Qt Circular No. 7122a

FEDERAL RESERVE BANK
OF NEW YORK

April 9, 1973

To All Member Banks, and Others Concerned,
in the Second Federal Reserve District:

At the request of the Board of Governors of the Federal Reserve System, we are enclosing a copy of a letter from Governor George W. Mitchell of the Board of Governors, dated March 21, 1973, to Representative St Germain, Chairman of the House Subcommittee on Bank Supervision and Insurance, in response to the Congressman's recent inquiry regarding the participation of savings and loan associations in automated clearing house arrangements.

The Board's letter, in setting forth the views of the Board of Governors regarding, among other things, the principles that should govern the operation of clearing houses, reflects important public policy considerations that may be of interest to you.

Alfred Hayes,
President.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

GEORGE W. MITCHELL
MEMBER OF THE BOARD

March 21, 1973

The Honorable Fernand J. St Germain, Chairman
Subcommittee on Bank Supervision and Insurance
Committee on Banking and Currency
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

I am writing in further response to your letter of January 24 regarding the relationship of savings and loan associations to the various developing systems for the electronic transfer of funds. More particularly, you inquire about the participation of California savings and loan associations in the program developed by the Special Committee on Paperless Entries (SCOPE) in California, now known by its operational title of California Automated Clearing House Association (CACHA).

The SCOPE program was undertaken, with the cooperation of the Federal Reserve Bank of San Francisco, by a group of commercial banks in California during the period 1968-1972.[1] It represents one approach developed by banks working together to achieve a system for electronic transfers of funds. This system, which covers legal and administrative arrangements as well as extensive software design for electronic equipment, provides for the creation of an automated clearing house to be operated by

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1/ Subsequently, SCOPE-type programs were set up in 22 additional areas: Atlanta, Baltimore, Boston, Buffalo, Chicago, Cleveland, Columbus, Dallas, Denver, Detroit, Houston, Indianapolis, Kansas City, Long Island, Milwaukee, New York, Philadelphia, Pittsburgh, Richmond, St. Louis, Seattle, and the Twin Cities. The Atlanta System, referred to as "COPE," is expected to begin operations in 1973. The Twin Cities committee includes Minnesota's only mutual savings bank as an associate member. A large Minneapolis savings and loan association has also applied for associate membership. The Twin Cities project is expected to become operational in early 1974. (Associate members participate in planning discussions, but do not have voting rights or participate in costs.)

the Federal Reserve Bank of San Francisco, as an interface among banks. The arrangement is intended to provide a mechanism whereby bank depositors can transfer funds into, and out of, their demand deposit accounts through the use of "paperless entries" rather than checks, and whereby banks can exchange such entries and make settlements among themselves with respect to them. Such an electronic system recognizes the inefficiencies and limitations of the existing check system. Its planning was encouraged, and, in limited ways, supported by the Federal Reserve Bank of San Francisco.

The electronic system parallels the existing check clearing system in its clearing and settlement arrangements among banks and the Federal Reserve. Access to this new mechanism is provided by magnetic tapes, or punched cards, generated by a participating institution. The tapes or cards contain instructions--substituting for checks--concerning debit and credit transactions on behalf of the banks' customers.

According to our information, the California Savings and Loan League approached the California Automated Clearing House Association in July 1972 and inquired about participation as financial intermediaries in the newly-formed electronic system. We are informed that since that time, CACHA has received several applications for membership from savings and loan associations, but has held them in abeyance pending consideration of a number of legal and technical questions. We understand that CACHA plans further discussions with the California Savings and Loan League. In the light of these plans, we have no reason to believe at this time that CACHA members have engaged in an unlawful boycott in violation of the letter or spirit of the antitrust laws. I can assure you that the Federal Reserve System does not intend to permit Federal Reserve facilities to be used in any arrangements which violate these laws.

As we understand it, savings and loan associations in California wish to participate in the CACHA arrangements primarily for the purpose of receiving credits to customer accounts arising out of direct deposit of payrolls. Presumably, at some future time they might wish to use the SCOPE system for preauthorized disbursements or debit transfers. It may be of interest to note that presently there exists a system, known as "Transmatic," under which a savings and loan association with prior authorization can draw checks on its customers' commercial bank checking accounts, payable to the savings and loan association, for such purposes as mortgage payments, deposits to savings accounts, and for certain other types of third-party payments related generally to housing expenses, including such items as utility bills.

The Federal Reserve regards its role in expediting and accommodating money transfers as highly important. Congress has authorized the Federal Reserve to provide a clearing system for the handling of checks drawn on one bank and presented to another. This clearing system, however, is not all inclusive. For example, checks drawn on a few banks that do not clear at par must be presented to those banks directly or through another commercial bank. Large volumes of checks, in addition, are directly exchanged or presented through city clearing houses operated by commercial banks. These items are not routed through the Federal Reserve System; although in cities where the Federal Reserve has an office, the Federal Reserve office is ordinarily a member of the clearing house for the purpose of presenting and receiving checks. The net transfer of funds may sometimes be settled in correspondent balances, but settlements of any significant volume are made on the books of the Federal Reserve.

These settlements and payments are made possible at minimal cost to the economy because member banks keep accounts at Federal Reserve Banks, and the Reserve Banks, in turn, maintain balances for nationwide settlements. Thus, a bank in New York or Providence can buy bonds issued by the State Treasurer of California in Sacramento, and pay for them by asking the New York or Boston Reserve Bank to transfer funds by wire from its reserve account to the reserve account of the State Treasurer's bank at the Federal Reserve Bank of San Francisco. The final step in payment, or settlement, is made by transfers within the inter-district settlement fund by the Reserve Banks involved. Similarly, an automobile dealer in Providence or New York can pay for a shipment from a Detroit manufacturer by a check that will be collected through the Federal Reserve Banks, with settlement made through the inter-district settlement fund, just as it was for the bonds. Thus, the reserve balances required of member banks at the Federal Reserve Banks, in addition to providing a fulcrum for the operation of monetary policy, constitute a fundamental instrument for effectuation of the trillions of dollars in money payments made annually in our economy.

Turning to your inquiry about the Board's position on the general question of including savings and loan associations in electronic funds transfer systems, we believe three general principles apply. First, the Board believes that so far as public participation and support are concerned, there should be a single, integrated nationwide mechanism for efficient transfer of funds. The existing system, using checks and drafts and functioning through commercial banks and the Federal Reserve Banks, is substantially of that character. In this connection, the Federal Reserve's Steering Committee on Improving the Payments Mechanism issued a statement in December elaborating on this and other points, and I am enclosing a copy of it for your use.

Second, even allowing for the existence of private clearing arrangements, the Board believes that the public system using check or electronic transfers of funds from one institution to another should be such as to insure that the conditions of entry into a general clearing arrangement are fair, and that equitable treatment is assured for institutions with similar powers and responsibilities. The presence of a public agency, such as the Federal Reserve, in any cooperative arrangement for transferring funds between institutions should be one way of insuring the public interest will be taken into account, and that no private clearing arrangement may be used to protect or enhance the market position of the participating banks at the expense of others. Whatever public action is taken, the innovative capabilities of banks and other financial institutions to improve money transfer services should be recognized and given opportunity for development. And of necessity, some innovations will involve cooperation among private financial institutions exclusively.

Third, the costs of the transfer system and the benefits of participating in it should be equitably distributed among all of the institutions involved. As implied above, the Board believes in comparable treatment for institutions having like powers, but the existing situation fails to meet this standard. Some institutions, namely nonmember banks, have a competitive advantage.[2/] These banks do not maintain reserve accounts in the

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2/ Exemplifying the existing advantage enjoyed by nonmember banks is the present structure of reserve requirements imposed on such banks by their respective States. Although in most States the nominal reserve percentage is comparable to that imposed on member banks--and in some States may even be higher than Federal Reserve requirements--in all States nonmember banks are permitted to carry their reserves in the form of what are effectively earning assets: Government obligations and correspondent balances. These correspondent balances, although technically noninterest-bearing, are a form of indirect compensation to the correspondent banks, which in turn compensates the nonmember bank through providing services such as check processing, accounting, investment advice, and the like.

Federal Reserve System--accounts which do not earn interest--but nevertheless are accorded certain Federal Reserve check clearing services deemed essential to the public's need for prompt money payment. If, in the future, extensive checking account powers are developed for savings institutions, the extension of the benefits of the payments mechanism, whether conventional or electronic, to such institutions, without their assuming a fair share of the costs, would exacerbate existing inequities.

In the present framework, direct access to the portion of the nation's payments mechanism that depends on Federal Reserve facilities is limited to commercial banks and the U.S. Treasury. Member banks of the Federal Reserve System currently may send all of their checks directly to Federal Reserve processing centers for clearing. Nonmember banks may send checks drawn on banks within a limited clearing zone to the Federal Reserve, but payment or receipt for checks going through the Federal Reserve collection system is typically made by debit or credit to an account maintained by a member commercial bank at a Federal Reserve Bank. For providing clearing services to nonmembers, member banks generally receive compensation through the maintenance by nonmember banks of "compensating" balances at the member banks. The effective costs of these arrangements are determined by competition among the various correspondent banks offering the services.

One method of providing a savings institution access to electronic transfers--a method which involves a minimal change from present practices--would be for the institution to arrange for a member bank to receive electronic debits and credits for the account of the savings institution and to provide the detailed electronic accounting entries required to effect the transfers to customers' accounts at the savings institution. This indirect procedure is entirely feasible from a technological standpoint, and is a service that could be supplied savings and loan associations on a competitive basis by various member banks.

A possible future alternative would be to provide savings and loan associations, or any banking or thrift institution, with <u>direct</u> access to an automated clearing house operated by the Federal Reserve. Such access could be conditioned on membership (or perhaps some more limited participation) in the Federal Reserve System. In addition to clearing facilities, such participation might be designed to include other important services, such as limited access to the Federal Reserve's discount window and coin and currency distribution arrangements. It should, however, entail conformance to appropriate interest rate ceilings and System reserve requirements. Should Congress decide on a major move of this kind, the Board would, of course, review its reserve requirements and interest rate ceiling structure with a view toward the possibility of greater differentiation among types of accounts, and the easing of the transition to the maintenance of reserve balances.

With regard to reserve requirements, the Federal Reserve has for some time recommended that all depository institutions that offer checking account services be required to maintain reserve accounts with the Federal Reserve System. As the payments mechanism evolves, and if it becomes necessary for all types of depository institutions to participate more fully in it, this recommendation of the Board takes on a more pressing aspect. The Board therefore urges that, in any investigation into the place and role of financial institutions in the payments mechanism, the extension of requirements for maintenance of reserve balances at the Federal Reserve be considered for all institutions providing, or seeking to provide, the transfer of funds on a demand basis.

Part of the Federal Reserve's concern that reserve requirements apply to all depository institutions has been the growing volume of financial transactions outside of member banking institutions. With respect to commercial banks, for instance, fully one-quarter of the increase in demand deposits over the past decade has been at nonmember institutions. Yet all demand deposits, whether they be in member banks, nonmember banks, mutual savings banks, or savings and loan associations, are equally a part of the nation's money supply. Uniform applicability of reserve requirements--as well as uniform applicability of interest rate ceilings to the various deposit classes--is urgently needed, on the dual grounds of: (1) equity and (2) the acceptance of public responsibility attendant upon participation in the nation's money transfer system.

If, in the long run, there is to be an integrated, nationwide payments mechanism, with participation by all financial institutions on an equal footing, then legislation seems indicated.

Such legislation presumably would recognize the need for an equitable set of ground rules. To the extent that financial institutions become more comparable in their activities, to that extent they should be expected to meet comparable standards and requirements.

Sincerely yours,

(Signed) George W. Mitchell

George W. Mitchell

Enclosure

Evolution of the Payments Mechanism

The following statement was prepared by the Federal Reserve System Steering Committee on Improving the Payments Mechanism to inform the Nation's bankers and the public of the general direction of payments mechanism development as currently envisioned by the Committee.

The essential features of the payments system that is evolving in response to electronic technology are reasonably clear. These features are not likely to change drastically unless a new technology develops. Private and public roles in this system probably will be very similar to those in being today with financial institutions interfacing with the public and the Federal Reserve maintaining the interface among financial institutions. The Federal Reserve has indicated its intent to accommodate visible evolution in the payments mechanism by continuously improving and updating its facilities to handle a growing volume of funds transfers along the channels of likely development. Thus, the regional processing centers and expanded clearinghouse arrangements now being established by the Federal Reserve System in some 40 trade centers for handling checks may become the nuclei of interconnected regional communications networks for handling wire transfers of funds and financial data.

The System's role in facilitating the development of automated clearing facilities and the linkage of such facilities to provide a nationwide network for automated crediting systems or preauthorized debiting systems may pioneer a similar role in the experimental point-of-sale terminals. Such terminals, now linked to a single bank's computer and energized by a unique credit-card authorization system, with appropriate standards and interlinkage, may potentially provide merchants and consumers with a convenient means of consummating transactions at the point of sale over a broad range of merchants and financial institutions and over large geographic areas. These transactions encompass use of an electronic communications network to transfer payments originating (a) at a point of sale, (b) with a wage, salary, or other income payment, or (c) with an authorization to charge a depositor's account. This network would serve all accounts from which, or to which, payments are made.

CHANGES IN PROSPECT

The Nation's payments mechanism can be expected to evolve in the direction of a system where credit to the payee's account is made at the same time the payor's account is charged. Increasingly, these transfers will be made over a computer-directed communications network. As electronic transfers become technologically and economically superior, checks would be largely displaced. The use of the credit card, or a similar means of activating electronic payments transfers, should expand greatly. Much of today's paper-oriented operation would be displaced by electronic terminals at the point of sale for making direct funds transfers, with the related accounting being done by computers. Significant reductions in the volume of transactions made through the use of paper currency may also take place—by the use of point-of-sale terminals and through other electronic techniques.

The electronic funds transfer system is expected to evolve in a modular fashion through the development and interlinkage of a comprehensive series of computer-directed communications networks. At the local level, the system would include commercial banks and possibly other depositary institutions linked to point-of-sale terminals in retail establishments, to computers in businesses, and possibly to terminal devices in homes. Through these financial institutions, connection would be made to regional, national, and international networks, enabling the movement of funds nearly everywhere in the world.

REPRINTED FROM
FEDERAL RESERVE BULLETIN
FOR DECEMBER 1972

OBJECTIVES

The payments system as it evolves will need to be aimed at providing the public with a convenient, economical, and secure means of moving funds. In comparison to the present check and other funds transfer systems, the new payments system should:

- be more efficient, as electronic data processing and communications technologies replace labor-intensive processing procedures.
- provide a more secure method of payment, less subject to theft, loss, forgery, and alteration of payments data, and a method of tracing all transactions.
- assure a more equitable balance of the debit and credit effect on participants.
- accommodate both debit and credit transfers.

The system would continue to:

- provide for the continuation of competition among financial institutions.
- involve public participation and surveillance over private institutions' money role.
- be capable of providing timely and detailed data on money flows, trade volumes, and other payments-related information for use in monetary policy and other relevant applications.

FEDERAL RESERVE INVOLVEMENT

The Federal Reserve Act directs the Federal Reserve System to provide an efficient payments mechanism for the public. The policy statement of the Board of Governors on June 18, 1971, called for "basic changes in the Nation's system for handling money payments [as] essentially transitional steps toward replacing the use of checks with electronic transfer of funds."

In further development of the payments mechanism, the convenience and needs of the participants should continue to be the primary considerations. These needs may be summarized as follows:

Consumers need an economical means of payment that is acceptable anywhere; is less subject to theft than cash; is less subject to loss, forgery, and alteration than checks; facilitates the keeping of necessary personal records; and enables them convenient access to a wide range of services from financial institutions.

Businesses need a system that reduces the time, costs, and risks in making and receiving payments; that facilitates the transmitting, storage, and retrieval of associated information; and that provides better integration of business electronic data processing capabilities with the payments mechanism.

Financial institutions need a more efficient system of transferring funds—one that is less labor intensive—a system that will enable them to offer customers a wider variety of services, including informational services based on the improved data generated by the payments system.

Government needs are similar to those of business, but with the additional special need for greater security against theft of checks issued to the public.

ROLE OF THE FEDERAL RESERVE SYSTEM

It is anticipated that the Federal Reserve will install and manage a nationwide communications network through which interregional settlements between financial institutions will be made.

A number of other networks may exist. In part, these will be local and regional funds transfer networks in which Federal Reserve involvement may be minimal. The total of transfers internal to banking institutions may expand if demand deposit market shares become more concentrated. Thrift institutions may set up their own networks. Credit-card clearing networks may become more widespread.

The level of Federal Reserve involvement in different regional or local networks for transfer of funds will vary depending on the banking structure. The Federal Reserve should expect to monitor the regional and local networks to assure that a satisfactory degree of security is being maintained and that the capability for interfacing with the national network is obtained.

Since the payments mechanism will evolve continuously, the Federal Reserve should expect to continue its participation in this evolutionary process in order to assure the desired development and coordination of the payments system, to insure the continued competition among providers of financial services, and to protect the public interest.

ROLE OF FINANCIAL INSTITUTIONS

It is anticipated that private financial institutions will continue to play the predominant role in local and regional communications networks through which intraregional payments will flow.

The number of private facilities engaged in processing payments transactions may decline as branching systems and holding companies centralize their accounting operations, or as correspondent banks expand their accounting services, or as smaller institutions use specialized service bureaus or band together to perform demand deposit and other accounting services.

Nearly all financial institutions will be linked together through local, regional, or national communications networks by means of compatible input and output devices. Customers with larger volumes of transactions will interface into their banks' equipment. Competitive marketing of collection and payments services may become less localized. Through the use of advanced equipment, more and better services will be available to customers.

ROLE OF BUSINESS

The evolution of the payments system will enable business and governmental units to utilize electronic data processing equipment more fully and streamline their payments procedures. It will be possible to submit payments data to and receive payments data from financial institutions in electronically transferable form. Businesses can now use computer-oriented input to initiate payment from their own deposit accounts or, through preauthorization agreements, initiate payment from the deposit accounts of customers. They will be able to send to their customers machine-readable invoices that, when forwarded to the issuing companies or the customers' banks, will be transformed into electronic payment messages.

Larger business and governmental depositors will establish computer-to-computer connections with the financial institutions that hold their accounts. This option will permit greater competition for accounts because distances will have a diminishing cost impact.

Instantaneous funds transfers will significantly simplify corporate funds management. Float will largely disappear and will not be a significant factor to consider in determining investable funds. Corporate treasurers will be able to obtain more timely information from financial institutions on the status of corporate balances, and the timing of certain classes of funds' receipts and disbursements will become more predictable.

Informational services provided by financial institutions will enable small- and medium sized businesses to manage investment of funds in a manner previously practicable only in large businesses.

ROLE OF THE INDIVIDUAL

It is anticipated that, due to rising costs and delays and given a more convenient, cheaper alternative, most individuals will minimize their writing of checks. Salaries, wages, pensions, dividends, and other income items will predominantly be credited directly into individuals' accounts and, through preauthorization, recurring payments will be deducted automatically from accounts. In addition, a consumer will be able to pay some bills simply by signing a machine-readable invoice and forwarding it to the issuing company or the financial institution holding the consumer's account. Other payments will be made through point-of-sale terminals, with either the individual's demand deposit account or possibly an interest-bearing deferred-payment account being debited.

The consumer will be able to complete financial transactions through the use of a card or similar identifying device, and this procedure will be accomplished through automated teller units conveniently located in shopping centers, in other places handling numerous consumer sales, and in the home.

FUTURE STEPS

As the electronic payments system continues to develop, some areas that may need continuing attention by the Federal Reserve System are as follows:

- public reaction and changes in public attitudes toward payments system improvements
- impact of payments system improvements on the public's use of coin and currency.

- bank cards and their relationship to the payments mechanism; the competitive impact of bank cards with respect to retail credit cards.
- international electronic funds transfer developments.
- impact of payments system developments on Federal Reserve System operations and policy.
- technological developments in data handling and transmission.
- development of the standards necessary for efficient transmittal and interchange of payments information.
- legal considerations surrounding actions designed to improve the payments system.

The Federal Reserve System will need for some time to continue to devote significant resources to the development of the Nation's payments mechanism. □