes under consideration which will affect the payments system and therefore may affect your options as cash managers.

The Federal Reserve System provides a public alternative to private check collection arrangements. This public presence is directed at maintaining the safety, solvency, and certainty of the nation's check collection system. The Federal Reserve also has the responsibility to regulate the check system and insure a viable payments system that is in the public interest.

Our involvement in the payments system goes back to 1914. Before the Federal Reserve System was established, private arrangements cleared all checks and drafts, but these arrangements were judged by Congress and by the designers of the Reserve System to be inadequate and a burden on commerce. One concern was that checks were frequently cleared with a percentage fee deducted from the face amount of the check. This procedure is known as non-par clearing and still persists, albeit only practiced by a very few. In framing the Federal Reserve Act, Congress established a requirement for the Federal Reserve to act as a nationwide check clearing facility that would clear checks paid at par value.

Private clearing arrangements also involved the pyramiding of balances at correspondent banks, a practice that probably contributed to recurring money panics like the one that occurred in 1907. The Fed System has taken its Congressional mandate seriously and has been instrumental in overcoming most forms of circuitous routing of checks and the problems of non-par banking and bank liquidity which Congress was trying to correct.

The Federal Reserve has used its regulatory authority and Congressionally mandated role in the payments system to aid in technological enhancements and improvements to the payments system. For example, in the 1960's we helped to develop and ultimately required MICR encoding of checks which clear through the Fed. During the 1970's we changed Regulation J to require all banks to settle with us for checks we present on the day of presentment thus equalizing settlement requirements among all banks. This change also made possible the expansion of immediate availability zones into what has come to be known as Regional Check Processing Centers (RCPCs). Establishment of the automated clearing houses in the 1970's was achieved partly by Federal Reserve involvement and assistance. Moreover, the implementation of the Culpeper switch in the 1970's reduced significantly the amount of time required to make a wire transfer and provided the computer to computer capabilities necessary for member banks to be responsive to the money transfer needs of their customers.

These examples are important because they indicate the importance of a public presence in the payments system serving as a catalyst to innovation and improvement. It is also interesting to note that many of these enhancements are key elements in sophisticated cash management.

There are other enhancements underway or under consideration that should be of interest to you. Most of you are probably aware of the Board's effort to create a pilot test of electronic settlement, a new financial service aimed at speeding and improving the clearing of large dollar value checks. Electronic settlement is a concept involving the capture of the data in the MICR line from checks to be cleared between Federal Reserve office territories and the use of the System's communication network to deliver this data and to effect settlement. The physical check would be delivered later, but we are hopeful that this can be discontinued once corporate participants become accustomed to these new procedures.

The Board's interest in electronic settlement is prompted by the need to modernize check settlement and by two operational concerns. First, transportation delays caused by weather, aircraft malfunctions, and other factors have generated an increased level of check float within the System. Second, the Federal Reserve and private sector check clearing systems rely heavily on special air and surface transportation systems which could be subject to reduced reliability if fuel again becomes scarce. Electronic settlement removes the risk of float on large dollar items in the event of transportation problems and reduces the need for special priority transportation systems.

Electronic settlement is not designed to speed up presentment and settlement, but rather to maintain present clearing speeds on a much more reliable basis. The exception to this, of course, is large dollar items drawn on remote locations with the specific intent of taking advantage of Federal Reserve float. Electronic settlement should remove this float advantage.

We believe that it is in the best interests of all parties to the collection process to keep the funds flowing in the face of bad weather, fuel shortages, or other disruptions. However, some of you may be skeptical as to what benefits electronic settlement offers to you as cash managers--especially if it does not provide better funds availability. I suspect that if you look closely at the amount of money your transit departments are spending to clear large items quickly including the costs of special handling, special transportation, and the services of your correspondents around the country, you may find that electronic settlement offers a clear opportunity to reduce your operating costs. Also, you should be aware that the Federal Reserve has taken a firm stand against remote disbursement, and the System does not intend to bear any cost--including the cost of float--associated with remotely disbursed items.

I am hopeful that the electronic settlement pilot can be developed soon and that it will be successful. Admittedly, there are legal, procedural, and timing problems to be resolved, but we believe the program is feasible. I urge you to consider how such a program would fit your cash management schemes and whether your bank is prepared to send and receive check payment data electronically on behalf of your corporate customers and other banks you may service. In this regard, we hope you will evaluate the opportunities available to you should your bank establish an ACH data transmission link with its local Federal Reserve office. Not only will the link allow you to receive and initiate ACH payments for your customers, it will also allow you to offer them early participation in electronic check settlement and possibly check truncation. I mention check truncation because it is closely related to electronic settlement in that the ability to receive and process items in electronic form is essential for participation in both.

The Federal Reserve's interest in electronic settlement of large dollar value checks raises the question of whether System policies, particularly availability schedules for handling high dollar value checks, might be changed. The System's policies in this area are now under review--not only because of electronic settlement, but also in relation to our efforts to reduce System float and to discourage remote disbursement.

With regard to System float, large dollar value items represent a high float risk and a less efficient use of the Fed's collection system to the extent that other payment means such as ACH or wire transfer are available. Frankly, given the greater speed and reliability of electronic transfer, I have to wonder to what extent checks are used for large payments in the hope that payment will be delayed. While the recipient of the check certainly bears the greatest burden in terms of delayed funds availability, the Federal Reserve carries float associated with such things as transportation delays, weather problems and equipment malfunctions. We bear this float because of our policy of granting credit on a fixed schedule in order to assure a reliable flow of credit in the economy. We have several alternatives under consideration including changing the deferment schedule on large items or handling them on a collection basis--that is, credit would be passed when we have collected the item. We are also considering special handling procedures and deposit requirements.

Turning now to current efforts in the automated clearing house area, as most of you are aware, the Board announced in May of this year certain improvements to ACH services. The changes give users of ACH services more time to get certain types of payments instructions to the Federal Reserve which results in earlier availability to financial institutions of the funds being paid.

Specifically, the time schedule improvements fall into two categories. The first provides financial institutions with five additional hours for initiating debit and credit payments, such as direct deposit of payroll, preauthorized bill payment, and cash concentration. The second allows certain payments such as cash concentration transfers to be handled more expeditiously. For example, a financial institution collecting funds on behalf of a corporate customer from another financial institution can initiate debits to those accounts as late as 9:00 p.m. Thursday for Friday settlement.

This second schedule change will allow corporations to collect funds from any financial institution in the nation on an overnight basis. I believe it is a cash management tool well worth your consideration. Our forecasts suggest that an estimated 25 million depository transfer checks could be replaced annually by ACH entries and that as much as 90 percent of this volume will be converted by the end of 1980.

The new schedules are presently being pilot tested by four Federal Reserve Districts. During the first three weeks of the pilot, I am pleased to report that over 40,000 time critical debits were originated totaling over $107 million. Of those 40,000 debits, almost 19,000 were exchanged inter-regionally. The pilot test has involved 17 companies and six originating financial institutions. We believe that such initial success supports our optimism regarding potential usage and I urge you to give careful consideration to the opportunities presented by the new ACH schedules.

Let me now elaborate on two issues which have already been mentioned--remote disbursement and Federal Reserve float.

The Board is presently reviewing the responses to its public statement of eight months ago on remote disbursement and has been gratified to find many instances in which the practice has been discontinued completely and others where internal bank policies and procedures have been tightened to prevent the more obvious abuses. We have been told by some banks that thorough reviews of customer transactions have been conducted to weed out accounts specifically designed to gain a float advantage. We have also been told that there has been greater awareness of the possible adverse effects of remote disbursement.

Despite these positive actions and the amount of cooperation exhibited by many institutions, remote disbursement is continuing in some places. We must now consider whether further action is warranted. As some of you are aware, the Board recently approved the application of the Stanley Bancorporation, Inc., to acquire the Farmers and Merchants State Bank provided that the bank terminates its remote disbursement practices before the bank holding company is formed. I believe this action indicates the Board's concern with remote disbursement and its intention to strongly discourage the practice. My personal view is that the Federal Reserve must insure that we are not subsidizing the process in any way and that the full economic impact of remote disbursement is carried by the participants in the practice. In that context, consideration of changes in our policies regarding large dollar value items would be consistent with our need to discourage remote disbursement while reducing the level of Federal Reserve float.

The Federal Reserve has been concerned for some time with reducing float levels. Moreover, there is evidence that Congress is interested in seeing that float either be avoided or the full value of the float charged to the depositing institution.

Since the first of the year, float has been reduced significantly although we are not yet where we would like to be and intend to be. We have strengthened our transportation arrangements, improved our monitoring of on-time performance of direct sending banks, and in some cases changed availability schedules to reflect actual collection times. We are also streamlining our internal procedures and accounting systems so that we can better track the causes of float.

To some of you, I suppose all this work to reduce System float does not come as welcome news. Of course the possibility that we may change our policies for large dollar items and continue to discourage remote disbursement are probably not happy prospects either.

However, I suggest that many cash management techniques in use today may rely too heavily on trying to use float. This narrow focus on float ignores the favorable cash management opportunities created by the ACH and electronic settlement, namely, predictable funds availability. In addition, use of electronic based rather than paper based systems may result in lower service charges and reduced depository bank balances.

The latter was the conclusion of a joint study by the Postal Service and Mellon Bank which jointly use ACH debits as a replacement for depository transfer checks in the Fourth Reserve District. In addition, Mellon and the Postal Service assessed the impact on float of this procedure.

They concluded that delays in presentment occurred on less than 1 percent of the DTC's and that no DTC's were delayed by more than one business day. Accordingly, the float loss was minimal.

It is my hope that opportunities for utilization of Federal Reserve float will continue to diminish over the next few years. Therefore, my message to you is to take a long hard look at whether you are managing funds or float. If you manage float, you may wish to rethink some of your cash management strategies.

Finally I have a few comments on pricing. Pricing of Federal Reserve services has been looming on the horizon for some time now. If it is implemented, pricing could stimulate more efficient usage of Fed check processing facilities. Correspondent banks, for example, who presently deposit items drawn on their respondent banks will probably reconsider this practice.

We expect that while demand for Fed check processing may change, our involvement in the payments system will not. We will continue to exercise an active regulatory role while providing a public alternative to private check collection arrangements.

Along with many others, however, I have concerns about pricing. First, I would not want pricing to cause an abrupt change in volume at any participant. Secondly, I hope the Federal Reserve will have the necessary flexibility to adjust its prices and service levels to meet changing circumstances and demands. If we do not have this flexibility, we face the prospect of major volume losses and our ability to offer a price competitive alternative to private clearing arrangements will be severely undermined.

Finally, I am concerned about the implications of pricing for specific items such as Federal Reserve float. I am not sure that including the value of float in our price will be as beneficial as some private check processors suggest. Much of our float, for example, occurs because we believe it is in the public interest to insure a reliable flow of credit within the economy. This means that we absorb the float resulting from major snow storms, hurricanes and other natural disasters. It also means that we insulate the payments system from many more routine problems--aircraft delays, power outages and so forth. Those who believe that they will benefit from our pricing of float may not have reckoned with the cost that will have to be borne by the private sector if that reliable flow of credit is to continue. I am also concerned that pricing of currency and coin services could mean pricing of a normal governmental service.

I have touched on a number of important issues this morning and I hope my comments have encouraged you to consider how you as cash managers may be affected by Federal Reserve policies now and in the future and how you might be able to utilize the more efficient electronic payment alternatives in which we are involved. It is always healthy to take a long, hard look at what you are doing and how you are doing it and that's exactly what the Federal Reserve is doing now. We expect that there will be many changes in the long run in the type and level of services that are offered.

Over the past ten years the banking industry, private customers, the Treasury, and the Federal Reserve have steadily improved the handling of payments in the United States. But we are approaching another watershed where a number of breakthroughs are needed to move our system toward a fully modern and efficient one. The payment of bills by preauthorized arrangements is reducing the growth of check volumes but much more can be done with the technology and procedures that are available to reduce handling of checks and speed up collection times. It would appear that we are nearing a new inflection point where wire transfer through ACH payments can make a major reduction in check handling. Similarly there are changes in our currency and coin which would promote a more modern system.

From my personal perspective I believe there are a number of improvements which could be made and a number of actions which the Federal Reserve could take to encourage the needed changes. Check handling, processing, timing, settlement, and returns can all be modernized. Pre-sorting of large dollar value checks, wire transfer of the funds with ultimate truncation, spacing of deliveries to avoid rush hours, elimination of remote disbursement, wire return item handling and immediate availability of credits, and enlarged local clearing houses for efficient settlement could all improve the check system. But our goal is a reduction in checks through electronic settlement. Even in ACH and wire transfers there are improvements to be made. Through new wire operating techniques and enlarged capacity, a nationwide marketing program, standardized rules and procedures, and inter-industry cooperation, the electronic delivery systems and payments mechanism will prosper.

For our part I am ready to use our full arsenal of carrots and sticks to help achieve these improvements. For example, I am ready to recommend that deferment schedules be changed to encourage wire transfer of large dollar checks while assuring immediate credit for wire transfers.

Also I am prepared to change receipt times and tighten up on direct sending. In addition, I could see the Federal Reserve subsidizing terminal use and development as well as issuing promptly the new Subpart C of Regulation J. Similarly, I think we should rewrite the rules on return items to require wire notification and return of credits. And finally, I can see the Federal Reserve using its regulatory power to stop unfair, deceptive, or deliberately delaying tactics but also using its pricing program to encourage the shift away from checks.

If nationwide NOW accounts are authorized they offer an opportunity to break check writing patterns. To insure that checks are not routinely used in such accounts I suggest that most transfers be made by electronic means and that Subpart C of Regulation J be issued clarifying the legal and operational rules under which such wire transfers are made.

Frankly I believe the time is approaching when all banks should stop forwarding checks of over $1,000 written on banks outside the immediate city of the receiving bank and should wire transfer the funds. The Federal Reserve could help to encourage this move by requiring separate sorts and passing credit only when collected. Perhaps the best way to start this would be on corporate accounts.

We should modernize our currency by promoting the $1 coin and $2 dollar bill. Both have the potential for major improvement in currency use and efficiency in production and we are approaching a watershed point to encourage their use.

It is apparent that currency habits are deeply ingrained in our people and that new currency and coin units are not immediately embraced as circulation mediums. Without forcing actions it may be some period of time before we reorient our thinking to reach for a coin instead of a one dollar bill and accept the two dollar bill as the lowest denomination note. The savings in production and the efficiency of use in these new units make it important that we encourage their use as promptly as possible.

The time will come in early 1980 when the supply of dollar coins will be high enough to warrant discontinued production and supply of the dollar bill. At that time, I believe we should meet commercial bank needs with dollar coins and $2 bills.

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