

Remarks by Vice Chair Alice M. Rivlin

The U.S. retail payments system

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Payments systems are a hot topic right now, both here and abroad. There is lots of excitement about technological miracles that could revolutionize the way average people pay for the things they buy. Smart cards, home-banking, and ideas still on the drawing boards hold the promise of making payments quicker, cheaper, safer, and more convenient for payor and payee alike, and for banishing cumbersome paper and coin to museums and private collections forever.

In this context, I'd like to focus my remarks close to home: on the U.S. small dollar or retail payments system, which has distinguished itself by proving extraordinarily resistant to change and persistently wedded to the paper check. The checkless society has been predicted at meetings like this one for several decades. But the number of checks Americans write is still increasing, albeit slowly, while total checks decline in almost all other industrial countries. Indeed, we appear to be the only industrial country in which the per capita number of checks written is still rising--despite rapid growth in payments by credit and debit cards or other electronic means.

In an age when messages go around the world in seconds at minimal cost, American citizens and companies are still writing 66 billion payment messages on little pieces of paper, most of which are mechanically sorted, transported by truck or airplane and stored in drawers and shoeboxes.

This anachronism is worthy of serious thought. Are Americans destined to continue our long love affair with the paper check for decades, or are we finally approaching the long-predicted dawn of the checkless society and the prospect of a rapid shift to all electronic retail payments? If so, what kind? What are the issues that need to be addressed by payments system providers and regulators (and the Federal Reserve is both) as we think together about how the U.S. can move to an efficient, convenient, and safe electronic payments system?

Why is this the right moment to focus on this subject? In general, payments issues attract little attention. The payments system is the lifeblood of the economy. It carries the essential messages without which our complex economy would break down, just as the human body would cease to function if the circulatory system did not get the oxygen to the right place at the right time. But like the circulatory system, few people think about the payments system as long as it works. As long as the payments system is at least reasonably convenient, reliable and efficient, as it had been for decades in industrial countries, including our own, no one pays it much mind.

The new focus on payments, however, does not arise out of a breakdown, but out of

simultaneous opportunities. Changes in the structure of financial systems and markets offer opportunities for rethinking how payments should be made. In Europe, the advent of the euro not only forces revamping of existing payments systems to deal with a new currency, but provides an opportunity to modernize old systems that might have lumbered along unnoticed for quite a while.

In the U.S., mergers are forcing financial institutions to combine their payments infrastructures. A merger may surface the fact that the new partners currently have different and possibly incompatible approaches to check processing, for example. The merger may provide an opportunity for designing a new approach to payments that would not otherwise have occurred, or not soon.

A simultaneous reason for the payments vogue is that technology is suddenly offering us options for sending retail payments faster, cheaper and more conveniently than ever before. The rapid advance of computer and telecommunications technology has already revolutionized wholesale payments, enabling huge volumes of transactions to move almost instantly across vast distances. Now, as familiarity with computers spreads beyond geeks and techies to ordinary folks, the potential has arisen for making retail payments systems faster, cheaper, and more convenient as well.

Why has the American system of retail payments been so resistant to change? There may be something about money that generates a special conservatism and fear of the unknown. The shift to the euro clearly has strong emotional overtones for many Europeans, especially older Europeans, who feel some important part of their heritage is disappearing with the franc, the mark, and the lire. The tangibility of paper may have some emotional appeal. It's not gold, but at least you can see it, touch it, lock it up and know where it is.

But one does not have to appeal to the irrational to see reasons for the persistence of checks. Checks are easy to write, widely accepted and their legal status as proof of payment is clear. Moreover, they appear cheap to the user. In their eagerness to attract deposits, depository institutions have made checking accounts as attractive as possible, seldom charging per check fees, relying on minimum balance requirements or low interest rates on transaction balances to recoup costs. Broker-dealers and other seekers after the same funds have offered "free" checking to compete. Moreover, check users get the benefits of float. Thus, the check writer and the receiver perceive the costs of using checks as low and have little incentive to seek an alternative.

Moreover, alternative electronic systems run straight into the network problem. The value of signing on to a new electronic payment network, such as electronic bill paying system or a smart card, depends on a lot of people and businesses being able and willing to accept the payment. At the same time, people and businesses are unwilling to invest in new payment processing equipment unless they are sure a lot of payors will use it. Electronic systems also exhibit huge economies of scale. Average costs plummet as volume rises, so small volume is a large handicap.

This vicious cycle makes it hard for any new system to get off the ground and even harder when there are several competing systems each claiming to be the great wave of the future. The result is ferment and frustration in the financial services industry, coupled with fear that some outside force--usually a particularly successful and often demonized software vendor--will suddenly find a way to overcome the reluctance and inertia of banks and their customers and set up a whole new payments mechanism that wholly or mostly bypasses the

institutions we now call "banks". Without strong leadership and active consensus building across the diverse institutions and constituencies that make up the users and providers of retail payments, we may be stuck in this dilemma for quite a while.

As we think about how we can get out of this box and modernize the nation's retail payments system more rapidly, it is a mistake to structure the problem as a stark choice between "free market" solutions, on the one hand, and governmental or regulatory solutions, on the other. The retail payments system, like telephone service or electric power, clearly has some public utility aspects. There is a strong common interest in ensuring that the economy has a safe, reliable, accessible and efficient payments system, retail as well as wholesale. It was in part this strong common interest that prompted the Congress to create the Federal Reserve and to give it both operational and regulatory authority in the payments area.

At the same time, the efficient delivery of retail payments is greatly enhanced by competition among providers and the technological and process innovation that results from that competition. The problem is that when the system is a network, relying on competition to move to the next generation of technology, without any attempt to build consensus or set standards, may retard change. It may result in under-investment, because no one knows which way to go, or balkanized systems may emerge that are not interoperable and can be made so later only at considerable expense. On the other hand, if choices are made too early, or standards set too soon, many of the benefits of competitive innovation may be lost.

The challenge, and it is a big one, is to find a way for the participants in the payments system--users, providers, and regulators--to work together so that we continue to get the benefits of competition, but clear some of these hurdles and move on to the next generation of retail payments systems as rapidly as possible.

Over a year ago, when I first came to the Fed, Chairman Greenspan asked me to chair a committee--composed of one of my fellow governors and two Federal Reserve Bank presidents--to consider the role of the Federal Reserve in the retail payments system, especially in the traditional areas of check and ACH and in the newly emerging electronic payments--some still just a gleam in some technical genius's eye--that might become important in the future. We didn't worry about cash because we assumed that as long as people want to use it, the Fed, as central bank, has to provide it. We didn't concern ourselves with wholesale payments systems like Fedwire, because they are not controversial. Wholesale payments and net settlements are essential functions of a central bank.

But we did spend a lot of time and effort thinking about the check market (where the Fed processes about 1/3 of the interbank checks) and the ACH market (where we process about 80 percent of ACH payments). In both markets, the Federal Reserve differentially serves smaller depository institutions and more remote locations. We considered some drastic options--including getting out of the check and ACH processing markets altogether or selling our operations to a private entity.

We drew heavily on Fed system staff and others for analysis, but the most interesting part of effort to me was getting out around the country to payments system forums held in all 12 Federal Reserve Districts to get input from participants in the payments system, including some in this room.

Those forums were diverse and often lively. We learned a lot, but two themes emerged clearly:

- One was that most depository institutions, especially smaller ones, including community banks and credit unions, did not want to see the Fed exit the check clearing or the ACH businesses. They feared being dependent on a small number of large institutions, often their competitors. They envisioned more limited service and higher prices if the Fed left the market.

A few big institutions seemed eager to absorb the business, but, surprisingly, not many. Most big banks are too busy with other opportunities to want to expand their correspondent relationships or invest heavily in the check clearing market--not obviously a future growth market.

- Another theme that ran through the forums was a call for more Federal Reserve leadership in helping the payments industry cope with change and emerging technology. Many institutions urged us to work more actively with them to help sort out the new technologies and figure out what some of the viable options are for the payments system (or systems) of the future.

The report of the Committee, which was released in early January, strongly reflects the impact from those forums. We came to two general conclusions:

- One was that the Fed should remain a provider of check collection and ACH services with the explicit goal of enhancing the efficiency, effectiveness and convenience of both systems; while ensuring access for all depository institutions.
- Second, the Fed should play a more active leadership role, working closely and collaboratively with the providers and users, to enhance efficiency of check and ACH and to help evolve strategies for moving to the next generation of payments instruments.

The first recommendation--not exiting--got the most attention. But the second is far more important--this was not a *status quo* report. The Committee believed that over the next few years, the payments system is likely to (and should) evolve rapidly, and that the Fed and the payments community need to think together about how this evolution can take place to everyone's advantage, especially the consumer. The Committee wants to explore how the Fed could play a constructive role, not operationally, but as convener of groups to try to chart new directions for the payments system and remove obstacles to its evolution.

Specifically, the Committee--which now consists of myself, Governors Kelley and Ferguson, Presidents McDonough and Minehan--is exploring four major initiatives.

1. We are considering whether additional steps need to be taken to level the playing field between the Fed and private check processors might increase competition and enhance the efficiency of check collection. In particular, would changes in Regulation CC (the same day settlement rule) enhance market competition?
2. We are also focussing on the question of whether electronic check presentment (ECP), truncation and imaging--if more widely, or even universally, used--would enhance the efficiency of the check collection system. The Committee examined this question in preparing its January report. We concluded the jury was still out and that the Fed should work actively with the private sector to array experience and information. If wide use of ECP with truncation early in the check collection process

would make the system as a whole more efficient, then it's worth mutual thought about what techniques and incentives would get us there faster. But we need to consider the possibility that ECP with truncation and imaging is an interim technology in a check market that might be disappearing. If so, investing in ECP could be a mistake that would delay the evolution of more cost effective future technologies.

3. The Committee wants to focus attention on the usefulness and potential future role of ACH. We will be working with providers and users as well as with NACHA to explore how to make ACH services more user-friendly and to increase ACH use for direct deposit of payrolls, direct billing and other actual and potential payments.
4. Finally, and most important, we want to interact with the financial services industry, vendors, and potential users to share information about emerging forms of retail electronic payments. What are the potential advantages and disadvantages of these new mechanisms? Is there a need for new standards, for security safeguards, or for legal changes to enhance the effectiveness of new forms of electronic payments.

I am not predicting the imminent arrival of the checkless society. Those who predicted that--and there were many--have lived to eat their words. I do believe, however, that we are at a stage in the evolution of retail payments in the U.S. when the technological potential for major change is available and all the parties concerned with payments should be thinking and talking about how we can best work together in the interest of more efficient, convenient, safe and accessible means of making retail payments in the future.

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