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**Challenges to the Federal Reserve
in the Payments Mechanism**

Presentation by

Manuel H. Johnson

Vice Chairman

Board of Governors of the Federal Reserve System

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Challenges to the Federal Reserve in the Payments Mechanism

It is a pleasure for me to be here in Williamsburg to participate in this conference, which affords us the opportunity to analyze payment system issues from an economic and public policy perspective. My interest in the payments system began while I was at the Treasury Department. It was during that time that the Treasury made a long term commitment to convert as many Government checks as possible to electronic payments. I was a strong advocate of that commitment despite a substantial reduction in the float benefit enjoyed by the Treasury as payments were converted from checks to electronics. While the benefit of float enjoyed by the Government has been significantly reduced, this has been offset by reduced Government operating costs and improved services to recipients of such payments.

My interest in payment issues intensified two years ago when I was appointed Chairman of the Federal Reserve's newly organized Payments System Policy Committee. That Committee, which consists of two other members of the Board of Governors and two Reserve Bank Presidents, is responsible for recommending policy positions to the Board on major payment system matters. Jimmie Monhollon of the Richmond Reserve Bank served with us in an ex officio capacity during his term as the Federal Reserve's electronic payments product director and Bob Eisenmenger now plays that role. Since its inception, the Committee has focused

most of its attention on the issue of payment system risk. That issue will continue to dominate the Committee's agenda as we work to develop a long-term strategy for controlling risk on larger dollar payment systems.

Finding solutions to credit and liquidity risks associated with large-dollar systems is critical because of the continuing growth of these payments and the large exposures faced by participants in these systems. This issue has taken a major share of this symposium's time, which is understandable given both the Federal Reserve's and the industry's attention to this matter, as well as the fact that the value of payments flowing over Fedwire and CHIPS account for 82 percent of the value of all U.S. payments. I will discuss the risk issue in some detail in a few moments, but first I would like to consider the more central issue of making the payment system -- broadly defined -- more efficient. This issue is of no small importance, for as Bob Eisenmenger as indicated, the resources spent by this country on processing payments may be as high as \$60 billion annually. To put that cost in perspective, it represents about 1 percent of GNP.

The Humphrey-Berger paper highlights one of the fundamental problems with the nation's payments mechanism. The most popular payment instrument, other than cash, is the paper check, which continues to grow in popularity. Although significant progress has been made in making the check collection

system more efficient, the check is still one of the more expensive instruments to use. Humphrey and Berger estimate that the average cost of a check is \$.79, which is more than twice the cost of an ACH item. Despite this sizable cost disadvantage, the number of check transactions is 50 times greater than ACH volume.

One cause of the overutilization of the check is the market's failure to allocate the cost of float to the check writer. This failure may be one of the primary reasons corporate trade payments are still predominately made by check. There is, however, another major reason that the market has failed to adopt a lower cost payment method, especially in the area of consumer payments. Banks typically do not price their services to encourage the use of the most efficient payments method. The common practice of charging a flat monthly fee or waiving fees if balances are above a certain amount does not encourage ACH utilization. Similarly, the lack of price differentiation between ACH and check also fails to encourage ACH direct deposit. Until corporations negotiate settlement terms for trade payments and banks develop more realistic pricing strategies, the annual growth in check volume may continue to outpace the growth in ACH transactions.

Given the heavy public demand for checks, and as a major payments system participant with a public interest perspective, the Federal Reserve is faced with an increasing dilemma: what is the proper balance between efforts to improve the check system and efforts to improve electronic payment services?

Congressional action in the past has led to the Federal Reserve taking steps to improve the check collection system. For example, efforts to reduce Federal Reserve float, as a result of the passage of the Monetary Control Act, have been quite successful. Over 20 percent of the checks processed by the Reserve Banks clear at least one day faster today than prior to 1981. Accelerating the collection of checks increases the attractiveness of the instrument to the receiptant. On the other hand, it encourages the growth of electronic payments by reducing the float benefits enjoyed by the check writer. But such inducements to move from checks to electronics are, unfortunately, modest because the float caused by the Federal Reserve is small relative to the float generated by delays prior to deposit and in bank clearings.

Last year, as part of the Expedited Funds Availability Act, Congress gave the Federal Reserve broad authority to improve the check system, with the expectation that the Federal Reserve would use that authority to speed the check collection and return process. Earlier this month, the Board approved a new regulation and a series of new services to be offered by the Reserve Banks designed to improve the processing of checks that are returned unpaid. These improvements will, over time, reduce the cost of the check collection system and the risks merchants face in accepting checks.

Thus, for the foreseeable future, and absent the reforms mentioned by Humphrey and Berger, the check will continue to be overutilized. The foreseeable challenge of the Federal Reserve and the banking industry is, therefore, to develop new processing techniques to migrate the check system toward electronics. The Congress has directed the Federal Reserve to consider the use of interbank truncation of checks and other electronic means to improve the check collection system. Studies have concluded that truncating checks early in the processing stream will reduce costs by eliminating the movement of paper. The banking industry initiated a program to truncate checks at the bank of first deposit about 10 years ago, but unfortunately, the types of checks eligible for truncation under that program are quite limited. The Federal Reserve Banks will be working with the banking industry to increase the volume of checks eligible for interbank truncation and to provide services to assist banks in clearing these checks electronically. Federal Reserve involvement hopefully will spur the development of this promising technique.

In comparison with the check, the ACH is a very efficient payments mechanism for a variety of consumer and corporate payments. The ACH is the most successful electronic payments network in terms of volume. I exclude ATMs from this conclusion because they are primarily a new method for delivering an old payment instrument--cash. Yet, we need to ask (1) whether

the ACH is as efficient as it could be; and (2) whether more can be done by the Federal Reserve and others to encourage use of the ACH.

On the first point, I would agree that as long as the ACH mechanism is not all-electronic, the ACH will not operate at its optimal efficiency. Presently, over 80 percent of ACH payments are submitted for processing on magnetic tape or delivered to the receiving bank on paper listings. This requires extensive manual handling at the banks, their processors, and at the Reserve Banks. Consequently, the ACH is more prone to human error and delays than if all payments were exchanged via telecommunications.

The Federal Reserve has been promoting a more electronic ACH by offering reliable, secure, and cost-effective electronic connections. In addition, we have set high fees for the manual aspects of ACH processing to cover the higher cost of these services and to create incentives for depository institutions to use direct electronic access to the Reserve Banks. These measures, however, have not been sufficient to cause a widespread conversion to electronic ACH access.

Perhaps the time has come to establish a sunset date for institutions to convert to ACH electronic access. This approach was recently taken by the New York Automated Clearing House, in its mandate to New York member institutions to convert from manual tape exchanges to data transmissions by 1990. This

policy has generally been viewed as positive by the financial community and has met with little resistance from the New York member institutions.

Other than converting to an all electronic ACH, is there more that the Federal Reserve and the financial community can do to encourage the use of the ACH? For example, should the Federal Reserve subsidize the ACH for the good of the payments mechanism? Prior to 1986, we did subsidize the ACH. This policy, however, had little effect on consumer and corporate demand for electronic payments because the Federal Reserve's cost of several cents per transaction is a small fraction of the total handling cost of an ACH transaction.

Berrell Stone has identified a number of improvements in his paper that can be made to make the ACH more attractive to banks and their corporate customers. However, in my view, those changes alone are unlikely to accelerate the growth of ACH payments. Until progress is made on either shifting the cost of float to check writers or until banks develop new pricing strategies that reflect check costs, use of the ACH will in all likelihood continue to grow at its current pace.

Another significant challenge facing the Federal Reserve and the banking industry is reducing the risk associated with large dollar payment networks. While there is risk of financial loss from using any payment instrument, the risk of a catastrophic loss that could destabilize the entire payments

process is far greater on large-dollar networks. Exposures on Fedwire, of course, are fully absorbed by the Federal Reserve, but there remains the specter that an individual bank unable to settle its position on a private network could induce other banks to fail as well. Indeed, the Federal Reserve's concern about systemic risk in the late 1970s and early 1980s was the original catalyst for the development of the Federal Reserve's Payment System Risk Reduction program. This background was discussed in the paper by David Mengle presented yesterday afternoon.

That daylight overdraft program, as this audience well knows, is now under intense review. The Payment System Policy Committee has recently reviewed a System staff report that analyzed a series of policy options as a first step in developing the next phase of the risk reduction program. In mid-June we will hear the views of the Large-Dollar Payments System Advisory Group, so ably chaired by Roland Bullard, on these options. The Policy Committee will then develop a specific proposal that will be reviewed by the full Board and eventually published for comment later this year.

It is fair to say that the Policy Committee's views are still evolving. Nonetheless, I would like to share with you the nature of the options facing the Committee and the Board. As is true of most complex issues, significant trade-offs will be required to achieve risk reduction without unduly hampering the payments system. On the one hand, we want to reduce both the

Federal Reserve's own direct risk of loss from an institution that fails while in overdraft with us; such risk, after all, is borne by the taxpayer. There is considerable support for an approach that shifts more of the risk exposure to private market participants, on the presumption that, if risk responsibility can be clearly assigned, markets will not only allocate daylight credit more effectively but the level of aggregate exposure will also decline.

On the other hand, as payments and intraday exposures shift to private networks and intraday markets, the systemic risk created rises, which remains one of our major concerns. Indeed, a prerequisite of any policy that shifts daylight exposure to the private market is the planned adoption by CHIPS of policies to further 'internalize participant banks' risks, i.e., to make banks responsible for the risk they create by some form of settlement finality and loss-sharing. But, even after such steps are taken, there still remains the gnawing concern that a significant increase in the share of intraday credit in the private sector may expose the banking system to unacceptably high risk. This balancing of systemic concerns against the efficiency and likely reduction in exposure associated with assignment of risk responsibility to its creator is at the heart of the decision making process on evolving payments system policy.

Development of a revised program is further complicated by several important constraints, which require the policy maker

to face and choose among still additional trade-offs. Indeed, it is impossible to reduce risks without breaching some of these constraints and thus our decisions will require some complicated weighting of costs and benefits. For example, we certainly do not want the next phase of the risk reduction program to slow payments flows, nor do we want to increase unduly the cost of transmitting payments. We also need to be sensitive to the competitive impact among providers of payments services. Moreover, we must be cautious that our daylight overdraft policy does not interfere with the conduct of monetary policy or increase the cost of the Treasury's operations unnecessarily. Finally, we must be sensitive to the possibility of driving risk offshore, with the same exposures to the U.S. financial system hidden from our view or beyond our control, and must guard against a policy that inadvertently places U.S. banks at a competitive disadvantage vis-a-vis foreign bank suppliers of dollar payment services.

Thus, in making our policy decision we will be forced to balance competing goals. The techniques available to us for developing policy--the menus from which we will choose individual and/or combinations of policy steps--are well known. We can, for example:

- o lower caps
- o prohibit daylight overdrafts
- o adopt explicit prices on our own intraday credit
- o collateralize intraday credit
- o impose higher clearing balances

The Committee has not decided what policy option or combination of options is the best course of action. Any policy or combination of policies that significantly increases the cost of using Federal Reserve intraday credit will have similar effects on payments users and suppliers, namely, the development of intraday private credit markets and higher user prices for large-dollar payments services. There is, I think, a growing consensus that such a development will more prudently and efficiently allocate the private benefits and private risks--and I hope reduce the public and total risks--of our nation's large dollar payment networks. But while all policy approaches can end up with the same general impact, each of these options implies different trade-offs between direct and systemic risks, as well as different effects on the speed and cost of payments.

The choices will be difficult, but the time for choosing policies has arrived. And, I, for one, am optimistic that the private sector and the Federal Reserve have come to recognize our common problems and are considering similar ways of addressing them.

During the past twenty minutes, I have highlighted just a few of the many challenges facing both providers and users of payment services. Both the Federal Reserve and the banking industry share in the responsibility of meeting these challenges. The Congress has charged the Federal Reserve with promoting a stable payment system. In addition, the mission of the Federal

Reserve in providing payment services is to promote the integrity and efficiency of the nation's payments mechanism. The banking industry, acting as both a user and provider of payment services, has a large economic interest in reducing both risks and the resources allocated to payments processing. The Federal Reserve has worked very closely with the banking industry in developing the large dollar risk reduction program that is now in place. If we continue to work together I am confident that progress will be made on meeting the challenges that have been discussed during the past two days.