Statement

by

Stephen S. Gardner

Vice Chairman
Board of Governors
of the
Federal Reserve System

at the public hearings

of the

Providers Committee
of the
National Commission
on
Electronic Fund Transfers

Rayburn House Office Building
Room 2128

November 11-12, 1976

Mr. Chairman, members of the Commission, I appreciate the opportunity to present the views of the Board of Governors on the important question of the role of government in EFTS. The Board follows the work of this Commission, very carefully and will benefit from proceedings before the Commission and hopefully contribute to its deliberations. The Board's positions on the questions with which the Commission is concerned are still under development. Board staff papers on some of these questions, e.g., consumer issues, competitive effects of terminals, and the Federal Reserve's current activities in the payments mechanism, have already been forwarded to the Commission. Additional Board staff papers on economic and monetary policy implications of EFTS, the cost of the current payments mechanism, the question of sharing EFT facilities, and other topics will be made available to the Commission when they are completed. As you know, we have had under way a comprehensive appraisal of pricing of and access to Federal Reserve payments mechanism services, and when this work is completed, we shall be pleased to share it with the Commission.

Since its origin in 1913, the Federal Reserve System has been an active participant in the nation's payments mechanism. Currently, the Federal Reserve System provides clearing and settlement facilities for the exchange of payments among depository institutions in paper form and on magnetic tape. The System also provides currency and coin services to its member banks, and the facilities for the wire transfer of reserve account balances and transactions in government securities. A brief summary of the System's statutory responsibilities in these areas may be useful.

Prior to the enactment of the Federal Reserve Act, checks were exchanged in this country through a system of clearing houses (or exchanges). Often exchange charges were levied by the bank that finally paid the check, and since the checks were not paid in full, the practice was termed "nonpar banking." The exchange charge was generally 1/4 of 1 per cent of the face value of the check paid, and many banks engaged in circuitous routing of checks to avoid such exchange charges. This resulted in check collection being slow, cumbersome, and costly, and the system had adverse effect on commerce and economic growth. Sections 13 and 16 of the Federal Reserve Act changed these relationships because commercial banks were required to pay for checks presented to them by Reserve Banks at par, and the Reserve Banks were authorized to collect the checks of commercial banks.

With respect to currency and coin services, Section 16 of the Federal Reserve Act authorized the issuance and redemption of Federal Reserve notes. The Federal Reserve Banks have issued and redeemed such notes since 1914, and, as you know, Federal Reserve notes are now the primary legal tender in the United States. On May 29, 1920, the Congress authorized the Secretary of the Treasury to transfer to the Federal Reserve Banks the duties and functions of the Assistant Treasurers in connection with the exchange of paper currency and coin in the United States (41 Stat. 654). Accordingly, Reserve Banks have been authorized and directed by the Treasury to make an equitable and impartial distribution of available supplies of currency and coin in all cases directly to member banks and to nonmember commercial banks (see 31 CFR 100).

The System has also provided the facilities for the wire transfer of reserve account balances and transactions in government securities since 1915. These facilities are integral to the maintenance of reserve account balances that are required by the Federal Reserve Act, and to providing a viable Federal Funds market.

Much discussion of the role of the Federal Reserve in an electronic payments mechanism has centered on the automated clearing house operations and the point-of-sale system. Both have the potential to be important electronic based substitutes for currency, paper checks, and other traditional forms of funds transfer. It may be beneficial to clarify the role of the Federal Reserve in automated clearing house operations in order to insure that we are proceeding from a common understanding.

More often than not the term "automated clearing house" has been incorrectly interpreted as being synonomous with the facilities provided by Reserve Banks in such operations. Rather, the term "automated clearing house" encompasses much more and extends to the activities of all of the participants and the many operations required in the processing of transfers from origination to final settlement. The Federal Reserve's role in such operations essentially parallels its role in the check clearing operation except that the payment information is exchanged on magnetic tape in lieu of paper checks. In ACH operations, financial institutions create computer tapes of credit and debit items based upon customer instructions and deliver the tapes to their local Federal Reserve automated clearing and settlement facility, just as those institutions would deliver checks to the Federal Reserve's check clearing and settlement facility. A Federal Reserve computer--which is also used for other operational purposes--reads, edits, and balances the information on the tapes, sorts according to the receiving financial organization, and makes the credit and debit entries in member bank reserve accounts for settlement for both the originating and receiving financial organization. When the processing has been completed, the computer creates output consisting of magnetic tapes and descriptive paper listings. The Federal Reserve delivers the output material to the receiving financial organization using the same courier system that is used for delivering checks. Currently, the System provides the clearing and settlement facilities for such operations in 25 offices. It is important to note that in this entire process, the Federal Reserve interacts only with financial institutions for purposes of effecting clearing and settlement. All other organizational, operational, and legal requirements are between the participating financial institutions and their customers.

At the invitation of its member banks, the Federal Reserve System agreed to provide the clearing and settlement facilities necessary for automated clearing house operations. The two primary factors considered in agreeing to this operational role were (1) the cost savings opportunity that electronic funds transfer provided and (2) a consumer alternative to the traditional methods of receiving and making payment. There is very little volume emanating from the commercial end of the operation, although government volume is increasing quite rapidly.

In common with other electronic payments technologies, the automated clearing house operation must afford customers a level of service or other reward which they cannot otherwise obtain, and such benefits must be paid for from cost savings over the paper-based alternative. If these benefits are realized, I believe that the automated clearing house operation can be a progressive and cost-effective alternative to the paper system. In addition, the automated clearing and settlement facility for these operations is well suited for Reserve Bank participation for two reasons. First, and most importantly, the Federal Reserve System has operated the nation's settlement system since 1913. Regardless of how EFTS develops, it is unlikely that member banks will choose to duplicate the existing facilities for settlement purposes. The reserve balances of our members banks are turned over repeatedly each day in transferring funds among member banks and their customers in making final settlement for the nation's commercial transactions. Like check transactions, ACH transactions are also settled among financial institutions through the reserve accounts of member banks of the Federal Reserve System. Secondly, and perhaps less importantly, the check courier network that is leased by the Federal Reserve is also employed in delivering ACH transactions; and our computer systems, installed and used primarily for other purposes, are also used for sorting the payment instructions on magnetic tape. In making available the clearing and settlement facilities for this alternative payments arrangement, the Federal Reserve provided the payments mechanism infra-structure that the private sector may not have been organized to provide and assume. And in doing so, the System expects to realize economies both of financial and of real resources.

Federal Reserve provision of automated clearing facilities was not intended to preclude private sector development and operation of similar facilities any more than its operation of check clearing facilities preempts correspondent or other clearings of paper checks. To the contrary, two privately operated automated clearing house facilities which have recently been established both use the Federal Reserve's settlement system and will use its check courier delivery system. These initiatives, in combination with the announcement in January 1976 (41 FR 3097) to study the basis for pricing System payments mechanism services, emphasize the System's policy of encouraging private sector alternatives to Federal Reserve operated automated clearing and settlement facilities.

On the question of a national exchange capability in the ACH operation, the Federal Reserve System has agreed to cooperate with the National Automated Clearing House Association in a pilot to test the feasibility of exchanging payments among six regions. Five of these regions use Reserve Bank automated clearing and settlement facilities, and one uses a privately operated clearing facility and the local Reserve Bank's settlement and delivery systems. Under the pilot test proposal, the Federal Reserve would use its wire network to transmit the payment instructions contained on magnetic tape among the six regions. The automated clearing and settlement facilities would then be used to sort, clear, and settle for the payments received by wire. Whether or not the Federal Reserve System will provide such interchange capability nationwide on a continuing basis will depend upon the Board's appraisal of the broad issues concerned with government participation in an electronic payments mechanism. As you know, this question was raised in the Board's Subparts B and C of the proposed changes to Regulation J which were published for comment most recently in January of this year (41 FR 3097). To refresh our memories, Subparts B and C would provide the regulatory framework for two types of funds transfer activity. First, they would set forth the rules and procedures--now contained in Reserve Bank operating circulars--for the transfer of reserve account balances on our wire network, an activity we have been performing on behalf of our member banks since 1915. Secondly, the subparts would establish the regulatory framework for the automated clearing and settlement of payments exchanged on magnetic tape nationwide.

In essence, the proposed subparts would define the rights of payors, payees, and their banks, and are intended to provide uniform and mutual protection from unauthorized transfers. In the broadest sense, the subparts would require financial intermediaries to manage their responsibilities to their customers and to other financial institutions in the payments mechanism. The subparts are not conceptually different, therefore, from the Board's current Regulation J concerning transactions with paper checks. The current Regulation J reinforces the Uniform Commercial Code, a system of law that required nearly 10 years to draft and pass the various state legislatures. As you know, the Board has given extended and continued consideration to proposed Subparts B and C, and has invited extensive public comment, including that of this Commission. However, the Board has not made a final determination in this matter, and we look forward to receiving the views of this Commission.

We are monitoring other developments. For example, we are cognizant that a Giro* system has been successful in Europe and that such a system might be accommodated by use of existing facilities. Although some attention has been given to Giro payments, the industry has been much more interested in an electronic mode of payment whereby a customer at a retail establishment would use an electronic terminal to arrange for the instantaneous transfer of funds from the customer to the retailer--what has become known as the on-line point-of-sale system. While interest has focused on the on-line point-of-sale system, off-line systems that accumulate information concerned with financial transactions for batched processing, clearing, and deferred settlement are beginning to receive serious consideration. An off-line system appears to offer most of the advantages of the on-line system, including consumer convenience, at substantially reduced costs. Moreover, such a system would accommodate the debiting of consumer accounts on a schedule paralleling the current paper-based payments mechanism--while providing for simultaneous settlement among the financial institutions.

The role of all participants in an electronic payments mechanism is, as yet, unclear. As I have stated earlier, the Federal Reserve has not arrived at specific positions on questions related to its role in the electronic payments mechanism and has been studying this issue for some time. In determining its role, the Board will consider such factors as

---

* Giro is the term used to describe the credit transfer payment system in use in European countries. Instead of sending a check to a creditor, a consumer provides his financial institution with instructions to pay a creditor. As a result, the financial institution initiates a credit transfer on behalf of the consumer and debits the consumer's account.

competitive developments in the electronic payments mechanism, the positive encouragement of the private sector, the preservation of consumer options and the willingness of the private sector to innovate and provide services beneficial to consumers, the preservation of equity among classes of financial institutions, and the maintenance of a viable and efficient payments mechanism.

Thank you.