The Future of Retail Banking and Payments—Developments in Global Markets
The Role of Central Banks

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Thank you for the opportunity to be here today and participate in this conference on retail banking and the role of central banks. It is a pleasure for me to join you and provide my perspective on the U.S. retail payments system.

Discussion regarding this topic could not be more timely. Retail payments in the United States and worldwide have undergone an enormous transformation over the past decade driven by technology and, just as importantly, notable changes in consumer preference. We get a sense of this change from a recent Federal Reserve study indicating that electronic payments now exceed two-thirds of all noncash payments in the United States. The efficiency, convenience, speed and ease of use have fueled this transformation and will continue to do so for some time to come.

Consistent with the Federal Reserve's mandate to ensure the integrity and efficiency of the payments system, we were a strong advocate of the migration of payments to electronic mechanisms. Though the electronic nature of retail payments has affected the Federal Reserve's traditional role, the Federal Reserve's mandate has not changed. Although some question whether the Federal Reserve can or should play an important role in retail payments over the long term, a strong case can be made for expanding the Federal Reserve's role in electronic payments if it is to fulfill its mandate.

Today I will discuss my own view that the Federal Reserve should not be contemplating an exit from retail payments. Coupled with the rise in electronic payments products, a dramatic change in the structure of the payments industry has introduced new challenges to assuring the competitiveness and safety of this system. The industry's structure has been heavily influenced by economies of scale, which has brought with it an increased level of concentration in debit and credit markets. For example, in 2007, the three largest PIN debit networks handled more than 81

percent of all transaction volume. Comparatively, in 1995, the three largest networks controlled only 46 percent of the market. More striking, perhaps, is the fact that over the same period, the number of networks dropped from 43 to 14. Similar trends are evident in signature debit and credit card issuance. And, of course, in the United States, three networks have long dominated credit card clearing. To me, these developments raise important concerns about the competitiveness of card payments systems.

There are also reasons to be concerned about the integrity of this system. Growing levels of concentration and an increasing complexity of systems have invited greater vulnerability to disruption and an enhanced potential for "single points of failure." The increasing complexity has raised the opportunity for fraud. There also has been a growth in the prominence of nonbanks, introducing new risks to the system.

In light of these developments, I believe that the Federal Reserve needs to continue playing a strong role in retail payments. Before looking more closely at what role the Federal Reserve could play in the future, it may be useful to consider the economic rationale for central bank involvement in retail payments more generally. This rationale revolves around the existence of externalities that potentially undermine the efficiency and integrity of payments systems.

Payments products and services require a critical mass of participants on two sides of a market. For example, a significant number of merchants must be willing to accept a specific form of payment before consumers will use it. Conversely, a substantial number of consumers must use that form of payment before merchants will consider installing any necessary equipment or software. In this situation, a new product or network might not develop because, at the individual level where such choices are made, neither consumers nor businesses have an

incentive to use the product. Both sides, however, might benefit if such a product was in place. Such externalities, in which individual benefits or costs do not coincide with those accruing to society, can justify a public sector role in providing the service.

Similarly, there are possible externalities related to coordination. Situations arise in payments markets where coordination among participants benefits both participants and users — for example, adoption of uniform standards or a common technology. But agreements around common standards or technology are difficult to achieve because participants vary in size and preferences. In addition there can be a "free-rider" problem, where those that stay outside the process avoid cost associated with any agreement that might be made. The result is an underprovision of services or products. One especially important example is the potential "underinvestment" in payments security by the private sector, for example, the continued use of magnetic strip authentication for credit cards rather than more secure smart card authentication.

These externalities help explain the Federal Reserve's traditional role in retail payments, especially its role as operator in check processing and ACH. Its early check processing involvement was largely a response to the fragmented nature of the industry as payments carried across literally thousands of commercial banks dispersed across a wide geographic area. Non-par clearing was the norm, and remote locations were inadequately served. Under such circumstances, it took only a few years for the Federal Reserve System to be involved in roughly 50 percent of the value cleared through clearinghouses. By entering the market and ultimately becoming a prominent participant, the Fed was, in effect, addressing coordination difficulties and network effects. Similarly, it was instrumental in the 1950s and 1960s in working with industry participants to establish the MICR standard and to develop high-speed sorting equipment.

With regard to ACH, in the 1970s, the Federal Reserve assumed a leadership role in promoting this technology to provide an alternative for bank-to-bank small dollar payments. Private sector banks, facing high startup costs and low ACH volumes, were understandably reluctant to invest in a new network. Without bank participation, there would not be consumer involvement. The Fed's participation helped address this externality. It became one of the key ACH operators, and for a few years following implementation of the Monetary Control Act, it subsidized the ACH network. Over time, a critical mass was achieved, and today the ACH is one of the nation's most heavily used retail payments systems.

In light of the trend toward greater industry concentration and the existence of important payments system externalities, the Federal Reserve should play a larger and more active role in electronic retail payments if it wants to promote the efficiency and integrity of the payments system. The key question is how this role should be defined. While the Federal Reserve could focus more on regulation and oversight to achieve its mandate as many other central banks are doing, I suggest that it should leverage its experience and position as an operator to achieve its objectives.

Historically, the Federal Reserve's role in both checks and ACH reflects a preference to operate within the market rather than as a pure regulator. We are well aware that industries can – and do – quickly develop methods to exploit any regulatory loopholes and avoid the intended outcome. By competing with the private sector on a level playing field, the Federal Reserve can encourage efficiency and integrity from an "on the ground" position.

Looking forward, I also suggest that it could do so in the realm of electronic payments more broadly. The Federal Reserve's operational role will likely revolve around its ACH

platform. Currently, the Federal Reserve is filling an important role in an ACH industry where the Electronics Payments Network (EPN) is the only other active operator, and where the elimination of either party leaves a highly concentrated and less competitive market. While a recent joint processing venture announced by Bank of America and Wells Fargo may spur the entry of a third ACH operator, economies of scale make entry difficult, especially in these times where capital is scarce and expensive. Without the Fed, it seems unlikely that a more competitive environment would emerge.

ACH volume has been steadily increasing in recent years with significant growth in nontraditional payments, such as Internet transactions and the conversion of paper checks to electronic debits. Moreover, the volume and nature of ACH transactions have evolved to the point where the ACH network is clearly of systemwide importance so that a major disruption could have significant effects on the payments system and the broader economy.

Thus, in my view, the Federal Reserve's future role in retail payments should be built around its current position in ACH. For example, in its operator role, the Federal Reserve could augment its ACH products and services, with the aim of enhancing competition and safety within the ACH industry. An example where this is occurring is with same-day ACH settlement, which the Federal Reserve recently announced it will begin to offer in the second quarter of 2010. This will provide originating and receiving banks the option to accelerate the clearing and settlement of certain ACH debit payments, which will provide an earlier opportunity to identify return items and reduce risk.

The Federal Reserve could also work with EPN to provide reciprocal backup services with each other as well as with other electronic payments networks, and thereby serve as a "switch of last resort." Such a role would prove invaluable in the event of serious disruptions to major networks, however unlikely such disruptions might be.

Finally, the Federal Reserve could enhance competition in payment card markets by positioning ACH services as an alternative to debit card payment networks. I am not suggesting the Federal Reserve would issue its own cards or operate its own card network. However, the Federal Reserve could add enhancements to its ACH network, enabling it to become an alternative to running transactions over card networks. The recent development of so-called decoupled debit cards provides an example of the industry making use of the ACH network in this way.

In summary, as the payments system continues to evolve, the Federal Reserve's role will need to change. In my view, it would not be desirable for the Federal Reserve to scale back its presence in retail payments or even exit retail payments as some might advocate. Rather, the existence of important externalities and increasing industry concentration suggest that the Federal Reserve must stay involved in retail payments. The question, then, is what form this involvement should take. Many central banks in a similar situation will likely opt to rely on a regulatory and oversight role. However, in part because of its unique history as an operator, I believe the Federal Reserve is well-positioned to leverage its traditional operator role to better enhance the integrity and efficiency of the payments system.