

Speeches

New Remedies for a Changing World of Payments

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Today, I want to talk about this extraordinary time in financial services from my vantage point as Retail Payments Director for the Federal Reserve System. I hope to give you a sense of the Fed's stake in our nation's payments system and offer a few thoughts for how community banks can grow and prosper at a time when the climate is changing rapidly in financial services.

Earlier in my career, I managed the Atlanta Fed's Miami Branch, and I still have a little sand in my shoes, as former Miamians are fond of saying. Our kids spent a lot of time on the beaches of South Florida, where, as you know, the weather can change suddenly. When the wind picks up and dark clouds begin to move in, it can get pretty uncomfortable. But even when the surf gets too rough you can still fly a kite in those high winds, if you're open to new ways of doing things.

With respect to financial services, I understand that today's business climate can be unsettling, particularly for community banks. But I want to suggest that the gale force winds blowing through our industry also bring exciting new prospects—or, if you will, opportunities to fly your kite higher.

The changing world of payments

The well-known business consultant Peter Drucker once said, "To manage in turbulent times means facing up to new realities. It means starting with the assertion: 'What is the world really like?' rather than with the assertions and assumptions that made sense only a few years ago."

Let me try to answer Drucker's key question as it relates to payments: What is the world really like?

From the viewpoint of the Federal Reserve, we have been aware of transition in the payments industry for several years. These changes include increased debit card usage, and our internal data have reflected the growth in automated clearinghouse, or ACH, volume. Also, Federal Reserve check volumes were increasing year-over-year as late as 1999. So in an effort to clarify a rather confusing picture, we sponsored a major market research effort that looked at year 2000 retail payments check and electronic data.

Basically, we learned that check volume was much less than the industry had expected, that check volumes were probably falling, and that electronic payments usage—particularly debit card volume—was greater than expected. We learned that Federal Reserve check processing volume had been growing because of increased market share, not because of growing volume within the industry.

Last year we repeated the study as a way to get a sense of the pace of change. The latest study revealed that between 2000 and 2003, the total number of checks paid decreased at an average annual rate of more than 4 percent, while retail payments in aggregate were growing around 3.8 percent, a growth rate faster than for gross domestic product over the same period. Specifically, the total number of electronic transactions for all of 2003 was more than 44 billion, compared with some 36 billion checks.

It is especially notable that the number of electronic payment transactions in the United States—for the first time—surpassed the number of check payments. This is a major milestone that underscores the dramatic change that is unfolding and suggests that the world of payments may be approaching what author Malcolm Gladwell described in his book "The Tipping Point." In his introduction, Gladwell writes: "We need to prepare ourselves for the possibility that sometimes big changes follow from small events, and that sometimes these changes can happen very quickly." One might logically pose the question, "Is the U.S. payments system now at a tipping point?"

Well, we now have a better picture of how payments are moving from paper to electronic form, and I'd like to provide some background on how we got to this point and a sense of where I see things going.

Looking back, you could trace many payments innovations to the 1960s. At that time, financial transaction volume was booming, and the manual processes of the day were unable to keep up. As we entered the 1970s, the Fed and some other banks began to improve the back-office payments function for handling paper. At the Fed, we also began to pilot new systems for electronic payments by collaborating with the industry to build a nationwide ACH network.

It was during this enthusiastic early phase of electronic payments that heady talk began to emerge about a cashless and checkless society by the end of the 20th century. As it turned out, these early predictions of doom for paper methods of payment were off the mark. Cash usage has continued to increase, and the checkless society became the "less checks" society.

I even made a few speeches myself way back when predicting the decline of paper checks. My forecast was right, but I made the rookie forecasting error of attaching a specific year to the outcome within the same sentence.

Even with the evidence that I've described for you today, I don't want to overstate the scope of change. Although check volume has begun to decline, checks are still a critical form of payment in the United States, accounting for some \$40 trillion in annual value (still more in terms of value than for all other retail electronic payments).

Given the caution that many consumers and businesses have shown in adopting new payments technology, some of you here today may be skeptical about the rapid transformation I've described. Indeed, many community banks have told me that much of their success has been from the traditional, paper-based approach to financial services.

And looking ahead I don't have any doubt that community banks have been and will continue to be successful. But I want to emphasize that the old formulas for success may not take you to the "Tomorrowland" of payments.

You don't have to take the monorail to the Magic Kingdom or Epcot to get a glimpse into the future. Just look at the business-to-business marketplace, where about 80 percent of transactions are now check-based. According to a 2004 survey by the Association of Financial Professionals, 28 percent of treasury management executives believe that in the next three years their businesses are "very likely" to shift most payments to electronic systems. Four years ago, only 9 percent of executives in the same group were planning to shift the majority of payments from paper to electronic systems.

Every day, more and more of your customers—businesses and consumers—grow accustomed to making purchases with debit cards or handling transactions on the Web. Even fast-food restaurants are accepting credit and debit cards.

I can't tell you how to capture and keep the customers of tomorrow, but I can reasonably forecast that if you ignore the shifts that are occurring in the market you will have a hard time being successful in the future.

The role of the Fed

As for the Fed, we are here to serve the financial services industry, and in that industry community banks like yours play a vital role. In addition to providing central banking services, the Fed has a clear public policy interest in fostering efficiency, safety, and confidence of the payments system.

We are in the business of ensuring that payments glitches that could damage the economy do not occur. And on a routine basis our mission revolves around the smooth transfer of payments not just in this country but also across borders, day after day.

As financial innovations come on line, the Fed also has a responsibility to make sure customers are protected, that the new systems are safe and secure. Information security is a real and growing concern. As a result, we spend a lot of time and effort working with financial institutions to ensure that payments technology is protected from threats from within the industry and also from external elements.

Another recent development I want to mention is image technology, which relates to the passage in 2003 of the Check Clearing for the 21st Century Law, or Check 21. Contrary to some early predictions that had little or no basis in fact, Check 21 has not led to the elimination of check float in the payments system or a big percentage increase in overdrawn accounts. But I do believe that Check 21 gives us a solid foundation for more efficient check payments over the long term, which is a Federal Reserve objective.

The secret to the success of Check 21 will be the ability of paying banks to accept electronic image cash letters of items so that the end-to-end electronic clearing process can occur. Every day, the Fed System handles peak volume of about half a million Check 21 transactions worth more than \$6 billion and average volume of about 300,000 transactions. These transactions result in the printing of a paper substitute check for presentment to the paying institution. And we have more than 200 customers in various states of readiness to come on line, including many that are preparing to accept electronic files.

It so happens that perhaps the most passionate receiver we have in queue is an independent banker from Iowa who is thrilled by Check 21's potential for dramatically reducing costs and processing duplication.

And as Check 21 gains a foothold, I want to acknowledge that the Fed is also sensitive to cost pressures. Because the Fed is accountable to Congress and is required to recover the actual and imputed costs of the financial services we provide, our organization has made several significant adjustments, some over the past few decades and others in the past few years. Instead of operating as independent entities when it comes to payments, the Reserve Banks now collaborate as a national network to reduce costs and improve efficiency. Last year, the Fed completed its first phase of check re-engineering that involved discontinuing operations of 13 check processing locations, including the one I used to supervise in Miami.

Currently, we're in the next phase of check reorganization, going from 32 to 23 processing locations nationwide. For a workplace culture like ours that has been geared to stability, this process has been painful. But we recognize these changes are vital as we continue to move from a paper-based payments network to one that will be dominated by electronics.

I know that you too are coping with these changes. And community banks are even more directly exposed to the "tender mercies" of the free market and ever-changing customer demands. I understand that from your vantage point the outlook may appear daunting. Huge financial conglomerates that operate on a global scale continue to move into your markets. The pressure to cut costs and adopt new technologies that boost efficiency is relentless. No wonder the number of commercial banks keeps declining, from more than 12,000 in 1990 to about 7,600 in 2004.

Implications for community banks

But there is more to the story of financial services than vanishing banks. So let me offer some ideas on how small and medium-sized institutions can not only survive but also thrive in today's climate and why bigger is not necessarily better.

Perhaps the most powerful agent of change in your industry is technology. This development is significant because technology, in my opinion, can be a great equalizer.

Your larger competitors might be able to operate on a mass scale at a lower cost than you, but you too have advantages. I would submit that most of you are more flexible and are closer to your customer base. Also, because your organizations are smaller, I suspect you also have the edge of responsiveness, with less entrenched management silos and flatter organizational structures.

Remember the independent banker I mentioned a moment ago who is so excited about Check 21? This banker was able to look quickly and decisively across his operation and customer base and see the net benefit of the changes ahead. By contrast, larger organizations tend to focus on the benefits to one aspect of their

operation and end up battling across silos for individual preservation as opposed to corporate success.

My point is, be forward-looking and leverage your customer insights and knowledge to find a niche, then take it as far as you can go.

Although Internet banking in the past has been hyped, it has evolved to the point where a broad segment of the banking population expects access to the Web's 24–7 service and time-saving features. Today, everyone knows and uses the Web. The Internet is a powerful tool that is here to stay, so make it another one of your competitive advantages.

For a growing number of small and medium-sized institutions, the Web is a profitable way to build customer loyalty and add to your customer base, even in remote communities.

Geography does not constrain the Internet. A bank in Oregon can offer online banking services to customers in Florida or most anywhere else.

And if you want a sense of how e-commerce is evolving, take a look at retail. Many small mom-and-pop hardware stores have closed in the past decade because they were unable to compete against lower-cost retail conglomerates. But many niche businesses have emerged on the Web to sell specialized products to loyal customers around the world.

These organizations may be in your town, and my guess is that they probably need a bank that can support electronic payments or even global settlement.

International banking is a growth business, and you don't have to build expensive offices abroad to capitalize on globalization. In many communities in this country, there is an opportunity to develop underserved customers and offer them access to cross-border payment technology that is already in place.

You can offer international banking services from just about anywhere. The Fed for years has offered banks ACH links to Canada and more recently Mexico and Europe. Through ACH, a bank account holder in this country can send money to a bank account holder in another country. Each transaction costs about \$1, which is much less expensive than alternative nonbank methods of making cross-border payments.

Given the large population of Hispanic workers in many parts of the United States who need a way to send money back to family members back home, we believe the Fed's Mexico Service has tremendous potential. And it's available for all banks, regardless of size.

In fact, it is not the nation's large banks that are breaking new ground with this service. I would describe most early users of our international ACH services as modest-sized institutions at the community level that take care of small suppliers and small businesses.

Clearly, remittances are growing. In 2003, Latin American and Caribbean countries received \$38 billion in remittances, compared with \$23 billion just two years earlier. The value of remittances to Latin America now exceeds the value of direct business investment in this region, and the Fed is encouraging lower costs and fewer barriers to cross-border payments.

As financial services continue to evolve, I expect community banks will encounter more challenges and choices. And along the way I hope you'll stay open to new ways of business, to be creative and test new ideas that may seem risky in the short term but could set your organization apart as a leader tomorrow.

Please don't get me wrong. Managing change also takes discipline, and you may have to pull the plug on new initiatives that don't work out as planned. But my point is, don't be afraid to venture into new directions.

In today's unstable environment, I believe the most dangerous course is to stay put. If you step back and watch the unfolding revolution in financial services, you are no longer a player. You're a spectator. If you do not adequately address the changing needs of your customers, your competitors will do so gladly.

Let me make one final suggestion. As you test new initiatives in the marketplace, make sure you give the reins to fierce advocates for change. If your person responsible for piloting change lacks passion or is wedded to the current way of doing things, then even your best new ideas probably won't take flight. Find a bold leader who believes in change, and let that person take charge.

Believe me, the Fed understands the pressures you face, day after day. We feel the same winds reshaping the payments industry. And looking at the horizon, I don't envision a violent storm like the four hurricanes that hit Florida last year. But I do expect that today's brisk pace of change will not ease any time soon.

Let me close by leaving you with a thought from the philosopher and statesman Sir Francis Bacon. He lived in the relatively slow-paced world of early 17th century England, but understood well the perils of inaction. He said, "He who will not apply new remedies must expect new evils, for time is the greatest innovator."

Translated into today's less poetic terms, Bacon is telling us: You can either change or become obsolete. For the world of financial services that we are here to discuss, this message is especially timely, and it rings true to all of us across the centuries.

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