Speeches

Making a Commitment to a Viable Payments Future

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This is a pivotal time in financial services, and I'm glad that we're here to take a good, hard look at our industry as we transition to electronic payments. But before I begin to discuss the many implications of this change, let me clarify some important points about the Federal Reserve's unique responsibilities. As the central bank of the United States, the Fed plays a lead role in running a safe and efficient payment system—a role few other central banks pursue. Although the Fed is not driven to maximize shareholder value, we are committed to promoting efficiency, both inside our organization and throughout the financial services industry.

Internally, the Fed is accountable to Congress and is required to recover the actual and imputed costs of providing financial services in order to keep a level playing field with private-sector providers. But as the central bank, we are also expected to look after the greater good of the industry while serving more than 7,000 commercial banks scattered over some 3.5 million square miles. The Fed also plays a leadership role in responding to crisis situations. A few weeks ago, for instance, when Hurricane Katrina battered the Southeastern coast of the United States, the Fed was once again called upon to stay open and keep financial services running as smoothly as possible. Interestingly, I have noticed that organizations that have urged us in the past to withdraw from providing payment services often do not hesitate to use the Fed when other clearing channels are disrupted.

At the same time, we're sensitive to market conditions, and I view our conference theme of running payments as a business as timely and relevant. To advance this notion, I'd like to begin my remarks by discussing change in the payments industry from my perspective as retail payments product director for the Federal Reserve System. Then, I want to examine some of the barriers to progress and look at why so many financial institutions are still bogged down in paper, especially those in the United States. Finally, I'd like to suggest some new models for running payments as a business and building a more efficient payments platform for the 21st century.

When I look broadly at the payments industry in the United States, I see progress. But we can—and should—do better. Payments are still plagued by inefficiency, and financial institutions are not yet leveraging the true potential of electronic payments. Right now, it seems to me the payments industry is mired in a confusing transition that reminds me—as a parent of three children who are now adults—of a young person going through adolescence. Like a lot of teenagers, electronic payments are growing rapidly. But our industry is going through an awkward phase as financial institutions cling to revenue from paper-based transactions and are reluctant to commit to a future built on the efficiency of electronics.

I understand the transition of payments to adulthood is tough for financial institutions, many of whom now find themselves with one foot in paper-based transactions of the past and another foot in the electronic payments of the future. Given this unsteady posture, more and more financial institutions find themselves burdened with hidden costs that may impede their overall performance. We all know payments are vital to revenue. And in the United States a key source of profitability is checks. While financial institutions in the United States are among the most innovative in the world, it's unclear how banks will respond as people write fewer checks and the volume of checks cleared through the fee-generating clearing networks decrease. I foresee many financial institutions confronting tough choices as they try to sustain growth in a time of rapid innovation, regulatory change and shifting customer demands.

Overview of payments

As we feel these growing pains, let me take just a moment to give you an overview of payments in the United States. According to the Fed's research, approximately 36 billion checks were paid in 2003. Compared with many other countries, the United States still has a high volume of checks—about 45 percent of all noncash transactions. But check volume in the United States is declining by about 5 percent each year. Debit card usage is growing rapidly, and Web banking and other online financial services are moving from fringe to mainstream. For the first time ever, the number of electronic transactions in 2003 exceeded the number of checks processed.

The Fed processes about 35 percent of all checks in the United States, or 12.5 billion items annually. In response to this transition in payments, the Fed has standardized systems, reengineered functions, downsized operations, and increased paper check processing prices. In general, we've done what has been needed to maintain the financial viability of the paper business. But we cannot achieve our long-term financial goals by perpetuating our paper business indefinitely. We believe it's imperative to aggressively speed the transition to electronic payments, including electronic check clearing.

Recently, we took what I will describe as a big step forward in this direction with the Check Clearing for the 21st Century Act, which most of you may know simply as "Check 21." For those of you from other countries, the United States Congress passed Check 21 in 2003, and the program has been in effect for about a year. In short, this law facilitates the shift to electronic check collection by allowing—without requiring—collecting banks to create and send electronic images of the check. The law, however, also lets the paying bank choose whether to accept that electronic image or require paper. Thus, the Fed or other processors may need to convert check images back to a paper document called a substitute check, the legal equivalent of the original item.

Does Check 21 reach our goal of a completely electronic transaction from end to end? No. But the law moves us toward that goal and offers practical advantages. For example, banks may now speed the clearing of large-dollar checks by a day or more, particularly from the West Coast of the United States. This faster availability far outweighs the cost of producing substitute checks. According to some estimates, a typical customer that clears some $10 billion in checks per day could save some $250 million in improved availability over a year. When you compare this improved availability to our fees, the value proposition is pretty compelling. Today, less than a year after the implementation of the act, the Fed is processing on average more than 1.3 million Check 21 items each day.

ACH gains traction

And I'm pleased to report more progress toward electronic payments. Automated clearinghouse, or ACH, volume increased 18 percent in the second quarter this year, compared with the same period a year earlier. Growth has gained momentum for about three years following a rule change that expanded the types of payments eligible to become ACH items. As a result, businesses may now convert checks to ACH debits at points of purchase or remittance processing locations that are sometimes called lockboxes. Last year, financial institutions converted 1.1 billion checks to ACH entries, and this year we expect the number to exceed 2 billion.

ACH technology has been here for decades, but we have continued to improve the ACH system, making it more adaptable and secure. For instance, ACH is emerging as an important provider of e-commerce. During the past year, the number of ACH Internet-initiated payments increased by nearly 40 percent. And given growing concerns about identity theft and fraud, the Fed recently introduced a new risk management service that allows financial institutions to keep a close watch on customer ACH transactions.

The advantages of ACH are more evident as the service expands. During and after Hurricane Katrina last month, for instance, the Fed's ACH system continued to function, although some banks that lost power in the region temporarily were unable to access the ACH system. But banks in the affected area quickly regained access to the ACH network and resumed electronic payments. By contrast, paper methods of payment were far more problematic. Weeks after the storm, some banks were still trying to recover and sort checks. Wet and contaminated checks were a serious problem that we managed to resolve by enabling paper check conversion to electronic ACH payments.

So I would say ACH has good traction in the United States, and we're using our electronic payments network to try to lower barriers to some of our key trading partners. International payments are growing, but sending money across borders is still too costly, and the process can be lengthy. Fees for international payments vary widely. Large banks in the United States charge consumers anywhere from $20 to $40 for overseas transactions and similar amounts for euro-denominated checks. In response, the Fed has extended our low-cost ACH service from the United States into Europe and Canada, and we've been developing an ACH service south of our border that we're calling Directo a Mexico. We believe that ACH in Mexico has great potential, and we'll have a chance to discuss this topic further during our panel on international payments later in the conference.

We've learned a lot since the heady days of the 1970s—back when we naively thought we were approaching a checkless society. But now we know that developing the technology is just a first step and not the endgame. In hindsight, I think we better appreciate the challenge of convincing the marketplace to adopt electronic payments. And this lesson comes through in a book from a couple of years ago titled "The Slow Pace of Fast Change." The author's main idea is, "Technology almost always deceives us into thinking that we are going to progress further than the fragmented reality of the market will allow." So, for example, it took a long time for the personal digital assistant to become an alternative to the paper calendar and black book for contact information. And then, finally, many years after the technology was available and affordable, people began to put away their old Rolodexes and began to organize their lives with the aid of electronic tools such as the Palm Pilot or Blackberry—a device that's at my side just about wherever I go. In fact, my wife refers to my Blackberry as my girlfriend.

Adding to the flow of paper

My point is, innovation is an unpredictable thing, and it can take time—maybe decades—for the market to embrace even the most promising technologies. Our financial services industry in the United States gives another example of the slow pace of fast change. We enjoy all sorts of new products and services. But millions of consumers and businesses persist in their long-standing habit of writing paper checks, and it seems to me that many financial institutions policies promote this counterproductive behavior.

Don't get me wrong. There's nothing wrong with writing checks. Indeed, checks provide certain advantages, especially for business-to-business transactions that need paper documentation. But looking at the big picture, our migration to electronic payments becomes problematic if banks persist in adding to the flow of paper. Some financial institutions clearly depend on a paper-based business model that involves charging customers fees for insufficient funds on paper checks or by capitalizing on float, which is the time required to settle and return a paper check to the originating bank. While this model may generate short-term profits, I would contend that a strategy that depends on revenue from a shrinking market such as paper checks does not enhance an organization's long-term intrinsic value. In fact, float as a source of revenue could well be eliminated sooner rather than later as Check 21 speeds collection in remote locations.

With this backdrop, I must admit that I am continually astonished by the number of financial institutions in the United States that continue to offer free checking. I understand the need to increase customer "stickiness." But the cold, hard truth is that check volume will continue to erode, and at some point customers who have grown accustomed to so-called free paper checking services may be in for a rude awakening. To accelerate the move to less resource-intensive electronic solutions, I believe that banks will have to begin passing along to their customers the true costs of paper processing.

Let me illustrate my point. I remember when I used to pay 15 cents for each check cashed, and it seems to me that day may once again return, perhaps in the form of a new type of fee, similar to the fuel surcharges that are more and more common in the United States. For our part, the Fed has been raising paper prices significantly in recent years while offering more attractive prices on electronic services. The longer banks wait to adjust prices to reflect the real costs in the marketplace, the more painful this transition will be for the customer.

In addition to unleashing the invisible hand of the marketplace, banks could respond to our changing environment in other ways. To begin with, I would recommend taking a good hard look at your entire organization to find opportunities—however small—to lessen duplication and improve the payments process. Without efficient back-end payments, new products and innovation will prove difficult and expensive to implement.

Breaking down silos

According to the Economist Intelligence Unit, more than three out of every four banks are organized along product lines. But this silo-based organizational approach may cause problems during periods of rapid change, especially when your customers must decide for themselves which silo they need to contact. From mortgage lending to consumer finance to credit cards, vertical product silos are easily viewed independently. But it's often hard to know when these silos operate at cross-purposes. If this problem sounds familiar, you may want to get a better view of what payments mean to the overall performance. For many organizations, it makes sense to hire a payments czar who is responsible for developing the big picture and forcing the institution to look at overall profitability. Today, many of these so-called czars are support positions—not senior management positions that are empowered to resolve disagreements that would address the needs for the entire organization.

Although I hesitate to cite the Fed as an example because our situation is unique, it might be helpful to share with you how we have responded to these challenges. The Fed's Retail Payments Office, or RPO, which is based in Atlanta, has some responsibilities that you might liken to a payments czar within the Federal Reserve System. Over the years, the Fed empowered the RPO with profit-and-loss responsibility and oversight for strategy for the ACH and check processing services of the Reserve Banks, which now operate under the RPO's umbrella. As local districts don't report to us in the conventional sense, this oversight job at times resembles herding cats. But we do have the responsibility and authority to promote efficiency and reconcile competing interests across the Fed system. And with the decline of checks, we've had to make tough decisions. Today we are in the process of reducing the number of check-processing facilities from 45 to 22.

Looking at the broader industry, we would very much like to see a swift and painless transition to electronics. But we understand the reality is more complex. Too many organizations have duplicative processing platforms or confront excess capacity. And so it seems to me that quite a few financial services providers in the United States are stuck in the same holding pattern, struggling to carry the burden of inefficient payments operations as more nimble and aggressive nonbank competitors emerge to gain market share. If we don't respond, I fear this holding pattern might well turn into a death spiral.

As we confront change, there's a strong temptation to step back and wait to see how events unfold. But I think Teddy Roosevelt, the U.S. president 100 years ago, offered some pretty good advice on leadership when he said, "In a moment of decision, the best thing you can do is the right thing." But, he added, "The worst thing you can do is nothing."

In financial services, inaction is a dangerous course—especially now. Banks are no longer the sole owners of the payments franchise. More and more nonbank providers such as PayPal, CheckFree, and others selectively target the most promising revenue streams and are moving fast to separate commercial banks from their best customers. In this competitive jungle, it's a matter of survival to align services with customers' needs and thus provide low-cost and convenient services.

In closing, let me reiterate that our payments system is going through a difficult transition that those of you who are parents of teenagers may recognize. Today, the development of new technology and the rapidly changing needs and expectations of our customers have our industry in a tough spot. Yesterday's business models will most likely fail under the pressures of tomorrow. Moreover, the wider scope of our payments operations—shifting from paper to electronics—demands that we get out of our comfort zones and become leaders across silos, looking for the best strategies and outcomes for our entire organizations.

I want to leave you with an illustration of this transition. Let me assume that you have all seen the video segments of the space shuttle as it lifts off from its launch pad in Florida. For that first few moments, the shuttle seems to barely move. But as it gains altitude and jettisons its external fuel tanks, the shuttle seems to leap into outer space. When I think of our payments industry, I view our paper-based processing system as those external fuel tanks. True, we may have needed them to get off the ground. But the sooner we jettison those inefficient processing systems, the earlier we will reach our desired goal.

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