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Statement by

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before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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I am pleased to testify today on two important issues, membership in the Federal Reserve and pricing of Federal Reserve services. First, I would like to express my concern about the continuing erosion of membership in the Federal Reserve and the need to solve this problem. Next, I want to discuss the issue of pricing for Federal Reserve services. Most of my testimony will be devoted to discussing pricing because of its potential impact on membership and on the nation's payments mechanism. Congress should be fully aware that pricing for services without reducing the burden of membership will further contribute to banks leaving the Federal Reserve.

As a member of the Board and former President of the Federal Reserve Bank of Dallas, I have observed the withdrawal of banks from the Federal Reserve System for nearly 27 years. At first the banks withdrawing from the System were generally rather small. But in recent years larger--even large correspondent banks and frequent users of Federal Reserve services--have found the burden of membership too great to justify remaining in the System and others have indicated intentions to withdraw unless the burden of membership is relieved.

Over the years, the Board has expressed its concerns to Congress about the loss of member banks and has recommended ways to reverse membership loss. Chairman Miller again stressed this concern in his testimony last week. In his testimony he explained the reasons why banks are withdrawing from the Federal Reserve System. I want to stress the point that increased competition for transaction accounts--particularly interest bearing transaction accounts--has forced all financial institutions to become increasingly cost conscious. In turn, member banks facing this and other challenges to profitability have been forced to carefully weigh the costs of retaining their membership.

In addition, his testimony provides a review of the adverse implications that declining membership has for monetary management and the quality of the banking system. Chairman Miller stressed the importance of bringing equity among financial institutions. Let me emphasize two factors he mentioned. First, the ability of the Federal Reserve to guide innovation and foster constructive competition in the payments mechanism among financial institutions will be enhanced. Secondly, at such time as all financial institutions are bearing an equitable reserve burden, there will be no unfavorable economic effects to allowing uniform access to Federal Reserve services at equal costs and under equal conditions.

It is important for the United States to have a strong central bank and certainly in the current economic situation steps should be taken promptly to offset any contrary trend. I am sure that Congress is as concerned as we are about the inflationary pressures evident in our economy and therefore will be interested in assuring the strength of one of its primary agents for resisting inflation.

This line of thought leads me to hope that Congress will be willing to stop the erosion of membership. The most evident and clear-cut support Congress could enact would be legislation requiring universal reserves.

It is essential for everyone to understand that monetary policy is not developed for banks or even the limited number of member banks, so there appears to be no good reason for the nation's central bank to operate under the shackles of a voluntary membership structure. We can debate a specific monetary policy on its merits, but from any standpoint, I can see no public purpose to be served by limiting the effectiveness of the central bank. Monetary policy is made for the entire nation, not a limited sector of the banking community. All depository institutions are chartered in the public interest and all should be directly supportive of and participants in the implementation of policy.

I would like to express my views on the part of the Board's plan and the parts of the proposed legislation that deal with charging for Federal Reserve services. I will explore with you possible impacts charging will have on the nation's payments mechanism.

You are no doubt aware that the System has been considering for over two years the subject of charging for its services. As studies have progressed, we have become increasingly aware that there are problems in the application of the theory that pricing should result in a more efficient allocation of total resources to payments mechanism activities. I believe there is a much more important goal than attaining optimum allocation of resources. That goal should be the continuing ability of the Federal Reserve to assure the Congress and the nation of a smoothly functioning payments mechanism.

In considering pricing legislation, the Congress should be fully aware that the Federal Reserve has no intention of enlarging its role in the payments mechanism to the exclusion of the correspondent banks of the nation. Neither, however, does it intend to allow a few very large private sector firms to dominate services now provided by the Federal Reserve. This could result, ultimately, in problems similar to those in existence when Congress created the Federal Reserve System and gave it the power to establish clearing house services.

In its proposal to the Congress, the Board made the following statement:

> "In order to assure continued efficient functioning of the payments mechanism and to avoid major disruption during the transition to a more competitive environment, the Board would follow a conservative and flexible approach in establishing charges for Federal Reserve services. To this end, the System has concluded that its charges should be competitive with those for comparable services (when available) in the private sector. However, the Board would retain flexibility to alter charges or service policies in order to meet its responsibilities to maintain a satisfactory, basic level of service for the nation as a whole and to encourage innovations."

I would like to elaborate on this statement and explain why the Federal Reserve believes it has a responsibility to retain an ability to perform a "basic level of service" nationwide in payments activities.

Payments mechanism activities are an important aspect of the functioning of the nation's economy. The Federal Reserve through its currency and coin distribution, check collection, funds transfer, and U.S. Government security transfer services is actively involved in all vital components of money supply and money movement through the nation's payments system.

The payments mechanism of the United States functions quite well today. Enormous amounts of money flow among financial institutions each day. Much of the nation's business is carried out with check payments and as you know the Federal Reserve is a major participant in the check collection system. Orderly markets in federal funds and government securities are important to the government and the banking industry and to monetary policy. The Federal Reserve Communications System plays a vital role in supporting these markets.

The government in protecting the public interest has a substantial concern with the smooth functioning of financial markets and payments mechanism activities. I believe those interests can be protected in only two ways, either exclusively through regulation or through limited regulation and an operational presence such as the Federal Reserve currently has in the check collection system.

If the Federal Reserve operational presence in payments mechanism functions were materially reduced, then regulation of payments operations probably would be needed to protect safety and soundness of depository institutions or to avoid payments practices that are contrary to the public interest. Who, for example, would enforce standards such as MICR encoding and routing number systems? Who would ensure that funds availability is maintained at a reasonable level so that checks would remain as acceptable as they are today? If Federal Reserve operational presence were reduced, it would be necessary to establish a body of regulations and examination, investigation, and enforcement mechanisms to ensure an efficient and equitable payments mechanism. The costs and burden of such a program should be a significant factor in determining the pricing and operational posture of the Federal Reserve.

We believe that Congress looks to the Federal Reserve to protect the public interest in payments mechanism functions and we believe that the public interest can best be served by continued operational functions that are performed by the Federal Reserve Banks. Therefore, while pricing of Federal Reserve services is intended to bring about efficient allocation of resources, there is a need for sufficient pricing flexibility for the Federal Reserve to maintain its operational presence in payments operations. In particular, the Federal Reserve should continue to provide a basic level of service and protect the public interest in the safety and soundness of the nation's payments mechanism. As an example, consider that through the participation of both the Federal Reserve and the private sector the check collection system has evolved into a system with the following desirable features:

1) Certainty - Checks and other cash items drawn on any financial depository institution are collectible. There is almost universal payment for checks at face value by paying banks.

2) Speed - Checks represent money to the payee and the collecting bank. Current arrangements allow for availability of funds to collecting banks for any checks in 2-3 business days. Rules also exist to assure prompt notice of nonpayment of items.

3) Accuracy - The incidence of error is relatively small and not readily visible to the public. Procedures exist to assure maintenance of sufficient records to correct mistakes (lost items, missent items, etc.).

4) Efficiency - For items drawn on distant banks the Federal Reserve collection system helps assure a minimum number of institutional handlings. Balances maintained solely for settlement are also minimized because of the use of reserve accounts for settlement.

5) Optional collection channels available - It is possible for a bank to collect items through a number of options in the current system. Federal Reserve collection channels are used primarily by member correspondent banks. Smaller banks, both members and nonmembers, use a correspondent bank as their primary collecting agent.

6) Nationwide scope - A similar level of service is available to all collecting and paying banks wherever located.

In operating the collection service, a public institution can assure that all regions of the country are provided a basic level of service at a reasonable price. Federal Reserve operations in the check collection system assure that clearing time is relatively fast to all areas. And, they assure that terms of access to the check collection system are equitable. However, this is done by providing subsidies to low-volume and remote financial institutions. The private sector could provide such cross-subsidies only if it earns excessive profits in high volume, high profit regions.

The Federal Reserve Banks pass credit to depositors on a predetermined schedule that is intended to approximate collection times for the items deposited. The fact that these schedules are fixed provides a firm basis upon which depositing banks can plan their cash positions and manage their funds. This certainty also provides a way for commercial banks to pass credit to their depositors in an orderly fashion without accepting undue costs or risks.

This certainty is financed by the quantity known as Federal Reserve check collection float, which is the difference at any time between the value of credit for deposits given by the Reserve Banks and the value of checks collected. If the private sector were to assume the responsibility of passing credit for checks on the same schedule as the Reserve Banks, the expense of financing the float would be a substantial cost to the banking system that it does not now bear.

If the Federal Reserve is not given the flexibility to adjust its prices to the marketplace, there is a possibility that the private sector will skim off only the most profitable services leaving the Federal Reserve with the least profitable services and significantly higher average costs. For example, in the check area the Federal Reserve could be left collecting checks drawn on low-volume and remote banks. Since the cost of providing only this service would be extremely high, it would then have to be decided whether users of Federal Reserve services should be subsidized in order to assure continued acceptability of these checks.

It is vitally important that the nation have available a fast, reliable and accurate payments network to support the nation's monetary policy as well as the needs of banking and commerce. Implementation of monetary policy is facilitated through Federal Reserve payments mechanism operations. For example, the wire transfer of funds and securities capabilities of the System provide a fast, reliable and accurate vehicle for the effects of open market operations to flow across the banking industry. Our extensive involvement in check collection operations allows us early warning of bank liquidity problems which become evident when settlement for checks presented each day appears to be increasingly difficult for a bank. Also, if normal payments mechanism services are interrupted by severe weather or other emergencies, these circumstances are reported to the open market staff who can forecast monetary policy implementation strategy utilizing data derived from internal operating reports.

A substantial reduction in the role of the Federal Reserve in the check collection system could have an impact on Federal Reserve payments services provided to the Treasury Department. Currently, the Federal Reserve provides many services that facilitate the payment of Government obligations. Financial institutions deposit Treasury checks with the Federal Reserve for payment. The largest number of these checks are Social Security and other benefit payments. For the most part, these checks are issued and cleared during the first few days of each month. The Federal Reserve uses employees and equipment which are employed in processing commercial checks to assist in processing Government checks. If commercial check volume were reduced to a point where employment and equipment is cut back, these resources would no longer be available to assist in processing Government checks.

The Federal Reserve uses the same courier service to deliver Treasury electronic funds transfer payments that it uses to deliver checks to financial institutions. If the number of banks to which we deliver commercial checks were reduced, the courier service would also be reduced. Without the courier service, the Treasury would have to rely on other means for delivering Federal Government payments.

Given the Federal Reserve's role as a provider of a basic level of service nationwide, which I believe is a major factor contributing to the smooth functioning of the payments mechanism, let me caution against any constraining legislation which could disrupt money flow operations. A provision in the Stanton bill, H.R. 12706, would require the Federal

Reserve to adhere to a fixed formula in setting prices. The provision which requires the Federal Reserve to base its prices on direct and indirect costs as well as costs that would have been incurred by a private firm might place the Federal Reserve Banks at a competitive disadvantage in relation to private firms. Private firms rarely have their prices bound to a fixed formula. It is my impression that complete cost accounting in the banking system is a little used procedure when pricing individual services. In most cases, adjustments are simply made to prevailing market prices, with the only price constraint being coverage of all costs in the long run. It is a common practice for correspondent banks which provide services somewhat comparable to those offered by the Federal Reserve to cross-subsidize their service lines. Banks may suffer losses on payments services, for example, while recovering those losses from earnings from other bank services such as lines of credit and loan participations. My concern is that unless the Federal Reserve utilizes similar flexibility, it will not be able to adjust to the realities of the competitive marketplace and may be forced to reduce or abandon its role as the provider of a basic level of service nationwide.

Let me make it clear that I have no problem with using pricing to define the terms of access to Federal Reserve services, to bring about a more efficient use of those services, or even to determine the role the Federal Reserve should play in the payments mechanism as long as we do not allow private concentrations to be substituted for the Federal Reserve. I do not believe that it would be in the best interest of our country to have the payments mechanism in the hands of a severely limited number of private institutions and I suspect that this concern is shared by a great many smaller banks and other nonbank financial institutions.

It is not absolutely necessary for the Federal Reserve to price for many of its services in order to allow the private sector to compete. The private sector is able to compete with the Federal Reserve because we have exercised restraint in our involvement in the payments mechanism. For example, correspondent banks and service organizations offer significantly broader check processing services including dollar amount encoding, proof of deposits, transit check processing (including both collection of some checks and routing others on for collection through other banks and the Federal Reserve) and demand deposit accounting (posting of checks to customer accounts). In providing transit check processing, the organizations are frequently able to improve upon Federal Reserve funds availability by direct routing of checks to banks. It should be made clear that Federal Reserve check clearing operations and commercial bank operations currently differ in many respects. A considerable proportion of Federal Reserve expense is related to delivery of checks to all banks in the nation each day and to transportation of checks among zones nationwide. Commercial banks expedite collection of checks based on the dollar amount of the items while the Federal Reserve generally does not discriminate based on dollar value. The Federal Reserve sets rather stringent pre-sorting requirements on depositing banks and requires all items to be fully encoded prior to deposit while commercial banks are much more liberal in sorting requirements and will perform encoding operations for a price.

My recommendation is that we take a cautious approach towards pricing of Federal Reserve services so that we do not unduly affect the performance of the payments mechanism. I believe that it is important for us to at least see how pricing works and for the Federal Reserve to gain experience in pricing before we become bound to a formula which may do more harm than good. I think this argues for flexibility in establishing prices so that pricing can help bring about a more efficient use of payments services while at the same time acknowledging the role of the Federal Reserve to continue to set the rules of the road and to provide a basic level of service nationwide.