

Importance of the Federal Reserve as an Operator in the Retail Payments System

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Introduction

I am pleased to have an opportunity to join you today at the conclusion of this year's Mid-America Payments Conference. We have had a long association with the Kansas City Clearinghouse, MPX and now EPCOR, as we share a focus on improving our nation's payments system and ensuring its benefits accrue to financial institutions and their customers here in the heartland.

As I begin my remarks today, I want to emphasize that I am expressing my own views, and they are not those of the Federal Reserve System.

As you know, our payments system is going through one of the most radical transformations since the advent of the ACH network more than four decades ago. The result is not only a payments system that is much more complex in its operation, but also in the challenges that it faces and the risks to its integrity.

In response to this evolution, central banks around the world are thinking about how they can continue to maintain an efficient, safe, and accessible payments system. In the United States, one key question going forward is what role the Federal Reserve can and should play in this new environment. While some in the industry and government advocate a reduced presence, I believe there is a strong case for the Federal Reserve Banks to continue active involvement.

Changes Prompting Rethinking of the Fed's Role

Since their founding almost a century ago, the Federal Reserve Banks have played a role in the nation's payments system. Charged with ensuring its efficiency, safety and accessibility to the public, this mission remains as important as ever.

The payments system today is very different than the one that was in place in the early 1900s. But more striking is how far removed it is from what we saw only a few years ago. Consumers have embraced debit and credit cards as the preferred form for payments. Paper checks, when written, are converted to electronic form and cleared via ACH or Check 21 networks. Today, paper checks represent only 2 percent of the total deposited with Federal Reserve Banks. By the end of the year, the Federal Reserve will have closed all but one of its paper check handling sites. The Federal Reserve helped drive this move to electronics and the public benefits are clear. For example, the aggregate fees paid by financial institutions to the Federal Reserve Banks for check collection will have declined from about \$700 million in 2005 to less than half that amount by next year.

While check clearing volume has been declining for a decade, ACH transaction growth began to flatten about a year ago. Whether that represents the temporary effects of the recession or is the result of a structural change, the past rapid growth rates that we have seen in our ACH transactions are unlikely to continue at such a pace.

Meanwhile, debit card transactions have continued to increase, even during the recession. We have also seen the growing presence and influence of nonbank providers of payments services. For example, firms like PayPal and Amazon are introducing the capability for software developers to apply their front-end payment solution to make online purchases for specific merchants wanting to control the buying experience. Mobile access to the Internet is projected to expand rapidly with implications for the positioning of financial institutions, telecom networks, and technology firms in the payments chain.

As we step back and take a broad look at these developments in retail payments, it is perhaps striking how much of the growth is taking place in the private sector with little

regulatory oversight. The Federal Reserve and other central banks have not played as active a role in the operation or oversight of card networks, the fastest growing portion of retail payments. Many nonbank providers of payments products and services have little, if any, oversight of their operations. If this continues, it will create a significant vulnerability for our payments system.

For many in the industry, the success and profitability of payments providers is a testament to the superiority of market solutions outside the Federal Reserve or regulatory environment. “Why mess with success?” I am asked. While in the short term this may seem obvious, I want to remind you that this was also said about subprime lending, complex financial products and commercial real estate guidelines only a few years ago. It is the nature of highly profitable private providers to oppose regulation and increased competition. However, in today’s environment, and based on recent experience, it seems clear that the central bank will be held accountable for the safety and accessibility of a reliable payments system. If consumers are overcharged or disadvantaged, or if the system comes crashing down everyone will ask, “Where was the central bank? Why didn’t it protect the public and the financial system?”

So yes, candidly, I do question whether the private sector alone can provide a safe, competitive and efficient payments system over the long term.

Economic Rationale for a Government Role in Retail Payments

In general, most economists believe that markets work well in most circumstances. The exceptions arise when there are externalities or other forms of market failure. Examples are when there are interdependencies among market participants that lead to important spillover effects or

when scale economies lead to the emergence of a small number of industry providers with potential market power.

Many payments markets have a number of these features, and I would like to highlight three that seem especially important in assessing the need for central bank involvement in retail payments. First, payments markets are networks, and economic studies of networks suggest there can be severe coordination problems that may inhibit their growth and development. These involve difficulties in creating standards and in undertaking large startup capital expenditures.

Second, because of externalities and spillover effects, networks may under invest in security as individual participants look first to their own profitability and do not consider system integrity as a whole. We are all well aware of the recent rise in major information breaches and identity theft in the retail payments system. I would note that many of these instances have been centered at nonbank payments providers.

Third, because of scale economies, payments systems and electronic payments systems in particular, tend to have a small number of providers, raising concerns about market power and noncompetitive pricing. In the United States, we have seen a trend toward increased concentration in debit card networks, with a decline from 43 debit networks in 1995 to 13 in 2007. Indeed in 2007, the top three debit card networks (PIN and signature) handled 88 percent of total transactions and Visa alone had a market share of almost 64 percent. As consolidation has occurred, we have seen significant increases in interchange fees, a development that has not gone unnoticed by the public and government officials around the world.

In light of these issues, I think a strong case can be made for continued central bank involvement in retail payments. The key questions at hand focus on the nature of central bank

activities and, especially, how these activities should evolve to meet the changing structure of the retail payments industry.

Historically, the Federal Reserve's involvement in retail payments has centered on overcoming coordination problems that have inhibited efficiency. In this regard, I believe the Federal Reserve's position as an operator has allowed it to be an effective catalyst and facilitator for payments modernization.

For example, in the early 1970s, as bankers, regional payments associations, and the U.S. Treasury struggled with the increasing volume of check payments and related costs, the Federal Reserve collaborated with the industry to build the automated processing systems and distribution network that would become the ACH. And, in 1984, the Federal Reserve provided the impetus for industry adoption of another major innovation by applying digital image capture technology to the backroom of the check processing business, again in response to a need from the U.S. Treasury to reduce the costs of microfilming checks it issued. As you know, this investment was later leveraged to establish check image exchange networks.

In each of these endeavors and others, we have worked closely with the industry and Congress to develop legislation, standards, technology and procedures to overcome the severe coordination difficulties that prevented the private sector from moving ahead on its own. Even today, we continue to leverage our operational role in ACH. For example, we're working with industry stakeholders to address problems such as how to more efficiently and safely exchange payments internationally with low volumes now, but growing volumes in the future. And we are working to introduce faster ACH clearing with a same day settlement capability, which we expect to roll out in the first half of next year.

Finally, I would be remiss if I did not emphasize that in times of crisis, the Federal Reserve's operator role has served to minimize the impact to public confidence that would occur with major disruptions to the retail payments system. In the hours and days following the Sept. 11, 2001 attacks, the Federal Reserve Banks were in a position to keep the check collection system operating despite the disruption to air transportation. While the probability of disruptions is low, crises will happen sometime in the future and I believe the Federal Reserve's operator role enhances the resiliency of our retail payments system.

In the future, the Fed's traditional role of catalyst and facilitator may be less needed outside of ACH. After all, card networks have developed and prospered without Federal Reserve involvement, and the innovation introduced by nonbank payments providers has been impressive.

Thoughts on the Federal Reserve Banks' Future Role in Retail Payments

In my view, a starting point for considering the Federal Reserve's future role is to consider whether the safety and efficiency of retail payments will be enhanced by the central bank's continuing presence.

As I indicated earlier, it is not clear to me that the private sector will make sufficient investments to maintain the safety and integrity of retail payments without some sort of Federal Reserve or government pressure. Consequently, I believe it is important to ask whether the Federal Reserve, as a traditional, trusted provider of secure payments services, can play a role in helping to enhance the security of the retail payments system and reducing identity theft. More broadly, I think it is important to consider the extent to which nonbank providers of payments

services pose systemic risks to the retail payments system and to explore how they, along with traditional providers, might be more effectively monitored by regulatory oversight programs.

I also think that the Federal Reserve could play a role in enhancing the competitive efficiency of the retail payments system by leveraging its operational role in ACH to provide a platform for clearing all forms of debit transactions. Note that I am not suggesting the Fed issue debit or credit cards, but rather, that the Federal Reserve provide a cost effective alternative to moving and clearing debit transactions, and as a systemic backup to the private sector – a role it has played in payments since nearly its founding. Such an approach may require additional investments in and enhancements to the FedACH network. Some may disagree, but looking back, the Federal Reserve’s role in check payments did not drive competition out, but assured broad, safe access in a more competitive environment, to the payments system.

As I have floated this idea over the past year, I have received feedback from some who disagree. However, we need to think about the effects of the likely alternatives. As I indicated earlier, concern about noncompetitive pricing of payments services and market power have emerged around the world. This has led to significant government interventions in market pricing and market practices in a growing number of countries. The course taken in many of these countries has been to subject the card networks and market participants to greater oversight and, in some cases, to direct government involvement in interchange pricing. As you know, similar bills are pending in Congress.

My own view, like that of many economists, is that government involvement in direct price setting in any industry is fraught with problems in implementation, generally leading to poor outcomes and unintended consequences. At the same time, noncompetitive market structures and pricing, if present, do need to be addressed. One alternative, of course is greater

antitrust enforcement. My suggestion is somewhat different, to increase competition via the Federal Reserve's role in retail payments, specifically as an operator of the ACH network. Of course there may be other means of making noncompetitive markets more contestable, which also should be considered.

Summary

In summary, the retail payments system is evolving rapidly and is more complex than ever. It serves as a critical component to the infrastructure of the economy. The Federal Reserve, working closely with financial institutions and the industry as a partner and competitor has been an important driver of efficiencies and current levels of safety and stability. However, the growth in payments transactions is now occurring in card networks, and nonbanks' presence is growing. Some may call for the Fed to exit retail payments now that physical distribution is no longer needed and its share of retail payments transactions is naturally declining. However, concentration in card markets, increased concerns about security and reliability, the unintended consequences of regulation versus Fed participation in these markets, and the success of the Fed in sparking industry innovation from its position on the ground, lead me to conclude that Fed's presence as an operator is needed now more than ever.