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COMPETITION IN PAYMENTS SERVICES

Remarks of

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COMPETITION IN PAYMENTS SERVICES

In recent years the characteristics of money payment service havebeen undergoing significant change. In the process the historical role of the commercial banking system as the exclusive vendor of the means of money transfer has been breaking down. Fragmentation is coming from the impact of competitive forces external to the banking system and also from the development of data handling and transmission technology. These forces have encouraged a growing number of institutions and industries outside of banking to offer specialized money or near-money deposit arrangements and to provide such infrastructure services as data processing or the transmission of money payment advices. Unless regulatory barriers are imposed on these external forces or unless combinations of the involved private interests suppresses emerging competitive forces, the public stands to realize important service and cost advantages from the payments evolution.

My purpose today is not only to elaborate on competitive developments but also to acquaint you with the role of the Federal Reserve in our money and payments system and how it interfaces with private interests. The Federal Reserve's role had its origins over 60 years ago when the Federal Reserve was established by Congress. The functions of a central bank were not as well defined in 1914 as they are today, but the idea of a central bank was not novel. The Bank of England, at that time, was well past its bicentennial. It is clear that Congress had in mind in 1914 what we would describe today as essential features of a central bank: managing the nation's money supply; providing a source of ultimate liquidity for the economy; acting as the Government's banker; providing a circulating medium adequate to serve the country's transactions needs.

Prior to the creation of the Federal Reserve, these functions were performed for better or worse in varying degrees and at different times by the First Bank of the United States (1791-1811), the Second Bank of the United States (1817-1836), the Sub-Treasury System (1846-1921), and the private State-chartered and national-chartered banks. The mix of public and private interest in money, credit and banking has been a source of political controversy throughout our history. That controversy did not end with the Federal Reserve Act because the Act was itself a compromise on the issue of public vs. private control of central banking. The initial quasi-public/private character of the Federal Reserve has, however, undergone gradual change as a result of operating experience and of amendments to the Federal Reserve Act. The status of the Board of Governors as a public institution has been established. Its functions and powers have been expanded to cope with the evolution of our money and banking system and to meet the national and international responsibilities of a contemporary central bank. The Federal Reserve today is an acknowledged government institution fully answerable to Congress although it still retains features which insulate it from partisan political pressures in its operations and decisions.

Congress, under its constitutional powers relating to money, has provided the Federal Reserve with broad regulatory authority over the quantity and circulation of coin, currency, and bank money (demand deposits). The money needs of our economy today total about $300 billion of which $225 billion is in the form of demand deposits. The Federal Reserve determines the amount of deposit money in circulation primarily through open market operations--paying out new deposit money for securities purchased or taking in outstanding deposit money for securities sold. A similar effect is achieved by changes in member bank reserve requirements or the terms under which commercial banks borrow from the Federal Reserve.

The public determines the amount of coin and currency in circulation by exercising its option to exchange deposits for cash or cash for deposits. Coin and currency in circulation today amount to about $75 billion. Congress has charged the Federal Reserve with the responsibility for the distribution of coin and currency to commercial banks who, in turn, make it available to the public.

The money function of commercial banks is to serve the public from over 40,000 banking offices in two ways: (1) as a retail source of coin and currency and (2) by offering to the general public demand deposit accounts to which and from which money transfers can be made.

The Federal Reserve interfaces with cash operations of commercial banks by acting as a storage depot for currency and coin from which additional supplies can be drawn as needed and at which unneeded or unfit moneys can be deposited.

The Federal Reserve interfaces with the movement of demand deposit money through the use of checks or other orders of withdrawal or credits to deposit accounts by providing a clearing facility for interbank items. Such a facility is needed when payments involve accounts at different banks. The Federal Reserve clearing facility is not an exclusive one; payments may be directly exchanged or routed through local clearing houses or cleared through correspondent accounts. However, it was the clearly stated intent of the framers of the original Federal Reserve Act that Federal Reserve participation in the clearing function should promote a prompt and efficient movement of funds among commercial banks.

The Federal Reserve also operates a wire network going back to 1918 which was developed to handle interbank transfers. Last year the dollar volume of such transfers was in excess of $30 trillion.

The Federal Reserve directly serves only two customers--its member banks and the Federal Government. In connection with its clearing activities the Federal Reserve presents items to non-member banks for collection but the actual transfer of funds is made through the accounts of member banks at a Federal Reserve office. Corporations, individuals, State and local governments or financial institutions other than member banks do not do business directly with the Federal Reserve; its contacts with the public are only as an agent of the Federal Government or its member banks.

Until recently, commercial banks have been virtually exclusive retailers of money services. That exclusive role is being eroded in many ways today, but not by the Federal Reserve as is sometimes implied. Major and obvious contenders for money transfer powers are the non-bank depository institutions--savings and loan associations, mutual savings banks and credit unions. They have already begun to offer money payment services and are seeking State and Federal legislative action to extend this activity. In addition, there are non-depository suppliers of money services such as credit card companies and nationwide retailers as well as vendors of money movement infrastructure all of whose operations encroach on or have the potential to divert business and functions away from commercial banks.

The banking system's perception and evaluation of the chipping away of its money powers is not entirely clear. It recognizes--and recently has opposed most effectively--the potential of pervasive thrift competition. It probably has succeeded in doing so because thrifts have been unwilling to accept the same government regulations with respect to reserve requirements and interest rate ceilings that are enforced on banks. I would assume Congress would continue to regard equality in government regulations among all depository institutions as a necessary condition to expansion of thrift powers. But Congress will be the judge of what constitutes equality. I see no reason why thrifts cannot compete on an "egalitarian" basis and, therefore, assume they will become, sooner or later, a new competitive source of money transfer service for consumers.

I do not sense that banks regard back-room, in-house processing of demand deposit accounting and check transit work as essential to retention of their demand deposit customers. A large and growing number of banks are now contracting for this service and the trend toward concentration of such work in both bank and non-bank processing establishments suggests that economies of scale in processing, transportation, and communication will eventuate in nearly all demand deposit account work being done in a few hundred such data centers. While there have been a few complaints by individual institutions that their customers are being solicited because of unauthorized access to proprietary information at processing centers, this is the kind of security problem that competition can remove.

The challenge to commercial banks from the card companies and payment infrastructure organizations, such as communication entities or equipment manufacturers, is far more subtle. It may develop in several ways. Because of past practices it is usually assumed that deposit accounts which can be credited and debited from payments flows are exclusive to banks and thrifts. Experience has shown that accounts of this kind generate large pools of loanable funds. The adhesive that holds the funds-generating customers to the bank is often the money service. If various elements in that service become disconnected or disassociated with the bank, the adhesive may no longer hold.

The argument can be extended by noting that money balances--positive or negative--and credits or debits to them need not be confined to depository institutions. Professor Henry Simons of the University of Chicago--predating Milton Friedman--strongly urged a money payment system supported by fees and completely disassociated from the extension of bank credit--in short, a pure money service. Perhaps this concept can be labeled as theoretical and beyond practical achievement. However, the competitive forces released by technology and new entrants into money payments business could naturally work in this very direction.

At this time, I would attach greater significance to another facet of this competition, namely, to the fact that all of the non-depository entities have the potential of coming between a bank or a thrift and its customers. The card companies, for example, already offer a broad money service directly to consumers independent of a particular banking connection and/or the proximity of the bank to the customer. The natural development and elaboration of that service could make it a complete money package for consumers. The equipment and communication companies have a similar opportunity of independently linking payor and payee and thus greatly reducing the customer allegiance to a particular bank. Moreover, the separation of operations prior and subsequent to actual transfer of funds will significantly impact the banking system's physical operations shrinking them as the need for bank lobbies and vaults, employees and equipment obsolesces or shifts to another kind of technology or to a different owner of infrastructure facilities.

Still another competitive threat lurking in the prospect for the future is an enlarged role for retailers who have forged well ahead of banks in adapting electronic technology to their operations. Again, though possible, it seems unlikely that retailers will establish, to any significant extent, credit as well as debit balances for their customers. The principal advantage the retailer has lies in his first cut at the extension of consumer credit. This is an old challenge for banks but in a new environment and it is far from certain that the environment will not shift the advantage toward retailers particularly if they get a head start in exploiting elements of convenience and cost-saving from technology.

Finally, in cataloguing the sources of additional competition for money payment services, one should not overlook the possibility of a public or private giro in the United States. A giro makes money transfers at the instruction of its depositors by directly debiting their accounts and at the same time crediting the accounts of other customers. European experience with giro systems based on paper transfers is, in many respects, outdated but the electronic systems in use are another matter. Obviously, it is a short step from a private credit card system to a private giro and that step must be under consideration. A postal giro is also a possibility and its attractiveness might be enhanced were it to displace the loss in financial transaction letter mail which will adversely impact our postal system.

I have been touching down very briefly on a number of facts and issues bearing on the role technology and competition may play in the payments system. As consumers, we have been exposed to an enormous range of technological innovation in products and services during our lifetime. Our receptivity to technological change has become well conditioned by the promotional skills employed by innovators. If anything, we are prepared to accept more innovation today than can be delivered and to do so without becoming embittered by shortcomings. Still, innovation in the form and use of money is widely believed to be a hard-sell service as of today.

This attitude is not surprising. Prior to the last 30 years or so, money had changed little for over two centuries. Attitudes toward money had long been conditioned by the fact that money had value as a commodity. Specie--mainly gold and silver coins--was money but it was also treasure. Other moneys were convertible into specie or so it was presumed, hence, money had a value independent of its denominational stamp. Overnight, on the century time clock, money lost its intrinsic value as gold and silver coins disappeared from circulation and were displaced with paper, book entries and metals of negligible value. On the same clock, in an even shorter time, money is becoming a phenomenon that can be neither seen nor heard nor felt even though it will do the work of earlier moneys with far greater certainty and ease and at far less cost.

However, it does not seem to me that a significant portion of the American public is "hung up" on the metaphysics of deposit money. Most people have been keeping their money resources in deposit accounts for some time. They only want to know and have a record of where their money came from, where it went and how much is in the account at any particular time. The obstacles to changing their money mores should readily be removed by convenience and cost considerations. Inertia and vested interests of one kind or another in money mechanics are more imposing obstacles to change than consumer attitudes. These factors show up in both public and private sectors.

As an example of an obstacle to change coming from the public sector, consider a recent decision of the United States Court of Appeals in Independent Bankers Association of America vs. James E. Smith, Comptroller of the Currency (March 22, 1976). This opinion construed a Federal statute enacted in 1927 to define offsite electronic facilities owned by banks as branches and thus in fact to limit their public use and convenience. Virtually the entire 65-page opinion is given over to consideration of the competitive equality between State and national banking institutions. As for the "public interest," the Court asserts ". . . it is best promoted by the orderly continuance of a sound dual banking system." The Court further and no doubt properly noted that the responsibility for dealing with such technological issues as electronic terminals lies with Congress and the State legislatures. But the case illustrates the nature of governmental barriers in its preoccupation with precedents made obsolete by institutional and technological developments and a lack of perception of the paramount interest of the public--not the banking system--in a more convenient and less costly money system.

Within the banking system, since it is not monolithic, attitudes toward electronic banking range from enthusiasm to rejection. Far from having a dog-in-the-manger attitude, many bankers are ready, able and anxious to extend services in any manner that will earn public acceptance. Other bankers are contributing to industry inertia, in my opinion, by failing to perceive that an essential phase of their corporate existence is at stake. Still others are hoping, "It will not happen in my time."

Let me add one final word on the National Commission on Electronic Fund Transfers and the spreading interest in participating in money payments activity. Under our Constitution, Congress is responsible for the nation's money system. It created the EFTS Commission for its guidance in legislating in this rapidly changing and controversial arena. But Congress did not bind itself to await the results of the Commission's deliberation nor did it attempt to stay technology or competition from their best efforts to establish a position in the payments business. Nor do I see evidence that any of the parties involved is attempting to contain his best efforts either. In other words, it is still an open season or at least one in which to establish "grandfather" rights.

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