



Collaborating to Improve the U.S. Payments System

I chair the Financial Services Policy Committee (FSPC). The Financial Services Policy Committee is responsible for the overall direction of financial services and related support functions for the Federal Reserve Banks, as well as for providing Federal Reserve leadership in dealing with the evolving U.S. payments system. In my remarks today, I would like to highlight several areas of strategic focus for the Federal Reserve's financial services. My comments this afternoon will cover three areas. First, I will briefly touch on how the Federal Reserve has adapted to the evolving payments industry. Next, I will talk about our vision for the payments system of the future. And finally, I will discuss the importance of our engagement with the payments industry.

I don't need to tell anyone in this room that the U.S. payments industry has undergone extraordinary change in a short period of time. Checks were the dominant form of non-cash payment from the 1950s to the 1970s. Check volumes peaked in 1995 at almost 50 billion items per year. Today, check volume is less than 25 billion items per year, and checks now represent just 10 percent of U.S. payment transactions.

Cash has also seen its market share fall significantly. At the beginning of the baby boom generation – the late 1940s – cash was the dominant form of consumer payment. Today, cash is used in about half of all payment transactions in the United States. Those are mainly transactions under \$20.

Of course, we know what has replaced cash and checks: credit, debit, and prepaid cards along with electronic transfers, that is, ACH. Together, these electronic transactions represent 40 percent of retail payments. At the Federal Reserve, we expect this migration to electronic payments to continue as end-user preferences change and as new products and services come on stream. A message I intend to leave with you today is this: across the Federal Reserve organization, we are actively engaged in adjusting our planning, our product development, and our resources to address innovation in the marketplace. Our strategy is to adapt with the industry, as electronic alternatives grow, and as checks and cash continue to decline as a share of all transactions.

Check 21 is a model that demonstrates the Federal Reserve's ability to change with the industry. As a consequence of Check 21, the Federal Reserve has reduced check-processing staff positions by about 5,000, and we have closed 44 check sites around the nation. We have eliminated our extensive air- and ground-transportation network for paper check delivery. We built an infrastructure that last year moved 7 billion check images from collecting to paying banks.

Additional Information

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[Cleveland Fed President Highlights Strategic Focus for Federal Reserve Financial Services in Remarks to Payments Industry Leaders](#)

Check 21 reduced clearing time for consumers, businesses, and banks. It reduced costs for the banking industry. And it improved safety and security.

Collaboration involving the people and organizations in this room gave rise to Check 21 and other significant milestones in the payments industry. I'm here today to say that we at the Federal Reserve will continue to be a partner and catalyst as the industry moves forward in the years ahead. And, our core mission of integrity, efficiency, and accessibility -- which together contribute to social benefit -- remains unchanged.

Historically, the Federal Reserve's focus has been on the interbank market, although changes in that market have had broader effects. The Federal Reserve's strategy today is to place greater emphasis on the entire payments supply chain and end users. Said another way, our strategy is to focus on payments from end-to-end. The most powerful, transformative payment innovations of the past, such as e-check and electronic billing, took into account the entire payments process.

With this end-to-end focus, the Federal Reserve will work closely with banks and others who provide payment services directly to end users. As an intermediary, we can play a crucial role in shaping the end-user payment experience.

Let me now turn to the Federal Reserve's vision for the U.S. payments system a decade from now. This vision is driving our plan of action, which includes organizational design, investments in technology, and industry outreach. Our vision has three key principles:

- First, the payment industry of the future will move transactions faster from origination to settlement.
- Second, the payment industry will function more efficiently.
- And third, the industry will develop the array of payment instruments that satisfy consumer preferences.

Let's take a brief look at each of these three overarching principles.

When we talk about a faster payments system, what exactly does the term faster mean? In payments, it is usually understood to be how quickly a transaction moves from the initiator of the payment, to the receiver of the payment. For instance, when a merchant processes a check or card, how long does it take for the transaction to move through the entire payments infrastructure? And, how long does it take for the maker of the payment to see the transaction in her online statement?

So what is the fastest payments instrument? Ironically, it is cash. That might surprise you, but consider this: when cash is tendered for a purchase at retail point-of-sale, it is immediate and certain. The merchant has the money. The customer has the merchandise. The transaction is complete. While cash as an instrument of commerce is declining as a share of payments, it nonetheless provides a standard for all other payment instruments in terms of speed of clearing, settlement, and reliability.

All other instruments take longer. Some, like a wire transfer, take just a little longer. For card transactions, clearing occurs on the same day as the transaction, but often at the end of the day when the card-issuing bank runs its accounting system.

The laggards of the payment world are check and ACH transactions. When it made its appearance in 1974, the automated clearinghouse was, at best, a next-day batch clearing and settlement system. And

so it remains today, almost 40 years later. For decades, the check system had a deferred availability schedule, with some checks not settling for as long as a week, and no certainty of good funds for longer than that. With many improvements since then, all checks in the United States now clear either on a same-day or next-day basis.

I am certain that there will be a time when all ACH payments and the surviving check payments will clear almost instantaneously, or, at the very least, on the same business day that they are initiated.

What gives me confidence that we can accomplish this goal is Great Britain's Faster Payments Service. Faster Payments went live four years ago and it demonstrates that it is possible to accelerate end-to-end delivery of individual payments from the next day to no more than an hour or two on the same day. This was a collaborative enterprise of banks, technology vendors, and regulators. The Faster Payments Service and Britain's ACH system operate independently. The Faster Payments Service now carries payments traffic that is equivalent to 13 percent of all ACH volume in that country.

The Faster Payments Service, or something more far-reaching, is within our grasp. NACHA has been working toward a same-day solution for several years now. Although its work has spurred divergent opinions and healthy debate, there is progress.

Here's the point: if we are going to move all or part of ACH to same-day clearing and settlement, we need to understand industry views on the benefits and costs. We need to dig into the technology and operations details. And we need to consider safety and settlement issues. At the Federal Reserve, we are working toward solutions, and we are interested in the industry's perspective and insight. This is a prime example of a challenge that the industry needs to tackle through collaboration. And we at the Federal Reserve aim to be a part of that process.

As we plan for the payments industry of the future, a second core principle is a lower-cost and more efficient payment system. Economists calculate the cost of operating the U.S. payments system in the range of one-half to 1 percent of our gross domestic product. In 2011, one percent of GDP was \$150 billion. Any reduction we can make in that number can free up funds for more productive uses in the economy.

The cost of the U.S. payments system, measured on a cost-per-payment basis, is undoubtedly lower than it was 10 or 15 years ago. Some of the improvement is the result of paper instruments being replaced by electronic instruments. Some of the improvement is the result of re-engineering, with Check 21 being the most prominent recent example. Check 21 helped to eliminate large, centralized proof operations in banks and helped to accelerate the shift to online statements. Research by the Federal Reserve Bank of Philadelphia estimates that the payments system savings attributable to Check 21 amounted to \$3.2 billion annually.¹

Again, let me suggest one case in point that presents a particular opportunity: business-to-business payments. B2B transactions are a category where it is widely accepted that the end-to-end cost of purchase and sale transactions is very high. The all-in cost of an individual B2B transaction is estimated between \$20 and \$50. That figure would include the cost of ordering, billing, shipment tracking, payments, and exception processing. Payments represent a small part of this cost. However, the payments channel can be leveraged to reduce the cost of the all-in transaction.

The industry has been working on reducing B2B costs since the 1970s, when the first Electronic Data Interchange standards were developed.

Later, in the 1980s, NACHA introduced a mechanism to carry invoice information along with each B2B payment. However, the vast majority of B2B payments are still not accompanied by trade information. Making use of the remittance fields in ACH and wire transfers could reduce exception handling costs by helping to match invoices with payments. Greater use of remittance information could also drive more B2B traffic from checks to electronic payments.

I wish I could say that there is a magic bullet that would instantly resolve the B2B cost challenges. We need to re-double our efforts in this important area. B2B is not the only category where end-to-end costs can be improved. I mention it today as an example of how far we need to go if we are going to make the payments system more efficient.

I have talked about two payments system principles – speed and efficiency – that we can improve with more knowledge about end-user preferences, and more analysis around the process of moving payments from end-to-end. Speed and efficiency are relatively straightforward concepts. They can be visualized. They can be quantified. Progress, or lack thereof, can be measured.

However, consumers often choose payment instruments on the basis of qualitative attributes, such as convenience, certainty, security, and privacy. Consumers are less conscious of the speed and cost of an individual payment. For instance, in the future, consumers will increasingly want to use their mobile phones and tablet computers to execute payment transactions, just as they already use those devices to make phone calls, surf the internet, and send text messages. Consumer payment preferences are shaped by qualitative factors that are difficult to foresee.

Mobile payments have yet to gain traction in the United States. But evidence from such countries as Kenya, South Africa, South Korea, and Singapore shows that the right combination of standards, teamwork, and marketing can yield strong demand for mobile and contactless payments. In the future, in the United States, you will be able to replace your leather wallet with a mobile wallet containing bank account data, linked to the ACH, check, and card networks. Your mobile wallet may also include personal identification documents such as your driver's license, insurance cards, and health records. The Federal Reserve has been working with mobile industry stakeholders in the United States to help collect information on the direction of mobile payments, and to understand the potential barriers and risks.

In sum, each of these areas – speed, efficiency, and consumer preferences – are embodied in the Federal Reserve's vision for the future of payments. Success in achieving these goals will require collaboration and engagement with the industry. And I'd like to close on that point.

The Federal Reserve is just one player in the U.S. payments system. Our strategy calls for more engagement with traditional providers – such as the banking industry – and with new market participants and innovators. Through our ongoing interactions with payment industry participants like you, we seek to fully understand user needs, and to be a part of the solutions. Many successes in the U.S. payments system occurred as a result of teamwork between multiple industry participants, including the Federal Reserve. I believe that a payment system built around competition and collaboration will best serve the needs of different end users, including banks, consumers, businesses, and government.

Collaboration in our industry is not a recent development. Even before the establishment of the Federal Reserve in 1913, banks,

clearinghouses, and trade associations worked together in the period between the Civil War and World War I to establish effective clearing mechanisms and address the payments system disruptions that occurred during financial crises. In the 20th century, collaboration was pushed along by the rise of new payment vehicles and the increased use of automation in payment processing. We can point to the introduction of check routing symbols, MICR encoding, reader/sorter automation, and the ACH as examples of successful collaboration.

Looking to the future, our goals at the Federal Reserve are two-fold. First, we want to gain the industry's insight in understanding end-user needs.

And second, we want to engage with the industry to bring forward improvements in U.S. payments that accelerate the speed, increase the efficiency, and enhance the convenience, accessibility, safety, and security of payments.

So at this conference, I would ask you to share with Federal Reserve staff your observations on how we can engage with you more effectively. Where are the gaps in knowledge or infrastructure? What are the obstacles you face on the path to a faster, more efficient, more responsive payment system? What role can the Federal Reserve best play as this important industry continues to transform? A panel of Federal Reserve leaders responsible for our operations is slated for this afternoon. They will provide you with more detail on our current and future initiatives in the areas of check, ACH, FedWire, and cash. I believe it is through formal and informal discussions like those that will occur at this conference over the next day and a half that we can energize the spirit of collaboration.

In conclusion, as we prepare for the payments system of the future, our Federal Reserve Financial Services focus will be on collaborating more broadly to foster innovation and place new emphasis on a faster and more efficient flow of payments and payment information. We will place greater emphasis on improving the efficiency of payments from end to end – that is from the initiator to the ultimate receiver of the payment. We will engage and collaborate with payments industry partners like you to ensure that we fully understand the needs of the industry now, and in the future, and we will expand our research and industry engagement efforts in pursuit of these goals. We also will partner with industry participants to enable us to be part of the solutions that will best serve the needs of different end users including banks, consumers, businesses, and governments. Throughout our work, we remain dedicated to ensuring the speed, efficiency, certainty, security, fraud resistance, and market responsiveness of the U.S. payments system.

All of us at Federal Reserve Financial Services are committed to the continual improvement of the U.S. payments system and to working collaboratively with the payments industry to implement innovations that meet evolving payment needs.

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1. David Humphrey and Robert Hunt, *Getting Rid of Paper: Savings from Check 21*, Federal Reserve Bank of Philadelphia Working Paper 12-12 (May 2012).