THE MONETARY CONTROL ACT AND THE ROLE OF THE FEDERAL RESERVE IN THE INTERBANK CLEARING MARKET

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I. INTRODUCTION

The Monetary Control Act of 1980 changed the terms of Federal Reserve participation in the interbank clearing market. It required services? which had previously been made available free of charge to Federal Reserve member banks, to be priced competitively and made available to all depository institutions on equal terms. This article explains why Congress legislated this change. To do this, the article investigates the origins of the debate over the Federal Reserve's role in the payments system that arose in the decade preceding the enactment of this legislation.

Two principal issues surfaced as part of this larger debate; namely, Federal Reserve access and pricing policies. The first dealt with the terms of access to Federal Reserve payments services. Debate over this issue arose as a result of thrift industry deregulation. To make use of new transaction account powers, thrifts requested access to the Federal Reserve's clearing network. The industry was granted indirect access to some Federal Reserve services, but not always on the same terms as those enjoyed by commercial banks. Subsequent thrift industry demands for a nondiscriminatory access policy were supported by the Justice Department's Antitrust Division, and finally resulted in congressional action to institute such a policy.

Pricing policy dealt with the pricing of Federal Reserve services. Debate over this issue arose for three reasons. First, since the Federal Reserve did not price its services explicitly, an expansion of its service offerings in the 1970s raised concerns among market participants that private sector competition in these new areas could be preempted. Second, measures then under consideration by Congress to end the Federal Reserve's increasingly serious membership problem were expected to result in a considerable loss of revenue to the U.S. Treasury. Pricing was adopted to mitigate this revenue loss. Third, a nondiscriminatory pricing policy was essential to the resolution of the access policy issue. The pricing provisions of the Monetary Control Act effectively resolved all of these issues.

This article is organized as follows. Section II discusses the origins of the debate over granting nonmember institutions direct access to Federal Reserve services. In this discussion, attention is focused on thrift industry deregulation as a driving force behind the debate over access policy. Section III reviews the debate over issues related to Federal Reserve pricing. Section IV presents a summary of the article and some concluding comments.

II. ACCESS TO FEDERAL RESERVE SERVICES

Before the Monetary Control Act was passed, member banks obtained most payments services from the Federal Reserve. As a result of the Federal Reserve's expansion of its Regional Check Processing Centers (RCPCs) in the early 1970s, many privately-operated clearinghouses c1osed.[1] Nonmember banks therefore tended to rely on correspondents,

[1] Many of the regional clearinghouses that closed when the Federal Reserve expanded its RCPC system have reopened since Federal Reserve pricing was initiated in 1981. In addition, there has been new entry into this market as a result of pricing. See Joanna H. Frodin, "Fed Pricing and the Check Collection Business: Private Sector Response," Federal Reserve Bank of Philadelphia, **Business Review** (January/February 1984), pp. 13-21.

most of which were members of the Federal Reserve, to clear checks and for other payments services. These correspondents were permitted to "pass through" their respondents' checks to the Fed and also to resell other services such as the wire transfer of funds over Fedwire, the Federal Reserve's electronic funds transfer network. In this way, nonmember banks were able to gain indirect access to Federal Reserve services.

When thrift institutions first began to offer limited third-party payments services, they needed access to a clearing network. A newly organized automated clearinghouse (ACH) system, designed to handle the electronic transfer of recurring payments from transactions deposits held with banks, appeared to be ideally suited to the limited powers initially granted to thrifts. Access to this system was controlled by the commercial banking industry, however, and bankers demanded regulatory reform that would eliminate much of the special treatment enjoyed by thrifts as the price of direct access. Thus, the question of access was linked to the broader issues dealing with the regulatory reform of the financial services industry. To complicate matters further, the Federal Reserve had assumed a major role in the operation of the ACH network. This operational role subsequently involved it in the ensuing debate over access policy.

Thrift industry deregulation and regulatory reform of the financial services industry constituted key issues in the debate over ACH access policy. Their importance necessitates a brief review of these issues. This is followed by a detailed review of the debate over thrift industry access to the ACH network. The response of the commercial banking industry and the Federal Reserve to these events is examined. Finally, the role of the Justice Department in resolving the debate over access policy is explained.

Deregulation and the Entry of Thrift Institutions into the Payments System

The U. S. financial regulatory structure that emerged from the Great Depression was designed to prevent a recurrence of the financial chaos experienced in that episode. The prevailing view then was that excessive competition among financial institutions contributed to instability in financial markets. Accordingly, the resulting laws and regulations were intentionally designed to limit competition. Restrictions on interest rates paid to depositors acted to limit competition among all financial institutions, while other rules limited the range of activities permitted for financial institutions. These rules placed each institution into a distinct category (for example, thrift institutions or commercial banks), and then restricted the activities permitted for firms in each category.

Within this scheme, making commercial loans and accepting demand deposits were activities relegated to commercial banks and prohibited to federally insured thrifts. The latter were to specialize in gathering consumer time deposits and extending mortgage loans. To help them attract such deposits, Regulation Q gave thrifts a slight competitive advantage in the form of somewhat higher interest rate ceilings than those imposed on commercial banks.

Until the late 1960s, this regulatory structure appeared to work more or less as its architects had intended. Most thrifts were able to operate profitably by borrowing money at relatively low, short-term interest rates while acquiring mortgage loans which paid higher, long-term rates. Because of interest rate regulation, the increased fluctuations in interest rates that began in the late 1960s resulted in severe disintermediation in the thrift industry. This disintermediation created funding problems for the industry as a whole. As a result, many thrifts became interested in diversifying their operations into new areas with the hope of restoring profitability.

Congress did not begin to deal with these issues comprehensively until the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Garn-St.Germain Act of 1982. However, the events of the decade preceding the enactment of these measures conspired to bring about a process of piecemeal deregulation driven by underlying market forces.[2] To help its members attract deposits and thereby mitigate the

[2] Detailed accounts of the events of this period and the debate that accompanied the financial industry deregulation are available in Thomas F. Huertas, "The Regulation of Financial Institutions: A Historical Perspective on Current Issues," in George J. Benston, ed., **Financial Services: The Changing Institutions and Government Policy** (Prentice-Hall, 1983), chap. 1, and also in Almarin Phillips and Donald P. Jacobs, "Reflections on the Hunt Commission," ibid., chap. 9.

effects of disintermediation, the Federal Home Loan Bank Board (FHLBB) authorized federally-chartered savings and loans to permit preauthorized, nonnegotiable third-party transfers from consumers' savings accounts for household-related expenses in 1970. These rules were further liberalized in 1975 to permit such transfers for any purpose.

The New England states acted more aggressively to help their state-chartered thrifts attract deposits. In 1972, state-chartered mutual savings banks in Massachusetts and New Hampshire were permitted to begin offering NOW accounts. These deposits were, for all practical purposes, interest-bearing checking accounts. In response, Congress granted all depository institutions in these two states similar authority in 1974. This authority was later extended to depository institutions in all the New England states in 1976.[3] Thrifts and other financial institutions nationwide were not permitted to offer interest-bearing checkable deposits until 1980, when the DIDMCA was passed.

To make use of these new powers, thrifts needed increased access to the nation's payments system. In New England, the Federal Reserve agreed to process and clear NOW account drafts for thrifts on terms similar to those extended to nonmember commercial banks. On a national level, the thrift industry became interested in acquiring access to the newly developing system of automated clearinghouses. The eventual resolution of this issue provides an interesting case study in antitrust law. Understanding the issues that were debated, however, requires some knowledge of the unique aspects of the automated clearinghouse system's organizational structure.

The Organization of Automated Clearinghouses

An automated clearinghouse, or ACH, is a computerized facility that performs basically the same functions as an ordinary clearinghouse. Rather than processing and sorting paper checks, however, an automated clearinghouse processes payments information stored on magnetic tapes and transmitted over a telecommunications network.

[3] Alfred Broaddus, "Automatic Transfers from Savings to Checking: Perspective and Prospects." Federal Reserve Bank-of Richmond, **Economic Review** 64 (November/December 1978) : 3-13, contains a detailed chronology of innovations in third-party payment services during this period.

Automated clearinghouses in the United States were developed through the cooperative efforts of commercial banks and the Federal Reserve System. These efforts began in 1968, when the Special Committee on Paperless Entries (SCOPE) was created by a group of California banks to study alternative means of reducing the volume of paper checks processed by banks. That same year the American Bankers Association (ABA) created the Monetary and Payments System (MAPS) Planning Committee, which subsequently recommended the formation of a national system of automated clearinghouses.

With some assistance from the Federal Reserve, SCOPE completed the development of a computer software package and a set of operating rules in 1972. The California Automated Clearinghouse Association (CACHA) was formed that same year and was the first automated clearinghouse in the United States. In response to a formal request from CACHA, the Federal Reserve Bank of San Francisco agreed to provide the necessary clearing and settlement facilities and assumed responsibility for operating the automated clearinghouse. These services were made available at no explicit charge to all banks that were members of CACHA.

Over the next several years, the number of regional ACHs grew rapidly. In virtually every case, Federal Reserve Banks assumed responsibility for operating these facilities. The first privately operated ACH was not formed until December 1975, when the New York ACH (NYACH) began operation. Today there are over 30 separate ACH associations in operation in the United States; most continue to be operated by the Federal Reserve.[4] The regional automated clearinghouses are linked together by a nationwide telecommunications network, also operated by the Federal Reserve.[5]

[4] Norman Penny and Donald I. Baker, **The Law of Electronic Funds Transfer,** (Boston: Warren, Gorham, and Lamont, Inc., 1980). Chapter 3 contains a history of the development of automated clearinghouses in the United States.

[5] This nationwide ACH network was completed in 1978. As with the regional automated clearinghouses, the nationwide network was organized through the joint efforts of the banking industry and the Federal Reserve. Further details may be found in Board of Governors of the Federal Reserve System, "Nationwide EFT Network," **Federal Reserve Bulletin** 64 (October 1978): 823-24.

Although Federal Reserve Banks assumed responsibility for managing the routine operations of most of the newly organized automated clearinghouses, the ACH associations themselves were governed by rules adopted by their member institutions. Association rules not only governed routine operations, but also dealt with the more fundamental questions concerning organizational structure such as the terms of membership and conditions imposed on access to services. These rules permitted all commercial banks (including banks that were not members of the Federal Reserve System) access on equal terms. Banks that were not members of the Federal Reserve System were required to maintain accounts with member banks for purposes of settlement, however, since nonmember institutions did not keep reserves with Reserve Banks.

When the development of an electronic alternative to the existing system of clearing paper checks was initiated in 1968, the question of whether thrifts should participate in such a system was not an issue since most thrifts could not then offer deposits with third-party payment powers. This had changed by the time CACHA began to operate in 1972, however, because of the FHLBB's 1970 rule and the advent of NOW accounts in New England.

The California Savings and Loan League approached CACHA in the summer of 1972 to inquire about the possibility of participation in the newly formed ACH. Subsequently, several savings and loan associations applied for membership in CACHA. At first, thrifts expressed an interest only in receiving ACH credits (such as automatic payroll deposits) and debits originated by others. After some negotiation, CACHA offered to permit thrifts to establish "pass-through" accounts with banks that were members of the ACH. Membership in the ACH on the same terms as commercial banks, however, was denied. This meant that thrifts wishing to originate ACH transactions were required to deal with a correspondent bank, which would initiate transactions on their behalf. This proposal was consistent with the ABA's recommended access policy.

Banking Industry Policy on ACH Access

The ABA's proposed policy on ACH access for thrifts was similar to the "pass-through" policy adopted by the Federal Reserve in response to earlier requests for access to its check-clearing system by New England thrifts. In the latter case, thrifts were permitted to establish pass-through clearing accounts (amounting to three percent of their NOW account deposits) with a Federal Reserve member bank, which would then clear checks and NOW account drafts through the Federal Reserve Bank of Boston on their behalf. This policy gave New England thrifts access to check-clearing services on the same terms as those extended to nonmember banks.[6]

In contrast, the ABA's policy treated all commercial banks alike, while imposing different conditions on thrifts. In retrospect, this difference in the two policies was a crucial one. Apparently thrifts were willing to accept a pass-through access policy when that same policy was uniformly imposed on nonmember banks. In the case of automated clearinghouses, thrifts claimed that the banking industry's discriminatory access policy put them at a competitive disadvantage.

To the banking industry the issue of ACH access was intimately tied to the broader issues of thrift industry deregulation and, more generally, to regulatory reform of the financial services industry. The rationale for the existing regulatory structure, which treated thrifts more leniently in several important respects, was based on the premise that thrift institutions were not permitted to compete in certain traditional banking markets. Bankers viewed the thrift industry's attempts to gain direct access to ACH services as an attempt to circumvent the legal restrictions that prohibited thrifts from offering demand deposits. In addition, they argued that their industry had borne the cost of developing the ACH system, and that the thrift industry was attempting to gain a "free ride" as a result of these efforts.'

The ABA did not completely rule out equal access to the ACH system. However, it demanded equal regulatory treatment of thrifts, including the imposition of more stringent reserve requirements (such as those imposed on banks) and the abolition of the more favorable interest rate ceilings enjoyed by thrifts under Regulation Q, as the price of such access. Direct access to ACH facilities for thrifts

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[6] See Penny and Baker, **The Law of Electronic Funds Transfer** at 19-7.

[7] Penny and Baker at 19-26.

(or any clearing facilities for that matter) was opposed ". . . unless authorized through legislative restructuring of the nation's financial system and equalization of regulatory and reserve obligations have been achieved."[8]

Federal Reserve Policy on ACH Access

The Federal Reserve became involved in the debate over ACH access because of the major role it had assumed in the operation of that system. Thrifts, unable to secure access on the terms they desired from the ACH associations, appealed to both the Federal Reserve and Congress to grant them direct access to these systems. Initially the Federal Reserve supported the banking industry's proposed access policy, citing essentially the same concerns as those expressed by the bankers. Congress took no formal action during the early stages of the debate, but appeared to agree with the Federal Reserve's position.

Like the banking industry, the Federal Reserve viewed ACH transactions as a substitute for paper checks. By law, banks were prohibited from paying explicit interest on demand deposits. The Board expressed concern that permitting thrifts direct access to the ACH system, including the authority to directly originate ACH transactions, could undermine legal restrictions prohibiting the payment of interest on demand deposits. It therefore argued that only those institutions explicitly authorized by Congress to offer demand deposits should be permitted direct access to the ACH system. Representative Ferdinand St. Germain of the House Banking Committee appears to have shared this view.[9]

In 1973, commercial banks had not yet received authority to originate preauthorized, third-party payments from customers' savings accounts such as that granted earlier to federally-chartered savings and loans. This meant that customers of commercial banks were required to originate ACH payments from non-interest-bearing checking accounts. A customer of a federally-chartered thrift, however, could originate such payments directly from a savings account. The ban on direct access did not prohibit thrifts from offering this service to their customers, but the banking industry apparently felt that permitting thrifts direct access under existing regulations would give them a greater competitive advantage in this area. The Federal Reserve Board, facing an acute membership problem and therefore aware of member banks' perceptions of unequal and unfair regulation, viewed thrifts' newly acquired third-party payments powers as a breach in existing regulations, and did not wish to ratify the existence of this "loophole" by helping the thrift industry gain direct access to ACH services. In the end, however, competitive pressures led to the extension of similar authority to commercial banks, while thrifts gained even greater powers.[10]

As a long-run solution to the problem of thrift access, the Federal Reserve proposed reforms that would place thrifts on a more equal competitive footing with commercial banks. As part of these reforms, legislation that would permit thrifts to join the Federal Reserve System was proposed. Under this plan, thrifts that joined the Federal Reserve would be granted direct access to all the System's payments services. Thrifts that became members would also be required to bear all the costs of membership, however, such as meeting the same reserve requirements imposed on member banks. Until such legislation was enacted, the access policy proposed by the banking industry was viewed as an adequate short-term solution. The following statement by Governor George M. Mitchell of the Federal Reserve Board summarizes the Board's policy:

> If Congress said, we want all the institutions to be part of the money system, then there wouldn't be any question about it. You know what the arguments are for making them more like banks, giving them the same reserve requirements and giving them the same interest rate ceiling arrangements-that is essentially what we are talking about.[11]

[8] "Fed Urged to Move Cautiously on EFTS; Many See Dangers to Private Competition," **American Banker,** April 9, 1974. This article also summarizes the comments of a great many other interested parties, including thrift industry groups, on the issues of pricing and access to the automated clearinghouse network. The views expressed by CACHA on this issue mirrored those of the ABA.

[9] See comments of Rep. Ferdinand St. Germain, in **Electronic Funds Transfer System (EFTS)/Failure of the U. S. National Bank of San Diego,** Hearings before the Subcommittee on Bank Supervision and Insurance of the House Committee on Banking and Currency, 93 Cong. 1 Sess. (GPO, 1974), p. 26.

[10] Commercial banks were first permitted to make preauthorized, nonnegotiable third-party transfers from customers' savings accounts in September of 1975, five months after the FHLBB further liberalized similar third-party transfer powers for federally-chartered savings and loans. Once again, see Broaddus, "Automated Transfers from Savings to Checking."

[11] **Electronic Funds Transfer System,** Hearings, p. 30.

The Federal Reserve's expanded membership proposals were also intended to provide a means of recovering the added costs of servicing thrifts under a policy of direct access. Giving thrifts access on the same terms as banks would require the Federal Reserve to bear the cost of servicing additional end points on its ACH system. Setting explicit fees for ACH services offered a means of recovering the added cost of servicing thrifts directly, but the thrift industry argued that any fees should be imposed uniformly on all institutions receiving ACH services. The increasing seriousness of the Federal Reserve's membership problem made the Board reluctant to charge its member banks for payments services.

It was widely acknowledged that the Federal Reserve's membership problem was due to the cost of the non-interest-bearing reserves member banks were required to hold. In contrast, nonmember banks and thrifts faced less stringent reserve requirements which could often be satisfied by holding certain interest-bearing bonds (most commonly, state or federal government bonds). Since the Federal Reserve was effectively prohibited from paying explicit interest on reserves, it offered payments services to its members at no explicit charge as a means of paying implicit interest. As inflation and interest rates rose throughout this period, however, the cost to banks of maintaining required reserves rose and banks began to withdraw from the System at an increasing rate.[12]

From the Federal Reserve's perspective, imposing explicit fees for payments services would amount to double-charging its members for services already paid for by holding required reserves. In addition to being viewed as being unfair, it was feared that the adoption of such a pricing policy would further exacerbate the System's membership problem.[13]

Thrift industry groups, on the other hand, opposed the Federal Reserve's proposals for regulatory reform and expanded membership. Instead, these groups put forward proposals to impose equal access charges on both thrifts and commercial banks while opposing any reforms that would extend the same regulatory treatment faced by commercial banks to their own industry.[14]

To summarize, then, the Federal Reserve Board supported the banking industry's pass-through access proposals for thrifts until such time as those institutions received explicit authority from Congress to offer transactions accounts to the public. Any explicit extension of such authority to thrifts was expected to be accompanied by other regulatory reforms that would place thrifts and commercial banks on a more equal competitive footing. Additionally, the Federal Reserve proposed that thrifts be permitted to obtain membership in the System as a means of gaining direct access to its clearing network. The thrift industry, however, was more interested in gaining direct access to the ACH system than in regulatory reform, and vigorously opposed these proposals. Instead, industry representatives argued that thrifts should be granted immediate access on the same terms as commercial banks without' regard to the resolution of the regulatory issues that concerned both the banking industry and the Federal Reserve. The thrift industry subsequently received aid from the Antitrust Division of the U.S. Justice Department in arguing its case.

Access Policy and Antitrust Law

The Justice Department's Antitrust Division sided with the thrift industry in the debate over the issues of access and pricing, arguing that any access policy that treated thrifts differently from banks violated existing antitrust laws. This argument was based on an established Access Principle, which the Justice Department explained as follows :

[12] During this period, the Federal Reserve repeatedly expressed concerns that the continuing withdrawal of its members would make it more difficult to conduct monetary policy. One notable concern in this respect was that diminished access to the Federal Reserve's discount window (which was then largely limited to member banks) might hamper the Fed's ability to deal effectively with a financial crisis. See, for example, "Statement by William E. Miller, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Finance and Urban Affairs, House of Representatives, July 27, 1978," **Federal Reserve Bulletin** 64 (August 1978): 636-42. Other writers have stressed the potential loss of revenues earned from the non-interest-bearing reserves member banks were required to hold as the primary reason for concern over the membership problem. This latter view is adopted by Marvin Goodfriend and Monica Hargraves, "A Historical Assessment of the Rationales and Functions of Reserve Requirements," Federal Reserve Bank of Richmond, **Economic Review** 69 (March/April 1983): 3-21.

[13] See Statement of George W. Mitchell, Member of the Board of Governors of the Federal Reserve System, **Electronic Funds Transfer System.** Hearings, pp. l-11.

[14] For a summary of the thrift industry's comments on the Federal Reserve Board's proposals see "Fed Urged to Move Cautiously on EFTS . . ."

> Antitrust law requires that those who control an essential facility must grant access to it on reasonable and non-discriminatory terms to all competitors.[15]

In the context of antitrust law, an "essential" facility is one that provides a significant competitive advantage to any market participants that have direct access to that facility. No alternatives to the Federal Reserve's ACH system existed at that time. Moreover, it was argued that because the Federal Reserve did not charge explicit fees for these services, no competing private sector alternative was likely to develop.[16] The Justice Department's view, therefore, was that the ACH system operated by the Federal Reserve was essential for purposes of antitrust law. On these grounds, it was argued that thrift institutions should be permitted direct access to ACH services on equal terms with commercial banks. Like thrift industry groups, the Justice Department favored the adoption of a system of nondiscriminatory fees for these services.

The Justice Department's position was apparently based on the premise that thrifts should be permitted to compete directly with commercial banks on equal terms. As has already been noted, however, the regulatory structure existing at that time intentionally discriminated between different types of financial institutions expressly to inhibit such competition. The Justice Department was aware of the fact that thrifts might enjoy certain competitive advantages as a result of these regulations, but argued that the existence of such advantages did not constitute sufficient grounds under antitrust law to deny thrifts direct access to an essential facility:

> On the other hand, the fact that thrift institutions may enjoy other regulatory or legal advantages does not justify a denial of equal access to an automated clearing facility; thus, in a recent antitrust case, the courts applied the bottleneck principle to the transmission system of an investor-owned electric company, despite the fact that the "competitors" gaining access were municipally owned electric systems who enjoyed various tax and other advantages. This decision was affirmed by the Supreme Court in February 1973.[17]

The Resolution of the Access Policy Issue

The controversy over ACH access policy was finally resolved by a pair of antitrust suits brought against the California and Rocky Mountain ACHs by the Justice Department in 1977. A more liberal access policy was instituted before then, however. The Federal Reserve had adopted a policy that encouraged the admission of thrifts into the ACH associations it serviced a year earlier (although none of these associations had adopted such a policy), and had also instituted the direct delivery of ACH items to thrifts.[18] In a related development, NYACH permitted full membership and access for thrifts from the time it was first organized in 1975.

In January of 1976, the Federal Reserve Board modified its access guidelines to accommodate thrifts that might become members of ACH associations that it serviced. The new guidelines stated that ACH deposits delivered to the Federal Reserve could ". . . originate from any account having third-party payment powers, e.g., savings, NOW, share draft accounts."[19] In contrast, earlier access guidelines had restricted authority to directly originate

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[15] Comments of the United States Department of Justice: Proposed Amendment of Regulation J and Related Issues (May 14, 1974).

[16] Earlier, the Federal Home Loan Bank of San Francisco had proposed to establish a separate ACH system for savings and loans. Both the Federal Reserve and the Justice Department objected to this proposal. The Federal Reserve's opposition stemmed from its view that there should be a single nationwide EFT network, operated by the Federal Reserve. See "Mitchell Would Bar S&L Access to EFTS, Except Through Commercial Banks," **American Banker,** November 27, 1973. The Justice Department favored leaving the market for EFTS services to private sector competitors and so opposed any entry from government agencies. A letter from Thomas E. Kauper, Assistant Attorney General, Antitrust Division, to Garth Marston, Acting Chairman, Federal Home Loan Bank Board, 1975 explained the Justice Department's opposition to the proposed FHLB System.

[17] Donald I. Baker, "Antitrust and Automated Banking," **The Banking Law Journal** 90 (September 1973): 703-18. Mr. Baker was Deputy Assistant Attorney General and Director of Policy Planning for the Antitrust Division when this article was prepared. He also participated in preparation of the Justice Department's comments to the Federal Reserve on the issue of access policy.

[18] The direct delivery of ACH items to thrifts was instituted in 1975 as part of the Federal Reserve's "interim access guidelines." Under these guidelines, thrifts that received a sufficient number of ACH items and that were located along existing check courier routes could receive ACH items directly from the Federal Reserve. In addition, thrifts were-given permission to pick up items directly from local Federal Reserve processing centers. See Board of Governors of the Federal Reserve System, "Access to Federal Reserve Clearing and Settlement Facilities: Proposed Policy," **Federal Register** 40 (June 17, 1975): 25,641, and also Board of Governors of the Federal Reserve System, "Interim Guidelines for Direct Deposit of Federal Payments," **Federal Reserve Bulletin** 62 (January 1976): 66-67.

[19] See Board of Governors of the Federal Reserve System, "Collection of Checks and Other Items by Federal Reserve Banks," **Federal Register** 41 (January 21, 1976): 3,097-105.

ACH transactions to banks and other institutions ". . . legislatively authorized to maintain demand deposit accounts."[20] In addition, language included in the later guidelines appeared to encourage ACH associations to adopt more liberal membership policies.[21]

The ABA resisted attempts to liberalize ACH access policy, arguing, as before, that ACH associations should be permitted to determine access policy for themselves and that only institutions legally authorized to offer demand deposits should be permitted to originate ACH transactions[22] The right of access for thrift institutions was finally established through two antitrust suits filed by the Justice Department in 1977. The first of these suits was brought against the Rocky Mountain ACH. The second was against the California ACH. Both of these organizations obtained their services from the Federal Reserve. In both cases the Justice Department argued that heavy Federal Reserve subsidies of ACH services and the resulting absence of explicit prices for these services effectively created local monopolies in this area. These subsidies, it was argued, discouraged the emergence of a private sector competitor and so turned these ACHs into essential facilities. Therefore, the denial of direct access to thrifts placed those institutions at a competitive disadvantage with respect to commercial banks in violation of established antitrust laws. The Justice Department won both suits, and soon thereafter all ACH associations began to admit thrifts to membership.[23] These suits had no substantial effect on Federal Reserve policies, however, since the access guidelines adopted the year before had made explicit arrangements for eventual thrift membership in ACH associations.

As a result of these suits, the Justice Department's position on the issues of pricing and access greatly influenced the provisions dealing with those issues finally included in the Monetary Control Act. As with many of the issues involving deregulation, the enactment of legislation dealing with such issues only served to ratify earlier developments in the marketplace.

III. ISSUES RELATED TO FEDERAL RESERVE PRICING POLICY

Debate over Federal Reserve pricing policy first surfaced in the early 1970s as a result of two related sets of issues. The first concerned the competitive and antitrust implications of Federal Reserve pricing policy. The second set of issues arose as a result of the growing Federal Reserve membership problem and congressional concern over the expected cost of legislative proposals put forward to solve this problem.

Concern over the effects of Federal Reserve pricing policy on market competition arose as a result of its announcement of plans to develop and operate a comprehensive nationwide electronic funds transfer (EFT) network. Although Federal Reserve involvement in the development and operation of the ACH system was actively encouraged by a large segment of the banking industry, it also resulted in debate over the appropriate role of the Federal Reserve in the nation's payments system. The development of this new network was viewed by some as an entry into new markets by the Federal Reserve. Some bankers expressed concern that, unless the Federal Reserve began to price its services explicitly, private sector entry into these new markets would be preempted. Separately, thrift industry complaints regarding ACH access policy led to calls for the adoption of a nondiscriminatory pricing system.

The membership problem experienced by the Federal Reserve during this period made the Board of Governors hesitant to adopt such a policy, however. In the end, Congress combined pricing policy reform together with other measures designed to solve the Federal Reserve's membership problem in the final version of the Monetary Control Act.

[20] Board of Governors of the Federal Reserve System, "Access to the Federal Reserve Clearing and Settlement Facilities."

[21] This is reflected in the following passage: "In providing clearing and settlement servic for ACH associations, the Board anticipates that these services will be made reasonably available on a comparable basis to depository institutions having need for such services." Board of Governors of the Federal Reserve System, "Collection of Checks and Other Items by Federal Reserve Banks."

[22] Letter, Willis W. Alexander, Executive Vice President, American Bankers Association to Theodore E. Allison, Secretary of the Board of Governors of the Federal Reserve System, March 19, 1976. This letter was published in **Federal Reserve Services,** Hearings before the Senate Committee on Banking, Housing, and Urban Affairs, 95 Cong. 1 Sess. (GPO, 1977), pp. 178-96.

[23] A more detailed account of these suits is contained in Penny and Baker, **The Law of Electronic Fund Transfer Systems** at 19-25.

Pricing and Competition

Soon after the Federal Reserve System was established, Reserve Banks made facilities available for the transfer of funds between member bank reserve accounts. Such transactions typically involved relatively large amounts and, like direct transactions between private correspondent banks, initially utilized either Western Union or Postal Telegraph facilities. In 1918, the Federal Reserve established its own Morse code system to provide for a more rapid and secure transfer of funds between banks. Since then, the system has been gradually updated. Fedwire, as it came to be called, became the primary facility for the transfer of funds in the federal funds market. In addition, commercial banks developed a number of private funds transfer networks that offered similar services.[24]

The Federal Reserve Act had authorized the Board to regulate transfers of funds among Reserve banks and to receive deposits from member banks. The Board interpreted this authority as providing the statutory basis for the operation of its own wire funds transfer network.[25] In 1972, soon after MAPS committee recommended the formation of a nationwide ACH network, the Federal Reserve announced its own plans to develop and operate an integrated nationwide EFT network.[26] The scope of this planned network was broader than that of the network then operated by the Federal Reserve in that it would provide facilities to process and transfer recurring ACH-type transactions in addition to the large-dollar types of transfers the Fed had offered throughout its history. There was also some discussion of using the Federal Reserve network for supporting a retail nationwide point-of-sale (POS) network.

There was a good deal of disagreement within the banking industry on the need for the Federal Reserve to expand its operations in the area of electronic payments systems. Many of the larger money center banks, which were also major correspondent banks, voiced concerns that the Federal Reserve's development of a nationwide EFT network could preempt all such private sector initiatives. The position finally adopted by the ABA appears to have been designed as a compromise between those bankers who favored the planned expansion of the Federal Reserve's EFT network and others interested in expanding their own profit-making operations. That compromise endorsed the Fed's involvement in the ACH system, but also advocated the adoption of ". . . a pricing system on a basis fully reflecting the costs which would be incurred by a private sector effort . . ."[27] for any new services it offered. This proposal was intended to protect private-sector incentives to offer competing services.

In addition to industry groups, the Justice Department also favored the adoption of a system of competitively-set prices for EFT services offered by the Fed. The Antitrust Division's comments to the Federal Reserve cited two principal reasons favoring the adoption of such a pricing system. The first of these reasons was connected with the issue of access policy. Here, it was noted that antitrust law required the adoption of a nondiscriminatory pricing system for essential services provided to competing firms on the grounds that: "A discriminatory pricing system can be as substantial a bar to competition as exclusionary ru1es."[28] Additionally, the Justice Department also expressed many of the same competitive concerns voiced by financial industry groups; that is, that private sector development of such systems might be discouraged if the Federal Reserve continued to offer these services at no explicit charge. To ensure against such an outcome, the Federal Reserve was urged to price its EFT services on the basis of fully allocated costs and '. . . including an appropriate allowance for capital costs."[29] It was argued further that such pricing concerns were tied to the issue of access because the presence of competing suppliers would lessen the likelihood that any one such supplier's services could become "essential."

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[24] A description of Fedwire and other privately operated funds transfer networks is presented in David Mengle, "Daylight Overdrafts and Payments System Risks," Federal Reserve Bank of Richmond, **Economic Review** 71 (May/June 1985): 14-27.

[25] See "Federal Reserve Operations in Payment Mechanisms: A Summary," **Federal Reserve Bulletin** 62 (June 1976) : 481-89.

[26] "Evolution of the Payments Mechanism," **Federal Reserve Bulletin** 58 (December 1972) : 1009-12.

[27] See "Fed Urged to Move Cautiously on EFTS . . ."

[28] Comments of the United States Department of Justice, Proposed Amendment of Regulation J and Related Issues, p. 27.

[29] Ibid., p. 28.

Pricing Policy and the Membership Problem

In response to these events the Federal Reserve Board announced its intent to establish a price schedule for its check-clearing and ACH services in January 1976, together with its liberalized access proposals. However, the Board continued to be concerned about the impact the adoption of such a pricing system might have on its worsening membership problem and so was careful to explain that: "In developing the pricing schedule, consideration would be given to the burden of required reserves maintained by member banks."[30] No timetable for the implementation of this pricing system was given, and in the end such a pricing system was adopted only after passage of the Monetary Control Act and the resolution of the membership problem.

Serious consideration of the pricing issue emerged in Congress in 1977 as part of the debate over legislation intended to alleviate the Federal Reserve's membership problem. Congressional attention initially centered on the costs of providing these services and the resulting loss of revenue to the Treasury, however, rather than the competitive and antitrust problems that concerned industry groups.

Legislation on Pricing

The Federal Reserve had long proposed the institution of universal reserve requirements as a means of solving its membership problem. However, such measures proved to be very unpopular among nonmember institutions who lobbied vigorously against them. As a result, legislation granting the Federal Reserve the authority to pay explicit interest on member bank reserves came under consideration. Provisions extending such authority were included in Senate bill S.1664, which was submitted by the Carter administration in the spring of 1977. It contained two main provisions. First, it permitted all depository institutions nationwide to offer NOW accounts to consumers and imposed uniform reserve requirements on those accounts. Second, the bill granted the Federal Reserve permission to begin paying interest on reserves. The bill also contained language explicitly authorizing the Federal Reserve to provide payments services to all depository institutions that offered NOW accounts.

Senate bill S.1664 was never enacted, largely because of the anticipated cost of the interest payments it would have permitted. These concerns were noted by Senator Proxmire in the course of the hearings held to consider the bill:

> Frankly, I am troubled about. the proposal to permit the Federal Reserve to pay up to $600 million a year to the Nation's larger banks in the form of interest on reserve balances . . . . Moreover, the legislation fails to direct the Fed to begin charging for the services currently valued at $300 million, which it provides free of charge to member banks.[31]

It was widely understood that the services the Federal Reserve supplied to its member banks served as a means of paying implicit interest on required reserves. Both the Treasury and Congress therefore appeared to expect that the extension of this authority would be accompanied by the institution of a pricing system by the Federal Reserve.[32] However, the Board was hesitant to commit itself to an exact date for the release of a proposed fee schedule or to set a specific timetable for the enactment of a general pricing policy before final action was taken to resolve the membership problem.[33]

In addition to dealing with the Federal Reserve's membership problem, the Justice Department's antitrust suits, which were successfully concluded at about the same time, put pressure on Congress to act on the problem of access policy. Members of Congress were very aware that over half the Federal Reserve's operating budget was devoted to the provision of payments services, and the prospect of further requests for these services by nonmember institutions promised to place further demands on that budget. Soon after the hearings on S.1664 were held, Senator Proxmire organized a separate set of oversight hearings to review the role of the Federal Reserve in the payments system and the issue of pricing those services.[34]

In the course of these hearings, many representatives of the banking industry were asked for their views on pricing and the appropriate role of the

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[30] Board of Governors, "Collection of Checks and Other Items by Federal Reserve Banks," p. 3,098.

[31] Opening Statement of Senator Proxmire, in **NOW Accounts, Federal Reserve Membership and Related Issues,** Hearings before the Subcommittee on Financial Institutions of the Senate Committee on Banking, Housing, and Urban Affairs, 95 Cong., 1 Sess. (GPO, 1977), p. 3.

[32] See, for example, Statement of W. Michael Blumenthal, Secretary of the Treasury, in **NOW Accounts, Federal Reserve Membership and Related Issues,** pp.

[33] See, for example, Statement of Arthur F. Burns, Chairman of the Board of Governors of the Federal Reserve System, in **NOW Accounts, Federal Reserve Membership and Related Issues,** pp. 26-59, especially p. 58.

[34] **Federal Reserve Services,** Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs.

Federal Reserve in the payments system. Representatives of major correspondent banks and other potential competitors favored a greatly reduced operational presence for the Federal Reserve. Others who testified, however, including representatives from a number of smaller banks as well as thrift industry and credit union groups, supported the maintenance of the Federal Reserve's broad operational role in the payments system. While there appeared to be no consensus on the exact services the Federal Reserve should be permitted to offer, there was universal agreement among market participants on the subject of pricing. It was widely acknowledged that private sector incentives to offer competing services should be protected and that this was best done by having the Federal Reserve adopt a pricing policy that would foster such competition.

Pricing was also favored as a means of promoting economic efficiency in the provision of payments services. In the absence of pricing, financial institutions that received Federal Reserve services had little incentive to conserve their use of such services or to encourage the use of the potentially more efficient emerging EFT services as a substitute for paper checks. However, while these latter economic arguments were recognized and discussed briefly during the oversight hearings, it was clear that the other related issues, those concerning the ultimate cost to the Treasury of the Fed's payments operations and the problem of fostering private-sector competition, dominated congressional attention. All future legislative proposals dealing with the Federal Reserve's membership problem would also address the issues of pricing and competition.

A year later, in May of 1978, Representative Stanton of Ohio introduced another bill, H.R. 12706, to permit the Federal Reserve to pay interest on reserves. The Stanton bill differed from earlier legislative proposals in that it also contained language explicitly requiring the Federal Reserve to set prices for all its payments services:

> . . . established on the basis of all direct and indirect costs actually incurred in providing the services priced, including overhead, and an allocation of imputed costs that take into account the taxes that would have been paid and the return on capital that would have been provided had the payment services been furnished by a private business firm.35

The bill explicitly authorized the Federal Reserve to continue offering its existing line of payments services and also permitted it to offer new payments services, ". . . including but not limited to payment services that effectuate the wire transfer of funds."[36] Any new services offered by the Federal Reserve were also required to be explicitly priced according to the requirements set forth in the act. The bill also addressed the access policy issue. Provisions contained in that legislative proposal required the Federal Reserve to make its payments services available to all depository institutions on the same terms.[37] Separately, an amendment proposed by Representative Reuss (then Chairman of the House Banking Committee) would have limited the gross amount of interest the Federal Reserve would be permitted to pay out to the total of the profits it earned from its payments services plus any profits earned on loans made through the discount window.[38] H.R. 12706 was not passed.

In the end, the House Banking Committee reported out a new bill, H.R. 14072, that dropped provisions authorizing the payment of interest on reserves and instead imposed universal reserve requirements on all commercial banks. The pricing provisions of the Stanton bill were carried over substantially intact, but included a number of new provisions giving the Federal Reserve somewhat more flexibility in setting its prices. As before, the Federal Reserve would be required to set its prices sufficient to recover all its costs, including an allowance for costs that would be incurred by a private sector competitor, but new language permitted these costs to be recovered "over the long run."[39] Additional changes permitted the Federal Reserve to depart from these strict cost

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[35] Federal Reserve Membership Act of 1978, H.R.12706, in **Monetary Control and the Membership Problem,** Hearings before the House Committee on Banking, Finance and Urban Affairs, 95 Cong. 2 Sess. (GPO, 1978), pp. 13-17.

[36] Ibid.

[37] Of course, legal provisions such as this one, which require the adoption of nondiscriminatory access and pricing policies, do not necessarily require that all purchasers be charged the same price under all conditions. Price discrimination arises when price differentials charged to different purchasers are unrelated to underlying differences in the cost of supply. Thus, the Federal Reserve can charge institutions that are more costly to service (because they are remotely situated, for example) a higher price than it charges other institutions without violating the requirements of the Monetary Control Act. For a more detailed discussion of price discrimination, see F. M. Scherer, **Industrial Market Structure and Economic Performance** 2nd ed. (Houghton Mifflin Company, 1980), chap. 21.

[38] See Opening Statement of Chairman Henry S. Reuss, House Committee on Banking, Finance and Urban Affairs, **Monetary Control and the Membership Problem,** Hearings, pp. 34-53.

[39] Federal Reserve Act Amendments of 1978, H.R. 14072, ibid, pp. 509-22.

recovery requirements when it was deemed to be in the public interest to do so.

This same language was later included in H.R. 7, The Monetary Control Act of 1979, which passed in the House of Representatives the following year. After a joint committee meeting, this bill was combined with a bill passed in the Senate to form the Depository Institutions Deregulation and Monetary Control Act of 1980. The final version of the bill contained only minor changes in the language dealing with the pricing of Federal Reserve services.[40]

IV. SUMMARY AND CONCLUSIONS

The Monetary Control Act radically changed the terms governing the Federal Reserve's participation in the operation of the nation's payment system. This change was brought about because of a number of related developments arising in the decade before the act was passed that caused Congress to reevaluate the Federal Reserve's role in the payments system.

First, the Federal Reserve's involvement in the development and operation of automated clearinghouses, while encouraged by a large segment of the banking industry, also raised questions concerning which services the Fed should provide for the banking industry. A number of market participants, notably the larger money center banks and private clearinghouses, viewed this action as an expansion by the Federal Reserve into new markets. These latter groups voiced concerns that a large-scale expansion of Federal Reserve service offerings could preempt private sector initiatives, and lobbied to have the Fed's activities in this area limited.

Separately, the deregulation of the thrift industry that began in 1970 resulted in the request for direct access to ACH services. Since ACH technology was new, no real alternatives to the ACH network operated by the Federal Reserve were available. The banking industry determined the conditions of access to this network, however, and this group set the enactment of legislation that would eliminate many of the regulatory advantages then enjoyed by the thrift industry as a condition of direct access. Since the Federal Reserve had a major role in operating this system, ACH access became tied to the broader issue of Federal Reserve access policy.

[40] See Raymond Natter, "Legislative Intent Regarding Pricing of Services by the Federal Reserve Board," in **Federal Reserve Competition with the Private Sector in Check Clearing and Other Services,** H.R. Rept. No. 98-676, 98 Cong. 2 Sess. (GPO, 1984), pp. 81-91.

The Justice Department supported the thrift industry's request for direct access, arguing that antitrust law required equal access be granted to all competitors. In 1977, the Justice Department secured access for thrifts by successfully arguing that direct access to ACH services was "essential" for purposes of antitrust law.

These developments posed problems that were not anticipated when the Federal Reserve Act was originally enacted. Before thrifts began to offer third-party payments services commercial banks were the only institutions requiring access to clearing facilities such as those operated by the Federal Reserve, and any bank desiring direct access to the Federal Reserve's services always had the option of becoming a member of the System. Membership in the Federal Reserve, however, meant bearing the costs associated with the System's reserve requirements. The thrift industry therefore opposed access conditioned on some form of Federal Reserve membership. The ruling subsequently obtained by the Justice Department granted thrifts access to ACH services without imposing the costs of membership.

At this time the Federal Reserve was already experiencing an acute membership problem because of the relatively stringent reserve requirements imposed on its member banks. Since the Fed was effectively prohibited from paying explicit interest on these reserves, its payments services served as a means of paying implicit interest. Therefore, the adoption of a nondiscriminatory price schedule, as the Justice Department argued was necessary under antitrust law, threatened to further exacerbate the Federal Reserve's membership problem.

With these problems in mind, it is easy to understand why legislative provisions addressing the issues of access and pricing were included as part of a larger package of reforms intended to alleviate the Federal Reserve's membership problem. The Monetary Control Act lowered reserve requirements for member banks and extended these same reserve requirements to all depository institutions offering transactions accounts, thus eliminating the previous discriminatory treatment of member banks. By itself, lowering average reserve requirements for member banks could be expected to result in a reduction of the revenues the Federal Reserve earned on these non-interest-bearing reserves and subsequently paid to the Treasury. Extending these new reserve requirements to nonmember depository institutions, however, mitigated this revenue loss. Nevertheless, on net, the lower average reserve requirements authorized by the act were expected to result in a net revenue loss to the Treasury.[41] Revenues earned by the Federal Reserve from the sale of its services were expected to offset a portion of these other lost revenues. Moreover, the adoption of a nondiscriminatory fee schedule permitted equal access to be granted to all depository institutions interested in receiving Federal Reserve services. (The act also granted access to the Federal Reserve's discount window to all institutions maintaining transactions accounts.) Finally, since this last provision would put the Federal Reserve in more direct competition with private correspondent banks, it was required to set its prices based on all direct and indirect costs, including an allowance for a return to capital that a private sector competitor would have earned in supplying such services.

Federal Reserve pricing has stimulated the growth of private clearinghouses as well as giving correspondent banks a greater incentive to process more of their own payments transactions. At the same time, nonmember depository institutions gained direct access to the Federal Reserve's clearing network. On net, the increase in private sector competition has resulted in the Federal Reserve losing some of its market share in the area of check-clearing services, although not in all other service lines.[42] In this sense, the Monetary Control Act has limited the Federal Reserve's role in the payments system.

In other ways, though, the act authorized an expansion of the Federal Reserve's role. Although the Fed must now compete more directly with private sector suppliers, it is no longer limited in offering its services to member banks. In addition, the Federal Reserve is now authorized to offer any new payments services, provided that the fees charged for such services are sufficient to cover all costs, including imputed private sector costs. The original Federal Reserve Act was written long before the most recent wave of technological innovation in the telecommunications industry. Those provisions authorized the Federal Reserve to clear checks and to otherwise effect the transfer of funds for member banks, but the extent to which the Fed was authorized to offer new services based on new technologies was unclear. This issue was resolved by the Monetary Control Act.

[41] On the basis of bank deposits reported for the month of December 1977, this net revenue loss was estimated at $155.6 million per year. See **Monetary Control Act of 1979,** H.R. Rept. 830, 96 Cong. 1 Sess. (GPO, 1979), pp. 5-6.

[42] See David B. Humphrey, "Resource Use in Federal Reserve Check and ACH Operations After Pricing," **Journal of Bank Research** 16 (Spring 1985): 45-53.