The Federal Reserve and the Payments System

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Welcoming Remarks
"Consumer Payment Innovation in the Connected Age"
International Payments Policy Conference
Kansas City, Mo.
March 29, 2012

Introduction

It is my pleasure to welcome you to the Federal Reserve Bank of Kansas City's 2012 Payments System Conference, "Consumer Payments Innovation in the Connected Age." This is the fourth such conference hosted by our Reserve Bank, and it has proved to be an important forum for robust discussion from policymakers, industry leaders and financial institutions in the United States and abroad about the emerging issues facing the payments system. I expect this year's event, which focuses on the role of the consumer, will continue this tradition.

We live in an increasingly connected world. Smart phones and social networks are allowing us to exchange information with each other more freely, more quickly and from a wider variety of locations. This increased connectedness has important implications for our society and our economy. We have designed this conference to focus on the questions these developments pose for consumer payments.

The Federal Reserve's Role in the Payments System

The Federal Reserve should take a strong interest in these developments in consumer payments. As part of its mission to promote economic growth and financial stability, the Federal Reserve has a mandate to foster the efficiency, safety and accessibility of the payments system. Most people agree that these are appropriate goals. Yet, as the payments system becomes more electronic, views will differ on how the Federal Reserve should go about achieving these goals.

My own view is that the central bank has a clear and compelling role in assuring the financial stability of the payments system. This responsibility has always—and understandably—included both wholesale and retail payments. Their safety and reliability, including reliability of access, are essential to the smooth functioning of the nation's payments and, therefore, its economy. Each involves significant volumes. Each involves the efficient movement of goods and services, large and small, among individuals and businesses, here and abroad. And importantly, each involves trust.

Arguments that defend the Federal Reserve's role in wholesale payments apply equally to retail. Of course, wholesale payments involve clearing and settling trillions of dollars daily. And although the dollar value of retail payments is substantially smaller, consumers and businesses are involved in a billion retail payment transactions every day. An interruption in the flow of this volume can easily affect the public's perception of the safety, reliability, and access of such payments.

The Federal Reserve's Role in Retail Payments

Throughout its history, the Federal Reserve has played an important role as a retail payments operator, enabling it to bring about socially beneficial changes. In its early days, the Federal Reserve was deeply involved in standardizing check-clearing practices across the country. The practice of nonpar payment of checks resulted in tremendous inefficiencies. To avoid the charges imposed by some banks, checks would be sent on a meandering route through numerous institutions, resulting in delays of up to several weeks before final settlement.

By offering par check-clearing as one of its services to member banks, the Reserve Banks addressed this problem, providing significant cost savings for commercial banks, fostering the development of the personal check as a popular payment method and, eventually, achieving a truly national check system. This achievement led to a more efficient and accessible payments system by eliminating the circuitous routing of checks that had become a burden to both consumers and financial institutions.

Later, the Federal Reserve's role as an operator helped it bring about other beneficial changes in check-clearing, such as the adoption of high-speed check-sorting equipment and the development of electronic check imaging that resulted in a more cost-effective, fully electronic clearing system for checks. As with its earlier check-clearing efforts, the gains in efficiency provided by these innovations were obvious.

Today, the Federal Reserve Bank of Kansas City is developing applications to further streamline electronic check-clearing through our work with the Federal Reserve Bank of Atlanta, which leads the Federal Reserve's Retail Payments Office. These new systems will allow the Federal Reserve to continue to meet the mandates of the Monetary Control Act by enabling us to price services at levels competitive with the private sector. My staff is also working with colleagues at the Federal Reserve Bank of St. Louis and at the Treasury to develop and implement technologies to improve the efficiency of the government's payments processes, producing important public benefits.

Even the proponents of a narrow role for the Federal Reserve in the payments system acknowledge that the central bank played a critical role in the development of the Automated Clearing House (ACH), the first end-to-end, electronic retail payment method. The ACH has become an important payments network, representing 18 percent of noncash payments, according to a recent Federal Reserve payments study.

The Federal Reserve's operator role also has helped keep the payments system running smoothly in times of crisis. This was not only evident during the grounding of airplanes following the terrorist attacks of 9/11, but also during banking crises over the past 30 years, when the failure of financial institutions disrupted correspondent relationships.

An Evolving Role in the Payments System

Today, the payments system is evolving in ways that further strengthen the case for the central bank to continue to play a key operator role in retail payments. A skeptical person might say that there will not be agreement on the Federal Reserve's role until there is a crisis. Unfortunately, as history has demonstrated, we cannot avoid crisis situations. The question is, How will the central bank be positioned to respond? I believe the Federal Reserve is obligated to be prepared as an operator, to facilitate payments in good times and to back-stop payments in times of crisis.

Changes in commerce and technology are creating new risks to the payments system by providing criminals with novel ways to commit fraud quickly and on a large scale. In this environment, consumers and businesses could quickly lose confidence in payment methods operated largely outside the banking system. To limit the economic damage from such events, the Federal Reserve could serve to ensure there is always a trusted way for consumers and businesses to pay each other through their banks. That back-up payment method used to be checks. As checks decline, the need remains for a safe, efficient and accessible alternative.

Increased fraud and privacy risks are not the only reason for the Federal Reserve to maintain its operator role in retail payments. Many new payment methods have appeared in the last few years, and others are likely to emerge in the years ahead. As we look at person-to-person (P2P) payments services, for example, we see a fragmented market that limits the benefits consumers enjoy from the "pay anyone, anywhere" ubiquity of the check instrument. As network economies allow one of the new P2P methods to dominate, a concentrated market may deliver higher prices, restricted access and slower innovation. By staying involved in retail payments as an operator—by offering a competitively priced, end-to-end product—the Federal Reserve may help to avoid these adverse outcomes.

Finally, of the various roles a central bank can play in retail payments, the role of regulator should be limited. My strong preference is for market forces to guide the evolution of retail payments. However, where market forces fall short in achieving safety, efficiency or access goals, the Federal Reserve can aid these forces in its role as an operator, identifying services valued by its customers and competing fairly and by pricing its services to recover its costs, subject to the spirit and letter of the Monetary Control Act.

As an operator, the Federal Reserve also is well-positioned to serve as an industry catalyst, such as by hosting this conference in order to bring together and collaborate with market participants and industry experts to ensure the retail payments system continues to meet the needs of end users and, ultimately, supports economic growth.

I look forward to the upcoming discussions. Thank you.