THE MONETARY CONTROL ACT OF 1980 AND THE PAYMENT SYSTEM

Remarks by

Frederick H. Schultz

Vice Chairman
Board of Governors of the Federal Reserve System

at the

Banking and Payment Systems International
Conference

Atlanta, Georgia
April 4, 1980

THE MONETARY CONTROL ACT OF 1980 AND THE PAYMENT SYSTEM

I AM DELIGHTED TO HAVE THIS OPPORTUNITY TO DISCUSS THE PAYMENTS SYSTEM WITH SUCH A DISTINGUISHED GROUP OF BANKERS AND BUSINESSMEN. THOSE OF YOU WHO ARE FROM THE UNITED STATES KNOW THAT THE FEDERAL RESERVE HAS URGED THE CONGRESS FOR MANY YEARS TO ENACT LEGISLATION WHICH WOULD GIVE IT BETTER CONTROL OVER MONETARY AGGREGATES AND THE RESERVE BASE. SUCH LEGISLATION WAS SIGNED INTO LAW THIS WEEK. IN ADDITION TO IMPROVEMENT IN MONETARY CONTROL, THE ACT HAS, AS A CONSEQUENCE OF RELATED PROVISIONS, SIGNIFICANT IMPLICATIONS FOR THE PAYMENTS SYSTEM. MONEY TRANSFER POWERS ARE GRANTED TO SAVINGS AND LOAN INSTITUTIONS AND CREDIT UNIONS, THUS HELPING THESE INSTITUTIONS TO STABILIZE THEIR DEPOSIT BASE. BY REQUIRING THAT THE FEDERAL RESERVE PRICE ITS SERVICES THE ACT ENCOURAGES COMPETITION WHICH SHOULD LEAD TO THE ADOPTION OF THE MOST EFFICIENT PAYMENTS PRACTICES.

LET ME GIVE YOU SOME SPECIFIC AREAS IN WHICH THIS LEGISLATION, THE MONETARY CONTROL ACT OF 1980, WILL HAVE A DIRECT BEARING ON THE PAYMENTS MECHANISM. FIRST, THE ACT REQUIRES THAT EACH FINANCIAL INSTITUTION HOLD RESERVES OF 3 PER CENT FOR THAT PORTION OF ITS TOTAL TRANSACTIONS ACCOUNTS WHICH AMOUNT TO $25 MILLION OR LESS. THE RESERVE REQUIREMENT FOR TRANSACTIONS BALANCES IN EXCESS OF $25 MILLION WOULD BE 12 PER CENT. THUS, CONGRESS HAS RECOGNIZED THE NEED TO ACCORD EQUAL TREATMENT TO TRANSACTIONS ACCOUNTS REGARDLESS OF THE TYPE OF DEPOSITORY INSTITUTIONS IN WHICH THEY ARE HELD.

WHILE ESTABLISHING UNIFORM RESERVE REQUIREMENTS FOR TRANSACTIONS BALANCES, CONGRESS AUTHORIZED ALL SAVINGS AND LOAN ASSOCIATIONS AND CREDIT UNIONS TO OFFER MONEY TRANSFER SERVICES. IN ADDITION, BANKS ARE PERMITTED

TO PROVIDE AUTOMATIC TRANSFER SERVICES FROM SAVINGS TO CHECKING ACCOUNTS. AT THE END OF 1979 DEMAND DEPOSITS AT COMMERCIAL BANKS TOTALED $265 BILLION, WHILE SAVINGS DEPOSITS WERE $250 BILLION. NOW ACCOUNTS, THAT HERETOFORE HAD BEEN CONFINED TO NEW ENGLAND, NEW YORK AND NEW JERSEY, ARE AUTHORIZED NATIONWIDE. ALL FEDERALLY INSURED CREDIT UNIONS CAN OFFER SHARE DRAFT ACCOUNTS. THESE ENLARGED POWERS FOR THRIFT INSTITUTIONS CREATE THE POTENTIAL FOR MORE COMPETITION IN THE PROVISION OF TRANSACTIONS ACCOUNT SERVICES AND ARE LIKELY TO RESULT IN A REDUCTION IN THE NUMBER OF FAMILIES WITHOUT TRANSACTIONS ACCOUNT SERVICES. IT IS NOT YET CLEAR WHAT PROPORTION OF DEMAND AND SAVINGS ACCOUNTS WILL BE MADE AVAILABLE FOR TRANSACTIONS SERVICES NOR WHAT PROPORTION MAY SHIFT TO TIME ACCOUNTS.

THE ACT PROVIDES THAT ALL INSTITUTIONS OFFERING TRANSACTIONS ACCOUNTS HAVE ACCESS TO THE PAYMENT SYSTEM INFRASTRUCTURE. THE FEDERAL RESERVE IS TO PRICE ITS SERVICES, INCLUDING CHECK CLEARING AND COLLECTION, AUTOMATED CLEARINGHOUSE, NET SETTLEMENT, WIRE TRANSFER, SECURITIES SAFEKEEPING, FEDERAL RESERVE FLOAT AND ANY NEW SERVICE WHICH THE FEDERAL RESERVE OFFERS. WITHIN 18 MONTHS AFTER THE DATE OF ENACTMENT THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM IS REQUIRED TO PUT INTO EFFECT A SCHEDULE OF FEES FOR ALL SUCH SERVICES. THE PRICING OF PAYMENT ALTERNATIVES WILL GUIDE AND BE GUIDED BY USER REACTION TO PRICE DIFFERENTIALS AND SHOULD RESULT IN GREATER ADAPTATION TO USERS' NEEDS AS WELL AS A MORE EFFICIENT UTILIZATION OF REAL RESOURCES.

Provision is also made in the Act for the Federal Home Loan Bank Board and the Central Liquidity Fund for the National Credit Union Administration Board to provide demand deposit accounting and service bureau functions for their members. Each agency is authorized to be drawees of, and to engage in or to be agents for, the collection and settlement of check or check-like items drawn on or issued by members. Each agency is also permitted to make reasonable charges consistent with the principles set forth in the Federal Reserve Act for pricing of services.

These elements of the Monetary Control Act will change the structure of the payment system. The Act, by making it possible for all depository institutions to offer deposit transfer services is likely to bring about some displacement of cash and currency by checks and electronic credits and debits. More families are likely to have deposit transfer accounts--about 20 per cent are without such service now and Congress has sought advice from the Federal Reserve on how the advantages of deposit accounts might be made available to lower income groups. Before I say anything about how the Fed's role might be changed, let me outline our current involvement in the payments mechanism.

The Federal Reserve presently maintains 48 check clearing centers which process over 60 million items each business day. It clears any check and check-like instrument that has been deposited by a member bank for collection. Among the check-like documents are the NOW account drafts for thrift and commercial bank institutions and the share drafts for credit unions. Nonmember banks may deposit items drawn on local banks, payable

THROUGH MEMBER BANKS WITH THE FEDERAL RESERVE. IN 1979 THE FEDERAL RESERVE PROCESSED ABOUT 15 BILLION CHECKS AND INCURRED COSTS OF $258 MILLION PROCESSING THESE ITEMS.

THE FEDERAL RESERVE OPERATES 35 OF THE 36 AUTOMATED CLEARING HOUSES. IN 1978, 176 MILLION ACH TRANSACTIONS WERE HANDLED AT A DIRECT AND SUPPORT COST OF $9.7 MILLION -- 5.5 CENTS PER ITEM. ACH VOLUME IS PRESENTLY DOMINATED BY GOVERNMENT PAYMENTS WHICH ACCOUNT FOR ABOUT 84 PER CENT OF TOTAL VOLUME. THIS VOLUME IS BEING FED INTO A SYSTEM WITH THE CAPABILITY OF HANDLING 500 MILLION ACH TRANSACTIONS ANNUALLY WITHOUT ANY MORE THAN A NOMINAL INCREASE IN COST AND BRINGING THE UNIT COST DOWN TO 1.9 CENTS.

THE FEDERAL RESERVE WIRE NETWORK HANDLES CREDIT TRANSFERS OF RESERVE ACCOUNT BALANCES ON BEHALF OF THE TREASURY, MEMBER BANKS, AND CUSTOMERS OF MEMBER BANKS. IN 1979, 35 MILLION WIRE TRANSFERS WERE MADE, VALUED AT $68 TRILLION. THE FEDERAL RESERVE INCURRED DIRECT AND SUPPORT COSTS OF $14.6 MILLION FOR WIRE TRANSFERS IN 1979.

THE NATION'S REQUIREMENTS FOR CURRENCY AND COIN ARE SUPPLIED BY THE FEDERAL RESERVE SYSTEM BY TWO BUREAUS OF THE DEPARTMENT OF THE TREASURY. CURRENCY IS PRINTED BY THE BUREAU OF PRINTING AND ENGRAVING AND IS SUPPLIED TO THE FEDERAL RESERVE AT COST. COIN IS PRODUCED BY THE TREASURY'S BUREAU OF THE MINT AND IS ACQUIRED BY THE FEDERAL RESERVE FROM THE MINT AT FACE VALUE. IN 1979, THE FEDERAL RESERVE SPENT $149 MILLION FOR ISSUE, PROCESSING AND TRANSPORTATION OF CURRENCY AND $25.9 MILLION FOR PROCESSING AND TRANSPORTATION OF COIN.

What is the likely impact of the Monetary Control Act on the Federal Reserve's role in the payments system? Uniform reserve requirements on transactions balances in all depository institutions will eliminate the distinction between members and nonmember commercial banks, and between commercial banks and thrifts, with respect to direct settlement with the Federal Reserve. Pricing will eliminate these distinctions with respect to access to the Federal Reserve's clearing and collection services. Currently, although more are eligible, the Federal Reserve provides full check collection services to about 3,500 commercial banks and under the Monetary Control Act, all 14,000 commercial banks as well as thousands of thrift institutions could conceivably make use of Federal Reserve services. There might be significant demand for cash and wire transfer services from even smaller depository institutions.

It is unlikely that the Federal Reserve which currently handles about 40 per cent of all checks written would experience a dramatic increase in volume. Smaller institutions prefer to use the facilities of correspondent banks and nonbank processors because they provide a fuller package of services which the Federal Reserve does not intend to duplicate. Thus, the Federal Reserve does not look for an expansion in clearing even though the number of accounts kept with the System might triple or quadruple.

The Monetary Control Act may set up a new relationship between the Federal Home Loan Bank Board, the Central Liquidity Fund and the Federal Reserve. Both agencies are given the authority to collect and settle items

DRAWN ON THEIR MEMBERS. IN PROVIDING THESE FUNCTIONS A FEDERAL HOME LOAN BANK OR AN AGENT BANK OF THE CENTRAL LIQUIDITY FUND IS PERMITTED TO UTILIZE THE SERVICES OF, OR BE A MEMBER OF, A FEDERAL RESERVE BANK. THUS, THRIFT INSTITUTIONS WOULD HAVE DIRECT ACCESS TO FEDERAL RESERVE CLEARING AND SETTLEMENT. TODAY, THRIFT INSTITUTIONS CLEAR AND SETTLE SOLELY THROUGH CORRESPONDENT BANKS. IT IS UNLIKELY THAT MANY THRIFTS WILL CHOOSE TO CLEAR AND SETTLE DIRECTLY WITH THE FEDERAL RESERVE BECAUSE CORRESPONDENT BANKS DEAL WITH SMALLER NUMBERS OF INSTITUTIONS AND CAN OFFER THEM CUSTOMIZED SERVICE. WE, ON THE OTHER HAND, PROVIDE A BASIC LEVEL OF CLEARING SERVICE TO OVER 3,000 INSTITUTIONS.

THE ACT'S REQUIREMENT THAT THE FEDERAL RESERVE PRICE ITS SERVICES SHOULD HELP IT TO EXPEDITE THE CONVERSION TO ELECTRONIC CAPABILITIES THAT NOT ONLY WILL REDUCE COST AND FLOAT, BUT WILL GREATLY ENHANCE CONVENIENCE AND CERTAINTY. AUTOMATED CLEARING HOUSE TRANSFERS (ELECTRONIC CHECK PRESENTMENT, AND CHECK TRUNCATION) SHOULD BE MORE COMPETITIVE WITH CHECK SERVICES UNDER PRICING, ESPECIALLY AS THE FEDERAL RESERVE ELIMINATES FLOAT OR PASSES THE COST OF FLOAT ALONG TO THE USERS OF THE CHECK SYSTEM. PRICING MAY RESULT IN A SHIFT OF VOLUME BETWEEN THE FEDERAL RESERVE AND THE PRIVATE SECTOR. WE EXPECT THAT PRICING WILL ENCOURAGE THE USE OF LOCAL CLEARING AND EXCHANGE ARRANGEMENTS BECAUSE THERE ARE ECONOMIES INVOLVED IN LOCAL CLEARING WHICH THE FEDERAL RESERVE WOULD NOT BE ABLE TO MATCH. ON THE OTHER HAND, THERE ARE ECONOMIES OF SCALE ASSOCIATED WITH THE FEDERAL RESERVE NATIONWIDE CLEARING OF 15 BILLION ITEMS THAT IT WILL BE DIFFICULT FOR ALTERNATIVE ARRANGEMENTS TO MATCH. FOR EXAMPLE, THROUGH PRICING THE FEDERAL RESERVE CAN ENCOURAGE INSTITUTIONS TO DO SORTING OPERATIONS IN THEIR OWN SHOPS WHEN THEIR COSTS ARE LESS THAN OURS.

THERE HAS BEEN A MIXED REACTION BY THOSE WHO HAVE ATTEMPTED TO PROJECT THE IMPLICATIONS OF THE MONETARY CONTROL ACT ON FEDERAL RESERVE PAYMENTS OPERATIONS. SOME--NAMELY THOSE IN THE SYSTEM--ARE FEARFUL THAT THE ACT AND ITS REQUIREMENTS WILL RESULT IN LOST PAYMENTS VOLUME, AND THUS, CONSTANTLY INCREASING PRICES MAKING OUR SERVICE OFFERING NONCOMPETITIVE AFTER AWHILE. OTHERS--MAINLY THOSE IN THE PRIVATE SECTOR--HAVE BEEN MOTIVATED TO LOBBY FOR THE INCLUSION OF REQUIREMENTS THAT WOULD, INDEED, MAKE FED PRICES NONCOMPETITIVE AND FED FLEXIBILITY TO REACT TO CHANGE, UNWIELDY. LET ME GIVE YOU MY OWN THOUGHTS ON WHAT THIS LEGISLATION WILL DO.

I LOOK UPON IT AS PROVIDING A CHALLENGE AND AN OPPORTUNITY FOR THE FEDERAL RESERVE TO MODERNIZE ITS PAYMENTS SERVICES, AND THUS, TO PROVIDE A SUPERIOR SERVICE TO THE PUBLIC. THIS HAS ALREADY STARTED. LAST YEAR, FOR EXAMPLE, THE BOARD ANNOUNCED A PROGRAM TO EXPAND THE USE OF ELECTRONIC DELIVERY OF PAYMENT ITEMS TO MEMBER BANKS. I EXPECT THIS AREA TO RECEIVE INCREASED ATTENTION NOW THAT WE CAN RECOUP OUR COSTS--THROUGH PRICING--AND PERHAPS EVEN ACCELERATE THIS PROGRAM. JUST THIS PAST QUARTER, THE BOARD ANNOUNCED TWO PROGRAMS, ONE ON OUTSORTING LARGE DOLLAR ITEMS AND THE OTHER ON ELECTRONIC CHECK PRESENTMENT. THE LATTER, YOU WILL NOTICE, REQUIRES ELECTRONIC DELIVERY TO BE SUCCESSFUL. OTHER ALTERNATIVES ARE UNDER REVIEW, INCLUDING THE POSSIBILITY OF MAKING CHANGES TO OUR CHECK AVAILABILITY SCHEDULE WHICH WOULD MAKE AUTOMATED HANDLING OF PAYMENTS--AND ELECTRONIC DELIVERY--MUCH MORE COMPETITIVE WITH OUR CHECK SERVICE OFFERING AND PROVIDE INCENTIVES TO THE PUBLIC TO SEEK OUT SUCH AN ALTERNATIVE ARRANGEMENT.