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Remarks by

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before the

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It is a pleasure to be here this morning at NACHA's 1987 annual conference. I find it particularly rewarding to meet with a group whose focus is on applying technology to improve the nation's payments system. As an economist, I am especially interested in programs that promote more efficient uses of society's resources. The ACH system has proven to be an efficient and reliable payments mechanism, and holds even greater promise for the future.

My remarks today will relate not only to the ACH, but also to issues that will affect electronic payments systems generally. First, I would like to discuss why the Federal Reserve's role in the payments system is important, and why we at the Federal Reserve are committed to enhancing the integrity and efficiency of the payments system. Second, I will briefly review why the ACH is a very important part of this commitment. Finally, I will address some of the issues confronting the payments mechanism today, both policy and operational, and look at some approaches for addressing those issues.

Congress established the Federal Reserve System in the early days of Woodrow Wilson's presidency in response to the near-universal belief that the banking system -- as it functioned in the early years of this century -- was inadequate to meet the needs of an increasingly complex economy. In part, these

concerns related to the inadequacies of the check collection system. Checks often traveled through a series of correspondent banks in a highly circuitous route before they were paid. When the checks finally were cleared, they were typically settled on a non-par basis.

The establishment of the Federal Reserve in 1913 altered the nation's payments system in three important respects. First, it reduced the need for banks to maintain their complex network of correspondent balances to clear checks and other payments, at least to the extent that Federal Reserve member banks could transfer funds using a single reserve account balance. This, along with the Fed's role in processing and collecting checks, brought long-needed efficiency to the check collection system.

Second, the need to provide convenient access to reserve account balances for both funds management and payments purposes quickly led to the establishment of a national wire transfer network. Fedwire operations began in 1914, using the telegraph system and Morse code to transmit messages between Reserve Banks. This laid the foundation for the Federal Reserve's long-standing commitment to electronic payments. Finally, the Fed's discount window provided a safety net that is an important tool in ensuring the integrity of the payments system. Thus, the Federal Reserve was in part created to promote operating efficiency and to ensure the safety and soundness of the payments system.

The Fed has sought, throughout its history, to stimulate improvements in the payments mechanism in cooperation with the private sector. It is this cooperative approach that has yielded such impressive results over the years. The establishment and continued enhancement of the automated clearing house system is just one example -- but an important one -- of the joint efforts of the Federal Reserve and private sector to achieve a common goal.

Some observers are critical of the progress of the ACH, because the volume is relatively insignificant when compared to the number of check payments. Although our early estimates were overly optimistic, we are encouraged by the public's increasing acceptance of the ACH. Over the last decade, private sector use of the ACH has grown at an average annual growth rate of 26 percent. And, in 1986, commercial ACH volume exceeded government volume for the first time, with slightly over 700 million commercial and government ACH transactions processed by Reserve Banks.

During its relatively short history, the ACH system has become increasingly more efficient and attractive; contributing to this progress is its evolution to a more fully electronic system. A decade ago, virtually all depository institutions relied on the physical delivery of magnetic tapes or paper listings to originate or receive ACH transactions. Today about a third of total ACH dollar volume is delivered electronically; and

in some parts of the country, this figure is as high as 70 percent. The automation of return items has also contributed to the system's improved efficiency, by cutting the return process by more than two days.

In addition to increased automation, consolidation of Federal Reserve operating sites and improved operating systems have decreased significantly the unit cost of Federal Reserve ACH services. During the past four years, for example, unit cost has declined at an average annual rate of 10 percent.

One of the greatest beneficiaries of the ACH system has been the federal government. In the mid-1970s, the Social Security Administration and the Treasury Department were facing a dilemma. Treasury's operations were not equipped to handle the ever-increasing volume of paper checks that were issued on behalf of Social Security. It either had to make a massive investment in new equipment to handle the growing check volume, or find an innovative alternative. The ACH proved to be the perfect solution. Today, 44 percent of Social Security recipients receive their benefits via the ACH.

While the Treasury used the ACH to curb its mounting check volume, some banks hope to use it as a vehicle to enhance the efficiency of the check system. Although truncation at the payor bank, often called check safekeeping, is very successful in certain segments of the industry, it still requires checks to be transported physically to the payor bank or its agent. If the

banking industry and the Federal Reserve are to reap the full benefits, checks must be truncated earlier in the collection stream. The ACH is being used to transmit payment information in the only interbank check truncation program now in operation. However, this program is progressing slowly, with only about 200 thousand checks truncated each year.

Substantial increases in interbank truncation volume are possible in the near future. We recently began exploring the possibility of using truncation to solve one of the problems with "nuisance checks." A perfect example of the nuisance check is the rebate check. Rebate programs generate millions of low value checks that require significant resources on the part of both the Federal Reserve and the industry to handle. Truncation of these checks would provide a much more cost effective answer, and may provide a significant growth opportunity for the ACH.

This potential use of the ACH as well as many others that you will be discussing today and tomorrow should contribute to significant future volume growth and increasing improvements in the efficiency of the nation's payments system.

Now, I would like to focus on the future of electronic payments more broadly. I believe several very important issues must be addressed. First, how will the structure of this country's financial industry evolve and what institutions will have access to the payments system? Second, how can the credit risks and operational risks associated with rapidly growing

volumes of payments be controlled? Finally, how do we ensure that the cooperation between the Federal Reserve and the private sector continues?

One of the more controversial banking issues is that of access to the payments system by nonbank banks. Proponents of nonbank banks are typically portrayed as advocates of less regulation and more competition for financial services, while opponents are painted as advocates of greater regulation. I, like some other members of the Board, am opposed to removing the barriers between banking and commerce. I hold this view in part because I believe that the combination of commerce and banking may lead to greater regulation of the marketplace, not less. I will elaborate on this point later, but first I want to discuss the access issue.

The Federal Reserve believes that the role of depository institutions as intermediaries in the payments process is critical to the safety of the system. They exercise an independent credit judgment that provides the first line of defense against undue risk. For example, a bank may insist that a corporation facing financial difficulty limit its funds transfers to amounts that it can cover with collected funds. This bank-provided protection may disappear when the bank is owned by an unregulated holding company. Will a bank be able to impose such restrictions on a financially ailing corporation if that corporation controls the bank?

Nonbank bank proponents argue that a "Chinese wall" would be erected between the bank and its corporate affiliates. However, to ensure that that wall is standing and structurally sound, the same apparatus that is used to examine and regulate the banking industry might have to be applied to the nonbank bank and its parent and other affiliates. In dealing with financial structure issues, minimizing the need for regulations should be an important objective. In my view, bringing nonfinancial corporations under the banking regulatory apparatus is a compelling argument against the removal of the banking-commerce wall.

Another issue that commands much of our attention is the risks inherent in the payments system. We at the Fed, and you in your banks and corporations, have seen a constant acceleration in both the number of payments and the dollar volume of those payments. Demand-pull and technology-push give us a transaction velocity that would have been unthinkable a decade ago. For example, on January 20 of this year, an unsurpassed dollar volume of payments -- over $1.5 trillion -- was processed on the nation's large-dollar funds transfer networks. This escalation of payments volume leads to increased risk and increased potential for disruption of the entire financial marketplace.

A year ago, the Fed implemented policies to reduce risks on large-dollar payment networks. The results to date have been encouraging. The level of daylight overdrafts in relation to the

dollar volume of funds transfers has declined 23 percent since last March. An important question that is raised quite frequently is "what is an acceptable level of daylight overdrafts." Rather than the Federal Reserve determining the appropriate level, one ultimate solution to the daylight overdraft problem may be pricing. Today, since charges are not imposed on the use of daylight overdrafts, there are inadequate incentives for institutions to minimize their overdraft position. Pricing could provide the needed incentive. Unfortunately, this concept raises a number of complex issues, which require the attention of both the Federal Reserve and the industry. Recently, in conjunction with issuing several proposals for public comment that are designed to reduce credit risk further, the Board asked the public for its views on the concept of pricing daylight overdrafts. I hope your organization will provide its comments to assist us in our analysis.

Another proposal deals with controlling risk in the ACH. While the ACH is an effective substitute for the paper check, it is an inadequate substitute for many large dollar funds transfers. Use of the ACH for such payments significantly increases temporal risk for the originating institution. While we recognize that risk on the ACH system today is fairly minimal compared to the large-dollar funds and securities transfer networks, the potential for high volume growth raises concern about future risk.

One objective of the ACH proposals is to improve the credit and operating controls in the system before the risk becomes significant. It is imperative that both the industry and the Fed do their part to ensure that as the ACH continues to grow, the risk does not grow commensurately. I won't address the specific proposals at this time, since they are the subject of a panel discussion later this morning.

Another issue related to payment system risk is reliability. The Federal Reserve, as well as the banking and corporate communities, now have a heightened awareness of the need for improved reliability in our payments systems. We have been devoting significant attention to contingency processing. As many of you know, the System has a contingency processing center in Culpeper, Virginia, that is designed to provide back-up in the event of an extended outage, including back-up for ACH processing. However, we realize that this alone is not adequate. The Federal Reserve Bank of New York has established a contingency processing center to enable it to continue its operations in the event of an outage. We are looking at longer term approaches to solving this problem, including the concept of having the Reserve Banks serve as back-up for each other.

The Federal Reserve has not only been looking at improving reliability but also at other potential changes to our electronic payment systems. The Fed staff has recently completed the first phase of a major study on the future of our electronic payments

systems. The study delves into a number of questions: What requirements do the banking and corporate communities have for the design of electronic services in the next decade? What are the demands for timeliness of processing and delivery of different types of payment messages? What hours should the service be available? Does it make sense to have one format for all electronic payments, as we have one MICR line standard for checks?

Cooperation between the Federal Reserve and the private sector will be a critical factor in developing answers to these questions. One aspect of cooperation is the constructive criticism and suggestions that are provided by the industry in the public comment process. A good example of this is the proposal to allocate the cost of ACH float through the use of a float factor. The comments we received on this proposal raised significant concerns with the approach we had suggested. We learned a lot from these comments, and are now in the process of developing a different approach to recovering ACH float. In contrast to our initial timetable, we no longer plan to implement a change in the way we recover the cost of ACH float in 1987.

As an economist, I tend to view most business decisions in terms of an economic model. The determination of the optimal electronic payments system for the 1990s is no exception. We intend to follow an economically rational decision making approach that will evaluate the costs and benefits of maintaining

the current system contrasted with adopting alternative approaches. Of course, in considering the costs of alternative approaches, the transition costs will also be factored into the model. From this exercise, we hope to design a system that will provide greater benefits than the current payments system at a lower cost.

But as you know, in economics things are never quite that simple. Defining the societal benefits and costs of various alternatives is no small task. And, of course, we are all well aware that these decisions will not be made in a political vacuum.

In conclusion, I would like to reiterate that cooperation in the development and operation of the payments system has been a key to success in the past. Cooperation will be one of the keys to the future success of the ACH.

Thank you.