Banking in the 21st Century

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Good morning. I am pleased to be a part of this year's annual convention of the New Jersey Bankers Association. I will spend my time with you today discussing a topic near and dear to your hearts. You have already heard several convention speakers discussing various aspects of payments. Now, I would like to add to the discussion the Fed's perspectives on the ongoing changes in the payments system.

As all of you know, the Federal Reserve System has three main responsibilities: conducting monetary policy, supervising and regulating banks, and maintaining an efficient and effective payments system. This third area — the payments system — has seen a great deal of change in recent years. This convention is an excellent opportunity to discuss some of these changes and their significance for you as individual banks and as a banking community.

At the outset, I want to emphasize two points. The first is the Fed is committed to working with you to improve the reliability and efficiency of the **current** generation of payments vehicles. The second is the Federal Reserve is also committed to working with you to foster innovation and support the **next** generation of payments vehicles. Both commitments are important. We know that people's payments choices evolve slowly. It takes time for them to become comfortable with new payments methods. In the meantime, it is important that familiar, well-established payment methods be there for them.

In that spirit, the Fed will continue to fulfill its traditional role as payments processor. As mandated by the Monetary Control Act, we will continue to offer our services to all depository institutions at prices that fully reflect our costs. To be sure, achieving full cost recovery will become more challenging for us as the volume of check usage declines. But that is a subject for another time.

Today, I want to focus on a second way the Fed is supporting an orderly evolution of the payments system. That is through our advocacy of a legal and regulatory framework that enables greater innovation in the marketplace -- innovation by banks and other payments service providers — in response to evolving technologies and evolving customer preferences.

The Check Clearing for the 21st Century Act, also known as Check 21, is an example of such legislation. The Federal Reserve vigorously supported Check 21 from the outset. We saw it as a means of enabling the marketplace to achieve greater efficiency and reliability in payments, proceeding at its own pace and in its own way.

Most of my remarks today will focus on Check 21, which is scheduled for implementation on October 28th of this year. But let me begin with a few words about the broader evolutionary path of the payments system and the role of checks.

Payments and the Check

In recent years, we have experienced a surge in electronic retail payments: credit cards, debit cards, smart cards, as well as direct deposit and direct debit through the ACH. The Survey of Consumer Finances, sponsored by the Board of Governors and compiled by the Research Department at the Philadelphia Fed, documents the emerging shift to electronics.

According to the survey, fewer than 18 percent of households used debit cards in 1995. By 2001, nearly half of all households were using them. Meanwhile, the percentage of households using automatic bill payment, although still small relatively, nearly doubled. Not only did usage of all means of electronic payments increase, but the increases were registered across all demographic categories: all age groups, and all levels of income and education.

Other statistics show that the conversion of check payments to electronic transactions continues to grow rapidly. In fact, this past year, these so-called electronic check payments more than doubled, and they now exceed 100 million transactions per month.

So, consumers are using electronic payments. In effect, the U.S. is catching up to the rest of the world in its use of electronic payments. Undoubtedly, the trend will continue. Indeed, a competitive marketplace will drive banks to offer new electronic payments vehicles in response to consumer demand for greater convenience at lower cost.

Yet, the use of that expressly American payment vehicle — the paper check — remains widespread here. Research financed by the Fed indicates that check use in the U.S. peaked in the mid-1990s and has been steadily declining since then. But Americans still write about 40 billion checks a year. That represents about half of the nation's retail noncash transactions. And checks are likely to represent a significant share of payments for a long time. People see them as a very convenient, reliable, and familiar payment instrument. Bankers see them as a substantial source of revenue. So while checks will continue to decline, they will not completely disappear any time soon.

Over the years, banks have become quite efficient at processing paper checks. But as check volumes decline, the pressure will be on to find new processing efficiencies. And processing electronics is more efficient than processing paper. Recognizing this, the Fed has been committed for some time to enabling greater use of electronics in check processing. Check 21 is an important step in that direction.

Check 21 and Efficiency

The goal of Check 21 is to facilitate check truncation and electronification via imaging without making it mandatory. Check 21 accomplishes this simply by authorizing the use of a new negotiable instrument — the substitute check.

The substitute check must contain payment information identical to that on the original check and must be in a specific machine-readable format. Properly created, the substitute check is the legal equivalent of the original check. So, under Check 21, a collecting bank can truncate and image the original checks it receives for deposit, process the checks electronically, and then print and deliver substitute checks at a location near the paying bank for presentment.

Notice that Check 21 does not require collecting banks to truncate or image checks. Nor does it require paying banks to accept electronic images. Check 21 only requires that paying banks accept substitute checks as well as originals. Whether they accept the substitute checks in paper form or electronic form is strictly their decision.

Having said this, the expectation is that Check 21 will, in fact, increase electronic presentments and foster the electronification of checks at the earliest possible stage of processing. The speed with which this evolution occurs is hard to predict. Like the use of the check itself, it is likely to be a gradual process.

But, over time, we should see substantial efficiency gains as a result of Check 21. It is estimated that once the full effects of Check 21 are realized, the banking industry could potentially reduce its check processing costs by over $2 billion a year. That estimate includes a reduction of $250 million in transportation costs alone. In addition, banks will benefit from improved availability of funds, greater efficiency in processing return items, and smaller losses from check fraud.

Check 21 and Reliability

I have emphasized the efficiency gains we expect from Check 21. Indeed, industry buzz has long expounded on the efficiency gains from the electronification of checks. But there is also a benefit in terms of risk mitigation. Check 21 will help alleviate the danger of checks being lost or delayed during transport. As clearing time shrinks, credit risk is reduced as well.

From the Fed's perspective, reducing the risks associated with the physical transportation of checks is an important benefit of Check 21. Our experience in the aftermath of 9/11 focused our attention on the value of electronification from the reliability standpoint. The interruption of air travel — and check transportation — in the days after the 9/11 attacks pushed the Fed's check float up to over $47 billion, more than a hundred times the normal level.

Clearly, if image exchange had been more prevalent among banks, the impact would have been much smaller. Indeed, it was the opportunity to reduce check processing's dependency on the transportation system that motivated the Fed to approach Congress in late 2001 with the proposal that would become Check 21.

Responding to Check 21

After much discussion with the industry and consumer groups, Congress passed the Check 21 legislation in late 2003, and set implementation for October 28, 2004. As I said a moment ago, it will take some time for the full effect of Check 21 to be realized. Nonetheless, I would encourage you to begin now considering how your bank will respond to the opportunities it offers.

Many of you are already imaging checks, both to streamline internal operations and to enhance services to your customers. For you, Check 21 offers the option of using those images to collect from any paying bank by presenting a substitute check. Whether exercising this option makes economic sense, of course, depends on the relative cost of presenting a substitute check rather than the original, either directly or through a third-party provider.

Imaging banks must also make some important decisions about aggregating and archiving. As you begin to receive electronic files from more institutions, it may make sense to outsource these activities to a third-party provider.

Perhaps you are not now imaging because the internal efficiencies and customer service benefits do not justify the cost. With Check 21, the expanded opportunity to transmit images for presentments may make imaging cost effective.

But even if imaging does not make sense for you, Check 21 will require you to accept presentments of substitute checks. That means your customers will likely be getting back some substitute checks with their statements. So you must consider how you will familiarize your customers with these new instruments and address their concerns.

Whatever your bank's initial response to Check 21, I encourage you to revisit that decision regularly. As the check processing network evolves, you may discover new opportunities to electronify along the check processing chain.

As I indicated a moment ago, we know that when a check is truncated at its bank of first deposit and a substitute check is created, the collection process is enhanced by expediting presentment, improving availability, and eliminating transportation costs. But consider an extension of this process, where presentment of the substitute check is replaced by an image. In this case, the benefits are further extended to the paying bank. Accepting images for deposit eliminates back office capture of the check as well as the inconvenience of physical transportation.

Let's extend our scenario even further. Suppose the bank of first deposit receives images from its own ATMs, from its own branch offices, or even from its corporate customers. Image capture earlier in the process will further benefit the bank by eliminating check transportation, physical proof and encoding, and check sorter processing. All this is made much easier with the passage of the new legislation.

So going forward, you will find that Check 21 offers you new ways to enhance your efficiency and new opportunities to offer products that differentiate you from the competition. You will be improving your bottom line, enhancing customer service, and, at the same time, helping to increase the speed, efficiency, and reliability of the U.S. payments system.

Check 21 and the Fed as Service Provider

The Federal Reserve will also be responding to market needs during this period of substantial change in the payments patterns of consumers and businesses alike. To make this point, let me say just a few words about how the Fed, as provider of check services, is preparing to support the banking industry's best use of options under Check 21.

The Fed is investing in enabling technologies for Check 21. We want to provide all customers, regardless of size or location, the opportunity to embrace and take advantage of the many benefits of Check 21 — without significant investment on their part.

The Reserve Banks have recently upgraded and standardized their check platforms, so that our bank customers will have access to the same check processing and adjustments services at all of our locations. For New Jersey bankers —both north and south — East Rutherford and Philadelphia installed the common System platform in the fourth quarter of last year. The conversion is progressing quite well thus far. Now, we are working hard to smooth our supporting processes and improve our operating efficiencies.

As that conversion progresses, we at the Fed are looking to October and preparing the service offerings we will make available once Check 21 is implemented. Within the next several months, the Reserve Banks will be rolling out a variety of new and improved products, services, and solutions designed to support banks' best use of their new options under Check 21. In addition, to support the current paper check services, we will offer image deposit services that have lower costs and improved deposit deadlines and availability. For our payor services, we will have lower prices for items we collect via images. Also, we will convert paper items to images where we can expedite collection.

Our national archiving service, FedImage, is already available. We are expanding our capability to produce substitute checks, and we intend to increase our services available on the Web.

Over time, Check 21 will provide financial institutions opportunities to broaden deposit options and extend deposit cut-off hours. This will have an effect on the Federal Reserve too. As we increase our processing efficiencies, we will pass the gains on to our bank customers in the form of accelerated availability and enhanced deposit deadlines. In short, we are both involved in and affected by the changes that the recent legislation has imposed, and we are prepared to respond to its implications for us and for the banking industry we serve.

In addition, as part of our public service role, the Federal Reserve is working to develop communication tools that will help you to educate your customers about Check 21. Specifically, Regulation CC Section D includes a disclosure model on benefits and recredit, as well as language to introduce and help customers understand Check 21.

So, we at the Fed will continue to develop our products and expand our electronics capacity in response to the market's evolution and our customers' needs. At the same time, we will take steps to foster an environment for improved payments system efficiencies and vibrant private-sector innovations. Check 21 is an important step toward this goal, but it is by no means the final step. The impact of this change and those that follow will ultimately transform the U.S. payments system and enable a radical restructuring of its service capabilities.

Conclusion

With this let me conclude. As you can tell from my remarks today, we at the Federal Reserve are pleased to see Check 21 nearing its implementation date. While people continue to increase their reliance on electronic forms of payment, checks remain an important and trusted payments vehicle. Recognizing this, the Fed proposed Check 21 as a means of enabling the industry to make check processing more efficient and reliable. Now, banks must consider how to use the new options offered by Check 21 to create shareholder value and improve service quality.

As we move forward, the infrastructure and convention of check processing will evolve, generating new check products and services, and new ways to deliver them. We at the Fed look forward to working with you in this dynamic environment for we share a common goal — the goal of achieving all of the efficiencies this new legislation offers.

Thank you. I would be happy to answer your questions on these issues.