

**Embargoed until
April 16, 2002
10:30 a.m., Central Time (CT),
or upon delivery**

The Future of Payment Services:
Hard Facts & Hard Choices

Cathy E. Minehan, President
Federal Reserve Bank of Boston

NACHA Payments 2002 Conference
Dallas, Texas
April 16, 2002

Good morning. This conference is taking place at a time of tremendous change, challenge and opportunity for the U.S. payments system. In the aftermath of September 11, we all know what a difference the resilience of that system makes for the economies of the U.S. and the world. Without the assurance that trillions of dollars were flowing, and that markets were liquid, the U.S. financial system could have added to the larger problem. That didn't happen, because of your efforts and ours in the Reserve Banks. And it is our joint responsibility to ensure the payment system remains strong and resilient--even as we address change, the challenges and the opportunities that face us.

The payments system now faces sources of dramatic change--change in the form of new payments choices by consumers and businesses, driven by the realities of an ever more competitive and technologically sophisticated economic environment. These sources of change create the challenges--how to become even more efficient and use technology to create even more innovative payments products. Moreover, as we see the walls between payment types slowly erode--as checks morph into ACH items at the point of sale, or in a lock box service, for example--we see opportunities to reshape the payments system, and finally realize that electronic vision that has eluded us for so long. "Hard facts, Hard choices" is a great theme for this panel. In the midst of change, challenge and opportunity lies the very real possibility that the comfortable world of payments processing that we have known for so long may be in the process of disappearing forever, forcing us all to make these hard choices.

Why do I state this case so dramatically? Well, in my role as chair of the Reserve Banks' Financial Services Policy Committee I am seeing a pace of change and innovation unlike any other time in my 30 years or so in the payments business. This morning I'd like to outline a few sources of change for us, and for you as well. I want to tell you about Reserve Bank strategic commitments. And I want to highlight a few really vital areas of Reserve Bank innovation--new ACH efforts; our work with check images in the context of a complete revamping of the check collection system, and our evolving web strategy. Each of these involved hard choices. Each is based on hard facts. But each also offers great opportunities--opportunities for improved Reserve Bank payment and information services, opportunities to gain efficiencies and to offer new value added

services and ultimately opportunities for all of us to work together to improve this nation's payment system.

One critical source of change involves payment choices now being made by consumers and businesses. The results of the System's recent payments research studies provide a few important, hard facts about how the nation's payments environment is changing, as well as insight into where things might be headed in the future. We had thought that paper check volume in the United States totaled about 69 billion payments annually, but this research found the number to be about 50 billion. Granted, a single data point does not make a trend, but this implies a much slower compound rate of growth in annual check usage than we all had estimated since the last study of this type done more than twenty years ago.

In all, this latest research found that retail payments total in the neighborhood of 80 billion transactions annually, or a bit more than double the retail volume of twenty years ago. But now electronic payments make up almost 40% of this transaction volume as opposed to 15%, while check volume fell from 85% to 60% of today's volume. Clearly, consumers and businesses are choosing electronic payment vehicles more often now. Our plan is to revisit this research in some fashion fairly frequently to map the transition, but I believe I can say with little fear of being wrong, that electronic payments are on the cusp of becoming the dominant retail payment. The question for all of us is whether we are poised to facilitate that transition and to benefit from it.

There is no doubt that technology is playing a key role in this trend. The pace of technological change is forcing hard choices, on the one hand, but also provides important new opportunities to innovate and to be more efficient. We recently made a critical decision to commit our full energy to providing access to Reserve Bank payment and information services entirely through open systems and networks. This decision involved a hard choice not to deploy a Fedline for Windows NT product in which we had invested more than a few years and a lot of sweat equity. Similarly, new technologies, and changes in telecommunications support, now allow all 46 of our Reserve offices to work from a single check automation platform--a major change for us and one that will bring not only more standard products, but also the wrench of downsizing. This pace of technological change also requires that we anticipate the inevitable radical business

process change that will be needed. The tried and true ways of doing things in the legacy systems environment just won't yield the results we are looking for.

Many of us are also rethinking our contingency arrangements in the wake of September 11. Although we should be proud of what we accomplished together to respond to the events of September 11, we need to rethink contingency arrangements to reflect an environment in which the unthinkable occurs. We need to look at increasing geographic diversification of "experts" who manage critical systems, review underlying infrastructure to ensure adequate diversity in such areas as telecommunications, and increase the security of both our electronic systems and our physical plants. The choices we make here clearly will take investment dollars and resources away from other important initiatives. Finding the right balance here is critical to our ability to bring timely, needed improvements to the payments system.

In the midst of all this change and tension, the Reserve Banks remain committed to our roles as both central bankers and competitive service providers. In our central bank role, our strategic focus is on the overall efficiency, accessibility, and integrity of the U.S. payments system. We want to work with the market forces that are moving this system from paper to electronics and we want to ensure the payment system continues to support the smooth functioning of the U.S. economy in as effective a way as possible. As a service provider, we need to provide cost effective and innovative products that meet the evolving needs of financial institutions and ultimately of businesses and consumers. That means being very efficient and technologically sophisticated. The prospect of major change in the payments system provides all of us a unique window of opportunity to help shape the future. I want to share with you some of the ways in which we are working to do this.

Our research has shown that, increasingly, the ACH is serving as the backbone for the electronic retail payments system. It is both a primary payment conduit, and a settlement mechanism; often consumers and businesses are unaware they are even using this network. According to information provided by NACHA, the ACH network is used by over 115 million consumers, four million businesses, and more than 20,000 financial institutions. ACH volume last year grew at an annual rate of over 16%. And, our market research studies confirm what many of us already believe; there is enormous opportunity

to grow the ACH even more. Almost 40% of the 50 billion checks written annually are payments made by consumers to businesses. Another 15% are business to business payments. Both these payment types can and should be converted to electronic payments, and the ACH is positioned to support this conversion.

We continue to look for ways to enhance FedACH to accommodate new and emerging payments needs and to support the development of new products that meet the needs of the market. Already we have made hard choices through consolidation of our operations and customer support to significantly reduce FedACH prices. We will continue, as will all ACH operators, to focus on making the ACH payments system ever more efficient and cost-effective. We want to create a same-day product; we want to make the ACH reach more international locations, and we want to support the critical POS transformation of checks into ACH payments. Standards are critical here, and we support NACHA's efforts to move to more open standards.

As electronic payments continue to grow, the challenge of paper remains. However, if the costs of processing this paper volume can be reduced, that will allow greater investment in electronics. That challenge has got to be met by an increasing commitment to stopping the paper as early in the collection process as possible, and making both the forward and return collection process fully electronic. Banks will be making hard decisions about the role that they will play and the extent to which they want to invest further in their check processing infrastructure. Again, we have had to make hard choices in this area. We have chosen to make significant investments in our check processing infrastructure so that the industry can leverage our services to achieve broader payment system efficiencies.

The standardization effort I spoke of before will make the Reserve Banks more flexible and able to respond to changing volumes as the payment system evolves. In the check adjustments arena, the Banks have invested in new systems, and implemented standard practices that should provide the industry with the opportunity to take much of the headache and cost out of the error-correction process.

But in some ways the most important effort involves check images. Here we see a product that is vital to full electronic collection--if the image of a paper check can be stored, and retrieved by consumers and corporations on demand, then the payment itself

can move through the collection process electronically. At least two things are critical--a user-friendly storage facility, and changes to payment system rules to recognize images. We are making progress on both these fronts. Both the Fed and the private sector are building national check image archives that will provide industry utilities for storing and accessing check images. FedImage, which is the name of the Fed's national check image service, will enable ever more timely cash management and other services to corporate customers and in its ultimate form it will allow consumers access to images through home banking systems. Robust access capabilities provide for a range of image retrieval and file export capabilities. FedImage has been designed using open standards. The ultimate vision is that customers will be able to store and access images located at the Fed and at other service providers in a seamless manner. And these images will be acceptable legal proof of payment when legislation, drafted by Federal Reserve Board staff, with extensive industry input, is passed into law, we hope in the near future.

Finally, we are all working hard on the challenges and opportunities offered by web-based technology and internet protocols. As some of you know, Reserve Banks already provide access to information services and low-risk transactions via the web. Today, we have almost 800 institutions that access a limited set of low-risk services over the web. These include cash and savings bonds ordering and access to some check services. Beginning this month, we are rolling out additional information services that will provide all 9,000 of our account holders nationwide with access to a broad range of accounting and billing information. A little later this year, access to ACH information services will be provided as well.

Clearly, information services are one important step, but value transfers using open systems are yet another issue. Amongst our highest priorities, we are pushing hard to find ways to make secure ACH and funds transfers over the internet, or more likely an extranet, using web technology and open protocols. Since we transfer on average about \$2.5 trillion daily, you can be assured that we worry about security in an "open environment" a lot.

So far, we have completed several pilots in which we have successfully exchanged ACH files and completed basic funds transfer transactions using internet protocols, but much more needs to be done to satisfy our concerns about the security of

value traffic. Again, hard choices will be required as we assess the types of risk and ways to mitigate the risk. Old paradigms do not work in the new world and new forms of technical and policy prescriptions have to be developed to address the risks inherent in delivery of value transfers over open systems.

In this environment it is critical that we work with each other to experiment with new ideas. For example, the New York Clearing House has developed a system that uses a Universal Payment Identification Code, or a "UPIC", to identify individual business entities, and ultimately individual consumers, in this more open environment. We are supporting the Clearing House effort so that together we can determine whether this system helps facilitate end to end electronic payments while protecting confidential bank account and bank routing information.

In sum, the U.S. payments system is in a state of enormous change. We all face a host of challenges as we look for ways to apply technology and create the business cases that will enable us to move from paper to more electronic payment processes. If we are going to be successful, we need to work closely together to understand clearly the needs of both businesses and consumers--the end users of the payments system. We also need to work together to improve the overall resiliency, efficiency, accessibility, and integrity of this all-important U.S. payments system. And, most of all, we need to make the hard choices that will be essential to realizing the opportunities that are within our grasp.