In Pursuit of a Better Payments System

Additional Information

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Cleveland Fed President Pianalto highlights "Payment System Improvement - Public Consultation Paper" in remarks to the Payments Symposium at the Federal Reserve Bank of Chicago.

It is a real pleasure to join you at this conference. I would like to thank our hosts at the Federal Reserve Bank of Chicago for once again making us all feel so welcome. I am speaking today in my role as chair of the Federal Reserve's Financial Services Policy Committee, which is responsible for directing the financial services operations of the Federal Reserve Banks. The committee also provides Federal Reserve Bank leadership for the evolving US payments system.

I don't have to tell you that this is an exciting time to be involved in payments. New technologies are expanding possibilities in ways that seemed unimaginable only a decade ago. Over the next two days, you will discuss many of these possibilities, and in the process help influence the course of our work in the years to come.

Today I am going to report on the gaps and opportunities the Federal Reserve Banks have identified as we have charted our strategic direction for financial services. I will then focus on the potential for pursuing a near-real-time retail payments system in this country. I will conclude with some thoughts on how industry collaboration can drive meaningful changes in the payments system.

The Federal Reserve has always kept a focus on the integrity, efficiency and accessibility of payments in the United States. We have largely pursued this mission in the context of our function as an operator in the interbank market. Last October, I spoke at this conference about the Federal Reserve Banks' strategic direction in payments. At the heart of the strategy is a vision to improve the end-to-end speed, efficiency, and safety of the US payments system over the next decade. By end-to-end, I mean more than just interactions between banks; I mean from the point of payment origination to the point of receipt.

In the past year we at the Federal Reserve Banks completed an analysis of the gaps and opportunities in the US payments system to understand key areas where the system could be enhanced. Some of that analysis shaped the content of this conference agenda, as well as the Payment System Improvement - Public Consultation Paper[1] that was released two weeks ago and made available to all of you. The purpose of the Consultation Paper is to solicit broad, cross-industry input on the challenges facing the payments system and to identify possible next steps.

The gaps and opportunities we identified as we have pursued our strategic direction for financial services should come as no surprise; they are well known. First, there is still too much paper. While the share of check payments in the US has been declining for many years, it still represents almost 20 percent of all non-cash retail transactions, or 60 million transactions per day. America's payments system is costlier as a result.

Next, we have not seen enough improvement in cross-border payments. Major drivers of cross-border payments are business-to-business transactions and remittances. The growth in cross-border business-to-business transactions is reflected in the value of imports and exports in the US economy, which has risen by 40 percent to $4.2 trillion a year over the past decade. The value of remittance flows to developing countries has tripled to $351 billion annually over the same period. Yet the options for cross-border payments have not kept pace. Opportunities exist for improving the cost-effectiveness, timeliness, and convenience of cross-border payments.

On the domestic front, the United States lacks a universal, near-real-time retail payments option for consumers and businesses. Cash and debit cards are the closest thing to it, but both fall short of fully satisfying business and consumer needs. We have heard from payments stakeholders that there is demand for a better system. At the same time, we are mindful of lessons learned in other countries that implementing a faster payments solution requires years of hard work.

As always, we are keeping a focus on safety and security. New ways of making payments and accessing bank accounts create new vulnerabilities. We must stay a step ahead of fraud schemes and cyber threats. Preserving public confidence in the payments system is core to our mission and requires the collective efforts of everyone in the industry.

Over the next two days, you will have an opportunity to share your insights on key challenges facing the US payments system. These challenges include the migration to electronics, the development of industry standards, and the need to raise levels of efficiency, security, and speed. Right now, I would like to specifically address the issue of payment speed.

We can ask ourselves, "How will most payments be made in the US 20 years from now?" I think the more appropriate question is, "How should most payments be made?" Our vision is that most payments will be executed in real time. This would mean that any consumer or business would be able to make an immediate payment to anyone, electronically and conveniently; the sender of the payment could initiate the transaction even without having the receiver's account information; most payments would be accompanied by confirmation of good funds and timely notification to both parties that the transaction had been made; and the automated payment instruction would accommodate additional information, such as invoice details, to ease reconcilement.

It is pretty clear that future generations will not use paper checks. In fact, I would add that Millennials as a group are not currently using checks to any material degree. Future generations will also rely less than we do on cash, although I hasten to add that cash will remain widely used and widely accepted. Future generations will expect that any payment they initiate, whether online, mobile, or at point-of-sale, will be executed immediately. They will gravitate to financial institutions and other providers that offer this level of service.

This vision of the future reflects the imperatives of the present. Our conversations with industry participants over the past year have underlined that they find many characteristics of near-real-time retail payments desirable. They see pursuit of a faster payments system as an opportunity, one that involves some risks and that requires industry collaboration.

Businesses and consumers alike have expressed interest in the ability to make last-minute payments of all types. Businesses and governments are drawn to the potential for enhanced cash management afforded by quicker confirmation of good funds. Real-time transactions could reduce fraud losses for banks and businesses. For consumers, a faster and more convenient electronic payments mechanism would be an attractive alternative to checks. As it stands, many consumers today believe that their payments are real-time. Most businesses know all too well that this is not the case.

The Federal Reserve is not alone in recognizing the opportunities of universal near-real-time retail payments. In the past few years, a number of providers have introduced networks with features resembling real-time payments. These networks work well when both the payer and the payee are members. But it is difficult for a participant in such a system to send money to a receiver who is not a member. These networks generally do not efficiently or quickly pass transactions to one another or into the mainstream payments systems. These emerging networks suggest the right course. But they lack the end-to-end speed and universal access needed for an efficient payments mechanism that will meet end-user expectations in the future.

“Faster” alone is not a solution, nor is it a stopping point. A faster payment method that is not convenient and accessible to end users does not achieve the goal. We seek a solution that better serves the end user and those of us who facilitate transactions for them. A faster payments solution must be built on standards that preserve opportunities to offer unique services in the market while ensuring interoperability across the industry.

Universal access is necessary to achieve the greatest benefit. This has been the case for check, ACH[2], and wire transfers. The benefit of each of these payment instruments multiplied as they became more widely accepted and used. Over many years, these systems have evolved to nearly universal access.

We know a near-real-time payments system is possible because a number of other countries have implemented or are in the process of implementing one. The UK introduced its system, the Faster Payments Service, in 2008. This service demonstrates that it is possible to accelerate end-to-end delivery of individual payments from the next day to no more than a few seconds or minutes. Consumers, businesses, and government entities make use of the service for both ad hoc and scheduled payments.

The UK’s Faster Payments Service is growing and evolving. In the past year, its traffic has grown to about 5 percent of all non-cash retail payments volume in the United Kingdom. Financial institutions have added phone-initiated and file-initiated transaction features to what began as an online-only service. In 2014, the Service will make new features available to participating banks, including mobile applications that enable bill payments and payments at point-of-sale. The UK Payments Council is working on a 2014 initiative that would liberate payment originators from having to know the bank account number of their counterparties. Instead, the mobile phone number of the receiver will be substituted.

There are other faster payment systems in various stages of implementation or planning in Australia, Singapore, Poland, and Mexico, among other nations. A lengthy collaboration effort was needed in all of these countries to bring faster payments from idea to implementation. These efforts involved financial institutions, processors, network providers, vendors, national payment authorities, and central banks.

You will hear about some of these initiatives at this conference. You will have an opportunity to consider lessons learned from these experiences and where our unique needs require different paths and solutions.

Let me also acknowledge that the pursuit of near-real-time payments in the United States is not a given. We are in the early stages of thinking about such a solution for this country. There are many challenges to consider before pursuing a near-real-time retail payments system in the US.

First, the strength and nature of demand for the service is unclear. In today's US payments system, there are concrete examples of demand for faster retail payments, such as expedited bill payments and cross-border remittances. But the examples remain anecdotal and episodic, in part because there is no existing infrastructure for universal faster retail payments. That is why the Federal Reserve is looking at the available research and undertaking efforts to get a clearer picture of end-user needs.

Another potential challenge is the lack of a definitive business case across the supply chain for near-real-time retail payments. But this is not an insurmountable obstacle. If we look back over the last few decades, universal payments systems that we now take for granted did not have clear evidence of demand, business cases, or infrastructure plans at this stage of development.

The development of electronic payments in the 1960s provides an instructive example. At that point in history, the organizations that are today identified as the founders of the credit card system, ATM networks, and the ACH, were awash in paper and costly branch systems. To address their seemingly unsustainable back-office situations, they turned to what was then state-of-the-art 1960s computer technology. They had no clear multi-decade vision for the US payments system in mind. However, over time, they created the nation's retail electronic payments systems - the ACH, credit card, and debit card systems.

Let me draw a parallel to the topic at hand. When many of us in this room think about the business case for faster payments, we give great weight to the possibility of eliminating costly paper checks. So we are motivated by the potential for cost savings, much like the motivation that the founders of electronic payments had in the 1960s when they embarked on their efforts. The investment decisions they made in the 1960s and 1970s did in fact provide cost savings, but there were additional benefits. These benefits included unforeseen cost savings, and new products and revenue streams for the financial sector. The new electronic payment channels created their own demand. That is why when I hear people argue that the demand for near-real-time payments is unclear, I counter that they may very well be underestimating the demand for a potentially groundbreaking new service.

Here is the point: Overall, I see more opportunities than challenges in pursuing a near-real-time payments system.

I am in favor of seizing those opportunities. But I recognize that whether we pursue near-real-time retail payments or not, the only way we will make an informed decision is by investigating the issues together. At a glance, this collective approach might seem contrary to the thrust of history. Innovation in the US payments system has mainly been driven by the individual, entrepreneurial activity of banks, vendors, processors, and nonbank service providers. They respond to customer demand in a fiercely competitive environment. It is safe to say that American businesses and consumers derive great benefit from this competition in the form of diverse options and lower costs.

There have been times, however, when individual action on the part of banks, vendors, and nonbank service providers was not sufficient to move the payments system forward. Collective action was needed to implement MICR technology; to establish the ACH, card and ATM networks; and to implement Check 21[3]. Collaboration will be necessary to continue to improve the US payments system.

Today at this conference, we continue our dialogue with the industry to understand your views. We are interested in your thoughts on the questions raised in the Consultation Paper. We are interested in knowing your views on the benefits and costs of addressing gaps and opportunities, the technical and operational impacts of potential solutions, and the associated safety and settlement issues. Speak up and speak openly during this conference; and then please take time to go back and submit your organization's written response to the questions posed in the paper. Your input will influence the Federal Reserve's strategy. We look forward to working with you to explore the best ideas for improving the nation's payments system.

I want to conclude on a personal note. As many of you know, I am retiring early next year as president and CEO of the Federal Reserve Bank of Cleveland. So I will not be back here in 2014 to report on our progress. I leave the next steps in the capable hands of Federal Reserve leaders who have guided our payments strategy for years and developed the vision in the Consultation Paper.

It has been a privilege to chair the Financial Services Policy Committee for the past four years. During that time and throughout my 30 years at the Federal Reserve, I have worked with many talented individuals and organizations, and I have observed the gains that can be achieved through collaboration. To succeed, we must continue to engage and find ways to leverage our collective strengths and resources.

We have done it before and I know we will do it again. I am confident that a year from now my colleagues will have exciting news to share. Thank you.

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1. Paper available at http://fedpaymentsimprovement.org/
2. Automated Clearing House, an electronic network for financial transactions.
3. http://www.federalreserve.gov/paymentsystems/regcc-faq-check21.htm