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Statement by

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I appreciate this opportunity to present the views of the Federal Reserve Board on issues raised by various emerging electronic payment technologies that go under such names as "digital cash" or "electronic money." Spurred by recent advances in computing, communications, and cryptography, this nascent industry holds the promise of improving the efficiency of the payment system, particularly for consumers.

While the potential for exciting developments in this field is certainly there, we should all keep the latest round of innovations in historical perspective. First, the concept of "electronic money" is not new; electronic transfer of bank balances has been with us for years. Indeed, some of the new proposals simply make available to consumers and smaller businesses capabilities that large corporations and banks have had for many years. Second, no one knows how this industry will evolve--either qualitatively or quantitatively. Some of us, for example, can recall predictions made a generation ago that the United States would soon be a cashless, checkless society.

This last point reminds us that, at present, we do not know which, if any, of the many potential electronic innovations will succeed commercially. In this testimony, I will concentrate on stored-value cards and other types of so-called "electronic cash" because they seem to raise the most challenging public policy issues. In particular, depending on their design, they could amount to a new financial instrument--an electronic version of privately issued currency. But even the concept of private currency is not entirely new. Travelers checks are, of course, familiar to everyone. And in the nineteenth century the United States had considerable experience--not always happy--with private bank notes. But widespread use of private electronic currency would certainly raise a number of policy questions.

On behalf of the entire Board, I want to state clearly at the outset that the Federal Reserve has not the slightest desire to inhibit the evolution of this emerging industry by regulation, nor to constrain its growth. On the contrary, the Board has and will continue to encourage innovations in payments technologies that benefit consumers and businesses. I am here today to raise questions, and to bring some issues to the attention of Congress, not to provide answers. Given the considerable uncertainties surrounding the design and ultimate usage of these products, it is far too soon for answers.

Nonetheless, it is not too early to begin thinking about a number of interesting and complex issues which may be raised by electronic currency. These include the impact on federal revenues, the legal and financial structure for these products, risks to participants, the application of consumer protection and anti-money laundering laws, and some issues related to monetary policy. Some of these issues may need to be addressed by the Federal Reserve and other regulatory agencies and some by the Congress. Some may need prompt attention, while others can wait. The present is, we believe, an appropriate time for public debate and discussion, a poor time for regulation and legislation.

Seignorage and the Budget

Let me start with a potential revenue issue that will arise if the stored-value industry grows large. The federal government currently earns substantial revenue from what is sometimes referred to as "seignorage" on its currency issue. In effect, holders of the roughly $400 billion of U.S. currency are lending interest-free to the government. In 1994, for example, the Federal Reserve turned over about $20 billion of its earnings to the Treasury, most of which was derived from seignorage on Federal Reserve notes.

Should some U.S. currency get replaced by stored-value products--which are private monies--this source of government revenue would decline. Indeed, one of the major economic motives for institutions to issue prepaid payment instruments is to capture part of this seignorage, just as issuers of travelers checks do now. Because the demand for stored value products and the degree to which they will substitute for U.S. currency is totally unknown at present, the loss of seignorage revenue is impossible to estimate. It is likely to be small. But it is something Congress should keep an eye on.

We should not, by the way, jump to the conclusion that the government's lost seignorage will go to the companies that issue stored value--though that will probably happen at first. It may be technically feasible to pay interest on stored-value products. To the extent that competition forces issuers of these products to pay interest, the lost seignorage will accrue to holders rather than issuers.

This discussion raises the question of whether the federal government should issue electronic currency in some form. (In posing this question, I refer to general-purpose stored-value cards, not to special-purpose instruments such as government benefit cards which, in our view, do not raise major issues.) Government-issued electronic currency would probably stem seignorage losses and provide a riskless electronic payment product to consumers. In addition, should the industry turn out to be a "natural monopoly" dominated by a single provider, either regulation or government provision of electronic money might be an appropriate response.

But such a conclusion seems quite premature. And the availability of alternative payment mechanisms would mitigate any potential exercise of market power. Further, government issuance might preempt private-sector developments and stifle important innovations. Finally, the government's entry into this new and risky business might prove unsuccessful, costing the taxpayer money. So, while we would not rule out an official electronic currency product in the future, the Federal Reserve would urge caution.

Legal and Regulatory Structures

One area that may need prompt attention from both policymakers and the industry is clarifying the legal and regulatory structure that will govern electronic money products. In this case, failure of the government to act may, ironically, impede rather than facilitate private-sector developments.

As with other payment mechanisms, issuers and holders of electronic currency take on some degree of ongoing credit, liquidity, and operational risks. The risk to a consumer using a stored-value card for small "convenience" purchases may be inconsequential. But such risks can become significant when larger amounts of money become involved--for example, when merchants and banks accumulate and exchange significant amounts of stored-value obligations during the business day.

Risks to participants arise from a number of sources. Cards might malfunction or be counterfeited. Issuers might invest the funds they receive in exchange for card balances in risky assets in order to increase their earnings. But riskier investments can turn sour, possibly impairing the issuer's ability to redeem stored-value balances at par and imposing losses on consumers and other holders (if the obligations are not insured). Further, the clearing and settlement mechanisms for stored-value cards and similar products--if they become widely used--could generate significant credit and other settlement risks.

We believe that both the industry and the government should focus on answering several mundane questions that seem to be receiving little attention amid the continuing publicity about these products. For example:

- Whose monetary liability is the particular form of electronic money?
- If an issuer were to become bankrupt or insolvent, what would be the status of the claim represented by a balance on a card or other device?
- In such a situation, when and how would funds be made available to the holder?
- Who is responsible for the clearing and settlement mechanism?

Developers of these products have discussed a variety of possible options, but the industry does not appear to be converging on one or more models that would be transparent and readily understood by users. In addition, there is no specialized legal framework for stored-value transactions, as there is for checks and other common retail payment mechanisms. For example, state or federal law specifies when an obligation is discharged by cash, check, or wire transfer--but not if payment is by stored value.

From the Federal Reserve's perspective, new and exciting technological developments in payments mechanisms should not overshadow the conventional and ongoing need for clear and soundly based legal and financial arrangements. It is essential that developers and issuers clarify the rights, obligations, and risks borne by consumers, merchants, and other participants in new systems <u>before</u> these products are widely introduced.

The need to attract and retain customers will naturally drive developers and issuers of electronic money products toward investment policies and operational controls that make their products useful and safe. So, to some extent, the market will be self-policing. Nevertheless, it could be costly and difficult for consumers and merchants to monitor and evaluate the safety of electronic money products, especially given their technological complexity. So the government is likely to become involved as well.

To guard against financial instability and to protect individual consumers, the government has, in the past, mandated a range of regulatory measures for private financial instruments. Three principal approaches are used:

1. Disclosure and surveillance: In the case of mutual funds, securities laws generally require disclosures about asset holdings. Audits and examinations of investment funds also help ensure that reported assets are actually held.

2. Portfolio restrictions: In some cases, standards or restrictions on portfolios help limit the riskiness of the assets. Money market mutual funds, travelers checks in some states, and, historically, privately issued bank notes are familiar examples.

3. Government insurance: Balances in depository institutions, of course, receive the most comprehensive protection mechanism available: federal deposit insurance.

At some point, though certainly not now, Congress will have to decide which, if any, of these protection mechanisms should be applied to stored-value products.

For example, if stored-value obligations of banks are treated as insured deposits--which is, by the way, another legal question that needs to be cleared up--then credit risk is effectively transferred from consumers to the government. In fact, the European central banks have gone so far as to recommend that only banking institutions be permitted to issue prepaid cards, presumably because that gives such cards the same degree of protection and financial oversight as traditional bank deposits.

The Federal Reserve Board has not viewed such a restrictive policy as appropriate. But the regulatory structure for electronic money products does merit further analysis. At a minimum, we believe that issuers of stored-value cards and similar products should clearly disclose the various risks that holders bear, including their coverage, if any, by deposit insurance.

Consumer Protection and Law Enforcement

The question of whether and how to apply the Electronic Fund Transfer Act (EFTA) and the Federal Reserve's Regulation E to these products has received considerable attention from industry participants, at the Federal Reserve, and in Congress. Among other things, Regulation E limits consumers' liability for unauthorized electronic withdrawals from their accounts, provides procedures for resolving errors, and requires institutions to provide disclosures, terminal receipts, and account statements. Uncertainty regarding the application of Regulation E may be holding back the development of the industry, and resolving this question would help clarify some of the major risks that consumers may bear.

H.R. 1858 would exempt all stored-value cards and a potentially wide range of other products, including transactions through the Internet, from the EFTA and Regulation E. The industry seems worried that, without such an exemption, the Federal Reserve will apply Regulation E in a heavy-handed manner. On behalf of the Board, I would like to assure industry participants and this Committee that we have no such intention. The Board recognizes that some of the requirements of Regulation E should not be applied to certain of these new payment products. For example, it makes little sense to require either printed receipts at ordinary vending machines or periodic statements detailing small transactions.

It seems premature, however, to legislate a blanket exemption from EFTA without first exploring some of the basic issues raised by these new payments mechanisms. Disclosure policy is a good example. If a consumer who loses a stored-value card with a balance of several hundred dollars is not entitled to a refund, he or she should know this when the card is purchased. In this case at least, Regulation E requirements could be beneficial at minimal additional expense. The Federal Reserve would like to develop, and then put out for public comment, proposals for applying parts of EFTA, such as appropriate disclosures, to stored-value cards--and for exempting them from the remainder. We would hope to be able to accomplish this within a few months.

Another issue related to consumer protection is privacy. While physical cash leaves no audit trail, many electronic currency products would. Such a trail may be desirable for certain purposes. But consumers would almost certainly be concerned if each purchase from a vending machine was recorded for possible reporting to marketers and others. Privacy is not a traditional Federal Reserve issue, but we do think it should be of concern to members of Congress.

The mention of privacy leads naturally to some potential, future law-enforcement concerns. While we would caution against establishing restrictive rules that could stifle innovation, the eventual opportunities for money laundering using electronic products may be serious. At present, the menu of new products proposed for distribution in the United States holds little appeal for illicit activities due to their relatively low balance limits, the potential audit trail, and their limited acceptability as a means of payment--at least in the near term. In fact, most of the proposed stored-value products are not designed to circulate freely like currency, and thus should be of limited concern to law-enforcement authorities. Over the longer term, however, it seems possible that electronic mechanisms that can hold large balances and make large untraceable transfers over communications networks could become attractive vehicles for money laundering and other illicit activities--especially if they are widely used and bypass the banking system. Existing anti-money-laundering regulations may then need modification.

A related side issue is the possibility that nonbank entities could offer banking services illegally over the Internet. Using the term "bank" to market banking services without an appropriate license is generally a violation of federal or state laws. But new electronic technologies may challenge both traditional definitions of "banking services" and the ability to enforce existing laws. At some point, therefore, Congress and state legislatures may want to review the basic legal concepts that define banking and their methods for preventing fraud and unlicensed banking activity. Because electronic messages show little respect for national borders, these issues will likely require the coordinated attention of the banking authorities in various countries.

Monetary Policy Issues

Finally, let me say a few words about monetary policy. Concerns have been expressed that introducing what amounts to a form of private currency might damage the Federal Reserve's control of the money supply and lead to inflationary pressures. I can assure you that this is most unlikely. The Federal Reserve currently issues or withdraws currency passively to meet demand, adjusting open-market operations accordingly to keep monetary and credit conditions on track. We would presumably continue to do this if private parties began issuing electronic currency which reduced the demand for paper currency.

In any event, electronic currency, if it grows large, will be only one of several changes in financial markets in the years ahead. Some of these may change the details of how monetary policy is implemented, just as financial innovations have in the past. We believe we have the capability of adjusting to these changing circumstances while continuing to meet our traditional responsibilities for economic stability.

However, there is a technical issue relating to our reserve requirements. Depository institutions are required to maintain reserves, either in cash or on deposit with Federal Reserve Banks, in proportion to their outstanding transaction accounts. Under current regulations, stored-value balances issued by depository institutions would be treated as transaction accounts and hence subjected to reserve requirements; the Board will need to review this treatment as stored-value devices come into use. But the Federal Reserve does not currently have the authority to impose reserve requirements on non-depository institutions. Thus there is a potential issue of disparate treatment of bank and nonbank issuers.

Depository institutions benefit from their access to the federal safety net; but they pay for this privilege by being subject to reporting obligations, reserve requirements, regulation, and supervision by the banking agencies. Nonbank issuers are free of most such burdens, and hence may have a competitive advantage over banks in certain product lines. The Federal Reserve has often expressed concern in the past about potential competitive inequities that disadvantage banks. But because of the pervasive uncertainties that I emphasized at the outset, it is far too early to have any useful insights into the implications of this disparity. We simply want to call it to your attention.

Conclusion

In summary, it is clear that new electronic payment products raise a number of diverse policy issues, both for Congress and for the Federal Reserve. I have not had time to mention them all here. But, at this point, the uncertainties regarding the future of "electronic money" are so overwhelming that we mainly suggest patience and study rather than regulatory restrictions. We do believe, however, that certain rules need to be clarified and future developments should be monitored closely. We look forward to working with Congress and other regulatory agencies in this regard.