NEW CLEARANCE PRACTICES
OF THE FEDERAL RESERVE SYSTEM

Address by
Monroe Kimbrel
President
Federal Reserve Bank of Atlanta

to the

Alabama Bankers Association
International Relations Conference
Spain and Portugal
August 18-26, 1972

Address by Monroe Kimbrel
President of the Federal Reserve Bank
of Atlanta, Georgia

NEW CLEARANCE PRACTICES OF THE FEDERAL RESERVE SYSTEM

Regional Check Processing Centers present a new approach to the expeditious presentation and collection of checks on an overnight basis over a relatively large geographic area. The amendment to Regulation J basically requires the payment for Federal Reserve cash letters in funds immediately available on the day of presentment. The amendment to Regulation D deals with the uniform application of reserve requirements to member banks of comparable size regardless of a bank's location and generally provides lower reserve requirements for member banks.

RCPCs

In a policy statement, issued on June 17, 1971, the Board of Governors placed high priority upon efforts by the Federal Reserve System to improve the nation's payments mechanism. This policy statement covered three areas: First, extension of present clearing arrangements in cities with Federal Reserve Offices to larger zones of immediate payment. Second, establishment of other regional clearing facilities for making settlements in immediately available funds. Third, encouragement of banks and their customers to make greater use of the expanded capabilities of the Federal Reserve wire transfer system by making this service more attractive.

Subsequent to the Board's policy statement, and in view of the urgency placed on speeding up the presentation and collection of checks throughout the country, guidelines were developed to assist the twelve Reserve Banks in establishing Regional Check Processing Centers--a relatively new term in banking circles commonly referred to as RCPCs.

Functions of an RCPC are comparable to the operations of local Clearinghouse Associations. Banks within a geographic area present checks drawn on other banks in the area to the clearinghouse which sorts the checks for presentation to the bank on which they are drawn. These associations are located normally only in large metropolitan areas and cover a relatively small geographic area. An RCPC will perform the functions of a clearinghouse but cover a much larger geographic area, in many instances encompassing the entire zone serviced by a Federal Reserve Bank.

The first experimental Regional Clearing Center was established by the Baltimore Federal Reserve Office to service the Washington, D.C. - Baltimore area, and is now in its third year of successful operation.

This center covers an area around Washington, with a radius of forty miles. The second such Regional Clearing Center became operational last year in the Miami zone of the Sixth Federal Reserve District. This center, servicing the entire thirteen southern counties of Florida, provides overnight presentment and collection of all checks deposited by and drawn on banks in the Miami Zone.

During the past year, four Federal Reserve Offices have expanded the area of their city clearing operations. Seven Federal Reserve Offices have announced the establishment of Regional Clearing Centers and other Federal Reserve Offices are moving rapidly in this area. By the end of 1972, such centers will be serving a significant portion of this country's banking community.

We anticipate that Regional Clearing Centers operated by our Atlanta, Birmingham, Jacksonville and Nashville Offices will become operational on or about September 21, 1972. Our New Orleans Center will open shortly thereafter.

Just how will this improve the existing presentation and collection of checks through the Federal Reserve System?

First, by establishing later deadline times for deposit of items drawn on RCPC participating banks, speedier collection of these items will be possible. Existing late afternoon deadlines will be extended into the evening and in many instances until midnight.

Second, by providing pickup points at strategic locations throughout the RCPC area, banks will be able to effectively meet the deposit deadline. Deposits made at such points by the deadline will constitute timely deposit for the purpose of determining availability of credit. Provision of these pickup points will give all banks within the RCPC area, regardless of their location, substantially equal access to the center. Transportation expense from pickup points to the center will be borne by the Federal Reserve Bank.

Third, by adding an additional shift to our present Federal Reserve check collection staff, greater processing capability will be realized. This third shift will provide a 24-hour check clearing schedule.

Fourth, by accepting deposits of items from <u>all</u> banks within the RCPC area, handling costs of commercial banks will be reduced.

Use of this service can eliminate one handling of the items by commercial correspondent banks.

You will recognize that these actions will provide faster presentation and collection of checks and justify the establishment of Regional Check Processing Centers. As by-products, however, additional benefits will be derived:

> Dishonored items will be received by the depositing bank one to three business days sooner;
>
> Opportunities now available for check kiting schemes will be greatly minimized as a result of the reduction in collection time;

Commercial bank float, as well as Federal Reserve float, will be reduced by shortening the collection time of checks;

Operational benefits will accrue to commercial banks to the extent they utilize the services provided by the RCPC.

Regulation J

Now, let's consider the change in Regulation J. The recent change in Regulation J, to become effective September 21, 1972, complements the operation of RCPCs.

The amendment to Regulation J provides an arrangement whereby cash letters presented by a Federal Reserve Bank will be paid for in funds immediately available to the Reserve Bank on the day of presentment, and,at the same time, promotes earlier availability of funds to depositors. For years, commercial banks in zones of immediate payment in Federal Reserve cities or in RCPCs have been paying for checks on the day of presentment, while other banks have been making payment on the day following receipt of the checks. Until the mid-1960's, most banks outside Federal Reserve cities paid for checks by dispatching a draft on the day of receipt of the checks. Because of transportation arrangements, remittance drafts were usually not received and collected until the following day, resulting in a deferment of payment.

In recent years, expanded use of special courier services, which virtually guarantees timely delivery of cash letters and the availability of modern accounting and communications techniques have reduced the need for remittance drafts. Roughly 80 percent of the total amount of payments for checks presented by Reserve Banks is through direct charges to reserve accounts. All of this has contributed to laying the groundwork for the universal adoption of remittance for cash letters on the day of presentment.

In addition to being a major transitional step toward a more fully automated payments mechanism, we believe that this change will produce three immediate benefits:

> Longstanding inequities that operate to the disadvantage of banks located in Federal Reserve cities will be eliminated by payment on the day of presentment. Until now, banks located outside of these cities have had an additional day to invest funds owed to the collecting banks.
>
> Checks drawn on country banks located in the same Federal Reserve territory as depositing banks will be collected a day earlier. Such amounts will also be credited to depositing banks a day earlier by the Reserve banks. It is assumed that banks will make the immediate credit received from the Reserve Bank available to depositors for use at an earlier time than under present practice.
>
> A major component of Federal Reserve float will be eliminated for checks drawn on country banks located in other Federal Reserve territories. At the present time, Federal Reserve Banks defer cash items drawn on "country" banks in other Federal Reserve zones a maximum of two business days. Three days are required to collect these items. One day "time schedule" float, therefore, is incurred on every country item shipped interdistrict. With this change, approximately 60 per cent ($2 billion) of Federal Reserve float will be eliminated.

Regulation D

At the same time that it revised the check collection regulation, the Board amended Regulation D--Reserve Requirements--to adopt a system of reserve requirements on net demand deposits based on the amount of such deposits held by a member bank.

The revision modernizes the system of reserve requirements in the light of general patterns that have evolved over the last 25 years. Under the changes, reserve requirements on net demand deposits will be based on the amount of such deposits held by a member bank regardless of its location in a particular city.

Prior to this amendment, member banks were divided into two classes on a geographic basis for the purpose of computing reserve requirements. This division into Reserve city banks and "country banks" has for some time resulted in serious inequities among member banks and has also made it difficult for the Federal Reserve System to apply the criteria for granting reduced reserves to small and medium-size banks in Reserve cities. There are banks of similar size in different locations conducting similar types of business for which reserve requirements are different. This, of course, is unfair to the banks that have the higher reserve requirements. The revised Regulation will eliminate these inequities because reserve requirements on demand deposits will be based on the amount of such deposits without regard to location.

The restructuring plan is intended to lower reserve requirements generally, thus relieving some of the burden on member banks. Also, it will tend to soften the impact that the change in Regulation J will have on member banks that will now be required to pay for items in immediately available funds on the day of presentment.

Payments Mechanism

We confidently expect these changes in handling checks to increase the effectiveness of the payments system sufficiently to meet the needs of the near future. There appear to be limits, however, on our ability to increase the effectiveness of systems based on the handling of paper.

Estimates place the national check volume at an average of 62 million checks per day, and 125 million checks per day by 1980 appear to be a distinct possibility. When you consider that an average check is handled ten times, it becomes evident that increases in productivity are limited since processing of checks continues to require a substantial amount of hand labor despite progress in mechanization and automation. Banks are, therefore, presented with the problem of constantly rising costs for their check handling operations.

In the light of this trend, the future role of a physical document serving to transfer funds must be critically examined. To make the payments mechanism more efficient and to reduce processing costs, the banking industry is devoting substantial time and resources toward the development of an electronic means of payment. Some of these developments look extremely promising. If the technology can be harnessed in a way that is cost effective and meets the needs of consumers, merchants, and industry, there is little question that the electronic systems will replace a substantial portion of the paper checks.

This should not be a signal to relax our efforts toward improving the check system. The development of successful electronic systems is expensive and time consuming. Miraculous shortcuts should not be expected. Although the basic technology is in existence today, this is a far cry from a viable and practical electronic system.

In metropolitan areas across the country, individual banks, banking organizations, and the Federal Reserve System are engaged in studies, projects and experiments on electronic systems. One of the most comprehensive of these is underway in Metropolitan Atlanta.

In a joint effort, the Atlanta banking community, including the Federal Reserve, has invested manpower and dollar resources heavily in the Atlanta Payments Project. We expect that the initial electronic system for Metropolitan Atlanta will emerge in 1973, after four years of intensive effort. Even then, we will still be in the development stages of a mature electronic system. Such a system, we estimate, could eliminate about 30 percent of the checks written on bank accounts in the Atlanta Metropolitan area. If check volume in the Sixth District continues to increase at an eight to twelve percent range, as it has for the past decade, we will manage, even so, merely to stay even with the total growth.

Three approaches to reducing the check volume within the greater Atlanta area are being considered as a part of the Atlanta Payments Project. They are: direct payroll deposit; "bill check"; and point-of-sale transaction.

In the direct payroll deposit procedure, individual employee paychecks are replaced by punch cards or magnetic tape sent direct to commercial banks for credit to the employee's account at the bank of his choice. In the "bill check" system an individual receiving a bill from a utility company or retail establishment simply signs and returns an enclosed authorization for the company to debit his account at a commercial bank. In point-of-sale transactions, a customer authorizes a retail establishment immediately to debit his account at a commercial bank, through a terminal device, at the time he makes a purchase.

An effective payments system is vital to a complex and highly developed economy such as ours. In my judgment, the establishment of RCPCs and the changes in Regulations D and J are among the most significant actions taken by the Federal Reserve System in recent years. Up to this point, the payments system has been accepted as a province of the banking industry. We have earned and retained this position by providing an effective system for meeting the needs of consumers.

Unquestionably, a certain amount of "labor pains" will be experienced by commercial banks in adjusting to the new environment created by these changes. Nevertheless, once these adjustments are made, the nation's payments mechanism will have built a solid foundation for future improvements in the areas of electronic fund transfers.