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Statement by

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before the

Subcommittee on Financial Institutions

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

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I appreciate this opportunity to present the views of the Board of Governors on S. 1008.

The Board welcomes Chairman McIntyre's call for a constructive dialogue on the issues addressed by this legislation: namely, extension of the authority to regulate interest rate ceilings on deposits and the development of negotiable orders of withdrawal ("NOW's") for use by savings account customers as currently offered by mutual savings banks in Massachusetts and New Hampshire. In particular, the appearance of NOW accounts as a competitive mutation somewhere between traditional demand deposits and savings deposits compels a reconsideration of the roles of thrift and banking institutions in the payments mechanism today and in the future.

First, let me comment on section 1 of S. 1008, which would extend for one year, through May 31, 1974, the authority granted in 1966 for flexible and coordinated regulation of rates payable on time and savings deposits. The Board continues to recommend that this authority be made permanent. This is not to say that interest rate ceilings on time and savings deposits should be forever in place. In making the authority permanent, Congress would, of course, enable the regulatory agencies to adjust or suspend the ceilings when conditions warrant.

NOW Accounts

With respect to NOW accounts, let me say at the outset that the present situation, from the standpoint of the financial institutions that compete with mutual savings banks in New Hampshire and Massachusetts, is an intolerable one. The Board shares the concern of those who feel that the developments in New England have occurred without the needed guidance from Congress to insure competitive equity.

If they are left to develop without proper consideration of their competitive impact, the adverse effects of NOW accounts on other institutions could become extremely serious. Should this subcommittee, and the Congress as a whole, find NOW accounts to be a worthwhile initiative, then ways must be found for an orderly phasing-in of similar powers for all financial institutions along with their assumption of comparable regulatory constraints.

The Board believes the program I shall outline below meets the need for competitive equity while still recognizing the desirability of improvements in the banking and money services offered to the American family. Corporations, governments, businesses, foreign institutions, and nonprofit entities find it more feasible than individuals to keep surplus funds continuously invested. By and large, most families are dependent on the range of services and yields which depository institutions are willing and able to offer them. The Board's program would provide more leeway for competitive forces to enrich and extend the services of depository institutions.

At the same time, however, the public interest and simple fairness suggest that any such changes be accompanied by the imposition of competitive equity in interest rate ceilings, reserve requirements, and tax treatment. The adoption of the legislative proposals I shall outline could go a long way toward the establishment of a firm base for continued evolution of a banking and financial system geared to the needs of the economy.

Legislative Recommendations

The Board suggests a three-part legislative program:

(1) All financial institutions should be authorized to offer money transfer services on savings accounts that bear interest, and that are used primarily for household purposes. These accounts ("family accounts") would be subject to regulation by the appropriate Federal regulatory authorities and to the conditions set forth in (2) and (3) below.

(2) "Family accounts" in all financial institutions should be subject to identical interest rate ceilings set by the appropriate Federal regulatory authorities. This requirement applies to all financial institutions, whether they operate under Federal or State charter.

(3) All institutions offering "family accounts" should be required to maintain identical reserves against these accounts with the Federal Reserve System, in accordance with regulations to be established by the Board. Limited access to the Federal Reserve's discount window might be provided institutions maintaining such reserves.

The first recommendation extends to commercial banks, savings and loan associations, savings banks, and certain other depository institutions the right to offer their customers what are in effect checking services on savings accounts, as this power may be circumscribed by their respective regulatory authorities. Checking or transfer privileges for interest-bearing accounts should be limited, in the first instance, to accounts owned by individuals. Savings and loan associations at present have limited money transfer powers, but have exercised them very little. Other institutions generally have not acquired this power, though there are some exceptions established by State law.

Under the second recommendation, the Federal regulatory agencies would establish competitive equality among various types of institutions with respect to the new category of "family accounts." A permissible interest rate ceiling for such accounts might lie somewhere between the rate currently allowed on passbook savings accounts and the zero level accorded demand deposits. The flexibility with regard to interest rate ceilings would allow for an orderly phasing-in of "family accounts" in institutions choosing to offer them.

The regulatory agencies should be given sufficient latitude to distinguish accounts affording instant liquidity in the form of money transfer facilities from other savings and time deposits for the purpose of establishing interest rate ceilings. Regular savings accounts, at higher interest ceilings but without checking or transfer privileges, would continue to be available to individuals and others who now may hold such accounts under existing regulations.

The third recommendation, relating to reserve requirements, reflects a position the Board has held for some time, namely that there be universal applicability of reserve requirements established by the Federal Reserve to institutions offering money transfer services.

In part, this recommendation arises out of the need for competitive equity--having all institutions that share the same money transfer functions also sharing the economic burden embodied in the reserve requirements set forth by Congress in the Federal Reserve Act.

Beyond this, however, the monetary control exercised through reserve requirements should impinge on all institutions participating in the nation's monetary processes and mechanisms.

To require the maintenance of nonearning reserve assets by only one class of institutions--commercial banks that are members of the Federal Reserve System--is not only unfair competitively, and, therefore, likely to be less beneficial to the public, but it also makes reserve requirements less useful as an instrument of Federal Reserve policy. As the institutional source of the money supply broadens--and it will if savings institutions continue to move in the direction indicated by the NOW account--the reserve base should also broaden, so that monetary policy actions can be smoothly transmitted through the entire financial system. As it applies to "family accounts," this argument would require that member and nonmember commercial banks, as well as thrift institutions, should have identical reserve requirements.

Transition to New Structure

If the Congress accepts this principle with respect to "family accounts," the Board would want somewhat greater flexibility in the range of reserve requirements which can, by statute, be imposed on various types of deposit liabilities. The statutory range on time deposits, now from 3 percent to 10 percent, might well be extended downward, for instance, so that consideration could be given to reducing to minimal levels reserve requirements on the smaller personal time and savings accounts of the types now held by banks and thrift institutions. The new "family accounts" might bear a reserve requirement somewhere between the present statutory minimum requirement on savings accounts--3 percent--and that on demand accounts--7 percent. Commercial banks and thrift institutions would add to their reserve accounts with the Federal Reserve at this rate as their "family account" business grew.

The transition to this new structure would require care and time to work out any monetary policy effects and to prevent any unfavorable effects on particular institutions; but, with cooperation on the part of the Federal regulatory authorities, it could probably be accomplished without great difficulty.

The Board looks forward to the extension of transfer powers to thrift institutions, therefore, only if there is a corresponding assumption of costs and public responsibilities by those institutions. The development of the NOW account and similar instruments makes it clear that the need for Congress to deal with the question is urgent, even though implementation of any changes Congress authorizes will necessarily be gradual.

Three General Principles

The Board's legislative recommendations have been developed while keeping in mind the Federal Reserve's present responsibilities in operating a clearing system for the handling of checks. The Federal Reserve regards its role in expediting and accommodating money transfers as highly important.

The Board believes, first, that so far as public participation and support are concerned, there should be a single, integrated nationwide mechanism for efficient transfer of funds. The existing system, using checks and drafts, and functioning through commercial banks and the Federal Reserve Banks, is substantially of that character. In this connection, the Federal Reserve's Steering Committee on Improving the Payments Mechanism issued a statement in December elaborating on this and other points and I am attaching a copy of it for your use.

Second, even allowing for the existence of private clearing arrangements, the Board believes that the public system using check or electronic transfers of funds from one institution to another should be such as to insure that the conditions of entry into a general clearing arrangement are fair, and that equitable treatment is assured for institutions with similar powers and responsibilities.

Third, the costs of the transfer system and the benefits of participating in it should be equitably distributed among all of the institutions involved, and among their depositors.

As implied in the foregoing, the Board believes in comparable treatment for institutions having like powers, but the existing situation fails to meet this standard. Some institutions, namely, banks which are not members of the Federal Reserve System, have a competitive advantage. Although in most States the nominal reserve percentage for banks is comparable to that imposed on member banks, the reserves required by the States may be carried in the form of what are effectively earning assets: Government obligations and correspondent balances. Reserves maintained with the Federal

Reserve, on the other hand, are generally nonearning assets. Although nonmember banks do not keep reserves with the Federal Reserve, nevertheless they are accorded certain Federal Reserve check clearing services deemed essential to the public's need for prompt money payment. If, in the future, extensive checking account powers are developed for savings institutions, the extension of the benefits of the payments mechanism, whether conventional or electronic, to such institutions, without their assuming a fair share of the costs, would exacerbate existing inequitites.

Background for the Evolving Payments System

Describing some of the background behind the principles enumerated above can help indicate how NOW accounts are related to larger developments in the payments system. For some years, concern has been growing that the volume of checks being handled is reaching the point where our present check collection and clearance systems will soon be inadequate. Last year, for example, individuals and institutions in this country wrote somewhat over 25 billion checks. Those checks were drawn on 94 million accounts with balances aggregating $192 billion. Seventy-nine percent of these accounts had balances of less than $1,000--the average was $253; nearly all of these accounts were "family" or personal.

To process nearly 500 million items weekly, about 30 percent of which flows directly through Federal Reserve facilities, we have stepped up check processing activities, revised procedures, and installed new electronic processing and wire transfer equipment. Yet we anticipate that in five years, money transfers will increase about 1-1/2 times from the levels in 1972. Obviously, we must move, and should move quickly, to a system placing much greater reliance on the electronic transfer of funds.

Up to now, the bulk of the expenditures for research and development in the payments area has been borne either by the Federal Reserve or by commercial banks. This activity has had tangible results. In the summer of 1970, the Federal Reserve System opened a new electronic communications center, equipped with special-purpose message switching units capable of high-speed transmission, to provide for anticipated increases in funds transfer and other types of electronic messages.

Individual banks are experimenting with electronic payments systems using terminals in retail stores that can be activated by plastic cards. On a more comprehensive basis, the Federal Reserve has cooperated with banks in Georgia and California in drawing up plans for payments systems which will minimize paper and emphasize electronics. More recently, the thrift industry has begun to consider the implications of electronics payments. The mutual savings bank industry last July incorporated MINTS (Mutual Institutions National Transfer System) as an affiliate of their association.

There appears to be no question that this attention to the future shape of the payments system, shared by the Federal Reserve, is both necessary and timely. The more innovative thinking that is applied to the problems involving the payments system, the better the ultimate solutions will be.

At present there are 163 million savings accounts at financial institutions with balances totaling $310 billion. About 52 per cent of those accounts are at commercial banks; 20 at savings and loan associations, 13 per cent at mutual savings banks and 15 per cent at credit unions. About 71 per cent of these accounts have balances of less than $1,000, and they average about $189 per account. The bulk of the money in savings deposits, about 74 per cent, is found in those accounts with balances between $1,000 to $20,000. The institutional shares in savings accounts, measured by dollars rather than number of accounts, are: commercial banks, 39 per cent; savings and loan associations, 32 per cent; mutual savings banks, 22 per cent; and credit unions, 7 per cent. (See table attached.)

Today, large corporate customers monitor their demand balances with great skill, keeping them just at the levels required to cover credit availability and the costs of money transfer services they receive. Any additional funds they have are invested in such assets as Treasury bills, commercial paper, and bank negotiable certificates of deposit. Individuals, too, have moved some of their funds from demand deposit balances into interest-bearing accounts. They may want to reduce further the proportion of their funds kept in demand balances.

Thus, by offering the convenience of NOW accounts, some mutual savings bankers have gained an early start in a possible evolution of the payments system that is logical and probably feasible. They have opened an avenue of exploration as to what type of deposit account ought to be available to consumers in coming years, regardless of present practices.

By building on past experience, it would be both prudent and responsive to afford household savings accounts greater flexibility through granting the regulatory agencies authority to approve money transfer arrangements as technology evolves. The proposals set forth above are consistent with this view.

Attachments.

Evolution of the Payments Mechanism

The following statement was prepared by the Federal Reserve System Steering Committee on Improving the Payments Mechanism to inform the Nation's bankers and the public of the general direction of payments mechanism development as currently envisioned by the Committee.

The essential features of the payments system that is evolving in response to electronic technology are reasonably clear. These features are not likely to change drastically unless a new technology develops. Private and public roles in this system probably will be very similar to those in being today with financial institutions interfacing with the public and the Federal Reserve maintaining the interface among financial institutions. The Federal Reserve has indicated its intent to accommodate visible evolution in the payments mechanism by continuously improving and updating its facilities to handle a growing volume of funds transfers along the channels of likely development. Thus, the regional processing centers and expanded clearinghouse arrangements now being established by the Federal Reserve System in some 40 trade centers for handling checks may become the nuclei of interconnected regional communications networks for handling wire transfers of funds and financial data.

The System's role in facilitating the development of automated clearing facilities and the linkage of such facilities to provide a nationwide network for automated crediting systems or preauthorized debiting systems may pioneer a similar role in the experimental point-of-sale terminals. Such terminals, now linked to a single bank's computer and energized by a unique credit-card authorization system, with appropriate standards and interlinkage, may potentially provide merchants and consumers with a convenient means of consummating transactions at the point of sale over a broad range of merchants and financial institutions and over large geographic areas. These transactions encompass use of an electronic communications network to transfer payments originating (a) at a point of sale, (b) with a wage, salary, or other income payment, or (c) with an authorization to charge a depositor's account. This network would serve all accounts from which, or to which, payments are made.

CHANGES IN PROSPECT

The Nation's payments mechanism can be expected to evolve in the direction of a system where credit to the payee's account is made at the same time the payor's account is charged. Increasingly, these transfers will be made over a computer-directed communications network. As electronic transfers become technologically and economically superior, checks would be largely displaced. The use of the credit card, or a similar means of activating electronic payments transfers, should expand greatly. Much of today's paper-oriented operation would be displaced by electronic terminals at the point of sale for making direct funds transfers, with the related accounting being done by computers. Significant reductions in the volume of transactions made through the use of paper currency may also take place—by the use of point-of-sale terminals and through other electronic techniques.

The electronic funds transfer system is expected to evolve in a modular fashion through the development and interlinkage of a comprehensive series of computer-directed communications networks. At the local level, the system would include commercial banks and possibly other depositary institutions linked to point-of-sale terminals in retail establishments, to computers in businesses, and possibly to terminal devices in homes. Through these financial institutions, connection would be made to regional, national, and international networks, enabling the movement of funds nearly everywhere in the world.

DEPOSIT ACCOUNTS IN FINANCIAL INSTITUTIONS
JUNE 30, 1972

	IPC Demand Deposits 1/ at Commercial Banks 2/	Savings Accounts (Excluding Time Certificates of Deposit)				
		Commercial Banks 2/	S&L's 3/	MSB's 4/	Credit Unions 5/	Total
Number of Accounts (Millions)						
Size of Account						
less than $1,000	74.8	63.7	18.4	12.6	20.4	115.1
$1,000 - $20,000	18.2	20.2	12.8	8.8	4.7	46.5
$20,000-$100,000	.9	.5	.7	.5	*	1.7
over $100,000	.2	*	*	*	*	*
Total	94.2	84.4	31.9	21.9	25.1	163.3
Amounts (Billions)						
Size of Account						
less than $1,000	$ 18.9	$ 11.6	$ 3.8	$ 2.6	$ 3.8	$ 21.8
$1,000 - $20,000	62.8	85.1	76.6	52.5	15.8	230.0
$20,000-$100,000	36.9	17.0	19.3	13.2	.6	50.1
over $100,000	73.0	6.4	.8	.5	*	7.7
Total	191.7	120.1	100.5	68.9	20.2	309.7
Average Size of Account						
Accounts less than $1,000	$ 253	$ 183	$ 208	$ 208	$ 186	$ 189
Accounts $1,000 - $20,000	3443	4212	5967	5967	3338	4946

Totals may not add due to rounding.
* - less than .05.
1/ Demand deposits of individuals, partnerships, and corporations.
2/ FDIC Summary of Accounts and Deposits in All Commercial Banks-June 30, 1972.
3/ Number of regular accounts (exclusive of special accounts) and dollar amounts for size categories partially estimated from mutual savings bank data. Total dollar amount in insured regular accounts from FHLBB; total dollar amount in uninsured regular accounts estimated by Federal Reserve staff.
4/ FDIC Summary of Accounts and Deposits in All Mutual Savings Banks-June 30, 1972.
5/ NCUA - Breakdowns by account size estimated, based on 12/31/71 NCUA figures.

OBJECTIVES

The payments system as it evolves will need to be aimed at providing the public with a convenient, economical, and secure means of moving funds. In comparison to the present check and other funds transfer systems, the new payments system should:

- be more efficient, as electronic data processing and communications technologies replace labor-intensive processing procedures.
- provide a more secure method of payment, less subject to theft, loss, forgery, and alteration of payments data, and a method of tracing all transactions.
- assure a more equitable balance of the debit and credit effect on participants.
- accommodate both debit and credit transfers.

The system would continue to:

- provide for the continuation of competition among financial institutions.
- involve public participation and surveillance over private institutions' money role.
- be capable of providing timely and detailed data on money flows, trade volumes, and other payments-related information for use in monetary policy and other relevant applications.

FEDERAL RESERVE INVOLVEMENT

The Federal Reserve Act directs the Federal Reserve System to provide an efficient payments mechanism for the public. The policy statement of the Board of Governors on June 18, 1971, called for "basic changes in the Nation's system for handling money payments [as] essentially transitional steps toward replacing the use of checks with electronic transfer of funds."

In further development of the payments mechanism, the convenience and needs of the participants should continue to be the primary considerations. These needs may be summarized as follows:

Consumers need an economical means of payment that is acceptable anywhere; is less subject to theft than cash; is less subject to loss, forgery, and alteration than checks; facilitates the keeping of necessary personal records; and enables them convenient access to a wide range of services from financial institutions.

Businesses need a system that reduces the time, costs, and risks in making and receiving payments; that facilitates the transmitting, storage, and retrieval of associated information; and that provides better integration of business electronic data processing capabilities with the payments mechanism.

Financial institutions need a more efficient system of transferring funds—one that is less labor intensive—a system that will enable them to offer customers a wider variety of services, including informational services based on the improved data generated by the payments system.

Government needs are similar to those of business, but with the additional special need for greater security against theft of checks issued to the public.

ROLE OF THE FEDERAL RESERVE SYSTEM

It is anticipated that the Federal Reserve will install and manage a nationwide communications network through which interregional settlements between financial institutions will be made.

A number of other networks may exist. In part, these will be local and regional funds transfer networks in which Federal Reserve involvement may be minimal. The total of transfers internal to banking institutions may expand if demand deposit market shares become more concentrated. Thrift institutions may set up their own networks. Credit-card clearing networks may become more widespread.

The level of Federal Reserve involvement in different regional or local networks for transfer of funds will vary depending on the banking structure. The Federal Reserve should expect to monitor the regional and local networks to assure that a satisfactory degree of security is being maintained and that the capability for interfacing with the national network is obtained.

Since the payments mechanism will evolve continuously, the Federal Reserve should expect to continue its participation in this evolutionary process in order to assure the desired development and coordination of the payments system, to insure the continued competition among providers of financial services, and to protect the public interest.

ROLE OF FINANCIAL INSTITUTIONS

It is anticipated that private financial institutions will continue to play the predominant role in local and regional communications networks through which intraregional payments will flow.

The number of private facilities engaged in processing payments transactions may decline as branching systems and holding companies centralize their accounting operations, or as correspondent banks expand their accounting services, or as smaller institutions use specialized service bureaus or band together to perform demand deposit and other accounting services.

Nearly all financial institutions will be linked together through local, regional, or national communications networks by means of compatible input and output devices. Customers with larger volumes of transactions will interface into their banks' equipment. Competitive marketing of collection and payments services may become less localized. Through the use of advanced equipment, more and better services will be available to customers.

ROLE OF BUSINESS

The evolution of the payments system will enable business and governmental units to utilize electronic data processing equipment more fully and streamline their payments procedures. It will be possible to submit payments data to and receive payments data from financial institutions in electronically transferable form. Businesses can now use computer-oriented input to initiate payment from their own deposit accounts or, through preauthorization agreements, initiate payment from the deposit accounts of customers. They will be able to send to their customers machine-readable invoices that, when forwarded to the issuing companies or the customers' banks, will be transformed into electronic payment messages.

Larger business and governmental depositors will establish computer-to-computer connections with the financial institutions that hold their accounts. This option will permit greater competition for accounts because distances will have a diminishing cost impact.

Instantaneous funds transfers will significantly simplify corporate funds management. Float will largely disappear and will not be a significant factor to consider in determining investable funds. Corporate treasurers will be able to obtain more timely information from financial institutions on the status of corporate balances, and the timing of certain classes of funds' receipts and disbursements will become more predictable.

Informational services provided by financial institutions will enable small- and medium-sized businesses to manage investment of funds in a manner previously practicable only in large businesses.

ROLE OF THE INDIVIDUAL

It is anticipated that, due to rising costs and delays and given a more convenient, cheaper alternative, most individuals will minimize their writing of checks. Salaries, wages, pensions, dividends, and other income items will predominantly be credited directly into individuals' accounts and, through preauthorization, recurring payments will be deducted automatically from accounts. In addition, a consumer will be able to pay some bills simply by signing a machine-readable invoice and forwarding it to the issuing company or the financial institution holding the consumer's account. Other payments will be made through point-of-sale terminals, with either the individual's demand deposit account or possibly an interest-bearing deferred-payment account being debited.

The consumer will be able to complete financial transactions through the use of a card or similar identifying device, and this procedure will be accomplished through automated teller units conveniently located in shopping centers, in other places handling numerous consumer sales, and in the home.

FUTURE STEPS

As the electronic payments system continues to develop, some areas that may need continuing attention by the Federal Reserve System are as follows:

- public reaction and changes in public attitudes toward payments system improvements.
- impact of payments system improvements on the public's use of coin and currency.

- bank cards and their relationship to the payments mechanism; the competitive impact of bank cards with respect to retail credit cards.
- international electronic funds transfer developments.
- impact of payments system developments on Federal Reserve System operations and policy.
- technological developments in data handling and transmission.
- development of the standards necessary for efficient transmittal and interchange of payments information.
- legal considerations surrounding actions designed to improve the payments system.

The Federal Reserve System will need for some time to continue to devote significant resources to the development of the Nation's payments mechanism. □