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SPEECH

Stewart: The Global Payments System: A Central Banker's Perspective

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Remarks by First Vice President Jamie B. Stewart, Jr. before the Bankers' Association for Foreign Trade Good morning, ladies and gentlemen. I am delighted to be here today to take part in the annual meeting of the Bankers' Association for Foreign Trade.

One of my major responsibilities as chief operating officer at the Federal Reserve Bank of New York is to oversee the activities of our Bank in the payments system. Providing payments services for depository institutions is, as you know, one of the three principal tasks of the Federal Reserve, in addition to our responsibilities for monetary policy and bank supervision.

Payments system risk is special primarily because the failure of a major participant to make payments can affect the ability of others to do so, potentially creating a problem for the entire financial system. I do not think it is an exaggeration to say that confidence in the whole financial system basically rests on confidence in the payments system. This is why making changes in the payments system and managing those changes are so important.

This morning, I would like to focus my remarks on how I believe the new information and communication technologies are affecting the role of the Federal Reserve--as both service provider and policymaker--in the payments business. Further, I would like to comment on a few major challenges that the banking industry faces in payments. Finally, I would like to consider some of the emerging payments issues from the perspective of the Federal Reserve and to describe briefly what we at the Federal Reserve are doing.

From its inception, the Federal Reserve has worked with commercial banks in the payments area to provide the U.S. economy with a variety of small- and large-value payment services. Cooperation between the Federal Reserve and the private sector is a critical element in ensuring that the payments system functions smoothly, especially during periods of stress in the financial sector. While in the past it was common to talk about credit-related problems as the only source of stress, we now recognize that because of the significant changes under way, operational failures--or technology-related problems--can also be a source of stress.

One of the most important goals of the Federal Reserve today as a service provider and policymaker is to promote efficiency in retail payments by encouraging a shift from paper to electronics. To date, success has been limited. Close to 70 billion checks are written each year in the United States and the volume continues to grow, despite efforts by the Federal Reserve to promote the ACH system, which reduces unit processing costs by about one-half to two-thirds. This lack of success in the United States in moving toward a more electronics-based retail payments system contrasts sharply with the experience of several European countries. A household in Europe is four times more likely to make a recurring payment electronically than its U.S. counterpart--and those countries are realizing the cost savings.

In this context, I would like to step back for a moment and highlight some of the changes that have been taking place in the payments system in the United States in recent years. As you well know, the payments system in this country is oriented around the Federal Reserve banks, the commercial banks, and various clearing organizations for checks and securities.

In my view, the importance of payments services as a business line for U.S. commercial banks is not widely appreciated. Research undertaken at the New York Federal Reserve shows that payments-related revenue accounts for as much as 40 percent of the total net revenue of the nation's largest banks. Moreover, this revenue appears to be a rather stable source of earnings. In addition, many banks have leveraged payments services into a "suite of services" to meet a range of customer needs, including the provision of cash management products and portfolio management services.

At the same time, technological advances in computers and telecommunications are generating more opportunities for banks to leverage their payments business further. These technological developments are not just evolutionary--they are revolutionary. Let me be a bit more specific and discuss some of the ways this new technology is affecting the payments business in the United States.

First, the Internet is making it possible for consumers to receive electronic bills and to pay for them immediately, or to schedule payment at a future date, merely by pointing and clicking. Businesses are also able to access their banks over the Internet and initiate electronic funds transfers as part of a larger package of deposit and credit services that banks are beginning to offer on-line.

Second, beyond these rather straightforward applications of the Internet, one of the most striking developments is the synthesis of new and existing services into enterprise resource planning or supply chain management. Many of these supply networks are clearly global in scope. Several large commercial banks in their role as trusted financial intermediaries are seeking to leverage their account relationships with corporate customers into supply chain management. To do so, they have forged alliances with technology companies to develop the software to facilitate business-to-business e-commerce. Just to be clear, what I mean by e-commerce is using computer networks for the procurement of inputs and the distribution of final goods, together with the execution of the associated payments, without reliance on paper documents and specific physical locations.

There is no question that more timely and accurate information on product offerings, services and supply needs, orders, and deliveries are resulting in considerable cost savings for businesses. For example, improved information flows and better communications with suppliers and distributors are allowing more firms to operate with just-in-time inventories. Finally, banks are offering e-commerce services not only to their largest customers but also to small businesses, so that these businesses too are able to obtain volume discounts--estimated at about 15 percent of their procurement costs--by joining bank-sponsored trading groups.

These technological developments pose a number of challenges. I would like to highlight four of these challenges that, in my view, basically pose interrelated strategic choices for the banking industry.

The first challenge concerns what services to provide. All of the technological changes we have been witnessing create a host of possibilities for banks to leverage their payments business into other product offerings. Over time, these developments may lead to a redefinition of the bundle of services generally considered to be "commercial banking." Banks have a long history of being the "trusted facilitators of commerce." Now they are adapting themselves to fulfill the role of "trusted facilitators of e-commerce."

As these technologies develop and consolidation takes place--not just domestically but also globally--it is important to keep in sight the interests of the customers, that is, the end users of the payments services. What the customers will be looking for in this new environment are lower transaction costs, reduced information costs, and less uncertainty in managing their materials, production, and liquid assets. Customers will also be looking to have the data and information they receive from their banks flow directly into their own computer systems.

Customers--firms and households--will also be looking for simplicity and ease of use. Ultimately, the goal is to have a bank's system provide the information and guidance that firms and households need to manage their increasingly complex financial affairs. The banks that respond best to these customers' needs will use technology to dominate the market.

A second challenge facing banks is how to manage the new technology. Change is occurring through rapid cycles of innovation. New products are leapfrogging others that have only recently been introduced. For example, before PC banking over proprietary networks had become established, it was superseded by PC banking over the Internet. This technology, in turn, could soon be superseded by wireless banking from a cell phone. Not surprisingly, senior managers are raising such questions as how banks should compete, how much risk they should take, how much cost they should incur, and how extensively they should become involved in the new technology.

In this environment, where there is great uncertainty about customer acceptance, industry standards, and the cost effectiveness of any particular innovation, many banks will invest in multiple technologies. But banks have limited financing resources and need to produce a high return on their equity. As a result, banks will have to make choices under conditions of unprecedented uncertainty. My sense is that making large investments in technology under these circumstances will be very difficult for many banks, but given the importance of payments to many bank strategies, it will have to be done and done well.

A third challenge that confronts banks is how to manage competitive relationships with nonbanks. Nonbank competitors are likely to be important in virtually every arena of existing bank activities. Every day a host of existing and start-up technology companies are working on projects designed to attack any identifiable inefficiencies in the financial services sector. One banking industry response for developing new applications has been to work through consortiums of financial firms, technology companies--including start-ups--the academic community, and in some cases, government agencies. Here again, I think, the comfort limits of many bank managers will be pushed.

Making technology investment decisions will present cultural challenges for banks and require changes in mindsets for many bank managers. No longer will it be possible for banks to develop all of their business products and systems in-house. As a result, management may need to cooperate with technology companies and with other banks and perhaps to outsource certain core applications. Managers will also have to be flexible in devising and reviewing their business plans. None of this, of course, will come easily for traditional bank managers.

A final challenge facing banks is how to ensure a smooth transition to the new technologies without sacrificing the safety and soundness of current operations. Now I am putting on my bank supervisor hat: Is it better for banks to develop new and innovative business lines as part of an existing, traditional business? Or, would a more effective strategy be to operate separate but parallel units, as some banking organizations are doing?

These organizational questions are important because to succeed in this new environment, banks will need to attract and motivate managers to deal with the old technology at the same time as they put the new technology in place. They will also have to decide whether to assign managers exclusively to the new-technology business units, or to let their managers deal with the old and new technologies simultaneously. Most important, banks will have to ensure that the existing operations of clearing checks and letters of credit under the old technology do not break down before the institution is ready to rely fully on the new technology. This will be a real challenge when people see that the future lies in new technology, not the old. The risks of not managing the old technologies correctly are huge given the high volume of transactions and the high profitability of these businesses.

These are just a few of the challenges the banking industry confronts as it sorts out the implications of the new technologies for the payments system. For its part, the Federal Reserve must grapple with many of these same challenges. We at the Federal Reserve must think about how to adapt the new technologies to the payments services we provide. We, too, have to consider what our relationships will be with nonbank participants in the payments system, such as Checkfree, EDS, and the ACH operators. And, of course, we also must make certain that any new technologies incorporated in the payments system do not compromise bank safety and soundness considerations. Like most of you, we are struggling to bring a traditional organization up to speed rapidly to meet the new technology challenges.

However we meet these challenges, I believe that three aspects of the Federal Reserve's current role in the payments system will continue in one form or another. First, the Federal Reserve will remain committed to participating in the payments business as a service provider. At a minimum, the Federal Reserve must be involved in the payments system to make certain that all depository institutions--large and small--have equal access to the system. Furthermore, the Federal Reserve provides unquestionable finality in payments settlement.

In the United States, the rules governing the participation of the Federal Reserve in the payments system were formalized by Congress in the Monetary Control Act of 1980. This act requires the Federal Reserve to recover the full costs of its participation in the payments system. It also calls on the Federal Reserve to ensure that all depository institutions have access to the payments system.

The Federal Reserve's participation in the payments system is further governed by the principles set out in its own white paper, issued in 1984. This paper states that the operating services the Federal Reserve provides must yield clear public benefits. The services must also be ones that the private sector cannot be expected to provide with reasonable effectiveness, scope, and equity. Clearly, the Federal Reserve desires neither to be an unfair competitor nor to perform duties readily handled by the private sector. We are committed to not getting in the way of technological changes in the payments system.

Second, the Federal Reserve will continue its oversight role in the payments system to promote the safety and soundness of domestic and international dollar-based payments systems. To this end, the Federal Reserve helps to establish sound principles for managing the credit, liquidity, and operational risks associated with payments and settlement systems.

The Federal Reserve pursues the goal of safety and soundness in the payments system through its supervisory oversight of large depository and clearing banks as well as through cooperation with private-sector groups seeking risk reduction, of which a timely example is the CLS Bank.

As the past several decades have documented, it is in the areas of clearing and settlement that problems in the financial sector can reach the critical stage. Missed payments by a participant are often the first manifestation of solvency or liquidity pressures. The inability of a single large participant in the payments system to meet its obligations can result in the inability of other participants to make payments as well, thereby creating gridlock in one part of the system that can quickly spread.

During the period of the Asian financial crises and Russia's default on its external debt in 1997 and 1998, for example, the payments systems in some segments were occasionally strained. The Federal Reserve, along with other authorities, actively monitored these developments to ensure that the payments system continued to function smoothly. This included making certain that we were aware of liquidity and solvency issues at specific firms as well as market sentiments that could lead to systemic problems so as to ensure an uninterrupted payments and settlement environment.

Third, the Federal Reserve will continue to work with the international community to improve the functioning of payments and settlement systems worldwide. In this effort, central banks, cooperating through the BIS Committee on Payments and Settlement Systems, have published a series of reports over the past several years covering a variety of important subjects: basic standards for net settlement systems, securities clearance, ways to reduce foreign exchange settlement risk, clearance of exchange-traded derivatives, security for emerging electronic-money products, design of real-time gross settlement systems, and core principles for payments systems in developing countries.

As both a service provider and policymaker, the Federal Reserve is fully committed to seeing that advances in technology yield efficiencies and risk reductions in payments systems. For example, in the wholesale area, the Federal Reserve is already offering volume discounts for electronic payments made over fedwire. High-volume users have experienced as much as a 50 percent decline in fedwire prices over the past three years. In addition to expanding the operating hours of fedwire, the Federal Reserve has enhanced message formatting to permit greater use of "straight through processing." Further, it is offering a new net settlement service to help private-sector clearing arrangements settle with finality on a timely basis. Eighteen net settlement services have joined, including several of the major ACH and check clearinghouses, accounting for aggregate daily net settlement that ranges from $4 billion to $8 billion.

As the Federal Reserve grapples with the challenges posed by the new payments technologies, it will, I believe, hold fast to certain basic principles. For one, it will not relinquish its commitment to making more effective the public-private partnership that has traditionally shaped the payments system. Working through the Federal Reserve's Payments System Development Committee, Fed officials have been meeting with private-sector processors of payments to better understand emerging technologies such as electronic bill presentment and payment. Second, in meeting the strategic challenges that lie ahead, the Federal Reserve will continue to ensure that its basic policy goals of efficiency, broad access, safety, soundness, and transparency are incorporated in the new environment.

Finally, the Federal Reserve faces the question of how proactive to be. In my view, a careful review of its traditional role in the payments system shows that the Federal Reserve has been an important catalyst for significant, positive changes. Historical examples I would cite include the development of fedwire from a rather simple Morse code operation in 1918 to the high-speed, computerized, encrypted communications system it is today. Other examples would be the book-entry system for government securities created in the late 1960s and the magnetic coding on checks that permits high-speed processing. Despite these successes in the past, our leadership role in the future of payments technology is not assured.

The basic strategy of the Federal Reserve at this point is to keep current with changing technology and industry needs. This in itself is a huge challenge. We are prepared to take a leadership role, if appropriate, in setting standards. But the attitude at the Fed is that we will stand aside and let the private sector implement new technology if, in our opinion, that will result in an effective and safe payments system for the future.

In summary, change in the payments system today is taking place so rapidly that no one can be certain which efforts will result in commercial success and which will fail. The environment is like the venture capital business in that one needs so many investments--many of which will fail--in order to have one or two successful programs. If banks are not investing in some high-risk projects, they will be left behind. This is a situation in which banks' conservative culture and risk-averse attitude may be a competitive disadvantage.

In this environment of uncertainty and rapid change, it is critical that basic values not get lost. Regardless of what else is happening, the most basic value of a commercial bank must remain its role as a trusted and efficient financial intermediary. As for the Federal Reserve, its most basic value must be its commitment to the efficiency and safety of the payments system as part of a healthy financial structure. I believe that, underpinned by a commitment to work together, the Federal Reserve and the private sector can arrive at solutions that will preserve the safety and soundness of this country's payments system to our mutual benefit.

Thank you.