Remarks by Vice Chair Alice M. Rivlin

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The Federal Reserve's Roles in the Payments System

This is an exciting time to have a conference on payment system strategies, because there are real opportunities for rapid change over the next few years in the way we make payments, especially retail payments in the United States. You will be discussing some of those opportunities and possibilities over the next few days with experts on the forefront of change. You will hear presentations that describe new worlds in which payments are made more efficiently, more conveniently, with greater security and less fraud than they are now--not just by giant corporations and sophisticated techies, but by ordinary folks and average enterprises going about their daily activities.

But while there are opportunities and possibilities, there are also enormous uncertainties, both about the direction that technological change will take and about the willingness and ability of individuals and institutions to embrace these changes. It is certainly possible that a decade from now we will have a radically different retail payments system in the United States than we have now. It could be a system that depends very little on paper or on land and air transportation of paper messages. It could instead be one in which both consumers and businesses, not to mention governments, make almost all of their payments by electronic means from wherever they happen to be. On the other hand, it is also possible that not much will happen to retail payments over the next decade or at least that change will not accelerate from its current pace. Some of the people in this room could be back here in ten years assessing why the promising innovations of the late 1990's never came into general use, and why, although credit, debit and automated clearinghouse (ACH) payments continued to expand rapidly, billions of paper checks were still being written and physically transported for presentment.

In part--although only in part--the outcome depends on us, on the people in this room, and the enterprises and institutions we represent. It depends on how effectively and imaginatively we all do our individual jobs and on whether we find constructive ways to work together.

I happen to be one of those who thinks change in retail payments could accelerate quite rapidly in the next few years and that paper check volume could begin to decline steeply in the relatively near term. I say *could* rather than *will* because I realize that prediction has been made many times before and has always proved wrong. I guess like so many others I am just struck by the absurdity of moving so many little pieces of paper around the country when the messages could be sent so much more efficiently by electronic means. Every time I visit a Reserve Bank and watch those high speed sorters working so hard and the trucks coming in and out to the airplanes, I think, "This is a really impressive, fast and cost-effective way of moving paper, but why are we moving paper?" The "we," of course, is not just the Federal Reserve, but all those banks and clearing houses and other participants in the system. And the answer to why we are all moving all this paper is that customers want us to move it and are willing to pay to have it done. But the answer still doesn't make a whole lot of sense.

There are several interrelated reasons why change could be expected to accelerate in the retail payments arena in the near future.

- First, of course, is the rapidity with which technology is evolving and costs are dropping in computing and telecommunications. Many types of information, including payments information, can be transmitted much faster and cheaper than was possible even a year or two ago, and there seems to be no end to the process in sight.

  But the avalanche of technological progress may actually be holding up a great leap forward in the efficiency of retail payments. Because the network effect is important and the players who have to commit to a new technology to make it viable are quite numerous, change may come slowly at first. Potential players may be confused by the multiplicity of options and reluctant to commit if they think it likely that something faster, cheaper and more convenient may come along soon. It's like hanging on to your old television for a while in hopes that the next generation of models will give you a lot more definition for less money.

- A second reason is that the restructuring of the whole financial services industry across geographic and product lines is providing a huge opportunity for major institutions to rethink how they transmit information and make and receive payments. This restructuring, combined with the onrush of technology and the heavy emphasis across all business sectors on competitiveness, cost reduction and efficiency, could accelerate the substitution of electronic for paper based payments at the consumer as well as business level.

  But in the short-run, restructuring, like rapid technological change, may actually slow things down just because information technology people and their top bosses simply have too much to think about at once. Coping with mergers, the year 2000, and the transition to the Euro -- not to mention wild swings in the financial markets -- may not allow radical changes in payments technology to get much attention in the next year or two.

- A third reason to expect acceleration of change in retail payments is the explosive growth of the Internet and its increasing use for shopping and business transactions. The number of consumers and small businesses using the Internet routinely for transactions that require payments could skyrocket if several different types of industries move in this direction at once.

  - It could quickly become "normal," not only to shop for mortgage rates on the Internet, but to apply for mortgage loans and get approved over the Internet as well.

  - It could also become normal for potential college students of all ages to shop for colleges or course offerings over the Internet and to apply and be accepted electronically as well.

  - It is possible that paying taxes, trading securities and making some kinds of purchases on the Internet could become routine activities of a large fraction of the population quite quickly (the way making phone calls and driving a car became routine quite quickly for earlier generations). If this happens, the demand for electronic retail payments is likely to rise rapidly as well as to spill over into increased demand for (or reduced resistance to) electronic payments methods for non-Internet transactions as well.

- The key unknown here is how fast average people become comfortable with PCS, lose their anxiety about electronic transmission and storage of data and overcome the feeling that if something isn't written on paper and saved in a drawer it isn't real.

- The usual assumption is that computer literacy is age- and income-related and that it will take a long time before older and less affluent (or at least less educated) people get comfortable with electronic payments and paperless transactions.. But we could be in for some surprises as governments move quickly to electronic benefit payments, which mainly affect older and less affluent groups. Aggressive efforts to improve computer instruction in low income schools, compensate for less rich educational environments with creative use of the Internet, and prepare welfare families for modern clerical and data processing jobs could undermine some widespread assumptions pretty quickly, as could aggressive marketing of senior citizen computer access and services. The most rapidly growing demographic group currently on the Internet is retirees.

For all of these reasons, I would be willing to bet that, despite the relatively slow pace of change in retail payments over the past several decades and despite Americans' long-standing affection for the convenience, flexibility and familiarity of the paper check, we are likely to get to some sort of tipping point early in the next century (less than a decade from now) after which electronic retail payments quite quickly become the norm and the volume of checks falls rapidly.

This does not mean that I see retail payments moving to some single electronic payment instrument that would substitute for the check in all or most of its uses. Rather, I suspect we will see the evolution of several different systems, adapted to different kinds of payments that consumers and businesses make. Some of these systems are in use already, some will be discussed today, others are not yet ready for prime time. Some will be developed by the banking system, some by non-banks in cooperation, or even in competition, with depository institutions.

So what will be the role of the Federal Reserve in all this? As you know, I chair a Fed committee which is explicitly focussed on this question. We issued a report last January and are continuing to discuss how the Fed can best contribute to the efficiency and safety of a retail payments system to which all depository institutions have access. The Committee now consists of Presidents McDonough and Minehan, Governors Kelley and Ferguson and myself. You will hear from Governor Ferguson tomorrow afternoon.

We see our role as working closely with the other participants in the payments process to help modernize the retail payments system and facilitate the transition over time to an efficient, convenient, and primarily electronic system.

We spent quite a lot of time and energy last year discussing whether we should exit the business of processing check and ACH payments. We decided to stay in and use our operational presence to help modernize both check and ACH and to work actively with others to evolve a vision of a more efficient future payments system and help remove obstacles to its realization.

In practice, what does that mean?

First, it means increased efforts by the Federal Reserve Banks -- as providers of check and ACH services -- to develop new products that reduce costs and to price and market them effectively. In the first instance, that means focussing on ECP with truncation and imaging, in order to meet market demand and gain experience with different technologies. We hope to learn a great deal more about whether the wider use of these products can reduce the cost of check collection by substituting electronic technologies for the transportation and processing of paper. We are involved in several pilot studies of ECP, including one which we hope will include all depository institutions in the whole state of Montana. Montana has small banks widely dispersed over great distances. It seems like the right place to see whether, if virtually all the institutions participate, it would be cheaper and more satisfactory to send images electronically rather than to move paper over thousands of miles.

Like others who have been studying the business case for ECP and imaging, we believe the jury is still out. It is not clear that moving the whole national check processing system to ECP (with or without imaging) would provide net societal benefits even if the willingness and resources to do it could be found. So you will see us working hard, in collaboration with others in the industry, to explore, in practical ways, the potential advantages and disadvantages of ECP.

You will also see us working hard, in collaboration with NACHA and others, to improve ACH service, make it more user friendly and increase its use.

You will see us trying, through surveys, focus groups and other tools, to learn more about how consumers and businesses use different types of retail payments and how they think about them. As we have worked on positioning the Fed to help move the nation to the payments system of the future, we realized that many of our assumptions about the composition and use of retail payments, paper checks in particular, are based on information collected by survey in 1979 and were likely seriously out of date. We and the industry need more current information on which to base strategies going forward.

We will also be reaching out to participants in the payments system in a variety of groupings to talk about alternative visions of the payments system of the future, what the legal, regulatory and technological barriers there might be to getting there and what we might be able to do to reduce those barriers.

We certainly do not see the Fed *managing* the process of transition to a more fully electronic payments system. We believe strongly that innovations must come primarily from the private sector and be tested in the marketplace to see if they meet customer needs at competitive prices. But there are times when progress can be stymied by legal or regulatory barriers or by the absence of technological standards, especially standards that allow communication among competing systems. In these instances, dialogue and collaborative effort can pay off for the whole system and its customers. The Fed wants to be an active participant in that dialogue along with other providers and users of the retail payment system as we work together to make it better.

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