

# Agendas for Action on The Payments Mechanism

George W. Mitchell

It now appears that coincident to this Conference, or a few days thereafter, a statute creating a Commission on Electronic Funds Transfer will have been adopted by the Congress. That statute will contain an agenda of public interest considerations the Commission shall take into account in its study of electronic transfer systems. The agenda set forth in the Act specifies several areas of potential public concern but does not purport to be inclusive of all relevant issues and interests. Your agenda specializes on the economics of electronic transfer. At the forthcoming annual meeting of the American Bankers Association, the agenda will focus on competitive issues in payments development.

My brief prefatory remarks today are intended to direct your attention to the importance of distinguishing payments issues that have public policy implications from those that are passé, are better left to data-handling technicians, or could be, in a truly competitive environment regarded as private arrangements between businesses and their customers.

The idea, for example, that the payments system should have a built-in element which can generate "float" and enables payors to defer actual transfer of funds by such stratagems as paychecks delivered on Fridays or the writing of checks on remotely located banks is a relic of non-par banking days and 19th century transportation facilities. If, in fact, a payor needs a brief deferral in charges against his account, both banks and business payees have a variety of arrangements to accommodate him without perpetuating expensive, time-consuming check handling.

Other issues of limited public concern are the alternative techniques of electronic transmission and processing and the technical legal rules governing the movement of funds. The only real concern for policy makers in such areas is to be certain that the systems authorized permit equivalent access to public facilities and the ability of participants to use as wide a range of technical resources as possible.

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Before turning to my agenda of public policy issues, which is partial at best, I need to characterize the status quo in our payments system as I see it.

In the United States most of the money transfer needs of individuals, corporations, and governments are now being met by a paper-based check system, which has developed through an evolutionary process over the past 300 years. Although many improvements have been made in this system — emanating both from technological and operational innovations — the basic method of making payments has remained essentially unchanged. A debtor prepares a paper instrument and forwards it to his creditor. The creditor deposits the instrument in his bank which, in turn, obtains the funds from the debtor's bank directly or through a clearing house or the Federal Reserve. The check, as the instrument of authorization, is physically transported from place to place and party to party in the process of payment. The actual movement of funds occurs, however, only at the end of a succession of processing operations and courier shipments.

Electronic data handling and transmission developments have shown that it is entirely feasible to alter this basic method of making money payments by replacing the paper instrument with an electronic image. The achievement of such a transformation is regarded by some as the ultimate goal in innovation in the payments mechanism. They choose to closely parallel the steps and procedures followed in the present paper system. Others look upon electronic processing as a revolutionary force providing not only a way of replicating check handling steps but of moving funds in an entirely different manner.

At the Federal Reserve we must be prepared to perform our clearing function so as to accommodate any technique of payment which involves the movement of funds from one bank to another and thus to cover the transition to an electronic payments mechanism which will be either evolutionary or revolutionary or both. During the transition period, and perhaps even beyond, it will be necessary to provide the consumer with alternative means of making payments. He will choose among these alternatives to fit his needs.

Federal Reserve offices now have the capability to clear and settle with member banks for credits and debits in check and wire form and very shortly will have the capability to clear and settle for payments on magnetic tape. Further, as is required in the automated clearing house operation, Reserve Offices will be capable of accepting payments in one form — such as magnetic tape — and delivering the payments in hard copy if the receiving bank is not equipped to handle wire input or tape.

Not everyone is aware that the upgrading of the Federal Reserve wire network was completed this past summer and at long last all Reserve Banks have installed integrated communications equipment. This wire network — in addition to the surface and air courier systems for the movement of paper — now provides the Federal Reserve with the capability to deliver payments by check, magnetic tape, hard copy, and wire form to

any bank in the nation, and for that matter to any other depository institution via a commercial bank. Increased volumes will not clog these delivery systems as they are capable of handling any expansion that is in reasonable prospect. Moreover, they are capable of extension to handle even larger volumes.

If the actual transfer of funds becomes separated from the flow of supporting information, as present trends suggest in the future it will, there should be a concentration of detailed money transfer information (payor and payee, their banks, date, amount and identification of transaction, etc.) in a limited number of major processing centers. Today, there are 620 major bank and non-bank processing centers whose activity is estimated to cover between 80 and 90 percent of the total U.S. check volume. In the thrift industry electronic accounting using contractual services has proceeded much more rapidly than in banking. I am told that in New England two-thirds of the mutual savings banks are serviced by three data centers and that as long ago as January 1973 three-fourths of the California savings and loan associations were serviced on-line by 11 data centers.

The implication of these recent developments is that one can envisage a payments system in which the movement of funds is completely divorced from the supporting documentation. As long as major banks maintain clearing balances at the Federal Reserve Banks, settlement will be by debits and credits to those accounts. But these settlements may be for aggregates involving large numbers of individual transactions which may go through entirely different channels. Thus, a payor bank in the case of credits would authorize a charge to its reserve account based on specified deliveries to processing centers of detailed item-by-item information. A payee bank could similarly receive a credit to its account for entries documented at one or more processor locations. Indeed, if this separation of payment from processing occurs, bank and non-bank credit card companies and retailers through their banking connections probably could displace a significant part of the check processing now handled by banks. As incongruous as it may seem to some, the economics and technology certainly are as congenial to such an eventuality as they are to the conventional handling of checks and settlement by commercial banks.

Turning now to issues of public concern, I would mention a few which seem to me to have been neglected, are particularly intractable, or urgently need early resolution.

One that has been neglected and should receive early attention concerns the confidentiality of data generated by payments transactions. This problem has been recognized by the public, the Congress, the banking system, and the Federal Reserve. The principal difficulties lie in how requisite security can be maintained in the depository and data processing institutions.

There is no question that access to individual customer data has been greatly facilitated in financial institutions — and their processing centers — by electronic payment processing and accounting. Given an intent to

achieve selective access to this body of data, the retrieval capabilities of the electronic system make possible the extraction of substantial amounts of information in a very short period of time. Statutory safeguards and standards probably should be incorporated into such systems to protect the public's interests and to insure complete confidentiality and privacy of customer financial information.

The problem is not a serious one for the Federal Reserve in view of our over-all security system covering money and check operations. We presently retain only that payment information required for settlement with member banks. This information is held in strict confidence within each Reserve Office and is retained only for the period of time necessary to complete settlement and reverse entries made in error. There is no reason for this policy to change in the transition to an electronic payments mechanism.

A more critical and very urgent matter that has been surfacing and resurfacing in the past year or two is the question of thrift institution participation in money payments. Most recently their access to electronic payment arrangements — mainly automated clearing house facilities — has become a contentious issue. In conjunction with the NOW account experiment in Massachusetts and New Hampshire, the Board announced a "pass-through" arrangement as the means by which thrifts could use Federal Reserve operated clearing and settlement facilities. This arrangement preserves existing competitive relationships between banks and thrift institutions in their payment role and thus does not prejudge Congressional action on the extent to which and the way in which thrifts can offer money transfer services. From the Federal Reserve point of view, it limits the number of endpoints in our settlement system and thus limits our costs.

So far as we can tell, the pass-through arrangement has operated successfully in the two-state NOW experiment, but there is doubt in the thrift industry that the arrangement will work satisfactorily in an automated clearing house operation. The reason seems to be that a separation of data processing and the movement of funds is contemplated in thrift-related transfers. In California, for example, a processor for a large number of thrift institutions would like to pick up tapes at the Federal Reserve office containing detailed credit or debit information affecting customers' accounts. While the movement of funds would continue to be in and out of the thrift institutions' commercial bank account, the processing of itemized transfer data would be performed outside of the banking system. ACH rules do not appear to accommodate such an alternative.

The general competitive postures of commercial banks and thrift institutions make it likely that the two industries will be unable to resolve their differences on payments participation without Congressional guidance. The differences here are complicated by other long-standing differences as to comparative powers, reserve requirements, tax treatment, interest rate ceiling differentials, and other matters, all having a bearing on their competitive capacity to attract loanable funds.

While the conditions and terms on which thrifts can offer money transfer services is of great importance to both industries, the interest of the public has suffered for some time from a lack of resolution of this problem.

A third issue in which the public interest languishes has to do with POS. Attempts to establish or maintain competitive POS beach-heads by various interests has delayed important pilot installations. There are, however, many unresolved questions of public policy associated with this development. Paramount among these are the following:

- Should joint ventures be permitted in point-of-sale developments? If so, what conditions should be attached?
- Should the location of off-premise terminals and automated tellers be restricted?
- What type of transaction should be permitted from the off-premise devices?

The resolution of these issues involves questions of competition, government regulation, concentration of economic power, and public participation. It is very probable that in the end they will be settled through the legislative process. By way of illustrating the thorny character of the POS problem, some of the economic implications associated with the use of joint ventures for such operations are instructive.

Inherent in the mode of operation currently being considered for point-of-sale systems are three conditioning factors. First, front-end costs are high for developing a system having the capability to effect the transfer of funds at the point of purchase. For example, our staff estimates the one-time costs for development of the computer switch capability alone on the order of \$1 million. Annual recurring costs to operate the switch, including the cost of communication lines, are estimated at \$500,000. The costs for the other required equipment, such as terminals, concentrators, and bank computer systems, add to these costs. It is not unreasonable to expect that the total development costs for a medium-sized system would exceed \$4 million.

In view of these high front-end costs, banks contemplating installation of such comprehensive systems must be assured that a substantial portion of transactions in the bank's market area are eligible to use the system. This eligibility provides the potential for cost-effective operations, as the system is volume-sensitive and requires a large number of transfers to be cost-competitive with other payment systems. In many regions, the level of market penetration necessary for a feasible operation requires the aggregate market shares of several banks.

A second factor to be considered is that a merchant or other user of the system should not be expected to maintain a separate terminal for each participating bank, but rather should be able to effect transfers for all customers, regardless of bank affiliation, from one terminal.

The third factor concerns market shares in a given transaction market. It is not reasonable to expect that the merchant and all of his customers will use the same bank for demand deposit services. Each funds transfer in a point-of-sale system will have a credit and debit side which will be directed, in most instances, to separate banks.

Thus, cooperation among participating banks is a necessity for a viable point-of-sale service. The public convenience seems to require that all terminals installed in merchant or other locations should be capable of accepting transfers from any customer desiring to use such a service regardless of bank affiliation. The consequence of this arrangement, however, is that such cooperation implies shared terminal, concentrator, and computer switch facilities. Thus, there are attendant legal problems and restraint-of-trade implications. How to resolve the competitive and anti-competitive aspects of this operation has been the major deterrent in the development of the point-of-sale system in this country.

Various parties are being discussed as potential candidates for the ownership role in a point-of-sale system, including a consortium of banks, a dominant bank, a third-party non-bank entity, the Federal Reserve, and various unregulated entities such as credit card companies. I have no problem with this list — provided the public interest in service, convenience and cost is effectively policed by regulation, competition or public participation.

Bringing the nation's payments system into phase with present-day data handling practices has been slowed until recently by lack of competitive pressures. Now these pressures are beginning to appear, mainly in the form of non-bank participation. That competition comes from the thrift industry, from the data processing companies, credit card companies and major retailers. It may well result in significantly reducing the operational role of commercial banks without disturbing the aggregate of their demand deposits. In doing so, however, it will give rise to a Congressional review of how money should move in our present-day economy.

I trust that this Conference, as well as others in prospect, will provide inputs which will aid the Congressional Commission on Electronic Funds Transfer to reach an early resolution of this vital payments issue.