EMBARGOED UNTIL 9:00 a.m. PDT
Tuesday, April 16, 1996

"THE FEDERAL RESERVE'S VIEW OF THE PAYMENTS SYSTEM IN THE 21ST CENTURY"

Remarks by
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NACHA's **Payments 96** Conference
San Francisco, California

April 16, 1996

It's my pleasure to be with you here in San Francisco at this conference. Before I begin, I would like to acknowledge my colleagues, Paul Connolly and Ernie Patrikis.

Both Paul and Ernie are key players in the management of our payments system services. Within each of their specialties--retail and wholesale payments--they coordinate activities across the 12 Federal Reserve districts and work with payments system participants to establish standards and improve the U.S. payments system. Their work and insight are invaluable to the Fed. My role, as you've just heard, is as chairman of the Fed's Financial Services Policy Committee. This committee is responsible for establishing strategic direction and policies for Federal Reserve financial services nationwide.

In preparing my remarks for today's session, one theme I gravitated toward is the way in which change is reshaping today's payments system. And, considering the speed at which innovation is occurring, and the fact that we're traveling into unknown territory, it's easy to draw an analogy to the exploration of outer space. This is also a natural comparison since James Lovell, commander of Apollo 13, is addressing today's luncheon session. While it's hard for us earth-bound types to appreciate what it must be like to sit atop a massive rocket, blasting off into outer space, it is not so difficult to think of change in the payments system today as a powerful rocket--blasting all of us, the Fed included, out of our usual orbits.

Technology, of course, is one of the factors fueling the change, and it offers us some very significant opportunities to improve the payments system and strengthen the economy. But there is an important lesson to be learned about technology, a lesson that is certainly not lost on astronauts like Commander Lovell: Technology alone cannot take us where we need to go. While the Apollo 13 mission certainly involved some technological achievements, it took human ingenuity and collaboration to bring the crippled spacecraft safely back to earth. The point I want to make here is simply this: Technology is moving us very quickly into new and unknown territories that are filled with exciting opportunities. But, along the way, we must not lose sight of the fundamental goal for all payments system participants: maintaining a safe, efficient and reliable payments system that bolsters our nation's economy.

I don't mean to imply that our payments system is in imminent danger. It isn't. It remains the international model of safety and reliability and contributes to a vibrant U.S. economy. But change can often bring with it both opportunity and risk--the opportunity to make the payments system even better and the risk that change could weaken it by jeopardizing integrity or narrowing access. As we approach the 21st century, the Fed's challenge is to protect the payments system and, at the same time, foster positive change. That's what I promised to talk about today.

As I do, I'll cover three points. First, I'll review the reasons why Congress chose to make the payments system one of the Federal Reserve's three main responsibilities. Second, I'll present goals we at the Federal Reserve think the payments system needs to achieve in the 21st century. Although no one can accurately predict what the payments system will look like in the next millennium, there are some fundamental attributes it must reflect. And finally, I'll briefly outline what we believe the Federal Reserve can and should do to support those goals. I'll speak about our plans generally, then Paul and Ernie will talk specifically about retail and wholesale payments. I'll come back at the end to wrap up and, along with my colleagues, answer questions.

Let's talk now about the mandates Congress has given the Federal Reserve. According to the Federal Reserve Act of 1913, we have three main responsibilities: conducting monetary policy, supervising and regulating banking organizations, and protecting the payments system. Throughout its history, the Fed has approached all of these vital responsibilities with one broad objective in mind: To provide a stable monetary environment in which the economy can achieve a maximum sustainable rate of growth. Inflation, banking failures and unreliable payments mechanisms all distort the public's financial decisions and prevent the economy from achieving its full potential.

Not surprisingly, these responsibilities are also closely linked in an operational sense. Changes in the Fed's monetary liabilities--currency in circulation and bank reserves--are the principal instruments of monetary policy. At the same time, these central bank liabilities constitute the only means of settling transactions with finality. Because commercial banks and other depository institutions are the only ones permitted to maintain reserve accounts at Federal Reserve banks, they alone are able to extend settlement services directly to their customers. Accordingly, these institutions are regulated not only to protect consumer deposits and ultimately the deposit insurance fund, but also to ensure the integrity of our nation's payments system.

Thus, the Federal Reserve's concern for the payments system is fundamental to our role as a central bank and operationally intertwined with our monetary policy and banking supervision responsibilities. The reason for this concern is that markets for both goods and services need a safe and reliable mechanism for settling transactions. Stated differently, a sound payments system is a key underpinning of our economy. But very few users know much at all about how a payment is processed and settled. They just know the important part: When they use currency, a check or an electronic payment, rarely, if ever, is there a problem. Many people simply take the payments system for granted because it works well.

Maintaining this public confidence is an ongoing challenge as the payments system evolves to meet the changing needs of our economy. And, today's environment is an especially dynamic one. I have already mentioned technology and the wide range of opportunities it presents to improve service and efficiency. But there are other changes occurring in the marketplace that will impact the payments system as well. I'll list just a few: International payments are increasingly important in a global economy. The banking industry is consolidating, and interstate banking and branching are a reality, not a probability. And, non-banks are entering the payments system, bringing with them new ideas and different perspectives.

Given all these factors, then, the question is not, "Will the payments system be different in the 21st century?" but rather, "How will it differ?" No one can answer that question today. However, I can tell you that changes will be determined largely by market forces with appropriate involvement by the Federal Reserve as a leader, service provider and regulator. The best solutions will arise from experimentation, collaboration and the joint efforts of parties working together to set common standards and workable safeguards that are ultimately in the public interest.

As we move forward, however, it will be important for us to keep certain goals in mind, and that brings me to the second point I want to address today. The payments system in the 21st century should, as it does now, offer access to a wide variety of participants and users. It also must continue to operate efficiently, reliably and with integrity. If the payments system of the future achieves these goals--integrity, efficiency and accessibility--it will support economic growth and continue to be worthy of the public's confidence.

By integrity, I mean the control of payments risk--both temporal and systemic--to preserve broad public confidence so that the system works well even under stress. The evolving system should be reliable and risk-averse and have the highest level of integrity so that economic stability can be maintained.

Efficiency is an important goal because operation and oversight of payments systems consume substantial individual, corporate and governmental resources. We want to foster an environment in which the market is encouraged to pursue technological innovations and develop cost-effective payments systems that reduce the amount of resources consumed.

By accessibility, I mean that the system should be open to and invite full participation by all sectors of the market, regardless of location or sophistication.

The changes that are taking place today, and that will continue into the 21st century, must be examined and managed collectively by all participants to achieve these goals. It won't always be easy to judge the value of a particular change because the impact may not be exclusively positive or negative. In general, however, if a change leads to less risk, greater efficiency and broader accessibility, it will be good for the U.S. economy. But if it increases risk, limits access or makes the system less reliable, it could threaten economic expansion and stability.

In many instances, payments system participants will have to make carefully considered tradeoffs between advantages and disadvantages. For example, a change that reduces risk, but significantly increases costs, may not be worth the price participants would have to pay. Likewise, affordable changes that increase perceived risk might not be desirable if they also jeopardize public confidence. This need to seek a careful balance is why it is imperative to keep all three goals in mind as we pursue innovations in the payments system both today and in the future.

Now that I've described the Fed's responsibilities and suggested some goals, you may well be asking yourselves, "What exactly does the Fed plan to do?" We have many efforts currently under way. Some are changes we're making to our own services that are intended either to reduce payments system risk or stimulate usage of more efficient payments methods. Others are collaborative efforts with the industry--including many of you here today--to set standards and address obstacles that impede payments system progress. Paul and Ernie will address the specifics regarding retail and wholesale payments, but let me list a few of our high priorities that are general in nature.

First, Reserve Banks will work closely together in meeting customers' needs. We'll interact with depository institutions and the public at the regional and local levels through the various offices of the 12 individual Reserve Banks. We'll also work closely together across Reserve Banks to serve a national marketplace. Toward that end, we are centralizing and standardizing processing in several functions, such as ACH, book-entry securities and funds transfer. These efforts will not only improve efficiency and reliability, but also enable us to respond more quickly to changing needs. We've also established a degree of uniformity with respect to our check services and will introduce certain nationwide services next month. In addition, we are creating a new account structure to better meet the needs of banks that operate in more than one Federal Reserve district.

In the wholesale payments arena, we will continue to focus on controlling risk, increasing efficiency and improving service. In Fedwire funds and book-entry transfers, over $1 trillion are moved each day, with an increasing percentage of volume associated with cross-border transactions. There are risks associated with the increasing interdependence and overlap of the world's markets and payments systems. Expanding Fedwire hours is one effort to help address these risks. Ernie will cover these plans, among other things.

In retail payments, we will continue to provide leadership in the shift from paper to electronics. We'll do this in several ways, such as improving our own ACH services and actively educating users about the advantages of electronic payments. The Federal Reserve and NACHA are already working together to promote the use of electronic payments by many of the largest corporations and charities in America. We want to work with the industry to move payments away from paper to more efficient electronic methods, in accordance with customer needs. ACH has an obvious role to play in this migration.

But many checks continue to be written--on the order of 60 billion a year--and some experts predict additional growth of as much as 10 to 15 percent before volume starts to decline. Consequently, we also are working on ways to use technology, such as imaging and the electronic delivery of check data, to streamline check clearing operations and stop the movement of paper earlier in the process. Paul will elaborate on what we are doing in the ECP area in his presentation.

Our educational alliance with NACHA is a model for how we want to address many other industry issues--a model that incorporates collaboration and coordination with a wide variety of industry participants. We want to establish an interactive working environment among all payments system participants and maintain a continual dialogue at the national and local levels. This interaction will aim to produce consensus and action so that, collectively, we can meet the challenges of the interoperability of networks and new systems, establish security standards, protect against fraud and, in general, ensure that the payments system of the future is accessible to all participants.

We'll conduct research and share our expertise with the industry as we strive, for example, to better understand the implications of innovations such as smart cards and electronic cash. We'll provide guidance, and when necessary, nudge the market in a positive direction. But we must not act prematurely to impose rules or inhibit innovations that might prove to strengthen the payments system. As I said earlier, progress will not be achieved by a single entity. The best solutions will arise from experimentation, collaboration and the joint efforts of parties working together to set common standards and workable safeguards. In the end, if all participants have properly focused on the goals of a secure, efficient and accessible payments system, our nation will reap tremendous economic rewards.

Let me now turn to Paul Connolly who will discuss some of our efforts in the retail payments area.

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As the nation's central bank, the Fed will continue to improve services, study new options and collaborate vigorously with the industry to help shape the payments system of the future. Our economy is a diverse one. Payments system users and participants have many needs, and technology enables us to offer a variety of payment options, including choices of methods, providers, and possibly even different levels of risk.

But in the end, technology doesn't run the payments system. People do. Technology is only a mechanism--a means to an end. It takes individuals to develop rules and procedures, and an equal commitment from all parties to ensure safety and soundness. The United States has a strong payments system today--one that meets the needs of a very diverse marketplace. This is a credit to all payments system participants and to their level of commitment and cooperation. I expect no less as, together, we take on the challenges of the future.