

For release on delivery
8:30 a.m. EST
February 2, 1989

"The Evolution of the Payments System"

Remarks by
Governor Wayne D. Angell
Board of Governors of the Federal Reserve System
before the
Eighth Annual Float Management Conference
Fort Lauderdale, Florida
February 2, 1989

Good morning. I appreciate the opportunity to speak to you at the Eighth Annual Float Management Conference. The evolution of float management reflects the transition of the payments mechanism over the last two decades. Prior to the rapid acceleration of interest rates in the 1970s, float management was not as crucial to depository institutions as it is now. Today, for most institutions, their ability to collect checks and manage the proceeds is essential to their financial well being. Critical to a float manager's success is that manager's ability to stay apprised of changes in the payments mechanism and to act on such knowledge accordingly.

I would like to discuss with you this morning the goals and ensuing direction the Federal Reserve is pursuing with respect to the payments mechanism -- both paper-based and electronic. The Federal Reserve looks at payments system objectives in the context of the recent history of the payments mechanism and considers the transition period that will be necessary to achieve these objectives.

Basically, the objective of the Federal Reserve is to promote an efficient and sound payments mechanism. This may sound like rhetoric, having heard it so many times in the last decade, but it does serve as the central focus for Federal Reserve actions in the payments arena. There exists

no perfect payments system that would completely achieve all of the Fed's objectives -- a payments system that would eliminate all risk, guarantee payments, and operate at optimal efficiency and in a cost effective manner. Even if we conceived of such a perfect system today, it would not be perfect by the time it was achieved. It is important to recognize that our payments system will always be in a state of transition. The effectiveness of changes in the payments system should be measured by how closely such changes fulfill our prime objective without imposing undue burden on payments system participants. At the same time, the need for the changes should be balanced with the need for stability in the functioning of the payments mechanism.

Certainly, the payments system is now undergoing a major transition as depository institutions implement the provisions of Regulation CC. Beyond implementing the specific availability and disclosure provisions of the Expedited Funds Availability Act, the goal of the Federal Reserve in adopting Regulation CC is to use the authority granted under the Act to improve the payments system. None of what the Federal Reserve is pursuing under this authority is new in concept to anyone familiar to the payments system. Banks have known for years that return item processing could be improved, but legal impediments and the lack of

incentives have prevented significant improvements until now. Delayed disbursement practices have been a matter of controversy for years, but the issuance of policy statements has not influenced bank practices sufficiently to reduce these practices. The same-day payment concept that was issued for comment last year had been previously discussed in concept, even though the details of the proposal were not developed. We believe that these and other proposals deserve consideration based on their potential to improve the payments system.

The Federal Reserve is not wedded to any of these concepts; rather we are wedded to the objective of a more efficient payments mechanism. We believe that these concepts have the potential to achieve this objective. Alternative concepts developed in the financial community, with the potential to fulfill the objective in a more effective manner or at least in a manner more acceptable to depository institutions, would be welcomed by the Federal Reserve. This is why we have pledged to work with the industry in designing improvements that benefit the payments system as a whole, and not initiatives that are designed to improve the system for only a small minority of players at the expense of many others. We recognize, of course, that all players will not benefit from all proposals. What we

consider to be overriding is the benefit to the system as a whole and thus, the public good.

With this in mind, I would like to discuss in more detail some outstanding regulatory proposals that I briefly mentioned earlier. First, I am sure you are aware that last June the Board published a proposal, to become effective April 1989, that would restrict the delayed disbursement of teller's checks. This proposal was designed to address institutions' concerns that a depositary bank would be required to make funds available for withdrawal before it would receive credit for the check through the check collection process. Today, some institutions issuing teller's checks impose costs, in terms of lost interest, on other institutions and retain for themselves the float benefits associated with any delay arising because such checks are presented for payment at another, often remote, location. In particular, teller's checks issued by institutions on the west coast that are drawn on distant locations have been found to impose additional costs on other institutions.

The Board received over 230 written comments from the public on the proposal, and Board staff has had numerous informal conversations with industry representatives. There are some indications that it may be possible for the

industry to cooperatively address this issue so that the need for a regulatory solution would be minimized. The Board favors cooperative solutions that do not require rigid regulations and that demonstrate the industry's willingness to work toward payments system improvements. For the most part, teller's check service providers have indicated that they are willing to make changes that would speed the collection of checks in markets that they serve. However, such solutions require the cooperation of all concerned. A few institutions can make cooperative solutions unworkable and necessitate the burden of regulation on all depository institutions. In any event, even if the Board does implement a final rule on delayed disbursement, we have announced that such a rule would not be implemented by the proposed April 1989 effective date.

Another proposal currently being analyzed by the Federal Reserve is the same-day payment concept that was issued for comment last April. Under the proposal, paying banks would be required to pay in same-day funds, without the imposition of presentment fees, for checks presented by collecting banks prior to 2:00 p.m. This requirement parallels the requirement in Regulation CC that depository banks pay in same-day funds for checks being returned to them. The proposal was issued for comment because a

same-day payment requirement could result in improvements in the payments system. The proposal also has the potential to address "competitive fairness" issues raised by correspondent banks with regard to the Federal Reserve's exemption from paying presentment fees. The Board recognizes, however, that the proposal may impose unwelcome burdens and operational difficulties on paying banks and their customers.

The fact is that the overwhelming majority of commenters, both corporations and depository institutions, were opposed to this proposal because of the perceived detrimental effect later presentments would have on corporate cash management practices. Even the most adamant proponents of change to promote "competitive fairness" do not have a clear vision of a workable concept. Although the users of the check collection system favor competition because a choice of service providers enables them to receive better service at lower cost, they do not see this particular proposal as furthering this goal. The Federal Reserve will continue to carefully consider the comments received on the proposed same-day payment concept, and will work with industry groups and others to pursue alternative solutions suggested by the commenters and determine whether a consensus on a viable solution can be reached.

The last regulatory proposal I would like to discuss briefly with you today is related to the handling of payable-through drafts. When we adopted Regulation CC, the Credit Union National Association brought suit against the Board regarding the regulation's treatment of payable-through drafts. The Board's definition of "paying bank" allowed institutions to rely on the routing number on the check to determine whether checks should be treated as local or nonlocal. But CUNA asserted that this rule was contrary to the provisions of the Act because many credit unions' payable-through drafts are drawn on banks nonlocal to the credit union. The court ruled that the strict language of the Act required that payable-through drafts should be treated as local or nonlocal based on the location of the credit union, not the payable-through bank.

Many institutions have expressed concern to the Board that the new treatment of payable-through drafts imposes operational difficulties and increased risks on institutions that accept such drafts for deposit. In order to address these concerns, the Board issued for comment four alternative proposals based on industry suggestions. We hope the comments on these proposals will provide us with further information on whether these proposals are necessary to facilitate compliance with Regulation CC and to improve

the check system by speeding the collection and return of payable-through drafts. In addition, we hope to learn whether the proposals impose undue burdens on credit unions and other institutions on which payable-through drafts are written. The comments received on these proposals are currently being analyzed, and we expect that the Board will consider a final recommendation on this issue in March.

Now that I have discussed the regulatory initiatives being pursued to improve the payments system, I would also like to note several initiatives being undertaken to improve Federal Reserve Bank services. The most noticeable change in Federal Reserve payments services is the offering of new return item services as of September 1, 1988. These new return services were implemented to provide depository institutions with a way to meet the requirements for expeditious return contained in Regulation CC. When the return item services were announced last year, the Federal Reserve indicated that the fees for these services were set based on estimated costs because, of course, no one had any experience in processing returns under this new system. At that time, we indicated that fees may be revised in mid-year 1989 if experience indicated that the costs of providing return item services were not as expected.

Experience has shown that actual costs incurred by the Reserve Banks in providing return item services are higher than projected. Generally, costs are higher because more institutions are depositing qualified returns than anticipated, and the quality of these returns is often poor, resulting in operational problems at the Reserve Banks. In addition, it appears that return items are subject to higher reconciliation and adjustment costs than anticipated. The Reserve Banks may continue to eliminate some of the additional costs associated with poor quality returns by educating depositors and may recover some of the additional costs by assessing raw return fees on qualified returns that do not meet quality standards. Nevertheless, our early experience indicates that return item costs will continue to be higher than originally projected. Now that Reserve Banks have some experience in processing returns, the Federal Reserve may reprice returned check services earlier than originally indicated. Preliminary indications are that some prices may be significantly higher than current levels.

The Federal Reserve Banks are also implementing other services to expedite the collection of checks, including expanding the use of electronics in the paper-based check collection system through truncation and extended MICR capture services. A mature truncation service

would stop the flow of the paper check, ideally at the bank of first deposit, thereby reducing the resources currently used to transport checks as well as eliminate multiple handlings of checks. The Federal Reserve is working with the financial industry through the National Association of Check Safekeeping to develop the requirements necessary for such a system to work effectively. As a first phase, Reserve Banks are offering truncation services to their local payor banks, with the idea of moving the paper retention site toward the bank of first deposit or the first collecting bank. The paper retention site would convert the check information into an electronic debit and collect it electronically, store the physical check for return and information retrieval purposes, and ultimately destroy the physical check, retaining only a microfilm copy.

The automated clearinghouse is one electronic mechanism that might serve to collect truncated checks. In fact, a format is being developed that would collect truncated checks in a more cost effective manner. Of course, the ACH is continually in transition as well. Currently, the Federal Reserve is exploring new technological alternatives to enhance the future electronic payments production environment and to make the electronic system more reliable.

Of course, many of these initiatives are longer-term projects. It will be many years before nationwide truncation reaches the level necessary to keep planes on the ground. New electronic services based on new technologies cannot be implemented until such technology is readily available and cost-effective. However, the Federal Reserve believes we have a public responsibility to pursue such efforts and perhaps provide the impetus necessary to accelerate potential improvements to the payments mechanism.

Thank you.

