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The Federal Reserve's Role in Check Processing

Remarks by

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It is a pleasure to participate in this year's BAI Check Processing Conference, and to discuss with you the Federal Reserve's role as a provider of payment services, particularly check collection services.

These past few years have been challenging ones for the Federal Reserve in fulfilling its responsibilities to the nation in the provision of payment services. The Monetary Control Act of 1980 (MCA) radically altered our role in this field. As you know, the Act required us to begin charging explicit fees for payment services, and to generate enough revenues to cover the costs of providing those services, including the cost of capital and taxes that a private firm would pay--that is, the private sector adjustment factor (PSAF). We were also required to make payment services available to all depository institutions.

Since implementation of the Act, access to Federal Reserve services has been opened to nonmember banks, mutual savings banks, savings and loan associations, and credit unions. There are now approximately 6,000 institutions depositing checks with Federal Reserve Banks compared with 3,500 prior to passage of the MCA.

When explicit pricing began in 1981, the Federal Reserve had to learn quickly how to price and package its services. We thought we were an efficient, low-cost provider of services, but we learned that we had to do better. We thought our services were high quality, and that they met the needs of depository institutions. What we found was considerable dissatisfaction with the types and quality of services we offered that forced us to improve. We thought that our internal management systems and information flows were adequate to the task of running the Federal Reserve's "business enterprise." In fact, they needed substantial modification. We thought that the transition period required for the Federal Reserve to adapt to a world of explicit pricing for services might take a year or two. In fact, while the early blizzard of Federal Reserve price and service level changes is now behind us, we find the world around us changing so rapidly that we dare not relax and rest on our laurels.

We have, I am happy to say, been able to match costs and revenues in the aggregate for all priced services. In 1984, our costs plus the PSAF amounted to $552 million, while our revenues totaled $575 million. However, in two of our service lines, revenues during 1984 as a whole--while sufficient to cover costs and make a small contribution to "profits"--were not large enough to cover both costs and the PSAF. This was true for commercial ACH, and definitive securities safekeeping and noncash collection. The targeted rate of cost recovery for commercial ACH was achieved following the March 1984 increase in ACH prices, however, and the net revenue shortfall in definitive safekeeping and noncash collection diminished as the year progressed, in accordance with targets established by the Board at the beginning of the year. And in 1985, the Federal Reserve expects full cost recovery for all of its major service lines except ACH, for which the Federal Reserve's target is to recover 80 percent of full costs in 1985 and 100 percent in 1986.

Indeed, one of the problems we currently face is a potential embarrassment of riches. In check, for example, 1984 total revenues exceeded total costs--including float costs and the PSAF--by almost nine percent, a much larger margin than had been expected at the beginning of the year. In this respect, I want to make it clear that it is <u>not</u> the Federal Reserve's objective to maximize net revenue. That would be contrary to the spirit of the MCA. We know that small surpluses or shortfalls are impossible to avoid in the shortrun. But the Board has indicated to the Reserve Banks in plain language that revenue <u>match</u>, not revenue maximization, is the objective of System policy. Large shortfalls must be avoided, but that is also true for large surpluses. The Board has also issued a policy statement that precludes the Reserve Banks carrying forward to the following year any surplus or shortfall from the current year.

One of the principal difficulties the Federal Reserve has faced over the past four years is that of clarifying its objectives as a provider of payment services. Perhaps we have devoted less effort than we should have to communicating our intentions. Let me therefore make several comments on this subject.

First, the Federal Reserve does not set objectives, as a private sector competitor might, for its share of the market. We make volume projections, but we do not set volume targets at either the product or service level.

In check, for example, the Fed currently has a lower market share than it held prior to pricing. When the check service was first priced in 1981, volume dropped by 15 percent. Since then, our volume has increased slightly, but only at or somewhat below the growth rate of the total number of checks written. Overall, volume has increased by only 8-1/2 percent over the last three years. Moreover, the rates of change of check processing volume at individual Federal Reserve offices are extremely disparate. Since the advent of pricing, some offices have had relatively large increases in volume while others have experienced decreases of up to 30 percent. Thus, our ability to compete effectively has varied greatly from one market to another. When private sector competitors can provide better services at lower costs, and do so in ways that enhance the functioning of the payment mechanism, we have had no choice but to reduce our presence in the market, and we have done so.

Second, the Federal Reserve does not accept the idea that it should confine its activities in the payment mechanism to that of acting as a service provider of last resort. It cannot do so, in my view, and fulfill its obligations under the MCA. The Federal Reserve could not be an efficient producer of services, giving due regard to the adequacy of the level of services nationwide, if it were confined to servicing only those high-cost endpoints that private sector competitors chose to ignore. Thus, when the Federal Reserve is confronted with pricing strategies or other devices that would move us significantly in the direction of being the processor of last resort, we have little choice but to respond.

Put more generally, we in the Federal Reserve look first and foremost to our public service responsibilities in deciding what our role is, and should be, as an operator in the payment mechanism. We have tried to spell out more concretely what we mean by this in a paper entitled "The Federal Reserve in the Payment System." That document sets forth specific criteria adopted by the Board for continuation of existing services and for introducing new services or major service enhancements. I will not go over those specific criteria here, but I would urge you to read that document carefully if you have not already done so.

Another area of possible misunderstanding between the Federal Reserve and its private sector competitors is the potential conflict stemming from the Fed's role as a regulator as well as a provider of payment services. Some private sector competitors express acute discomfort with this state of affairs. We recognize fully the potential problem and have gone to great lengths to address it. The Board of Governors has issued a policy statement entitled "Standards Related to Priced Services Activities of the Federal Reserve Banks" that establishes a "Chinese Wall" between the two roles consisting of both external and internal safeguards. The external controls include

Congressional oversight and statutory controls. The internal safeguards include oversight by the Board of Governors and Reserve Bank boards of directors; restrictions on the way Reserve Banks are organized; specific standards to govern the Federal Reserve Banks' business practices, and an appeal process to the Board of Governors to be used in the event that any depository institution encounters Reserve Bank practices that it regards as a breach of the Chinese Wall.

We are prepared to discuss with anyone, at any time, constructive ways to insulate further the regulatory and service provider functions of the Federal Reserve. But the fact of that dual role is inherent in the basic provisions of the MCA. It is something that you in the private sector, and we in the Federal Reserve, will have to learn to live with.

The years since the passage of the MCA certainly have been a learning experience for the Federal Reserve. Too often, our intentions have been misunderstood, and perhaps the fault is largely our own.

The Federal Reserve's experience with noon presentment is illustrative. The concept of noon presentment seemed to us sound; its potential to improve the payment mechanism was clear, and it was technically feasible. Accordingly, the Federal Reserve developed a proposal to implement noon presentment without adequate discussions with the banking industry. It soon became evident that the concerns of the industry with the original proposal needed to be addressed. We did so, and noon presentment, as it was implemented, incorporated modifications designed to address most of those concerns. As implemented, noon presentment successfully met its objective of accelerating the collection of checks--approximately $2 billion daily is now collected one day faster than was previously possible.

With the High Dollar Group Sort program, we did a little better. Discussions with the banking industry got underway before the proposal was put out for public comment. Even so, in response to concerns raised by the banking industry, the Federal Reserve made substantial modifications to its HDGS proposal following the public comment period.

One important modification was the enhancement of payor bank services. In the past, most payment services produced benefits for the collecting institution in the form of lower-cost collection or accelerated availability. Payor institutions, on the other hand, were being faced with later presentment times, placing a strain on their internal operations. Payor bank services were enhanced to mitigate this effect of later presentment and allow the payor institution to continue to provide effective cash management services to their customers.

We regard the HDGS program as successful. Over $1 billion daily is being collected through this program.

More recently, we considered implementing a limited pilot program to test the concept of two-tiered pricing for checks. Under two-tiered pricing, the Fed would establish separate fees for checks payable within the same collection zone where there are significant cost differences associated with collecting the checks. Normally, pilot tests are conducted to gain experience before putting out a proposal for public comment. But, profiting from earlier experience, the Board asked for public comment before starting up the pilot.

It was a good thing we did, since the responses indicated industry concerns. For example, some depository institutions were concerned that the collecting institution would experience difficulty in reconciling its Federal Reserve bill and passing along the charge to its customers.

The original proposal has been modified to address these concerns, by making two-tiered pricing available to depository institutions on a voluntary basis.

The pilot program will be implemented at only two Reserve offices. Information from the pilot will then be shared with the banking industry and evaluated by the Board. I would emphasize that the Fed has no present plans for introducing two-tiered pricing on a wider geographical basis, although that possibility has not been ruled out.

Informal discussions with industry representatives as regards the two-tiered pricing pilot program have been beneficial in helping us understand concerns of the industry and affording us an opportunity to explain our objectives and purposes. Such informal dialogue between representatives of the banking industry and representatives of the Federal Reserve is increasingly being used to good advantage. That is a development that offers promise for the future.

The Fed is committed to improving the payment system and has initiated further study on some major service enhancements and new services to foster that objective. Two major areas currently under study include improvements in return item processing and check truncation. Progress in these two areas could make a substantial contribution to making the payment system more efficient and safer. You in the banking industry have much to gain, as does the public at large. The potential for progress in those two areas will be much greater if the Federal Reserve and the banking industry work constructively together.

As most of you probably know, the Dallas Reserve Bank currently is conducting a multi-phase pilot program designed to test the feasibility of unbundling unpaid items, returning them directly to the institution of first deposit, processing return items not originally presented for collection through the Fed, and providing notification of all large dollar returns. Phases I and II have been implemented to date. Phase I unbundled the return item fee. Eleventh District payor institutions were assessed a $.50 per item charge for each return. In addition, notification was provided on all returns over $2,500. Only unpaid items originally collected through the Fed were eligible, and items were returned through the normal collection chain. Phase II was implemented in October 1983. During this phase, the Eleventh District offices began returning unpaid items directly to the institution of first deposit located within the Dallas District. Also, unpaid items were accepted for processing that were originally collected outside the Fed.

Results of the first two phases of the pilot have been encouraging. We are still studying the legal issues surrounding the program. In addition, a cost-benefit analysis is being conducted of expanding the program nationwide. This analysis will include the cost of the current return item system to the banking industry. As you know, the BAI has been collecting these data as part of its recent survey on check collection costs. We hope to have the cost/benefit study completed shortly. At the same time, we will be finishing up our studies on the legal and operational issues associated with expanding the Dallas pilot. At that time, a decision will be made on publishing a proposed amendment to Regulation J that would permit all Reserve Banks to provide these services.

Recently, the Federal Reserve approved an amendment to Regulation J that would require a payor institution to notify the institution of first deposit in a timely manner when a check in the amount of $2,500 or more originally collected through the Federal Reserve is being returned. The banking industry was invited to comment on this proposal, and over 250 responses were received. Comments were generally supportive, and we recently adopted the proposal to be implemented in October 1985. The Fed also took note of the commenters' suggestions that extension of the notification requirement to all return items, whether or not the checks were originally collected through the Federal Reserve, would greatly enhance the benefits of the proposal. The Board has recently sent a letter to the House and Senate Banking Committees recommending legislation to make that possible.

Commenters also suggested a number of other initiatives for improving return item processing, many of which the Federal Reserve already was exploring. A list of these proposals would include:

a) Enforce existing endorsement standards.

b) Consider Regulation J changes to facilitate use of courier where faster than U.S. Mail.

c) Pursue legislation to permit direct return in all remaining jurisdictions.

d) Evaluate a proposal to use the regular check collection system for processing returns.

e) Consider having the Federal Reserve provide a universal return item service.

f) Consider Regulation J changes to extend the midnight deadline for the return of small dollar items.

g) Consider extending the St. Louis Reserve Bank pilot progam which automatically reenters for collection low dollar return items upon request of the individual depository institution.

An informal industry advisory group consisting of representatives of trade associations and depository institutions was recently formed and met to review and advise the Federal Reserve on return item initiatives. This group plans to meet on an _ad hoc_ basis to discuss the status of these initiatives.

Another development that has great potential to improve the payment mechanism is check truncation. The

Federal Reserve is about to begin a limited pilot operation at four Reserve Banks to test the operational feasibility of truncating selected checks and share drafts for a limited number of payor institutions. The pilot will include all aspects of a truncation operation, including MICR capture, tape delivery or data transmission of check data to the payor, microfilming, information storage and retrieval, storage of the physical check for a limited period of time, and handling of returns.

In addition, discussions are underway between the Fed and the National Association of Check Safekeeping (NACS) concerning the Fed's participation in its truncation program on a pilot basis. In the NACS program, participating commercial banks agree to truncate certain low-dollar checks drawn on other participating banks. Check payment information is exchanged electronically via the ACH. Should these experiments prove successful, the Board may consider publishing for public comment toward the end of the year a more permanent Federal Reserve involvement in truncation.

In years to come, the payment system in this country will continue to evolve as rapidly as it has in the recent past, if not more so. Further gains in efficiency are most likely to come through the application of electronic payment systems. However, since checks will continue to be around for awhile, the Fed will continue to pursue long-term initiatives designed to improve the check payment process as much as possible.

Many areas of improvement are being pursued by the Federal Reserve with the cooperation of others involved in the payment industry. The Treasury Department has recently agreed to participate with the Federal Reserve in a study of the feasibility of image processing for government checks. This new technology would electronically record (digitize) the image of the check so that it can subsequently be reproduced in its original form. If the study suggests that image processing has the potential to make further improvements to the check collection system, the Federal Reserve may encourage other providers of payment services to join in developing this technological concept.

With the industry's involvement, the Federal Reserve also intends to explore automated processing and other enhancements to speed the processing of return items, rejects, and other check categories. The Federal Reserve is considering development of an RFP for this purpose.

In short, we can all contemplate an exciting future. We in the Federal Reserve look forward to working with you in the banking industry in improving the check collection system during the years to come.

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