

PAYMENTS AND SETTLEMENT SYSTEMS: FUTURE PLAYERS AND ISSUES

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Overview As everyone attending this important conference is aware, the payments system is evolving toward an ever more universal and sophisticated level of operation. Payments system innovations are an integral component of the new e-economy. In both wholesale and retail areas, new technologies, new participants, and new alliances are beginning to transform the payments system landscape. One by-product of this transformation, for example, is the blurring of the distinction between wholesale and retail activities, as when large dollar payments are made through ACH transactions. There also is the growing integration of domestic and international payments flows, as efforts are well under way to develop a functioning cross-border ACH.

Another critical factor in this new landscape is the emergence of nonbanks in the payments system, where they are playing a prominent role in significant new developments. In many instances, banks remain at the forefront of change, as with credit card usage on the Internet. But in other cases, nonbanks are dominant, as for example, Checkfree and Paytrust in electronic bill payment and presentment, PayPal in person-to-person payments, and Yodlee and VerticalOne in the aggregation arena.

Clearly, the payments system is in a state of flux, marked by intense competition and jockeying for position. Firms with new, competing products and services are attempting to reach a critical mass of users, but few have yet done so, which makes for a very dynamic and rapidly changing environment.

As this evolution of payments continues in a dynamic environment, an ongoing issue of importance is this: what roles will the private sector and the Federal Reserve play? This morning, I want to focus on this important question and put some of the key issues on the table.

The public's preferences

In assessing what might drive change and influence outcomes for our payments system, we must start by understanding the public's goals. In this regard, we have come to realize that, regardless of the mechanism involved, people expect the payments system to

possess three fundamental characteristics. First, it must have integrity--transactions must be safe, reliable, and secure. Second, it must be accessible--available to all. And finally, it must be competitive and efficient--the cost of making payments should be as low as possible.

Implications for pace of change

Assuming these three characteristics are indeed the public's priorities, there will be no significant public clamor for rapid change in our current payments mechanism. The present mechanism works well, is reliable and, is generally efficient. The public clearly is comfortable with the payments system, so payment methods will be slow to change. What does occur will need to be driven by substitutes that are every bit as reliable and efficient, easier to use, and have pricing schemes that provide incentives to change. These are significant hurdles in attempting to introduce new forms of payment.

Implications for private sector and Federal Reserve

If these payments characteristics remain the public's priorities in the future, important and evolving roles are implied for both the private sector and the Federal Reserve. But how these roles will develop relative to one another is not preordained. They are a matter of consumer and public choice. Let's look at these possible choices and related issues.

Both the private sector and the Federal Reserve have played important roles in the development of the U.S. payments system over most of the past century. The Federal Reserve, of course, serves as both a provider and a regulator of payments services. The Reserve Banks process checks, operate Fedwire, and run an ACH system. The Board of Governors writes many of the rules and regulations that create the framework for the U.S. payments system.

Given the public's preferences for integrity, accessibility, and efficiency, and the Federal Reserve's long history of involvement, what are the implications for the private sector and the Federal Reserve as we move forward? My overall message this morning is that the private sector, in responding to consumer preferences, will go a long way by itself in determining the shape of a safe, accessible, and efficient payments system. But can the private sector alone fully deliver all three characteristics to the public? To the extent the private sector cannot, to what degree should the Federal Reserve remain involved as part regulator and part participant?

Reasonable people disagree on these issues, and I would not suggest to you today that I have the unambiguous answer. But the issues are worthy of examination.

Integrity. Turning first to integrity and what private sector initiatives might produce, I am confident that new payments methods must be reliable, safe, and secure. The public enjoys these elements now and, in fact, takes them for granted, so will tolerate nothing less going forward. Firms that convince the public that their products and services are

easy to use and trustworthy will be the most likely to succeed. All others will almost certainly fail.

In addition, new participants in payments markets will often want to align themselves with products and firms that the public already trusts. It is no accident, for example, that much of the "electronification" of the U.S. payments system to date, such as check imaging, point-of-sale check conversion, and point-of-sale debit transactions with ATM cards, is linked to traditional products or processes with which consumers already are comfortable. It is also no accident that many of the new nonbank entrants are seeking to align themselves with banks and other financial institutions with established reputations. Examples of such alliances include Yodlee, an aggregator, with Citibank and Chase; and Paytrust, a bill presentment firm, with American Express. Banks would appear to have a special advantage in promoting new payments products because of their historic reliability and trust. What about the Federal Reserve? While the public's integrity priority gives private sector firms a strong incentive to stress reliability, safety, and security at the individual transaction and network level, such firms do not have such a strong incentive to take an economy-wide view of systemic risk issues. That broad perspective has been the Federal Reserve's responsibility, and the Fed will continue to meet this responsibility no matter what payments system develops.

Historically, as you know, the Federal Reserve has played a major role in examining systemic risk issues, specifically with respect to Fedwire transactions and daylight overdrafts. Going forward, the Fed will continue to be involved in studying systemic risk issues as new technologies and new interdependencies raise risk concerns across industries and, indeed, across countries. From a public policy perspective, evaluating systemic risk is of paramount importance.

As nonbank firms expand their role in the payments systems, monitoring and evaluating potential systemic risk introduced by this segment of the industry will become increasingly important. As I noted at the outset, nonbanks are leading the charge in many of the latest payments system innovations, raising numerous questions. For example, how should we regard the growing presence of nonbanks in payments? Should an attempt be made to keep the "payments system" largely in the banking sector? Or should the payments system be allowed to expand beyond traditional boundaries?

These are important topics and, I might note, not unique to the United States. They are also getting significant attention, for example, in the UK and continental Europe. But regardless of the venue, there are two points worth keeping in mind.

First, there is an important distinction between transaction and processing activities, and settlement activities. Transaction and processing activities now involve firms operating outside the banking sector. This strikes me as healthy, at least at this time. I admire the innovation and energy that are emanating from these nonbank firms, and consumers will continue to benefit.

However, settlement activities are a more complicated issue and for the present probably should stay within the banking sector. Nonbanks do not have access to the safety net, nor do they typically have credit-generating capability. Hence, a breakdown or failure within the nonbank group could potentially have serious systemic consequences unique from those of the banking industry. We must move cautiously in this arena. Here, the cost-benefit to the consumer is a more complicated equation to balance.

Second, as the payments industry continues to evolve, the bank-nonbank issue can only be evaluated on an ongoing, ad hoc basis. Understanding potential systemic risk implications and how to deal with them if they remain outside the safety net will be especially critical as we go forward.

Finally, in speaking of integrity and the Federal Reserve's role, I have focused principally on the Fed's role in assessing systemic risk and in helping regulate the safety net. But, of course, the Federal Reserve is also a provider, not just of Fedwire, but of check and ACH services. This involvement in payments has provided a useful and immediate practical facility to the payments mechanism during periods of financial crisis. It was used effectively during the eighties banking crisis and contributed importantly to the public's confidence in the payments system. I believe the Fed's involvement helped staunch a very real crisis of confidence in the U.S. banking and financial system during that difficult period.

Thus, as we speak about the future of the payments system, I am confident that for the foreseeable future, at least, the Fed will provide wire, check, and ACH products that meet the highest reliability and safety standards and that contribute to the public's confidence in our systems.

Accessibility. Turning now from the issue of integrity, I want to move to the topic of accessibility. Private sector firms seeking to introduce new payments methods have a strong incentive to promote widespread access. Without widespread access, a critical mass of users cannot be reached, and the so-called "network effect" dooms the venture to failure. Past successes in reaching critical mass include credit cards, ATM/debit cards, and the ACH network. Past failures include smart cards, at least for now in the United States, and e-cash schemes. Current critical mass battlegrounds for new products include electronic bill payment and presentment, and person-to-person Internet payments.

I would point out, however, that reaching critical mass for a payments product does not require universal access and, indeed, providing access to certain segments of the population may be judged unprofitable at a given price point. For example, economies of scale considerations may mean that smaller, low-volume customers are excluded. Thus, universal access to new payments methods is not a guaranteed private sector outcome.

This is the access issue that concerns Independent Community Bankers of America and similar groups as new electronic payments systems develop. While such groups have been reassured that they would have access--at a price--they worry that the price, in effect, may put them out of reach of the payments mechanism. This is an important issue

as it has brought the Federal Reserve's role as participant in the evolving payments mechanism into sharper focus and controversy, for reasons other than concern for systemic risk.

Historically, of course, the Federal Reserve has provided universal or near-universal access to the check collection system and the ACH network. Looking forward, however, some payments systems participants are concerned that depository institutions and their business and household customers may not always have sufficient access to emerging electronic systems. As checks decline in importance, these participants fear they will be disadvantaged as large-scale alliances and the consolidation of electronic networks raise the potential that dominant participants will exercise undue market power in both access and pricing.

Such a possibility has caused some to suggest the Federal Reserve make its electronic payments infrastructure available as the "switch of last resort." While such a suggestion is intriguing--or frightening, depending on your perspective--it most certainly raises important issues. For example, is the public's need for universal access of sufficient importance to warrant such entry? Are systemic risk issues sufficient to warrant a role for the Federal Reserve in participating as a payments switch? If not sufficiently important by themselves, do these issues in combination warrant such entry?

In the accessibility context, a case may develop for the Federal Reserve to be a provider, not just of check, ACH, and funds transfer services, but of other electronic payments services. But it is too early to define the boundary for Federal Reserve involvement, because electronic payments, including switching systems, are still evolving. There is no evidence yet that the private sector will fail to provide universal access at affordable prices. But access is an issue that should be addressed—and seriously—and it will be a very hotly debated topic. And from a public policy perspective, it would be healthy for the Federal Reserve to increase its efforts to evaluate network activities and assess potential impacts on the public's ability to access payments as safely, easily, and affordably in the future as it does today.

Efficiency. Finally, let me turn to the topic of efficiency. To maximize profits and value to shareholders, private sector firms introducing new payments methods have an incentive to be as efficient and cost-effective as possible. If the product or service they offer is successful, new entrants will be induced into the market, promoting efficiency. As long as a competitive environment prevails, firms will tend to provide consumers the products and services they want at the lowest possible cost.

The U.S. economy is one of the most efficient and competitive in the world, and in the payments industry, as in most others, the private sector should be as unbridled as possible. We have achieved our remarkable economic performance of recent years in large part because of our private sector's initiative and drive.

What should the Federal Reserve's role be in this efficiency/competition context? In my view, this is another instance where the Federal Reserve's dual role may be beneficial. In

its regulator role, the Federal Reserve can serve a useful purpose by establishing rules and standards and by facilitating interoperability between similar payments products. Electronic check presentment and digital imaging, for example, are areas where the Federal Reserve and the industry seem to agree that common standards and practices would be beneficial.

In addition to facilitating standards, the Federal Reserve might take a leadership role in clarifying legal uncertainties that may be inhibiting the use of new products and services. As an example here, the Fed is currently looking into possible ways to clarify responsibilities of payments aggregators and check conversions at point of sale.

It is in the Federal Reserve's provider role, however, that it might continue to effectively promote efficiency and competition in the payments system. In this role, the Federal Reserve is a participant in the market. It competes under rules established by Congress and in this sense promotes efficiency at the individual product level, such as in checks and ACH. As a competitor, the Fed has incentives that drive it toward greater efficiency. When it is to the Fed's advantage, from a competitive and efficiency perspective, it has an incentive to introduce new products or services that might help move the payments system away from paper and toward more efficient electronics, such as previous initiatives in truncation and check imaging check products. If, indeed, such activities promote economy-wide efficiency, then the Federal Reserve's role as competitor is in the public interest.

Federal Reserve's dual role. Finally, as I have discussed the topics of efficiency, accessibility, and integrity, one persistent thread is the sometimes controversial matter of the Federal Reserve's dual role of provider and regulator. While there are reasons why the Federal Reserve might extend its operations role in the payments system, there are also good reasons to be cautious.

Certainly there are issues associated with these dual roles. Could or would the Federal Reserve use its regulatory role to its advantage relative to the private sector? To the extent the Fed is mandated to price to recover its production cost plus a private sector adjustment factor, and to the extent that it is open to audit, I believe the Fed's regulatory role would not be a major detriment to private providers and would benefit consumers of payments products.

Beyond competitive presence, another possible advantage in the Federal Reserve's active role in the payments system could, and I suspect would, be less proliferation of regulations designed to protect consumers accessing the payments system. As the Federal Reserve competes, it will tend to reduce rents that might accumulate to those institutions that experience large economies of scale and market share control. One could argue, for example, that this has been a benefit of the Federal Reserve Banks' role in the check business.

Thus, rather than take the public utility approach and aggressively regulate the evolving payments system--an option that the UK is seriously considering--the Fed instead could

remain a player in various payments areas, enhancing competition and access. One advantage of this approach would be that private sector innovation would be encouraged rather than stifled by restrictive regulation. This rationale is, at least, worth considering.

Maintaining and improving the integrity, accessibility, and efficiency of the payments system are clear public policy objectives, and remain important rationales for the Federal Reserve's presence in the payments system, both as a regulator and as a provider.

Lastly, a public policy issue, which I note here in passing because I am so often asked about it, is the effect of new payments methods on monetary policy. In today's environment of low effective reserve requirements, the demand for reserves is increasingly determined by settlement needs. Consequently, the effectiveness of interest rate targeting is linked in part to payments system developments. This is another area where the Fed will need to remain vigilant and "quick on its feet."

Conclusions

In closing, let me reiterate that technological advances and changing industry structure are two key forces clearly impacting the U.S. payments system. However, the acceptance of new payments methods is likely to be modest given the public's priorities of integrity, accessibility, and efficiency--three characteristics that current payments methods already largely provide. The public's preferences will also have important implications for the roles of the private sector and the Federal Reserve in the future. I suspect that the Federal Reserve will continue to play an important role--both as a regulator and as a provider--as the U.S. payments system evolves in this electronic age. The question at issue will be not whether the Federal Reserve should play a role in the future, but the degree to which it will be involved. And that, no doubt, will be an interesting debate.