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THE PUBLIC INTEREST AND THE PAYMENTS MECHANISM

Remarks of

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THE PUBLIC INTEREST AND THE PAYMENTS MECHANISM

In 1973 the opportunities for thrift institutions to play a role in the payments mechanism have begun to crystallize. Earlier the Hunt Commission hearings and report had stimulated study and analysis of various hypothetical possibilities. The actual inauguration of electronic payment which took place early this year in the California Automated Clearing House focussed attention on a specific application--how to handle payroll credits to savings and loan associations' depositors. And more recently the NOW account experiment in Massachusetts and New Hampshire, authorized by Congressional action, further precipitated an environment in which an early decision on participation is imminent, if it is to be timely. Thus, unless the industry is prepared to accept a verdict by default, whether it participates or how it participates in money transfers is a decision for today.

Even if Congress does not, at this point, write specific rules for thrift institutional participation in the money transfer system beyond the two-State NOW experiment, technological change seems likely to force the issue in the near term. Electronic payment technology is versatile and can be adapted to a variety of institutional characteristics and objectives. Electronic payment systems operating with large volumes are extremely cost-effective as they displace labor intensive operations involving huge quantities of paper. But the technology is costly in dollars for equipment and in time for manpower training.

Experience thus far with electronic data processing suggests that it is a sufficiently different way of doing business to require its

own generation of managers and operators to make best use of its capabilities. Needless to say, transition into the new way is a difficult adjustment for many organizations and institutions.

My purpose today is to describe the problems and opportunities I see in thrift institutions' participation in money payments. I approach the degree and character of their participation primarily from the standpoint of the impact it will be likely to have in terms of the public interest. Of course, if savings and loan associations participate individually or as an industry, their institutional interest must also be served.

Electronic Payment

Going into the payments business, actively or passively, is not, in my opinion, a venture in which the prospects for risks are nil and the prospects for profits are overwhelmingly favorable. Metaphorically speaking, any bovine impulse to leap the fence into a greener pasture should be resisted until it is fairly certain that the landing will not be in nettles and wild onions! But on the other hand, there is no doubt, in my mind, that the money transfer needs of the public generally can be better and more widely served than they are now. For example, the efficiency of electronic transfer permits such services to be extended economically to a segment of the population that does not use a checking account and is wholly dependent on currency, money orders, and cash withdrawal from savings deposit accounts.

Over the past decade the use of checking and savings accounts has been becoming more pervasive among American families. Despite this

trend, however, in 1973 approximately 25 per cent of the 71.5 million American families, and income recipients outside of families, still do not have checking accounts and 16 per cent have neither checking nor savings accounts. This potential market for improved payments service, in particular, should have the opportunity to benefit from the economies of electronic technology.

In what follows I will be dealing almost entirely with electronic money transfer because, in a word, I do not see how thrift institutions could derive any commensurate benefit from the effort required to offer paper check services in competition with commercial banks, particularly if they make use of the commercial bank payable-through draft. Check handling in any volume has become a highly mechanized operation and relatively few banks or data processing service bureaus are in a position to perform this service efficiently.

So far as the general public is concerned, the electronic payments system now seems to be developing in the U.S. along two main lines. One is directed at meeting the needs of business organizations and governments that make income payments in large volume. These payments are usually to repetitive payees and are preponderantly for wages and salaries, dividends, interest, annuities, and retirement and welfare programs. Since the payment function is usually centralized in such organizations, conversion to an electronic system involves a minimum of disturbance to existing arrangements. Income crediting is operational today but in very small volumes. There are, however, active plans to dramatically increase the use of this technique in 1974.

The other line of development serves the needs of the individual consumer whose payment volume is small, irregular in timing and does not originate at a single location, but, more often than not, occurs at the place of purchase of some good or service--thence, the designation, "point-of-sale." Point-of-sale transfer is not operational, except experimentally, in the United States but there has been enough study and pilot experience to justify confidence in its operational feasibility.

These two emerging developments accommodate another payments arrangement in which consumers agree to permit their accounts to be electronically debited for contractual obligations, such as insurance premiums, rents, mortgage and installment credit payments, and for utility bills, credit card purchases and similar type payments. The income crediting machinery is best adapted to these "pre-authorized" payments but "point-of-sale" mechanics could also be used.

An electronic system capable of accommodating both these paths of development is visible today, and is capable of displacing, at a substantial saving in overall costs, more checks and a substantial amount of currency. Based on the experience in other countries more advanced in electronic payments technology than we are, the conversion toward electronic settlement should be comparatively rapid unless, of course, additional technological changes or more ingenious application of existing technology bring into being superior data handling techniques. Or unless commercial banks and the other depository institutions that may become involved, abstain or delay offering such services because of consumer resistance or due to the lack of competitive incentives. The nature of

our banking system has inhibited innovations of this kind because their introduction requires, at a minimum, the concurrence of groups of banks instead of action by a single institution.

There are, of course, many features and problems connected with these systems of electronic transfer of great interest and importance but I will deal with them only as they affect public interest and acceptance of electronic payment.

Present Payments System

Commercial banks now serve virtually all of the money transfer needs of individuals, corporations and governments in the United States. They act as retailers of coin and currency replenishing and returning excess supplies from stocks at the Federal Reserve Banks. Together with 43 Federal Reserve regional offices they operate a check accounting and sorting operation linking each of the 14,000 banks with every other and involving nearly 500 million items and \$350 billion of transfers per week.

An operation of this magnitude, given its predominantly repetitive features--the same banks, the same customers and even a frequent iteration of amounts--is a natural application of computer technology. And so the economics of money transfer has worked rapidly to bring "back room" money transfer operations into data handling factories where labor inputs are minimal. In the space of less than a decade check accounting and transfer have become largely converted to electronic accounting and processing though still utilizing paper checks. For example, at present 84 per cent of the transit items (those drawn on a bank other than the bank of first deposit) presented to the Federal Reserve check clearing centers have been processed on high speed electronic equipment.

As check handling has moved from a highly labor intensive activity into a machine tending and machine feeding operation, it has still involved considerable clerical support. And, as is often the case in innovation, this computer application too has initially failed to use the electronic technology to the best advantage because the functions to be performed are viewed in a context limited by the capabilities of the old technology. In consequence documents, road and air couriers, and hard copy survive even though electronic transmission, storage and reference is fully capable of displacing them. Thus, commercial banks have moved rapidly to make use of electronic data processing techniques but slowly to take advantage of a fully electronic system.

Public Acceptance

One reason often given for stopping short of providing a fully electronic system is that bank customers--individuals and businesses--are not demanding such a change. There is evidence, but of a fragmentary type, which indicates that many customers want the status quo.

This is hardly surprising in view of the public reception given to many innovations--such as the use of social security numbers when the social security system was introduced, or the abolition of counter checks when MICR encoding was made universal for all checks. The lesson from such experiences, however, is that such opposition to change, regardless of its intensity at the time, is short-lived if the change has a sound economic and operational basis.

Several marketing studies, some self-serving to the status quo, have provided explanations of the public's coolness toward change in money transfer technology. Some go so far as to implicitly argue that

people like to go to their bank to deposit their checks even though it may be an inconvenient, often delayed, trip; that they like to stand in line waiting to make deposits; that they don't really mind if their checks are stolen from their mail box and cashed by some one else (they will get replacements); that if their checks are delayed in the mail or deposited late because they were away from the office on payday, they don't really mind overdraft charges because of the delayed credit, and so forth. Conversely, the implication is that the assurance pay checks will always be credited to their account on payday without any action on their part is a service of safety, certainty, and convenience they have long done without and can continue to do so. No doubt inertia, suspicion, secretiveness in managing receipts and disbursements, ostentation, hoarding, evidence some of the habits and mores conditioning individuals' reaction to trusting their money transfers to an impersonal electronic system.

All of these explanations have relevance to the task of marketing electronic transfers, but I think that insufficient attention has been given to the rationalized advantages that have been attached to the present check system and which are incompatible with electronic transfer. Users' apathy toward electronic transfer is better understood if we examine the advantages they exploit in the existing system. To do so a distinction should be drawn between individuals and the professional money managers employed by corporations and some governments.

Money Management--Corporate Treasurers

The professionals have adapted their payments practices to the existing technology in order to bolster corporate profits and corporate treasurers' prestige. They do so by managing their principals' bank

balance and payments so as to achieve the highest possible total of debits to the lowest possible balance in the account--thus producing a ratio of debits to balance just short of infinity. How well they have succeeded is evidenced by the fact that in New York City all demand deposit balances now turn over 252 times per year or just about every banking day. It is said corporate treasurers can do this expertly because they have been well trained by their bankers. Numerous devices are used, some slyly, and others openly to take advantage of float whether it arises from the indifferent attitude of their payees toward depositing checks, vagaries in mail delivery, the willingness of their banks to credit uncollected items or to share with them the credit availability from Federal Reserve float.

This maneuvering is reversed, of course, when they are on the crediting end of transfers and seeking to convert payments into "good" money at the earliest possible time. In this they need as much vigilance as they can muster to block off the very practices they pursue as payors. As a recent bank advertisement aimed at corporate treasurers put it, "Fast coming in - slow going out that's what cash management is all about!" If a corporate treasurer can satisfy the company's creditors with money "futures" while getting paid by an electronic credit he is getting the best out of both payment systems. He may also be retarding progress toward a fairer and more efficient money system.

The roots of aberration in present-day payment practices lie in pricing mores. If employees, stockholders, suppliers and others will accept payment in tomorrow's or next week's money, they do so because they are indifferent to that disadvantage or because the price of the

product or service purchased includes all of the costs implicit in deferred payment. If settlement were in "good" money--i.e. currency, Federal funds or in deposits in a commercial bank withdrawable on the day of deposit, as it would be with electronic transfers--money management would have a new set of rules. They might even include an explicit price for float or the converse, a discount for payment in "good" money.

In this situation, corporate treasurers would tend, I believe, to look favorably on the real efficiencies of electronic payment, which are very substantial for a very large percentage of corporate checks. That is, the savings from electronic delivery and verification over check preparation, delivery and reconciliation are, for most payments, greater than the interest earnings from deferral of payment by use of the check.

Money Management--Individuals

Most individuals are less sophisticated in their money management than corporate treasurers. But they, too, have noticed that retail establishments--except supermarkets--do not generally distinguish in their pricing between deferred payment and cash. Naturally, they take advantage of deferred payment and when they compare their checkbook balance with their bank statement they have incontrovertible evidence that slow mail, and that delays in the handling of deposits by the retailer and the banking system, further defers charges to their account. It seems like a pretty shrewd operation. Why should they trade it in for a system that hits their balance on the day of purchase? The answer, again, is they obviously should not if no distinction is to be made

between cash and credit. Not until consumers are offered some incentive to pay in cash or "good" money, will they shed their reluctance to embrace a floatless system.

Individuals might show more enthusiasm for an electronic transfer system if they could visualize its operation resulting in some financial advantage for them. Strange as it may seem, the greater convenience, safety, and certainty of payroll credits has not persuaded the majority of depositors who have been given a choice, to opt for them in preference to a check. An aggressive marketing program is needed to change this attitude.

The change-over from currency to the check was a long time in becoming the prevailing practice--it is not yet universal--and has probably achieved its dominance only by making available a job-site check cashing service.

Advantages of Electronic Transfer

General reliance on electronic handling of payroll and other income credits awaits the opening of several million additional accounts in commercial banks or the use of accounts in other depository institutions such as credit unions, mutual savings banks, and savings and loan associations. How this is to be done is a controversial issue in the United States at the moment. But there can be no doubt that the public--as employer or other disburser of income payments, and individuals as recipients--would derive substantial benefits from such a system. The employer will reduce his costs--as will the participating financial institution--and the income recipient will realize convenience benefits--no trip to the bank is needed; certainty--the deposit is available for

use on payday; safety--loss and theft of currency or the payroll check are obviated.

In recent years free check services for individuals have become common in many States and sections of the country. Such free services may be constrained by minimum or average balance requirements. The effect of this competitive development on the attitudes and psychology of many depositors is their belief that money transfer services have a nominal cost and are in the category of "throw-aways."

Of course, check payments are not a "free" good nor so cheap to handle that their cost can be ignored. Worse yet, the costs of "free" checking are not necessarily borne predominantly by the bank or other institution which offers the "free" service. Rather, the bank of first deposit usually stands the brunt of the cost. Many depositors have developed payment practices which waste checking services because they are "free."

The recent introduction of the savings account with money transfer privileges in Massachusetts and New Hampshire has important implications for "free" checks. For one thing it has excited a great deal of depositor interest in an account that pays interest and permits transfers--a practice previously prohibited except to the extent payments may be in the form of services. Another result has been the stimulation of the efforts of mutual savings banks and savings and loan associations to become a part of our money transfer system.

The testing of the dual purpose account, used for savings and money transfer, is quite likely to eventuate in depositors making an

economic choice between an interest yield and the number of debits to their account especially if check transfers are used. If this experiment succeeds and spreads, it will stimulate competitive rivalries and concentrate a good deal of institutional attention on the most efficient method of effecting money transfers.

In this connection, the cost advantage of electronic transfers over checks has an important bearing on the potential for extending more money transfer services to more people. From such evidence as I have examined, I think it clear that taking an inclusive view of costs--public and private, direct and indirect--beginning with those incurred once the capability to initiate the transfer has been reached and ending with reconciliation, the reduction in costs owing to electronic transfer is on the order of 80 to 90 per cent. For this size saving to be realized, of course, the system needs to handle a substantial volume of transactions. At this level of cost, virtually all income recipients could enjoy the convenience, safety and certainty of electronic credits and debits.

In summary, my views are that

- 1) There are no technological barriers to achieving a rapid but orderly transition to a fully electronic system.
- 2) The ground rules for transfers in "good" money are different from those which involve or permit deferred credit. The new rules would not discriminate against payors or payees although the advantages some payors have been enjoying would probably disappear.
- 3) The major marketing task to gain public acceptance of electronic credits and debits to deposit accounts would need to be directed at individuals who have yet to experience or appreciate the superior convenience, safety and certainty of this method of paying and being paid.

- 4) The greatest sales appeal to individuals may turn out to be an account in a bank or thrift institution which pays interest and to which and from which transfers can be made.
- 5) Depository institutions other than banks are increasingly interested in providing a money transfer service. At present they lack requisite operating and technological skill and experience but they have millions of loyal customers who constitute a ready market for such services.
- 6) Commercial banks do virtually all of the money transfer business in the U.S. today. They have been actively working to adapt electronic technology to money transfer. But they have been slow compared to banks in several other countries, including Japan, Great Britain, Sweden, and France, to embrace a fully electronic system and to market it aggressively. The rising nonbank interest in entering and competing in this field may well stimulate them to move ahead far more aggressively.