

Speeches

National Strategies for Electronic Check Presentment

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Good morning. As I stand here before you, I guess it's fair to say that we are attending one of the first industry conferences to take place since the tragedy of September 11. While I know that each of us continues to struggle personally with the situation, it is important for us all to begin to reinvest our energies in improving the things that have made this country a great place. I thank you for being here to get us moving forward with those efforts.

I'm sure, however, that you too have spent a great deal of time in the last few days looking at how we handled the disruptions that occurred as a result of the crises in New York and Washington. Certainly, we at the Fed learned a lot about what else we could do as we ensured that the automated clearinghouse (ACH) business was up and running. We learned even more as we worked hour by hour with the Federal Aviation Administration and other transportation firms to piece together a ground transportation network to move checks until we could get our contracted Check Relay planes back in the air. But what we really learned during this unimaginable situation was that the proper functioning of this nation's economy is critically dependent upon the reliable performance of our payments system, including this country's massive check processing network.

Historical perspective

Certainly, we have collectively suspected for some time that our payments system as a whole, but the check system more specifically, is not the most nimble component of our nation's infrastructure. It has been slow to change and is based upon legacy technology that is not easy to modify.

Moreover, we have seen time and time again that seemingly terrific payments concepts don't always turn into profitable products. Payments concepts like Point of Sale in the 80s, Electronic Data Interchange in the 90s, and Electronic Bill Presentment most recently all seemed like great concepts on the surface, but unless consumers use them, they will never reach the level of success we have hoped would be achieved.

I suppose this is yet one more example that the payment habits of this nation are in the words of the songwriter, "hard habits to break." Americans like the check; they like the concept of float; they like the feel of cash in their pockets; they like finding their bills in their mailbox; and they like to feel like they are in control of their money.

History has also shown us that our payments systems exist largely in silos—debit, credit, check, cash—that do not easily inter-operate. We have seen this as we have tried to truncate checks and turn them into electronic items, whether at the point-of-sale or at the lockbox.

Furthermore, as we have tried to add new functionality and services for our customers, we have layered these services and the new technologies that support them directly on top of our existing backroom systems. In talking to my colleagues I have become increasingly aware that the tangled web of legacy systems, new on-line services and Web-based activities have left our backrooms in a jumble. In fact, if a customer puts a stop payment on a check, and that check has been converted to electronic form during the collection process, it may completely bypass the stop payment-system.

Certainly, we have the capacity to collectively address these problems, but that would take a great deal of cooperation among competing parties. While I have seen this happen more frequently of late, when push comes to shove, our competitive juices kick in and we fall back to our competitive positions. Holding together diverse industry groups that are chosen to address issues may be more difficult than coming up with solutions to our industry's problems.

A perfect storm

And yet I do feel that the winds of change are blowing. I am somewhat of a movie buff and recently invested in a home theater system. Big screen, Surround Sound, the whole nine yards! Now, I have seen a lot of movies that really "grab" you, but I must say that a recent hit, *The Perfect Storm*, went over the top. I jumped several times to avoid the wind gusts and ducked beneath the waves of the greatest recorded storm in North Atlantic history. I can't help but think that we have our own perfect storm building in the banking industry with respect to our payments system—a storm that could change our landscape forever.

Certainly, the massive restructuring of our industry has created large, national organizations that control the types of resources and command the payment volumes to begin to evoke change in how we do things. In 2000, the Federal Reserve processed just under 16 billion checks. Bank of America says they paid nearly 12 billion. That's a lot of checks. Bank of America is now being joined by other large national banking organizations. These new, large institutions have the intellectual power and the processing infrastructure to effect change.

The way to most rapidly effect change appears to be through the use of new technologies, and I think all of us in this room feel the pressure to begin to employ these technologies. More specifically, we must leverage the use of the Web and the image to our benefit and to the benefit of our customers. The opportunities are limitless if we can only figure out the way to bridge them into our old, heavily invested legacy operations.

The investment required to embrace new technologies, however, coupled with rising costs in other areas of our operations, have resulted in lower profit margins in traditional payment processing—thus giving us the motivation for change.

I mentioned the Web a few moments ago, and it is clearly a part of creating this storm of change. While we all struggle with trying to realize the dream of inexpensive and easy-to-develop Web-based systems, it is increasingly clear to me that the Internet is the key lever in the greatest paradigm shift we have experienced in the payments arena since the invention of the plastic card. Let me give you a few statistics that illustrate consumers' accelerating acceptance of electronics.

A recent consumer preferences survey has revealed that the electronic share of the consumer's retail wallet has grown from 43 percent to 49 percent in the last two years. Sixty to 70 percent of all Americans have access to the Web and have purchased at least one item on-line. Thirty-three percent intend to increase their use of on-line bill payment in the next two years.

These factors together have indeed created a perfect storm like none other in recent times. The question now before us as an industry generally, and for the Federal Reserve specifically, is what we are going to do in the face of these remarkable conditions. Will we work to facilitate the change, or will we plod along at a pace that promises more years of spending more per capita on our payments system than any other industrial nation?

To set the stage for that answer, let me recall a bit more recent history as a way to position the rest of my presentation and to discuss some truly national strategies for the advancement of electronic check presentment.

You may recall that in 1997, then vice chair of the Fed, Alice Rivlin, headed up a study to try to determine what role, if any, the Fed should play in the future payments system. Many of us began to dust off our resumes in anticipation of our early exit from the Fed System. However, we quickly put them away as the results of the study confirmed a desire by banks for the Fed to remain active in the payments system as an operator, even a leader, and a facilitator for change as well as an "enlightened" regulator.

I sat in on some of the regional workshops held by the Rivlin Committee and listened to participants from all aspects of the industry—large players and small, banks and technology firms, trade associations and consultants—as they brought to the surface their frustrations with the inability of the collective industry to work together to resolve common problems. The need for an independent party to help was clearly noted.

As a part of that study, a great deal of attention was paid to the concept of electronic check collection as a meaningful way to begin to reduce the cost and complexity of our paper-based payments system. Interestingly, the staff working on the study could not construct a business case that proved that electronic check presentment (ECP) would, in fact, be a more efficient way to do business. The case was simply too complex and too dependent on variables we could not easily measure.

But we know more than we did two years ago. Perhaps the most glaring observation is that the profitability of our check processing operations is clearly on the decline. This is not surprising in light of the fact that the costs associated with personnel and transportation are escalating. In other words, the economies of scale associated with paper processing are eroding.

On the other hand, tremendous economies of scale are present in other new, electronic check technologies, such as image, the Web and data communications networks. If we can replace trucks and planes and reader sorter operators with these technological alternatives, economies of scale can be reintroduced into the business.

Coincidentally, we are beginning to see changes in an area that has stubbornly refused change in the past—the acceptance of new alternatives by the consumers who use our payments systems.

There is growing evidence that consumers now see the check as a less convenient and easy-to-use alternative at the point-of-sale in comparison to other electronic choices. In fact, there is growing evidence that most consumers no longer demand the return of their checks. Most who have been exposed to check conversion at the merchant level had no problems with it. All these observations support the idea that the time is ripe for the concept of ECP to flourish. Others might say that ECP is an unnecessary step along the path to full electronification. However, one rather interesting observation also surfaced from the market research I alluded to earlier—44 percent of respondents use only checks to pay their bills and they find it convenient to do so. Folks, I believe that we will see great change in the near future, but there are a whole lot of checks out there to deal with first.

On the horizon

As we cast aside the fog that clouded our view in the past, a possible model for success is beginning to emerge, at least for us at the Fed. I should add that not all will agree with my thoughts and the model's success is dependent on certain key pieces coming together in the very near future. I believe a cost-effective model exists for electronic check presentment.

Five key features are needed to support a cost-efficient model. First, we must truncate the checks as early in the collection stream as possible. Each earlier stage promises reduced transportation costs and improved return-item performance, yet each earlier stage brings with it complications and the need for further cooperation. Truncation at the point-of-sale, the lockbox, or the bank or Fed of first deposit are critical to achieving the savings needed to improve efficiencies.

Second, all items captured early in the stream must be imaged into what, for lack of a better term, I will call a "national" archive. By this I mean an archive that can stand on its own and be accessed by both the collecting and paying institutions.

Third, we must truncate the flow of the actual paper so as not to incur the expense associated with transportation. Presentment must be based on the electronics.

Fourth, we need to base the return process totally on the image of an item, not the physical paper. We have been able to demonstrate in a pilot operation in Montana, which I will tell you more about in the next few minutes, that this is feasible. It will expedite the return collection process and reduce losses to the collecting party.

Finally, we must put in place a legal infrastructure and a set of standards that facilitate the flow of the paper, balance the rights of counter-parties, and provide the maximum opportunity for efficient interchange of items between the image and check processing systems operated by industry participants.

Now, I want to let you know that this model is not something we have conjured up out of thin air; it is based on an accumulation of research, data and operational experience. While the argument about the long-run viability of ECP has raged, we in the Fed have quietly increased the percentage of checks we clear electronically. So far this year, we have presented 22 percent of all our items electronically to several hundred institutions around the country.

Exploring the Montana experience more closely might help here. Some of you may remember that beginning in 1999, we instituted a pilot project at the Helena office of the Federal Reserve Bank of Minneapolis. That pilot project was intended to explore the potential for reducing check collection costs in a fully image-enabled environment. Internally, we referred to this effort as the EPIC project. The geography, weather and bank composition of the state made it an attractive pilot site. We image-enabled the Helena sorters, captured images and archived them, accomplished presentment electronically, and allowed access to images through a web

interface. Further, we allowed selected participants to generate image returns items.

The future of EPIC

We learned a great deal from the EPIC project that should be of interest to the public and the industry by operating an image-enhanced ECP system for some 18 months. Certainly, ECP penetration rose to the highest in the system at 44 percent. However, we were less successful from a financial perspective than we had hoped because we struggled to reach the mass economies we had anticipated. In essence, while volume increased considerably, we did not reach the targets we had set. Large bank involvement was not up to expectations and participants were harder to recruit than we had originally thought.

Nevertheless, we learned a great deal. As a partial fulfillment of our promise to the industry to share the results of the pilot project, I thought I would share some of our findings here today. Certainly, we witnessed efficiencies in the operating environment. Helena was able to reduce staff in their backroom as a result of the ability of customers to retrieve their own items and research certain cases themselves. Self-service is a model that works. Earlier access to information has value to our customers. In fact, customers were willing to pay for access to images on the deposit side, a factor which we had not anticipated in the original plan.

Certainly, we learned that one size does not fit all. In other words, the wants and needs of large and small customers are not always the same. We learned a very important fact, that image-replacement documents, which we issued to paying banks that requested them, were easily accepted. Interoperability between systems was not trivial. And, software vendors need broadly accepted standards.

Perhaps the most compelling observation I can offer today is that running two parallel processing platforms, one based on image and electronics and one on pure paper, is expensive—too expensive to operate in parallel for an extended period of time at the volume levels we had in Helena. In essence, we have been encouraged that an image-enhanced ECP environment can be successful on a widespread basis with some key changes.

The first such change is that we must reduce the costs of such operations by increasing the level of cooperation that exists between competitors. I call this “co-opetition.” If there was anything truly positive that emerged from the tragic events of September 11, it is the remarkable amount of cooperation that took place between parties that were fierce competitors. All of us were focused on making the payments system work under extreme stress. We worked hour-by-hour with Airnet to cobble together ground and air transportation systems for checks. We worked closely with the various arms of the New York Clearing House to ensure ACH and wire transfer networks stayed open to meet the needs of banks. We were able to demonstrate that we can cooperate when needed without affecting market choices; in fact, we were able to all succeed together.

We hope this same spirit of useful cooperation can carry over to other endeavors. For example, we are talking with SVPCo to explore better ways to exchange electronic checks. We are talking with Viewpointe to see what it would take to “share” archives. Through the auspices of the Payments System Development Committee we are bringing together industry leaders to isolate and address the barriers to increased ECP adoption. We are working actively on industry groups. We chair some of the groups that are putting in place the standards for electronic presentment and image exchange. Finally, in an effort that is unique in my 34 years of service with the Fed, the Board of Governors is drafting legislation, referred to as the Check Truncation Act, that is intended to allow the image of a check to be the legal equivalent of paper. I'll say more about this in a minute.

Fostering a standard ECP environment

What else can we do at the Fed to further the evolution to electronic check? Certainly, we can start by recognizing that we in the Fed support multiple standards for ECP in our existing systems. I want to announce today that we have made the decision to move to a single standard by mid-year 2005, creating the opportunity for a well-orchestrated transition that can be accommodated as systems are changed over the next few years.

We will base our systems on ANSI standard 9.37, and we will provide adequate lead-time for all parties to change. We will produce implementation guides by the middle of next year. A vendor conference is planned for later next year, leading to a two-year transition that will follow on the heels of our check modernization effort. This effort, which I know most of you are familiar with, will standardize and consolidate all our check systems to include our processing platforms, our image systems, our adjustment systems and the electronic interfaces to each.

One big wave

Returning to my earlier analogy, the perfect storm ultimately culminates in one big wave. In this case, I think this could come from the unprecedented efforts of the Board of Governors to draft legislation that will allow the image of a check to be the legal substitute for the paper. I mentioned this earlier, but let me go into a bit more detail. In essence, under the proposed law a substitute check, produced in a standard format from the original image, would take the place of the original check in problem-resolution cases. Certainly, there is widespread support for the idea that an image-supported ECP process would allow for more rapid returns and dramatically reduce associated risks.

At this time, the draft act has been out for comment and the final votes are in, so to speak. Our current hope is that Congress can get the Act by year-end, and, if approved, it can be effective in the 2003–4 timeframe.

If we are to take full advantage of the big wave created by the Act, we must begin to work today on the issue of end-to-end interoperability of electronic payments and electronic check payments. This will require us to work together to determine exactly what systems and operational changes will be required, to identify issues and concerns, address operating rules, and establish service level agreements. These efforts may be extensions of the standards efforts I mentioned earlier, or they may include basic operating practices between banks and the Fed. I am convinced that there is more to be gained by working together and agreeing to individual modifications than there is to be lost.

Let me take us a little further up the wave by announcing our support for a number of key standards that can be used to facilitate the type of interoperability needed. The Fed intends to support a variety of X9B standards for the electronic exchange of checks and images, the exchange of bulk media, image replacement documents and electronic check adjustments.

In addition we will adopt other de facto standards, and we will create a specific plan for adopting such standards and rolling them out to our customers. In essence, I am telling you that we believe that interoperability is possible and that standards are at the heart of such a possible achievement. We will not follow our old paradigm of preferring and implementing proprietary Fed standards, and we will encourage others, including software vendors, to move to industry-supported standards.

Challenges will emerge

Now, I am not naïve. Thirty-four years of experience in the banking industry tells me that there are many reefs that block the way to a safe harbor and we need to work together to remove them in a systematic way. We have done this over the past two years in the ACH arena, resolving problems with deadlines and inter-operator pricing, settlement day finality, EDI translation and the absence of a true cross-border service. We are prepared to do the same in the electronic check environment.

Certainly, we should not assume that consumers will automatically accept what we have to offer. But as I noted earlier, there is growing evidence that they are accepting truncation at the point-of-sale. Truncation later in the stream may be challenged. We must get some information out to them to help them understand the alternatives and the legal rights that exist under each. To that end, my Retail Payments Office staff is working on developing some easily understandable Web pages to educate readers on the variations of electronic check services and the legal structures that apply.

There will be lots of little pieces of the infrastructure to hook together. Implementing such things as Web access will not be cheap. Tying together our archives will challenge our vendors. Eliminating the silos that exist in our backroom systems will be difficult but ultimately will facilitate the more widespread integration of other electronic services into our operations.

These investments will be difficult to fund and we will inevitably need to look at unbundling some of our less efficient, paper-intensive operations to create the right incentives. There is no way to effect this kind of change without serious redundant costs, as I mentioned in my earlier discussion of the Montana effort. Research has shown that fees are the most effective way to change behavior and we will need to use them to move our customers toward accepting ECP as well as other electronic alternatives.

Finally, we need to move together to decide once and for all whether we will develop some new clearing and settlement alternatives or simply modify our existing alternatives to meet the needs of electronic checks.

I have covered a lot of material today, suggesting many ways in which we can work together to solve mutual problems and pointing out how we can learn from history to seize the day. However, I want you to know that I realize that there are many changes in our environment that pose new problems, but there also are solutions that did not exist in the past. Perhaps Thomas Jefferson provided us with the proper balance between history and the future when he said, "I am captivated more by the dreams of the future than by the history of the past." Let's dream together about the ideal future and see if we can't do the hard work to make that dream become a reality.

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