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Statement by

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before the

Subcommittee on Bank Supervision and Insurance

of the

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I am pleased to be here to present the views of the Board of Governors on a feature of the rapidly evolving payments mechanism in which you have a particular interest -- namely, the way in which thrift institutions can receive electronic wage and salary payments in much the same manner as they now handle salary checks. At the same time I would like to summarize recent developments in payments technology and Board actions bearing on these developments and to suggest in a very general way where we seem to be headed in the development of electronic credit and debit transfers.

The problem of immediate concern involves a broad issue on which the Congress may wish to provide guidance and a narrower issue of the mechanics of money transfer. I would like to set aside, for the moment, the broad issue -- that of the means of participation of thrift institutions in money transfer -- and clarify, if I can a purely technical matter of moving funds electronically.

This issue has arisen because savings and loan associations want to be able to receive their customers' payroll deposits as electronic payments in much the same manner they now receive payroll checks. Commercial banks, on the other hand, in light of their innovative effort in developing the necessary software and legal framework, and because they have assumed liability for transmission errors or failures, have sought to be satisfied that participation of thrift institutions would not create complications that might disadvantage them or their customers.

There is a technical arrangement for crediting payroll checks to accounts in savings and loan associations that could function equitably and, I am convinced, satisfactorily for all concerned. It can be effected quickly and can serve until the Congress chooses to address itself to the broader issues involving the role of thrift institutions in the nation's financial system. Its implementation now appears imminent. But let me describe the development and nature of the new system.

The Development of the Automated Clearinghouse

In California and in Georgia pathbreaking technical changes are being worked out. These permit the conversion of payrolls from individual checks -- each of which must be sorted, counted, accounted for and routed by a combination of low speed machine and hand labor, at substantial cost to all parties involved -- to deposit instructions electronically imprinted upon magnetic tape. The electronic instructions are passed to banks receiving the deposits through automated clearing houses, quickly, at very low unit cost, and with much improved certainty and safety. Savings institutions are now concerned, and understandably so, about the manner in which they can receive electronically directed deposits emanating from an automated clearing system which they did not create and in which they are not member participants.

An electronic funds transfer system sponsored by the California Automated Clearinghouse Association (CACHA) began to function in October 1972. The Georgia Automated Clearinghouse Association (GACHA) started operations in May of this year. The California association includes 111 banks in the Lost Angeles-San Francisco area, and the Georgia association includes 178 banks in Georgia. The two electronic payments associations clear transfers among their members through automated clearing houses in which the equipment is owned and operated by the Federal Reserve System, in Los Angeles, San Francisco, and Atlanta. The automated clearinghouse (ACH) is the electronic counterpart of check clearing facilities owned and operated by the Federal Reserve at 43 locations in the United States.

The electronic facilities at commercial banks linked to the Federal Reserve automated clearing houses were privately developed and equipped over the past several years, with the advice and technical help of the Federal Reserve, and they operate at private expense. Participating banks deliver to the Federal Reserve electronically recorded instructions for the transfer of funds from one institution to another. A computer sorts the instructions and makes deductions from the reserve accounts of banks from which funds are being transferred, and credits the reserve accounts of banks to which funds are being transferred. Electronic messages, tapes, or cards with instructions for debiting or crediting the accounts of individual customers are made and delivered to participating banks.

These arrangements, again, parallel electronically the debiting and crediting processes that occur in check clearing. But due to the fact that little or no paper need be handled, the clearing is done at a cost in terms of mills per item, rather than the cents per item cost of paper check handling. This results in large savings for all participants, including the Federal Reserve.

A principal use currently being made of these systems is payroll deposit. An employer prepares a magnetic tape with instructions to the employer's bank to make payroll deposits at banks and account numbers supplied by employees. The employer's bank extracts any deposits being made in that bank, and sends the remainder of the instructions on to the automated clearinghouse

There, as described above, the pay of other employees is distributed by electronic processing to their banks and to their accounts. Since this means of handling payrolls is a repetitive process, and involves large numbers of payments, substantial savings -- both public and private -- can be made, and it is thus a natural and beneficial application of electronic transfer.

Main Lines of Development in Electronic Payment

The electronic payments system now seems to be developing in the United States 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 repetitive as to recipients and are preponderantly for wages and salaries, dividends, interest, annuities, and retirement and welfare programs. Since the payment function is usually centralized in organizations making such payments, 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 chief 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.

Access by a Payable-through Transfer

A feasible and immediately available method of access to the benefits of electronic transfer for savings institutions, and one that appeals to us as being equitable and fair to all, would be an adaptation of the "payable-through" draft. Savings banks have been using this technique for some time. Adapted to electronic transfer, it can be used for credits as well as debits. To explain:

Access by a thrift institution to electronic transfer of funds involving an automated clearinghouse would, in the payable-through process, involve a number identifying the institution in an operationally feasible way. The clearinghouse computers would be able to associate deposits bound for a particular savings and loan with a commercial bank through which the savings and loan was participating in the clearing and settlements process.

Specifically, an employee wishing to have his pay deposited automatically in a savings and loan would provide his employer with the number assigned to his savings and loan, together with his personal account number. Using this number, the employer would provide his commercial bank with instructions on magnetic tape to deposit the employee's pay in the savings and loan. The employer's bank would send taped instructions to the automated clearinghouse There, the clearing computer would recognize the identifying number as that of a savings and loan clearing through a certain commercial bank. It would credit the payroll deposit to that bank which, in turn, would credit it to the indicated savings and loan. This would be accomplished in the same time span as applicable to customer deposits in a commercial bank.

The payable-through method would operate without inconvenience to the savings and loan depositor: he would be dealing directly with his savings and loan just as if he carried his check there for deposit. The commercial bank through which payment was made would be involved only as an agent of the savings and loan. The savings and loan customer would need no contact with the commercial bank to effect pre-authorized deposits in (or withdrawals from) his account at the savings and loan.

Payable-through clearing would have a further advantage, from the point of view of the savings and loan and from the point of view of a competitive financial system. It would permit a savings and loan to select the commercial bank offering it the most advantageous arrangements -- and to change its agent bank if it wished -- without disturbing payments arrangements with its customer. The savings and loan would merely tell the clearinghouse to reprogram its computers, so that the number identifying the savings and loan would be associated with Bank B instead of with Bank A. Everything would then go on as before.

Other solutions to this problem have been advanced. Some have advocated the assignment of a regular bank number, thus implying that savings and loan associations, for clearing purposes, should be treated exactly as commercial banks. Others have suggested that the Home Loan Banks be participants in the clearing process and all debits and credits to accounts in savings and loan associations should be routed through the Home Loan Banks.

The first of these suggestions would add to Federal Reserve costs by increasing the number of "end points" to which it would need to make daily sorts and delivery. Looking ahead to the precedent for future policy, if all thrift institutions, or even the large ones were included in this system, thousands of new end points would be added. (There are 4,300 savings and loans and 390 mutual savings banks, and 23,000 credit unions, in the nation.)

Since present channels can be used to achieve essentially the same result it does not seem desirable to treat the thrift institution exactly as commercial banks are treated in this respect unless they become more like banks in other respects, or until the Congress considers the basic questions involved in such a transition. A similar line of thinking applies to incorporating a check clearing function into the activities of the Home Loan Banks. It may be that Congress will find this to be desirable at some point, but such an arrangement is not necessary, in our opinion, to provide a thoroughly equitable and equivalent treatment for savings and loans in the receipt of payroll deposits. Thus, the payable-through method involves minimal cost to the Federal Reserve and imposes no unfair burdens of cost or inconvenience elsewhere.

Considerations of equity, as well as of costs to the Federal Reserve (and, indirectly, to the Treasury), are involved in the question of access. The Board has stated its general views, as you know, Mr. Chairman, in a letter I addressed to you on March 21 in response to questions you had raised about the operation of the California Automated Clearing House. I should like to ask to include that letter in the record of this hearing.

The letter noted the Board's belief that the public system using check or electronic transfer 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.

Let me just emphasize, in ending these remarks concerning the technique of access to electronic funds transfer, some of the broader questions invoked by that problem. All institutions should have access on terms that place no unfair burdens on any. The very great benefits that will result from electronic funds transfer should be equitably related to the pattern in which the costs of electronic transfer -- both private and public costs -- are borne. The eventual system involving all financial institutions wishing to participate in it should offer the maximum convenience to its users, small and large. And that system should be such as to preserve competition in the types of service offered, the convenience of the service, and the cost of it, so that the incentive to innovation is encouraged, and the benefits of innovation are widely distributed.

The Responsibility for an Efficient Payments System

Senator Carter Glass commented, at the time of the passage of the Federal Reserve Act:

> ". . . If the Board will have the wisdom and courage to establish . . . a comprehensive and economical plan of bank clearings, it will be difficult to compute the advantages that this section of the currency bill will secure . . ." (51 Cong. Rec., Part 17, p. 563).

The Board's efforts with regard to the development of an electronic transfer system have been focused on general and equitable enjoyment of these benefits.

More than a decade ago, the Federal Reserve, in collaboration with the nation's banks, took an important step toward stretching the viable life of the check payments system by developing the method of magnetic ink encoding on checks with bank account and routing numbers, to which magnetic ink encoding of the amount of the check is added in the clearance process. Making this standard usage for checks made the machine processing of checks possible. That, I might add, required a public education task similar to that needed now to bring to the public the benefits of electronic funds transfer.

More recently, guidelines for regional overnight check clearing arrangements were announced by the Board February 3, 1972, as an effort to squeeze as much efficiency as possible out of the check. This has now resulted in a national network of regional clearance centers, mostly located at Federal Reserve Banks or Branch Banks, currently clearing more than half the checks handled by the Federal Reserve on an overnight basis.

The regional overnight clearance system was established in furtherance of a policy statement issued by the Board June 18, 1971. This called for "basic changes in the nation's system for handling money payments (that) are, essentially, transitional steps toward replacing the use of checks with electronic transfer of funds."

This announcement in turn rested upon the fact that since 1968 the Federal Reserve had been engaged in building up a computerized communications network, linking the Board and all

Federal Reserve Banks and Branch Banks. This network has now been brought to a high state of operational capacity, and can be extended to direct links with commercial banks.

The Board's Request for Comment
on the Development of Electronic Transfer

The development of electronic funds transfer systems calls for an overhaul and extension of the Federal Reserve's Regulation J, which presently governs only the collection of checks through the Federal Reserve. The Board one week ago published for comment such a revision of Regulation J, and I am submitting a copy of it for your records. The proposed revision suggests a legal framework for electronic funds transfer, both the passing of credit, and the collection of payments.

But the Board, in proposing this regulatory modernization, recognized that the development of electronic funds transfer involves new relationships and roles for various institutions, public and private. The Board, therefore, went beyond the specifics of the rule changes it was suggesting and asked for comment also on the basic structure of the nation's payments mechanism, and the appropriate roles in it of the Federal Reserve and other institutions.

The range of questions on which the Board requested comment in connection with Regulation J so as to accommodate electronic transfer delineates, in broad form, the main public policy questions arising from this technological development. I want, therefore, to cite the main issues on which we seek advice.

The Board asked for comment on basic issues including:

> (1) The appropriate roles in the ownership and operation of an electronic payments system -- including adjuncts thereto -- of (a) the Federal Reserve System, (b) other public bodies, and (c) individual or groups of private institutions, including commercial banks, automated clearinghouses, credit card companies, thrift institutions, credit unions, the "bank wire," and other institutions or organizations such as those specified in the attached proposal;
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> (2) The extent and the conditions of access to the electronic funds transfer system by various kinds of depositor institutions, and of other financial institutions, as well as the terms of access;
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> (3) How the cost of electronic funds transfer should be allocated, including such questions as whether the Federal Reserve should charge for the use of its facilities; if so, against whom should the charges be levied, whether they should cover all costs, and whether reserves maintained by member banks should be taken into account in any fee schedule which might differentiate between Federal Reserve member and nonmember institutions.

We expect to benefit substantially from the response we receive with respect to these issues, including -- perhaps I should say particularly -- the advice we receive from the Congress.

Policies or attitudes which inhibit participation in the economies and added capacities that will be provided by future electronic technological development tie us to obsolete costs and inconvenience. By avoiding rigidities, the policies and attitudes of both public and private parties to electronic transfer will give ample opportunity and incentive for innovation to continue to occur in electronic transfer facilities, and to be put to timely use.

Technological change can alter institutional relationships. Here also, avoidance of rigidities in either public or private policy will permit us to accommodate not only to technical change, but also to altered relationships among financial institutions.

Some
Conclusions

Let me add only a few words of emphasis and conclusion:

There are no technical barriers to the spread of electronic funds transfer. It parallels all the work done by the check system, and does it better, more cheaply, faster and at greater convenience to all users of the payments system. The new payments system should aim at bringing into the payments mechanism the money transfer needs of that substantial part of the nation's families not now using the check system.

The allocation of the costs of electronic funds transfer among its vendors and its users -- both public and private -- must be such that the economies realized from electronic transfer are spread fairly.

There should be a public presence in electronic transfer, to the extent necessary to guarantee that the new payments system develops in a way that makes it capable of doing the job of money transfer, from whatever quarter, without unwarranted exclusions of would-be participants. A goal of the public presence should be provision of a maximum range of different services -- including credit cards and other payment "concentrators" -- compatible with the degree of technological uniformity necessary to ensure efficient operation.

The Board looks forward, in the discharge of its segment of responsibility in this area, to the advice and encouragement of the Congress.

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