For release on delivery
9:00 a.m. E.D.T.
May 2, 1990

Remarks of

Manuel H. Johnson

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Annual Conference of the

National Automated Clearing House Association

May 2, 1990

Washington, D.C.

Good morning ladies and gentlemen. I would like to thank Elliott McEntee and the National Automated Clearing House Association for inviting me to speak at your annual conference. I consider it a valuable opportunity to meet with bankers and corporate cash managers to discuss payments system issues.

My responsibility this morning is to set the stage for the panel discussion that follows by providing a broad policy perspective, from the standpoint of the Federal Reserve, on the evolution of the payments system. In doing so, I will stress the three primary attributes a payments system should have, namely, safety, responsiveness, and efficiency. Both the private sector and the Federal Reserve have contributions to make in helping ensure that these attributes characterize the payments process.

I believe that now is a particularly appropriate time to reflect on the safety, responsiveness, and efficiency of the payments system because significant regulatory, technological, and structural changes are occurring that have important implications for its evolution.

Clearly, a strong and healthy payments system is critical to a smoothly functioning financial system. This has always been true domestically and is now taking on global importance as financial markets become increasingly integrated internationally. Linkages between national payments systems provide the support necessary for the world economy to function effectively. At the same time, these payments system linkages pose new challenges in that financial disturbances in any part of the world are now felt directly, through the international payments process, in the rest of the world.

As the nation's central bank, the Federal Reserve has a particular interest in payments system safety, especially from a systemic perspective. A primary objective is to ensure the integrity of the payments <u>process</u>, not just the soundness of individual linkages in that process. A safe payments system is based on both credit safeguards and operational controls. Credit safeguards allow payments system participants to control their direct credit risks and, if effectively constructed, can limit the potential for systemic failures, that is, the danger of financial difficulties spreading throughout the system. Operational controls provide the tools that allow payments system participants to implement the credit safeguards.

In June 1989, the Board issued proposals to address the risk faced by the Reserve Banks as providers of payments services, through their extension of intraday credit to depository institutions. The Board also issued a policy statement setting forth the risk-controlling features that should be followed to help ensure that private book-entry delivery-against-payment systems settle in a timely manner should a participant not be able to meet its obligations. The four basic risk-controlling features are:

1. liquidity arrangements, to provide access to sources of readily available funding to complete the settlement;
2. avoidance of reversals of funds and securities as a substitute for liquidity arrangements, inasmuch as payments reversals simply act to transfer a liquidity shortfall;
3. credit safeguards, for example, bilateral credit limits, collateralization of daylight credit, and the like, together with formal loss allocation rules, to help ensure an orderly settlement; and
4. monitoring systems that provide timely information to the participants on their net positions and on progress in achieving settlement, or what is called "open settlement accounting."

Although specifically tailored to delivery-against-payment systems, this policy statement nevertheless embodies principles that should be reflected in virtually any private payments clearing arrangement.

The payments system should also be efficient in terms of accurately assigning the operating costs and the implicit costs associated with managing clearing and settlement risk -- in other words, the risk associated with a counterparty's inability to meet its payments obligations. Although reducing clearing and settlement risk could entail increased transaction costs for payments monitoring and other operational control safeguards, skimping on such safeguards in the name of operational cost containment could result in higher clearing and settlement risks. For example, clearing arrangements that involve the netting of transactions exchanged among a group of participating institutions, called multilateral netting, enable participating institutions to reduce their gross payment obligations to a single net obligation per institution, thus lowering operating costs and reducing liquidity needs. Such netting arrangements have many positive benefits but must be accompanied by appropriate operational and legal safeguards to control intraday credit exposures. Such safeguards, I believe, are in general appropriate for virtually all private clearing arrangements, including small dollar value systems such as ACHs, to ensure both a safe and efficient payments process.

Private and Public Roles in the Payments System

Maintaining a viable and robust payments system requires contributions by both the private sector and the Federal Reserve in the areas of safety, responsiveness, and efficiency. These contributions are, to some extent, shaped by the differing roles of the private sector participants and the Fed. Private firms operate in a competitive environment and are motivated by profit maximization. This environment applies to payments services and provides a strong incentive to meet customers' needs and to adapt services to meet customer requirements that change over time. The Federal Reserve, of course, shares in this incentive as a result of the Monetary Control Act of 1980, which requires it to earn an imputed return called the private sector adjustment factor.

Like the private sector, the Federal Reserve provides payments services, although in a highly specialized manner and primarily to depository institutions and the U.S. Government. The Fed might be viewed as the "backbone" of the payments system, connecting depository institutions nationwide through services and through the depository institution accounts maintained on the books of the Reserve Banks.

In the role of payments service providers, the Reserve Banks are restricted as to what services they may provide and how these services are offered and priced. In particular, the Reserve Banks must offer the same published prices and provide the same services to all depository institutions. While the private sector also supplies some "backbone" services, it primarily meets the needs of the end users of the payments system, including businesses and individuals.

The Federal Reserve's unique role in the payments system is to provide a sound policy basis for a safe payments system and, to the extent that it has an operating presence, to serve as a source of stability in times of financial stress. The Fed can also use its accounting relationship with depository institutions to facilitate the efficient settlement of payments that are cleared directly between depository institutions, subject to provisions that ensure the integrity of the payments process.

The Evolving Payments System

Regulatory, technological, and structural developments are changing the financial landscape and, as a result, may significantly alter the Federal Reserve's and the private sector's participation in the payments process. Regulatory and policy changes, for example, are causing depository institutions to internalize the full costs of the payments process. This shift began with the enactment of the Monetary Control Act of 1980, when the Fed was required to price its services explicitly. Charging what now amounts to over $700 million annually to service users has helped to spur competition and, on net, has reduced reliance on the Fed as a service provider. More recently, the Board's payments system risk reduction program has made participants in the payments system more aware of the implicit cost and risk of utilizing intraday credit as part of the clearing and settlement process. In this connection, the Board's proposal to begin pricing daylight overdrafts provides a further incentive to privatize payments processing by reducing the implicit subsidy offered through free Federal Reserve intraday credit.

Technological changes are also having a significant effect on the payments system. Advances in data processing and telecommunications are rapidly reducing the costs of providing payments services, thus allowing easier entry into the payments market, both regionally and nationally. Other things equal, this implies increased potential for private processing of payments, especially in electronic services such as ACH.

Finally, as we all know, the U.S. financial services structure is undergoing significant change. From a decentralized structure with statutory and regulatory limitations on the lines of business that various types of institutions can participate in, the financial system is evolving into a more national and, I believe, competitive industry. The most likely outcome will be relatively fewer financial institutions serving a broader customer base and offering a wider variety of financial products and services, including payments services.

The overall implication of these changes, in my view, is greater privatization of the payments system in the 1990s and a relatively smaller operational role for the Federal Reserve. In short, depository institutions will have additional incentives to assume more of the "backbone" payments processing and will be better able to do so as a result of technological and banking structure changes. As privatization of the payment process proceeds, the Federal Reserve, as the central bank, will exercise its policymaking role to help ensure a safe and sound evolution of the payments process. At the same time, I believe that the Fed will continue to be a broad-based provider of payment services, ensuring access to reasonably priced services by all depository institutions, including those that private providers may be unwilling to serve. In addition, the Federal Reserve will continue to provide settlement services -- where private clearing arrangements have appropriate credit and operational controls -- in order to facilitate the efficient handling of payments.

## Conclusion

Thus, despite what I perceive as a relative shift toward private-sector processing of payments in the decade ahead, the Federal Reserve will continue to play an integral role in the nation's payments system. In the future, this role will be exercised more along policy than operational lines, although both functions should continue. Private-sector providers of payment services and the Federal Reserve must make unique contributions in order to achieve the common objective of maintaining a robust and viable payments system. By performing their respective roles, the private and public sectors can adjust to change in a manner that results in a more responsive and efficient payments system that ensures the integrity of this critical financial process.

Thank you.