STATEMENT BY

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BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

DIRKSEN SENATE OFFICE BUILDING
ROOM 5302

FEBRUARY 24, 1978
10 O'CLOCK

As a member of the National Commission on Electronic Fund Transfers I am pleased to have the opportunity to comment on the two bills before this Committee, S.2470 and S.2546. The substance of both bills falls well within the scope of Commission recommendations and findings with respect to consumer interests in EFT as Mr. Wegner's review has indicated.

My comments deal with three consumer-related policy issues that were among those considered by the Commission. None of these resulted in positive legislative recommendations. This was not an oversight but was based on the Commission view that, in some matters, primary reliance should be placed on market forces emerging from an abundance of competition between banks, thrift institutions and their equipment and service suppliers. It believed that payment features consumers prefer and believe to be in their interest, both as to price and service terms, would be competitively available.

The three consumer-related issues for my discussion are:

(1) The implications of extending to non-depository institutions and non-deposit accounts the legal framework of rights, responsibilities and liabilities for EFT transfers applicable to banks and thrifts.

(2) Safeguarding the rights of consumers as payees.

(3) Paying for money transfers.

I will cover these topics briefly in my statement and in doing so endeavor to set forth relevant Commission attitudes and differences. To avoid misunderstanding, a few statements of fact and use of terms are in order.

Money comes in two forms: cash (currency and coins) and checkable deposits in banks, savings and loan associations and credit unions. Cash passes from hand to hand, deposit transfers are authorized by check, draft, debit card, magnetic tape or computers. All other payment instruments, such as travelers checks or money orders, depend upon credit or the prior transfer of a deposit balance or cash. A credit card, whether a two- or three-party card, does not make a payment. It produces evidence of an agreement to pay later. In the meantime, the merchant payee may convert these agreements to pay (receivables) into deposits by selling (discounting) them.

Travelers checks, money orders and certain credit-based payments are employed for some types of transactions when they are safer, more convenient or more available than cash or a check transfer. Some consumers use these methods of payment from necessity: they cannot afford a deposit account in any institution.

Non-depository institutions. The language of both bills that could make possible a money-payment-type role for non-depository institutions appears to derive from a Commission recommendation "...that finance companies and other credit grantors that do not normally offer revolving credit at the point of sale should not be denied by law access to or sharing of point of sale EFT facilities for their authorized lines of credit for loans."[1/] I believe this statement should be taken literally and that the Commission did not recommend that finance companies should have payment powers similar to those of banks or other depository institutions.

1/ EFT In the United States (Final Report), p. 135.

Under the language used in both bills, however, it seems to be implied that a finance company could offer a bill-paying service to consumers short of cash or without a checking account. Since a finance company cannot accept deposits and make loans without becoming a bank, it would pay bills from its deposit account on behalf of consumers from the proceeds of a loan or line of credit. Thus, if a finance company offers a money payment service, it becomes an intermediary between the payor and the payee, i.e., the payor borrows from the finance company and the finance company transfers its funds to the payee.

This arrangement adds another layer to the payment process, increases transaction costs and adds interest costs. Moreover, it is unlikely to provide the payor the ready access to proof of payment that he has from a cancelled check or descriptive bank statement. The natural market for money transfer by the finance company or other non-bank entity, therefore, would seem to be limited to individuals who do not have a checking account in any type of depository institution.

It is doubtful that consumers who are forced by circumstance to use such higher cost, roundabout payment services are being given the protection and assistance they need or are entitled to. The Commission recognized this fact when it recommended that "...Congress should direct an appropriate existing Government agency to study and determine what actions need to be taken by the Congress or other authorities to make the benefits of EFT available to low-income persons, while ensuring that their rights and freedom of choice are preserved. The feasibility and desirability of a Giro-like system in this country is one of the alternatives that should be explored."2/

Consumers as payees. Neither of the bills before us today has much to do with the interests of consumers as payees. Being paid is fully as important as paying; most people would say more so. How do consumers fare when it comes to the payment of their salaries, wages, dividends, social security, pension and welfare allowances? How might EFT be used to enhance consumers' interests as payees as well as payors?

Most income payments to consumers in the United States today are by check. Checks, unlike cash where value passes as the cash is exchanged, are not spendable money until deposited and funds have been finally collected from the payor's bank. Check payment, unlike cash payment, involves other parties than the payor and payee. At a minimum, the bank or banks in which the payor and payee have accounts and clearing intermediaries must arrange for the transfer of funds.

Consider how consumers as employees and payees might benefit from EFT. Friday is a common payday but a check received on Friday may not be deposited until Monday and not credited to the employee's account before Tuesday. If the check is drawn on a bank in another city, crediting will be delayed another day to several days, particularly if the check is drawn on a bank in a hard-to-reach location--a not unknown practice. It even has a name, "remote disbursement."

2/ Ibid., p. 73.

EFT, on the other hand, has the capability of transferring value on payday by using the device of a credit transfer. A credit transfer, in contrast to the check, moves funds from the payor's account to the payee's account without question as to the time and certainty of its availability. The transfer takes place within the banking system and cannot be initiated unless funds are in the payor's account. This service is now available on a limited basis through the automated clearing houses. It is expected to become widespread as the capability to handle regional and nationwide payrolls becomes available. But there is a barrier to acceptance of this method of payment--the somewhat self-deceptive practice of using "float."

"Float" is a well-understood feature of our check system. The tendering of a check to an employee or a merchant on due date is not payment until the funds are available for expenditure from the payee's account. The payor's account is not charged until the check arrives at his bank--his "float" derives from the delay in charging his account while the check is en route to the payee's bank and is in the clearing and transportation steps prior to deposit in his bank. "Bank float" is also involved and it arises from delays in crediting the payee's account. Items cleared through the Federal Reserve System are credited to payees' banks on a schedule of one or two days but some banks hold up credits to payees' accounts for several days to allow for possible reversal. There is a name for this practice too--"deferred availability."

Float is like coin clipping or non-par banking so far as payees are concerned--they do not get paid in full. Some payees can protect themselves. Merchant payees, for example, can include in the cost of doing business, along with the cost of convenience credit, the delay they experience in receiving payment in good funds. Consumers, including employees, stockholders and retirees in the past have no effective defense.

The Commission was aware of the role of "float" in the payment of salaries, wages and other items. It judged that the availability of a superior--quicker, more secure, more certain--EFT-type payment would spread in response to consumer demand given the existence of national ACH infrastructure which it recommended be put in place. The Commission pointed to the action taken by the United States Treasury Department to initiate a program over a year ago for direct deposit of salaries and social security payments which is planned to be made available to all government payees requesting it. The practice of direct deposit is common, if not virtually universal, in Western Europe.

Two legislative measures might be considered. One would add to the periodically disclosed listing of terms and conditions governing the use of deposit accounts, an item respecting the availability of deposits. This simple step would facilitate the comparison of competitively offered payment services. Another possibility is to explore the practicability of requiring that by some future date salaries, wages, social security and other like payments be made in "good" funds--

spendable on payday. The Commission's presumption is that the second suggestion is not necessary and that competitive markets will offer this service to all consumers with checkable deposit accounts. That presumption does not apply to low-income persons without deposit accounts as the Commission was well aware.

Paying for money transfers. The Commission's findings were limited by the paucity of information on the costs of completing money transfers within the banking system. Such costs are essential to the pricing of money payment services to encourage resource saving and to meet rational user preferences. The reason is obvious, costs are fractionated and widely and haphazardly dispersed among payors, payees, depository institutions and public agencies. Many costs are unknown, though knowable. Others are obscurely joint or lost in "overheads." Pricing policies, frequently in the absence of even as much as a knowledge of internal costs, are blindly responsive to competitive offerings. Bundling is pervasive but so are activity charges. Government services are "free" to users if the implicit interest on currency is ignored. Unfortunately, though it tried, the Commission was not able, given its time horizon, to put together a cost analysis that could provide a rational basis for pricing policy.

The Commission recognized that EFT has features of convenience, certainty, lesser cost and security which make it superior for certain types of transactions. The most obvious and important categories are (1) the direct deposit of salaries, wages, social security, dividends, and other income payments; (2) the "standing order," a preauthorized periodic contractual payment to the same payee, and often for the same amount, and illustrated by payments for insurance premiums, mortgage and installment loans, rent, and utility bills; (3) bill payments for goods and services purchased with the use of convenience credit extended by the vendor or a third party such as a credit card company. In total, money transfers of the above types account for as much as two-thirds of all check payments today.

To put the problem in its proper perspective, we need a rough idea of the dimensions of our payments system. Well over 100 million checks flow through the banking system every business day. About 40 per cent of them are mass produced by governments and employers as income payments of various types. Banks do not typically charge consumers for income credits to their accounts but it is common practice to charge employers for handling their payrolls.

Consumers generate about half of the checks written; most of them are for cash or bill paying. Some banks charge activity fees (so much per check) or require balances for this service; others advertise free payment services. Banks usually charge merchants for collection services on the checks they deposit.

It is evident that bank fees might be assessed on both payors and payees--a doubling up so to speak but it is almost certain that if enough alternative sources of services are available charges will be policed by competition. Check handling costs vary widely depending on wage rates, the degree of automation and transportation costs. In the aggregate they are estimated to average 35-40 cents per item and, despite the degree of automation in processing, costs have been rising rapidly.

Consumers as payees can realize significant benefits in cost, convenience and certainty of payment if they have depository accounts and these accounts are directly credited with any type of income payment whether coming from business or government. The great bulk of these payments are generated in volume by payors who have the capability of using electronic technology to realize operating efficiencies for themselves. Payors should not use a method of payment that generates "float" at the expense of their employees. Employees who having delivered their services and waited until the end of a pay period of one or two weeks or more should be paid in funds that are immediately available for expenditure.

Most of the checks consumers write are for bill paying or purchases at the point of sale and are made out to merchants, public utilities and service establishments. The retail businesses ordinarily reimburse their bank on a volume basis for collecting consumer checks and providing a cash service. A high proportion of retail transaction volume involves payment at point of sale or is in response to a bill or statement. Many of these statements are electronically prepared and this practice can be grafted onto various types of electronically arranged payment from customers' bank accounts. By combining statement preparation with actual payment, an efficient resource utilization is achieved, consumers gain important convenience benefits, and retail businesses reduce their exposure to credit losses and redundant paperwork.

Assuming consumers bear no part of the cost of credits nor certain types of debits to their accounts, it is obvious average checkwriters (200 items per year) are costing payment system suppliers about $75 per year. This is clearly an unstable situation as two-thirds of consumer checking accounts have an average balance of less than $300. What is likely to occur?

Unnecessary check writing will be disciplined in some fashion, by fees or balances or by a maximum number of free checks in a given period. Employers and governments will assume the cost of making "good" funds available on payday. Merchants as payees will continue to pay the cost of collection involved in the handling of cash, checks, debit cards or credit cards at the point of sale or for remittances on statements. As costs continue to rise and the potential effectiveness of EFT becomes apparent, the payment system will trend toward more cost-effective methods of payment than prevail today.

It is obvious, as I indicated earlier, that the Commission did not feel that legislation was needed to realize certain of the benefits of EFT; these would flow from the competitive efforts of depository institutions. Other recommendations, as those authorizing saving and loan associations, credit unions and mutual savings banks to offer money transfer services, were intended to step up the level of competition activity.

This is a rational approach to the public policy issues affecting the vast majority of money users but it does little or nothing for the 15 per cent or so of the nation's income recipients that do not have deposit accounts at any type of depository institution. Most of these parties, by circumstance of poverty, are forced to use currency and money orders, the most high-priced (risk, cost and convenience considered) of payment alternatives. The Commission did not see the answer to this problem and suggested further study.

The alternatives it faced seem clear to me. One is to follow the European experience and create a postal giro which accepts transferable deposits, subsidize its operation should its operating costs exceed the yield on deposits with it, and make transfer services available to anyone. The other would involve offering inducements to low-income consumers (such as a direct deposit linked to a limited bill-paying service) and seeking cheaper, more secure methods of operating low-balance deposit accounts at depository institutions. It might be possible to achieve about the same level of service in our existing framework that a public giro would provide.

For a conclusion, let me use a few one-liners to reflect some of my views.

The Commission used one of two alternative solutions for every problem; pass a law or leave it to the market place. The statutory solution always involves numerous specifics--the market place provides its own specifics.

The Commission's recommendations should be viewed in the whole because of their interaction. Treat consumer issues separately as long as you adopt the measures needed to achieve free market competition.

Consumer interests in money payments have been awakened by EFT. Turn this spotlight on cash and checks.

All of the specific measures proffered to meet consumer interests still leave those consumers at the low end of the income distribution with the least satisfactory and most costly means of making payments.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

March 10, 1978

Dear Senator Schmitt:

In response to your letter of March 1, 1978, in which you asked me to comment on four questions regarding my testimony before the Subcommittee on Consumer Affairs, I am enclosing a brief statement on each.

The responses speak for themselves but on the issue of whether one bill covering all Commission legislative recommendations is preferable to a consumer bill to be followed by enactments dealing with other issues, I am not in a position to make the best judgment. The fact that consumer recommendations are less controversial may be a factor. A single bill has the fundamental advantage of a complete reflection of the Commission's findings. However, certain of these findings, such as the removal of the prohibition on the payment of interest on demand deposits and the authorization to the Federal Reserve to pay interest on reserves, are only tangentially related to EFT and would be more appropriately considered in another context.

Three other recommendations, those relating to the use and deployment of terminals and to the sharing of EFT systems by depository institutions, are an integral part of the Commission's legislative package and are closely linked to the Commission's consumer recommendations. The fact that they impinge on other legislative proposals affecting competition between classes of depository institutions should not be a governing consideration as indicated in the case of the monetary proposals.

I hope these comments will be useful to you.

Sincerely,

George W. Mitchell

George W. Mitchell

Enclosures 4

The Honorable Harrison Schmitt
United States Senate
Washington, D. C. 20510

(1) Governor Mitchell, as you will recall when Congress was working on the Financial Institutions Reform legislation, it was felt desirable to keep those proposals as one package. Do you feel the best approach to Electronic Fund Transfers would be to have an integrated and coordinated legislative package which would include consumer protection, privacy, sharing and competition?

ANSWER

The wisdom of including issues related to consumer protection with those affecting depository institutions in one legislative package involves a reading of Congressional priorities. It appears to me that among the issues involved, consumer protection and privacy now seem to have the broad support necessary to enact legislation. The National Commission on Electronic Fund Transfers, which included consumer and industry representatives, concluded that consumer protection legislation is needed at this time and recommended specific safeguards.

It is relevant to note that the Commission's findings viewed in fine detail gave rise to over 100 specific recommendations, the greater part dealing with consumer interests. A majority of these specifics do not require Congressional action but are addressed to regulatory policy, to the monitoring of future developments, are simple declarations, or advise against legislation at this time.

Looked at in terms of broad issues instead of specific details, Congressional action was recommended on 12 consumer issues, including 3 on privacy. Two recommendations dealt with the branch-terminal issue; one with sharing; one with security; and two with monetary policy.

The security recommendation relates to penalties for computer fraud and seems non-controversial. Those dealing with monetary policy should be considered in another context. The recommendations on terminals and sharing are integral to the Commission's consumer findings but also impinge directly on depository competition and regulatory policy.

Under the above circumstances, I can perceive no conclusive reason for taking either a one- or two-stage approach though I believe it is clear that the privacy and computer fraud issues should be covered in a consumer bill and that monetary policy recommendations should be excluded.

(2) In your statement, you state that we should turn "this spotlight on cash and checks". Is it your recommendation that if federal legislation is enacted at this time it should cover all of the payments systems--checks, drafts, EFT debits and credit cards--in a coordinated manner?

ANSWER

In my statement, I mentioned shortcomings in certainty, security, and funds availability for consumers as payees when checks are used for payroll, social security, retirement and other income payments to individuals. I believe that payments of this kind should be made in "good" funds on the date due; to accomplish this objective legislation may be needed. However, European experience with payroll crediting suggests that depository institutions will market a service of this kind effectively under favorable conditions.

Payment delays are inherent in the check system. These delays have been exploited by many payors who retain control of the funds well beyond the date the check is mailed. The net advantages of "float" are often more apparent than real especially for consumers. In any event protracted delays in settlement, unless functionally required, increase real costs and introduce frictions into the process.

Cash has many convenience aspects for small-value transactions but does not provide proof of payment, involves risks of loss and theft and is totally unsuitable for large transactions. These are major shortcomings and are reflected in the relative decline in cash use over the past 25 years.

Looking at the three payment alternatives--cash, checks and electronics--it is apparent all have advantages and defects which users, in the case of cash and checks, have reflected in their use patterns. Up to the present time consumers have had little exposure to electronic transfer and its receptivity has had a limited market test. The test may be biased in some degree if statutory constraints on EFT are more onerous relative to its capability than those applied to cash or checks. Consumer choice should not be biased by governmental action imposing unneeded "protection" costs.

(3) Is there a danger of weighting down the system with regulatory requirements which will prevent its development to bring conveniences to the consumer and savings to the financial institutions?

ANSWER

Yes, there is a very serious danger of weighting down the EFT system with regulatory requirements which will prevent its development as a lower cost, more convenient, and more secure payment system than checks. This is especially true with certain consumer protection proposals which would add significantly to system costs. For example, the practice of "stop-payment" is an expensive and seldom used remedy for a situation that can be corrected by better and far cheaper means.

The Commission's deliberation on consumer issues revolved around the extent to which competition can protect consumer interests and how much law and regulatory surveillance is necessary. I believe that in general the Commission struck a reasonable balance between law and competition. Specifically, I would endorse provisions relating to privacy, account statements and terms governing the use of payment accounts as being most appropriate for legislative consideration. It must be borne in mind that competition among depository institutions is not of the "free market" variety but is circumscribed by law and policed by Federal and State regulations. In consequence, its capacity to provide service alternatives is diminished.

(4) You mention in your statement that the "Commission's findings were limited by the scarcity of information on the costs of completing money transfers within the banking system." Before moving ahead, would it be prudent for Congress to have its Office of Technological assessment to run a cost/benefit study on the Commission's recommendations?

ANSWER

The cost information I alluded to relates to both check and EFT-type deposit transfers and to the use of cash. These three methods of money exchange are alternatives available to most money users.

The cost of using cash is widely dispersed among banks and other financial depositories, retailers, consumers and the Government. A variety of costs are involved--coining, minting, handling, counting, accounting, shipping, storing, security, insurance, police protection, etc. Analysis would show that cash use for larger transactions is the most expensive of the three alternatives, but there are no figures to determine where the break-even point in size of transaction falls--10, 20, 30 or more dollars.

Check costs vary widely among banks depending on labor cost, degree of automation and scale of operation. From fragmentary data and informed estimates, I would judge such costs today would average between 35 and 40 cents per item. In my opinion, the most knowledgeable source of information on check costs would emanate from the Bank Administration Institute, a research organization devoted to the study of commercial bank operations.

The expenditure by the Federal Reserve for money transfer is known. On the basis of all direct costs and fully allocated overhead the System in 1977 spent $24.6 million for coin use; $144.0 million for currency use; and $223.6 million for check clearing. The check cost on a per item basis is 1.68 cents.

EFT costs depend on volume projections. The uncertainties in such projections arise from estimating when break-even volumes in transmission and equipment use can be achieved as a result of public preference and what rates of obsolescence for existing equipment are appropriate to the rate of technology advance.

In saying that the Commission needed better transaction cost data, I was looking to the role of cost--in terms of real resources--as a primary determinant in fixing user prices. While money users should be able to exercise a choice among the three payment alternatives, their preferences should not be subsidized, which is to say that if payment by check costs 35 cents and electronic credits for payroll or bill paying are one-third of that amount, this differential in cost should carry over to prices which will influence users' choices.