

Electronic Payments Set to Grow

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Moderator: *Welcome to the Federal Reserve Bank of Atlanta's Financial Update Focus podcast. We're speaking today with Rich Oliver, executive vice president of the Atlanta Fed, about the ongoing decline of paper checks and the growth of electronic payment transactions. Rich has a first-hand view of how consumers pay for things. So, thanks for joining us today, Rich.*

Photo of Richard Oliver**Rich Oliver:** My pleasure.

Moderator: *Well, first off, Rich, it's become abundantly clear that Americans are using traditional paper checks a lot less and paying for things electronically a lot more. What are the main things that are driving this trend?*

Oliver: Well, it's unlikely that it's any *one* thing in particular that's driving it, but I think rather a confluence of *many* events, sort of a "perfect storm" of payments, if you will. Certainly one of the big items is demographics. I think we all anticipated over time that as the younger generation became a more prominent part of our financial society that they would begin to use electronics more easily, and in fact that's happening. I think most of our children view the check as an archaic instrument, and they use it once or twice a month to pay rent or something that they can't figure out how to pay electronically.

Another thing that's changing are the incentives and economics around payments. Economics from the standpoint of the payments providers...who, as the process of declining check volume has taken place, find themselves in a downward-spiraling curve, if you will, related to revenue. And as a result, the economics of offering and promoting electronic alternatives to customers have become more attractive. Customers, on the other hand, are being offered a lot of incentives to use electronics. I think there are many of us who have flocked to various debit and credit card programs in order to earn reward points and other types of benefits. In addition, a lot of the laws and rules and regulations that surround payments have changed also to facilitate the change that's going on. For example: Regulation E that's promulgated by the Federal Reserve provides considerably stronger consumer protections for electronically initiated payments than it does for paper checks. The National Automated Clearing House Association, who governs the automated clearinghouse process nationally, has modified their rules to make it attractive to allow participants to take paper checks and convert them to electronic transactions during the actual flow of the transaction, which is much cheaper for them in terms of overall operating costs.

In addition, there was a major act passed by Congress in 2004 called the Check Truncation Act, and it has facilitated the possibility of financial institutions deciding to take a paper check and collect it electronically as a check. And that has made a significant change, too.

As consumers begin to experience these types of activities and realize they're not getting their paper checks back anymore, we think it then leads them to say, "Why am I writing it in the first place? Why don't I just use the debit card or credit card?"

Finally, I think there's another thing, and that's the advancement of technology and the interweaving of technology with social acceptance of various things. It's now become socially attractive to use electronic alternatives. To shop on the Internet, to buy and sell on eBay, and other types of transactions that we probably would not have even conceived of five to 10 years ago.

Moderator: *Well, Rich, I suspect some of those things probably factor into this, but predictions, if you will, of a "checkless" society go as far back as the 1970s, so why has it taken until relatively recently to see this sort of dramatic decline in check usage?*

Oliver: Well, that's a good question because I was actually around and involved when people began to talk about the "checkless" society and, you know, then they talked about the "less-check" society, and then they stopped talking about it altogether when check volume continued to grow. What we have to remember, though, is the prognosis of that change at that time came from bankers and technologists who saw the opportunities here to reduce their own costs, their teller line problems, their back-room operational costs and so forth, by changing to electronic payments. They had forgotten, along the way, to actually ask the consumer whether or not they agreed with doing that...and the early evidence was that the consumer didn't. They were pretty strongly wedded to their cultural norms of writing checks, getting checks back, and actually viewed the writing of a check as a relatively convenient event. But what's happening now is different. At that point in time, consumers then voted on what was acceptable with their own behavior. But now I think the change is occurring for many of the same reasons: The benefits of the old ways are being lost, and the attractiveness of the new ways are overcoming it.

Moderator: *So these benefits to the consumer are why we're seeing this shift accelerate even faster all the time?*

Oliver: I think so, yes. And let's recall that most of the acceleration is occurring with consumer payments. The majority of corporate payments are still being made by check, for a wide variety of reasons, but when you look at consumers' reaction today, many of the alternatives, like the debit card at the point of sale, are, in fact, more convenient than the check. It takes less time, you put in a PIN number and you're gone. So convenience is a big issue. Ease of use is a big issue. At first, many people felt that the electronic alternatives were complicated—even using an ATM, people viewed it as perhaps complicated. But, as they started to use it more and more, they realized that it's in fact a very easy thing to do.

There's also changing values associated with things: Interesting social demographics, where people are beginning to talk to each other about what they did electronically, or what have you. And finally, I think the card people themselves have made a big impact by offering their products the way they do, by providing attractive terms for the provision of the card products and by putting in many of these reward programs that we just

talked about.

Moderator: *Well, Rich, are we likely ever to see checks disappear entirely? And also, I want to ask you to distinguish between a couple of things and that is, rather than see checks perhaps go away completely, are we more likely to see a time when people will still write a few checks, but those checks will go through the process as an electronic transaction and that its days as a piece of paper are numbered.*

Oliver: Well, that's a great question because we have a tendency in the industry to get those two things mixed up. Let me say this first of all: checks, in terms of checks being written, are obviously in decline, they're going to continue to decline, but there are still a big number of them out there. So, they're not likely to disappear quickly in terms of checks written in the near future. In fact, our estimates are that the decline in actual check writing is probably still a single-digit year-over-year phenomenon. And, in fact, we have these last bastions of check writing in the area of consumer-to-consumer and business-to-business checks for which the electronic alternatives are not yet as attractive. But, as we talked earlier, the advent of Check 21, which allows a paper check to be converted to an electronic image for collection and the advent of many conversion products that allow paper checks to be converted to automated clearinghouse debits, are having a huge impact. To give you an example, our legacy paper processing volume in the Federal Reserve is down 37 percent year over year. But our total check processing volume is only down 8 percent. So I think the latter is more indicative of the rate of change in terms of check writing. So I think what we are going to see is a continuous decline in the number of checks written, but that may take many, many years to see the end of, but a much more rapid increase in the number of checks converted to electronics for the purpose of clearing them through the system more efficiently.

Moderator: *Well, we've talked a bit about this already, Rich, but can you further explain a little bit about how retailers and other businesses that receive payments, how they benefit from the rise of electronic payments and the decline of checks?*

Oliver: Everything we've seen, first of all, is that the economics of clearing checks are becoming significantly worse. The cost of check clearing is going up on a per capita basis because, as check volume falls, the cost of transportation, processing, and other costs associated with an item on a unit basis will inevitably rise.

But we also find that for retailers and others that the checkout experience is faster with the electronic alternative. And to a retailer, the ability to move people through the line fast is a *very* big thing to them. There's less handling and storage of physical items to maintain in their backroom; faster funds availability because the items are clearing electronically in a day rather than two days or longer if it's a paper check. And overall, less risk. The faster they can collect an item, it turns out, from any company, the better chance they have of actually making the item good if in fact there are insufficient funds in the consumer's account. It's been determined that the quicker they can hit the count, the better off they are. So there are many other factors beyond the backroom cost that are actually driving them to favor electronics.

Moderator: *Well, Rich, what we're talking about are pretty dramatic shifts and pretty fundamental shifts in the way people pay for goods and services. Do we know yet what the consequences of this shift are for the overall economy?*

Oliver: We don't know anything specific, but we suspect many things. There was a study done about 15 or 20 years ago by a Federal Reserve economist who calculated that the United States was spending four or five times more per capita on its payment system than other competing industrial nations. So, if we believe that's true, and I have some reason to believe that's true when you look at the way that payments are made in Europe and other places, one can only suspect that the move to electronification will in fact have some visible effect on the U.S. economy. But the economy is a big and complicated subject, but on the margin I think it will help and it will position us better as a competitive nation on the global front.

Moderator: *But Rich, what does this mean for entities like the Federal Reserve that actually process these transactions?*

Oliver: Well, it's not particularly good news. We have a huge amount of infrastructure dedicated over the years to processing billions of checks each year, and as check volume falls and as paper check volume falls as precipitously as it's falling today, that means that we have the obligation and responsibility to begin to pare back our resources as rapidly as possible to match the decline in check volume. For us, it's meant that we're having to close check processing offices. Consolidate our transportation activities. Centralize many of our other activities that used to be decentralized. In the last three years, we've contracted the number of Federal Reserve check processing facilities from 45 to 22. That's a big change for us, but it's something we have to do. It's likely that every other provider of check services in the industry, whether it be special purpose service bureaus or large financial institutions, are going to have to go through this same painful series of events in order to begin to scale back their costs.

On the other side, one might say yes, but you're moving to electronics so you're recapturing the volume there... but it's important to note that the revenue associated with electronics is a *fraction* of the revenue associated with paper. And likewise is the case with the costs. What it means is, however, that the margins associated with electronic payments are not as *big* as the margins associated with paper. And consequently, the profitability opportunities for electronics aren't as big either. So this is a very gut-wrenching experience. A true sea change in an industry that over the years hasn't been characterized by very rapid change. It's been a glacier-like evolution of the payment system, and today it's happening rapidly.

I close by saying that, during our lifetimes, there has never been a payment system in decline. Whether it's cash, ATMs, debit and credit cards, ACH, or checks, it's always grown continuously as the population has expanded. But now we have one in decline, and it's the *big* one that we've all counted on on our bottom lines over the years, and it's going away. So we have a tremendous challenge and a serious change process ahead of us as an industry.

Moderator: *Are we likely, Rich, to see advances within the electronic payments realm? In other words, what is sort of the most futuristic payment method that you could conceive of right now that we might actually see?*

Oliver: Well, I think the one that's coming out right now and makes the most sense to me is the movement of payments to a totally wireless environment, perhaps based around cell phones. Much of this is already occurring in the Far East. It's being piloted here within the United States with programs in which people can actually conduct a myriad of transactions from their cell phone. Both banking transactions and perhaps things like consumer-to-consumer exchange of monies. So now, in the future when you buy some Girl Scout cookies from the girl next door, you can actually use your cell phone to transfer money to that Girl Scout rather than write a check, and probably both parties would be excited about the experience. So, I think the whole wireless communication, debit card, Internet and cell phone experience is going to totally change the way we do things.

Moderator: *Thank you, Rich. Again, we've been speaking with Rich Oliver, executive vice president of the Atlanta Fed. This concludes our Financial Update Focus podcast on changes in the payment system. For more information, please see Financial Update on the Atlanta Fed Web site at frbatlanta.org. Thanks for listening and please return for more podcasts. If you have comments, please send us e-mail at podcast@frbatlanta.org.*