

Mark W Olson: The Federal Reserve in an electronic world

Remarks by Mr Mark W Olson, Member of the Board of Governors of the US Federal Reserve System, at the 2005 Payments Conference, Federal Reserve Bank of Chicago, Chicago, 19 May 2005.

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Michael, thank you for your kind introduction and for the opportunity to share with you my perspective on the forces shaping today's payments landscape. We have heard a great deal during this conference about various innovations within the payments system and how payments providers can take advantage of them. What I would like to focus on this morning are some of the effects that these innovations, and market changes, in general are having on the payments industry and to address the role of the Federal Reserve in this time of rapid market change.

Let me begin with a review of marketplace changes. It is clear that a market-driven change is under way within the payments system. Overall, users of the payments system are moving away from the use of paper checks and toward much greater use of electronic payments. A recent Federal Reserve study shows that in 2003, for the first time ever, the number of electronic payments in the United States exceeded the number made by check. Although checks are likely to remain an important part of the payments system for some time to come, a long-term decline in the use of the check appears, finally, to be taking hold. Still, it is important to remember that this changeover has been a long time in coming. After all, electronic wire transfers have been around for most of our lives and debit cards and the automated clearinghouse (ACH) system were developed three decades ago.

There is, of course, more to the story of increased use of - and confidence in - electronic payments by consumers, businesses, and governments. The payments industry itself is taking innovative steps to collect more payments electronically. Let me highlight two of the most significant innovations. The first one, which was discussed earlier at this conference, is electronic check conversion. Simply put, electronic check conversion amounts to using the bank account and routing information printed on a check to debit a consumer's bank account electronically via the ACH system or a debit card network. In 2004, more than 1 billion checks were converted to electronic payments using the ACH system, reducing the number of checks that would otherwise have entered the paper collection system.

Electronic check conversion is sometimes confused with innovations associated with the Check Clearing for the 21st Century Act (commonly known as Check 21). This very important law will ultimately bring about fundamental changes to the check-collection system, because it facilitates the adoption of check truncation and electronic collection of checks through the action of market forces. I would note, however, that even before Check 21 became law, one out of every five checks collected through the Federal Reserve Banks was being presented electronically.

Check 21 contains consumer protection provisions that differ from those provided under electronic check conversion. But the substantive rights of consumers are very similar whether they are derived from check or electronic fund transfer law.

To date, little has changed within our national check collection system since Check 21 came into effect a little more than six months ago. However, as banks make the investments necessary to take advantage of Check 21 and modify their operations to make the best use of the new technologies, the acceptance of digital check images for presentment and return of checks will accelerate. And costly substitute checks, though they are critical to the change allowed by Check 21, will eventually be looked back on as a transitional vehicle that helped achieve greater electrification of payments.

Overall, a more electronic payments system will benefit society and will help improve payments system efficiency. The need for physical transportation of paper checks will decrease. With more channels for processing payments, the payments system infrastructure will become more diverse and more resilient. At the same time, however, the payments industry will have to rely more heavily on key telecommunications networks and computing systems. Mitigating the risk associated with greater reliance on electronic processing is vital and should be a top priority for the payments industry.

There are other challenges arising from the ongoing transition to a more electronic system. Many payments providers are trying to determine how best to manage investments in paper check processing as check volumes decline. Many are also trying to decide what, if any, investments to

make to take advantage of the authority provided by Check 21 to convert checks to electronic funds transfers.

Changes within the payments system are also presenting challenges to the Federal Reserve System. Since 1999, the number of checks collected through the Reserve Banks has fallen nearly 20 percent, and the pace of decline is accelerating. The Reserve Banks have undertaken a range of cost-reduction initiatives to keep pace with the declining volumes, including an ongoing realignment of their check collection operations. Among their restructuring efforts is a reduction of the number of offices at which checks are processed from forty-five as of 2003 to twenty-three by early 2006. As the check market continues to shrink beyond 2006, the number of check processing centers will almost certainly decrease further.

The Reserve Banks are also increasing their use of technology as part of a longer-term business strategy to facilitate the greater use of electronics in check processing. That strategy includes providing products and services that help banks take advantage of Check 21. To date, the adoption of those services has been slow, however. On average, only 400,000 of the 50 million checks the Reserve Banks collect each business day involve the deposit of digital check images or the printing of substitute checks. Using Internet technology, the Reserve Banks are improving customers' access to such core clearance and settlement systems as ACH and Fedwire. They are also offering new services consistent with heightened customer account activity and risk management capability.

Any discussion of the Federal Reserve's evolving role in payments would be incomplete without a review of the Fed's role vis-à-vis its private-sector competitors. From its inception, the Federal Reserve considered its role in payments to be an important component of its central bank responsibility. The Fed's check and ACH services, in addition to Fedwire for commercial transactions, have provided a consistent, reliable, and efficient payment capability that has enhanced the performance of the U.S. economy.

While the Fed has had a significant role in payments, it has not been the only player. The Monetary Control Act of 1980 (MCA), by requiring that the Fed explicitly price all the fee services it offers to banks, establishes, as a matter of public policy, a competition between the Reserve Banks and the private sector in the provision of payment services, to ensure that the efficiencies of market competition are realized fully.

Other legal and policy limitations on the Reserve Banks also affect the Fed's competition within the private sector in the provision of payments services. First, the Reserve Banks, as directed by the MCA, must make their payments services available to all depository institutions - in contrast to private-sector competitors, which may offer their services to a limited, more profitable market segment. Second, the Reserve Banks, again as directed by the MCA, must recover, over the long run, the full direct and imputed costs of providing payments services to depository institutions. While the Reserve Banks' competitors also must recover their costs, they may, in addition, offer non-payment-related services that the Reserve Banks may not offer, thereby giving competitors greater flexibility in recovering payment service costs.

This mix of competition and statutory obligation is highly beneficial to consumers and businesses alike and is an important source of efficiency and innovation within the payments system. The Reserve Banks' direct involvement in the payments system and ability to facilitate the adoption of standards and practices through their operating circulars also helps the Federal Reserve achieve its broader public policy goals, such as improving the efficiency and smooth functioning of the payments system.

Unlike the Federal Reserve Bank obligations under the MCA, private-sector payment providers have a single-sided option. That is, they can compete in any segment of payments without the requirement to offer a full range of payment alternatives. As will be discussed later, this competitive option for private-sector firms is good for the consumer.

There are many examples of private-sector payment providers making strategic decisions on payments that affect competition. One example involves check-clearing services. Many large banks with significant correspondent banking networks have historically offered check-clearing services to downstream correspondents as a core component of their product mix. Through consolidation, some of those banks have discontinued all or parts of their correspondent banking services. Others have promoted their check-clearing services, as the incremental cost of clearing checks is small relative to their existing fixed-cost structure. As this example suggests, banks have a wide range of strategic reasons for either discontinuing or expanding their check-clearing operations, and their pricing strategies can be as varied as their strategic reasons for participating in the business.

Other examples of strong private-sector competition provided by the Clearing House Interbank Payments System (CHIPS) and the Electronic Payments Network (EPN), are the large-value funds transfers and ACH processing services to an increasing number of large banks that originate many of these payments. A diverse mix of banks, corporate credit unions, third-party processors, and other service providers also provide competitive payment services in markets across the country.

An important question raised by the ongoing innovation and change in the payments system is whether regulatory response is necessary. At this conference we have heard a variety of opinions on this topic. Some believe that as payments are made and collected in new ways, certain laws and regulations need to be clarified. Others suggest that the change offers a unique opportunity to reconsider the relationships among legal and regulatory regimes that support the payments system.

When considering the need for regulatory response, it is instructive to recall efforts by committees of both the House and the Senate in the very tech-conscious environment surrounding Y2K. After extensive hearings, committees concluded that caution should be exercised in changing laws and regulations to accommodate technological innovations. This sensible conclusion was based in part on two important realizations - first, that however well intended, efforts to alter current laws and regulations may assume that today's technological state of the art will also be tomorrow's and, second, that any changes based on that assumption could have the unintended consequence of stifling innovation.

Rather than attempting to address specific technological changes, a starting point might be to identify certain principles. One principle, for example, might be that regulation in general (not just regulation within the payments system) should be effective and as clear as possible, and should support market-led innovation. Another principle might be that payments laws and regulations should be viewed holistically. As the distinctions between paper and electronic payments become increasingly blurred, there may be opportunities to simplify existing laws and regulations to achieve greater consistency among them.

But I would be wary of making fundamental changes to the existing regulatory regimes without substantial study and careful consideration of the potential implications. Careful consideration would argue for a gradual, cooperative approach to identifying regulatory concerns and impediments to innovation and to address those concerns in a way that meets the needs of our economy for flexibility and growth. Of course, government organizations must carry out their specific mandates and act according to the public interest.

The development and enactment of Check 21 offers a good example of this approach. As you may recall, the development of Check 21 began as the result of the banking industry identifying legal barriers to clearing checks electronically - specifically, state laws governing check collection that allow banks to demand that the original checks be physically presented for payment. Although these laws typically allow banks to agree to alternative presentment arrangements, the large number of banks in the United States has made the widespread adoption of electronic check collection through agreement extremely difficult. The Federal Reserve worked with the banking industry, consumer groups, and legal experts to analyze these barriers to innovation and determine how best to address them. The resulting legal innovation was the introduction of paper substitute checks that are legally equivalent to original checks, thereby allowing banks that choose to collect checks electronically to create and present substitute checks to paying banks that demand presentment by paper check. The resulting proposal was then presented to Congress and formed the basis of what became known as Check 21.

This bit of history leads me to the role of the Federal Reserve in regulating the payments system. While the Federal Reserve has an interest in the smooth and secure functioning of the overall payments system, our regulatory authorities are specific to only certain operational aspects of the system, such as the interbank collection of checks, and specific consumer rights and protections, such as consumer liability for unauthorized electronic funds transfers. These authorities are derived from statute.

With regard to the operational aspects of the payments system, the Federal Reserve is responsible for regulating the operations of the Reserve Banks, particularly their check collection and wire transfer activities. The Federal Reserve also has regulatory authority, under the Expedited Funds Availability Act and Check 21, for various aspects of the collection and return of checks by banks.

The Federal Reserve's regulatory authority over electronic payment operations is limited to those of the Reserve Banks. Instead, the private sector, through bank associations, card networks, and other cooperative rule-setting bodies, establishes many of the operating rules for electronic payments. For

example, NACHA - the National Automated Clearing House Association - sets the operating rules and establishes contractual liabilities and warranties among the banks that participate in the ACH system. Similarly, Visa, MasterCard, various electronic funds transfer networks, and card companies establish the particular operating rules their members must follow in their credit and debit card operations.

A potential implication of this distribution of rulemaking authority within the payments system is that as more payments are made by ACH or by debit and credit cards, the relative importance of private-sector rulemaking may increase. At the same time, as checks are increasingly collected electronically, the Federal Reserve may need to use its regulatory authority over the interbank check collection system more actively. In particular, we will be monitoring the banking industry's experience with the Board's regulations implementing Check 21 and will revisit them over the next few years to determine whether any refinements are necessary.

With regard to consumer rights and protections, the Board has a more extensive role with both checks and electronic payments. For checks, the Federal Reserve's statutory authorities relate to the obligations of banks to make deposited funds available to their customers and to recredit their customers for losses suffered as a result of receiving a substitute check. We take these responsibilities seriously. For example, we monitor developments in the check-collection system on an ongoing basis to determine if the maximum permissible hold periods in Regulation CC should be shortened. If we find sufficient improvement in check-collection and return times, particularly as more banks make use of Check 21, we will reduce the funds availability schedule accordingly.

For electronic payments, specifically debit cards and ACH, the Federal Reserve has equally important responsibilities. They include establishing the rules that help protect consumers from unauthorized transactions and the various reporting and notice requirements associated with electronic funds transfers that must be made to consumers.

The card associations and private-sector rulemaking organizations complement these regulatory protections and disclosure requirements by offering additional rights, protections, and notices. For example, the card associations provide consumers with "zero liability" for certain unauthorized credit and debit card transactions that are processed on their networks.

While the private sector plays an important supplemental role in the area of consumer protections and notices, the Federal Reserve has become increasingly active in this area. For example, we have clarified that consumers have the same general rights under Regulation E (Electronic Funds Transfers) when their payments are made via electronic check conversion as they do when they pay their mortgage automatically each month.

We also are considering how to address concerns about the notices that consumers receive when their checks are converted to electronic payments. We have found that the quality of these notices varies tremendously, creating some confusion among consumers about what they are authorizing. The Board is considering whether to revise the commentary to Regulation E to include model language that could be used in these consumer notices. We are also considering whether to require, along the lines of current industry rules, a written authorization signed by the consumer when the check is converted at a merchant location.

I expect that the need for further clarification of regulations by the Federal Reserve will only grow as more innovation occurs within the payments system.

An important conclusion from this discussion is that the role of the private sector is growing. This is happening in all segments of the payments system, from providing payments services, to setting industry rules or establishing industry technical and operational standards, to providing consumer rights and protections.

Nevertheless, the Federal Reserve will continue to have an important role within a more-electronic payments system. We will continue to monitor developments within the payments system to better understand their implications. As a policymaking body, we will continue to promote the integrity and safety of the payments system while also supporting improvements in efficiency and accessibility. We will facilitate private-sector efforts to improve the payments system through a combination of dialogue and leadership. Where appropriate, we will work cooperatively with the private sector to identify and remove regulatory barriers to innovation and efficiency within the payments system. And, finally, when necessary, the Federal Reserve will act as a catalyst to greater efficiency, safety, and accessibility within the payments system.

I would be happy to answer any questions you may have.