HIGHER PRODUCTIVITY DEMAND DEPOSITS

Remarks of

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I am genuinely happy to be here today to participate in the work of your panel on the Federal Reserve System's activities in the payment mechanism area, because the efforts of the past few years are bearing fruit. And we appear to be in the vanguard of the program Mr. Nixon and his lieutenants are suggesting to the nation--sharply improve the nation's productivity.

Before the end of this year most of the 66 million checks now being written by Americans each business day will move into Federal Reserve Regional Check Processing Centers--which we call RCPCs--initials that will very soon be part of most bankers' lexicon. With the RCPCs clearing, presenting and collecting most checks overnight, demand deposit money will have been given a faster turnaround period. That is, the RCPCs will substantially increase the payment productivity of demand deposits, since what was deposited yesterday can be respent tomorrow, instead of two or three days from now.

Also during 1972 we will see the beginnings of the second stage of the task of building a higher productivity payments mechanism begin to come into operation. This will be the first one or perhaps two city or area exchanges in which the payments instructions now usually given and effected by check will be made instead--where authorized by bank customers--by instructions stored electronically on tapes, and cleared in a computerized Federal Reserve electronic clearing house. Commercial banks in the San Francisco-Los Angeles area, and in Atlanta, have put several years of faith and hard work--with Federal Reserve encouragement and assistance--into pioneer designing of "paperless" payment systems for customers who want to make use of this low cost, high convenience means of paying and collecting.

Every type of repetitive payment--payrolls, utility bills, dividends, social security payments, periodic interest payments are a few examples--can be made at substantially lower cost in this way. Recipients will get their money sooner--and with less risk--than they do by mail. When the systems develop to point-of-sale use, terminals at the supermarket counter, for example, can be used to reduce costs and risks much further, by built-in processes for the verification and truncation of checks, and validation of customer balances or credit.

It looks like the initial stages of both the San Francisco-Los Angeles and the Atlanta systems would become operational before the end of 1972. Looking on with interest are at least 22 other commercial banker groups that we know to be in various stages of study or design of city--or area--electronic payments systems.

As for the Federal Reserve, we have already agreed to supply space, equipment and management for electronic clearing houses to serve both the San Francisco-Los Angeles and the Atlanta systems. I am certain everyone who comes up with a practical design --one that will receive and can handle a high volume of payments at reduced costs--and with firm pledges of money and management to market the new services can be assured that we will give them at least as much help. That is not our only interest. We see the proliferation of these local electronic payment systems as creating nodes that can be linked together, via Federal Reserve communications, into a national system. This would be the primary implementation of the general substitution of electronic payments for checks that the Federal Reserve Board looked forward to in its June 1971 policy statement on improving the payments mechanism.

Rather than go back into the important history of the foundation laying of the better payments system that is now coming into being, I want instead to focus now on what is happening in the watershed year of 1972.

In effect, as Governor George Mitchell has put it, the Board's June 1971 policy statement called for all possible efficiency to be squeezed out of the check while a paperless payments system is brought on line.

This challenge was taken up by the Federal Reserve System Steering Committee on Improving the Payments Mechanism headed by Governor Mitchell and on which I now serve. On the basis of intensive study by the Steering Committee, the Board in February issued Guidelines for the establishment and operation, under the supervision of the Federal Reserve Banks, of Regional Check Processing Centers--RCPS.

The Federal Reserve Board's Guidelines made a number of crucial decisions, which include:

--Most of the new clearing centers are to be located at the 37 places where Federal Reserve offices now exist: the 12 District Banks, the 24 Branch Banks and our Miami office.

--The clearing regions surrounding our offices are to be as large as optimum use of transportation facilities permits for afternoon and evening gathering and processing of checks deposited that day, and delivery of those checks for payment the next morning.

--The new system will make maximum use, consistent with improved service to the public, of check processing centers operated by commercial banks.

--A clearing center will accept from participating banks in its clearing region all checks written on other participating banks in the region. From the Federal Reserve member banks in the region, it will accept all items wherever they originate.

--Participating banks must agree to payment for their checks upon the day of presentment, in immediately available funds.

--Participants should exclude checks drawn on them and, generally, those performing check processing services for other banks should exclude items drawn on banks they are servicing.

--As an assist to small banks, participating member banks may send in up to 2,000 unsorted items daily.

One of the important requirements for use of an RCPC--a requirement that completes the circle of higher productivity of demand deposits--is payment, in immediately available funds, upon the day checks are presented. In March, the Federal Reserve Board proposed an amendment to Regulation J, covering check collection, that would require all banks using Federal Reserve check collection services to give payment in immediately available funds for their checks the same day they are presented. If this proposal becomes final--and I am optimistic that it will -- banks contemplating participation in an RCPC will not need to look over their shoulder to see if a nearby bank, by staying out of the RCPC, is going to get early credit for many of its checks, while making deferred payment. This is a matter of equity that is essential if we are to have a banking system that benefits from a healthy level of competition, because it places all competitors on the same payments taw line.

Why the RCPCs? Why the emphasis upon moving toward electronic transfer?

Modernization of the check payments system is not a matter of choice but a matter of timely preparedness. You might call the difficulty the check payments system is in, a problem with the least recognition for its size. The fact that we have a major problem looming in the operation of the check payments system, but that practically everybody concerned is reasonably happy with the check system as it now stands, is perhaps the most difficult aspect of reaching a solution, because it tends to unusually suppress acceptance of change.

Here, briefly, are the numbers. As I indicated earlier, we are writing some 66 million checks per business day right now. That is approximately 24 billion checks a year. Almost all of those 24 billion checks are, in effect, a special piece of currency, created for one transaction only, that has to pass through complex and repeated identification, verification, accounting and sorting operations--to say nothing of the large amount of transportation involved--before it is retired. These checks transfer some 16 trillion dollars yearly right now. The best available estimates suggest that by the end of this decade, we will be using some 44 billion checks a year, unless we are able to switch a substantial part of our payments instructions into more efficient--that is, electronic--channels.

Checks require so much human attention, despite all the banking industry has done to develop and install automated handling devices, that on the growth curve we are climbing--doubling check usage every 10 years--we will soon overrun the amount of low cost clerical help available for such work (and that type of help will be decreasing, as more people are educated). So the unit cost of handling a check is bound to go up. It will go up not just because it will require banks to bid for more people from a shrinking labor pool. It will rise also because wages will rise relative to productivity in such work. And it will rise also because--if nothing is done--of the indirect costs associated with the amount of nonproductive assets tied up in uncollected balances.

There will come a time--again, unless very substantial changes in our payments system intervene--when two things will happen to the banking industry, one possibly only a disaster, the other merely a calamity:

--There will be a disastrous piling-up of checks in the back offices, slowing down financial transactions, multiplying errors, and impeding the transactions of the entire nonbanking part of the economy which looks to banking for swift, smooth money settlements.

--There will be a calamitous loss of public satisfaction with bank services, as banks seek to preserve their soundness by passing on mounting check handling costs to the users of checks. Businesses, which keep a sharper eye on their balances, will revolt first, and seek alternative, nonbanking means of making and receiving payments.

Following that, banks will be assailed by an outcry by housewives who will come to realize that the checking account they have always thought of as an inexpensive and very useful service is becoming an expensive convenience.

What this all adds up to is something centrally important--a severe loss of productivity in our principal financial sector: banking. Ours is a high-consumption, high-transaction, large-scale economy that can only succeed if productivity increases in every sector of the economy where it can possibly do so. If productivity declines at the financial heart pump of the economy, all other sectors will be affected, perhaps in greater degree.

This cannot be allowed to happen. That is why we in the Federal Reserve are doing all we can, as quickly as we can, to strengthen the banking industry by increasing--through revisions such as now proposed in Regulations D and J--equity among banks, by increasing the productivity of the check payments system through the RCPCs to make the check system operate at acceptable cost levels for as long as possible, and, meanwhile, encourage and prepare for large-scale payments transfer by electronic means.

Where do we stand right now?

Let me touch on St. Louis--just to suggest that in the RCPCs, and in demanding immediate payment, we are not doing anything that commercial bankers themselves have not long accepted as a normal way of doing business. There has been an RCPC operating in Greater St. Louis for half a century.

It got started back in the 1920's for reasons that no one now recalls. And it has had a record of slow, continuous growth. This, and particularly the fact that as new banks in the Greater St. Louis area have come into being, they have joined up--suggests a high degree of acceptance. I am told that within its area--roughly 15 miles out from the St. Louis city limits--this grandfather RCPC serves 69 banks at a processing center in the St. Louis Federal Reserve District Bank, doing a nightly check volume averaging 366,000 items, all on an immediate "good money" payment basis.

Every bank in the area covered is a member, with the exception of one small bank on the outer fringe. Management of the Center reports no complaints from participating banks.

There is another RCPC with a long enough lifetime-- a history of growth and evident satisfaction among participants-- to be encouraging. This is the until recently "experimental" Baltimore-Washington RCPC. It began operations in January 1970. And just today it expanded from 109 to 128 banks. Before expanding, volume averaged over 1,000,000 items each business day. In the area it covers there are only two banks that are not participating. But they have informed the Richmond District Bank, which started this experiment, that they will come in when the proposed new check collection procedures under Regulation J are in effect.

This is in line with a considerable number of enquiries we have had, indicating that many banks regard the earlier credit they will get in the RCPCs as an offset to the earlier payment they must make for their checks under the proposed change in Regulation J.

Other history in the Baltimore-Washington Center would appear to be of interest. It was set up with five specific objectives for improving the productivity of demand deposits in participating banks. These were:

1. Earlier collection of items.
2. Earlier credit on checks.
3. Earlier return of unpaid items.
4. Reduction of check kiting.
5. Reduction of commercial bank float.

A survey of the then 96 participants in this RCPC found that all five objectives had been accomplished. Furthermore, the survey indicated that both large and small banks found benefits in the arrangement. The distribution of dollar gains and losses to individual banks appeared to be as much a factor of individual bank management finesse as of dollar trade-offs resulting from the changed way of doing business.

An RCPC in and around Chicago went into operation at the beginning of April. It has 282 participating banks, with a daily check volume of about 900,000. The Center reports that since it got going, only one bank had asserted a wish to pull out, for what was found to be a trivial and easily remedied reason.

The Kansas City Federal Reserve District Bank has two RCPCs currently in operation. These are expanded zones of immediate payment around Kansas City and Denver. The Kansas City region includes 97 banks, with a daily check volume of about 410,000. The Denver Branch Bank is operating an RCPC with 142 participants sending in approximately half a million checks each business day. Our Kansas City management reports that it would rate acceptance in the two RCPCs as better than 90 per cent.

Kansas City adds two items of information that I want to pass on to you. First--the larger banks have been active in selling the RCPC to their correspondents. Second--these larger banks have encouraged small banks' participation by making adjustments in their correspondent balances. This last item is of very considerable interest to us, since we are aware of some apprehension among independent bankers that they will not get such adjustments. The Kansas City experience demonstrates two things: no such assumption can be taken for granted, and, where reasonable adjustments to the new situation are not forthcoming, a little competitive pressure might do wonders.

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