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Direction of Supervision: Impact of Payment System Innovation on Community Banks

Remarks by

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at

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It is a pleasure to be here today. I appreciate the invitation to speak to you as part of this year's Banking Outlook Conference at the Federal Reserve Bank of Atlanta.[1] I think this year's theme, *Age of Advancement: The Intricacies of a Digital World*, captures the dynamic and evolving landscape of our country's financial system well. Advances in technology are occurring at a rapid pace and present the opportunity to make our financial system safer and more efficient for more Americans.

From faster payments to artificial intelligence, technological advancements touch nearly every aspect of our financial system and affect institutions of every type. As the first Federal Reserve governor to serve in the role designated by Congress for someone with community banking experience, I am especially interested in the impact these kinds of advancements may have on community banks. I am also committed to ensuring that as policymakers and supervisors navigate the intricacies of today's digital world, we do so in a way that considers the important role of community banks in cities and towns and rural communities across the country, and our nation's financial system more broadly. To that end, I believe the Federal Reserve is well positioned to support innovation and the future of banking in a way that ensures our nation's evolving financial system works for community banks and the customers they serve. So I would like to spend my time with you today focusing on how the Federal Reserve can achieve this objective in one specific area, that of our nation's payment system.

[1] These remarks represent my own views, which do not necessarily represent those of the Board of Governors or the Federal Open Market Committee.

Importance of Community Banks and the Payment System

As many of you may know, before joining the Federal Reserve, I was a community banker and more recently had the privilege to serve as the Kansas State Bank Commissioner. I have seen firsthand the vital role that our nation's community banks play in the financial industry and in the economy more broadly.

Through the services they provide, community banks help support strong cities, towns, and rural communities across the country, which are central to a vibrant economy. For example, small business lending is an essential part of community bank portfolios. Many community banks often specialize in serving small businesses, which account for the majority of new job creation in the country.[2] In fact, community banks hold 48 percent of all loans to small businesses and farms in the United States.[3]

Community banks are also often seen by their customers as an important source of financial advice and a source of civic leadership.[4] Community banks have a deep understanding of their local areas. They also have close relationships with those living in the communities they serve and the organizations that serve those communities. In many instances, community banks are also serving markets that tend to be neglected by larger banks. These connections allow community banks to focus on specific local needs to provide a variety of services, which often include tailored and innovative products. Payment services in particular are a key component of these relationships and are

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[2] See U.S. Small Business Administration, Office of Advocacy, *Frequently Asked Questions* (September 2019), https://cdn.advocacy.sba.gov/wp-content/uploads/2019/09/24153946/Frequently-Asked-Questions-Small-Business-2019-1.pdf.

[3] Data on loans were compiled from Consolidated Reports of Condition and Income, also known as Call Reports, that banks file with the Federal Financial Institution Examination Council.

[4] See Board of Governors of the Federal Reserve System, *Perspectives from Main Street: Bank Branch Access in Rural Communities* (Washington: Board of Governors, November 2019), https://www.federalreserve.gov/publications/files/bank-branch-access-in-rural-communities.pdf.

essential to the role of banks in their communities. Community banks help ensure that consumers and businesses can safely and efficiently access and move their money. By doing so, the payment services they provide act as the foundation for economic activities that help cities, towns, and rural communities grow and thrive, which in turn is essential to a strong and stable financial system.

A strong and stable financial system also depends on the smooth functioning of the nation's payment system. Today, many Americans take the ability to move money across the country safely and efficiently for granted, but history shows that payment system disruptions can affect the economy more broadly.[5] In the past, our nation's payment system was fragmented and inefficient, creating costs for consumers, merchants, banks, and, ultimately, the U.S. economy. For example, before the Federal Reserve was established, check clearing fees and banks' efforts to avoid them often led to circuitous check routing, with recipients facing long, unpredictable delays in receiving their money. When they did eventually receive their money, fees had often consumed a considerable portion of what they were expecting. In extreme instances, this led to checks moving from city to city before eventually ending up at their destination. One often-cited example described a check that started in Rochester, New York, and traveled to Jacksonville, Florida, then to Philadelphia, Baltimore, and Cincinnati before it finally reached its final destination in Birmingham, Alabama.[6] To put that in terms of miles traveled, if the check had gone directly from New York to Alabama, it would have

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[5] "Policies: The Federal Reserve in the Payments System," Board of Governors of the Federal Reserve System (issued 1984; revised 1990), https://www.federalreserve.gov/paymentsystems/pfs_frpaysys.htm.

[6] Noted by Federal Reserve Chairman W.P.G. Harding in Robert Kramer and W. Putnam Livingston, "Cashing in on the Checkless Society," *Harvard Business Review*, September/October 1967, p. 143; Bill Medley, *Highways of Commerce: Central Banking and the U.S. Payments System* (Kansas City: Federal Reserve Bank of Kansas City, July 2014), p. 23, https://www.kansascityfed.org/~/media/files/publicat/highwasyofcommer/highwaysofcommerce.pdf?la=en.

traveled about 1,000 miles. Instead, it traveled 3,000 miles up and down the east coast, likely for days, before it finally reached its destination. The distance from Atlanta to Los Angeles is shorter than the route that check took.

These kinds of inefficiencies were so significant that one of Congress's motivations in creating the Federal Reserve was ensuring a safe and efficient nationwide payment infrastructure. Shortly after they opened for business, the Reserve Banks began providing a nationwide check collection service. This service helped speed up payments by reducing circuitous routing. It also facilitated access to more-efficient payment services for banks across the nation. Since then, the Federal Reserve has continued to support ongoing efficiency improvements in the nation's payment system, including the development of the Fedwire funds transfer system and the implementation of the automated clearinghouse, or ACH system, in partnership with the private sector.

This operational role has allowed the Federal Reserve to support the goal of a safe and efficient payment system throughout its history. It has also contributed to widespread public confidence in the nation's payment infrastructure. At times, the Federal Reserve has taken extraordinary steps to ensure the payment system can function reliably. After planes were grounded on September 11, 2001, in the aftermath of the terrorist attacks in New York and Washington, D.C., the Federal Reserve arranged alternative transportation for millions of checks that normally would have moved across the country by plane. The Federal Reserve also started giving immediate credit for all checks that it received. This provided a key source of liquidity for the payment system and temporarily caused the daily float held by the Federal Reserve to increase over 6,000 percent.[7] After September

[7] Medley, *Highways of Commerce*, 105, https://www.kansascityfed.org/~/media/files/publicat/highwasyofcommer/highwaysofcommerce.pdf?la=en.

11, the Federal Reserve also took steps to improve the future efficiency of the nation's check collection system by working with Congress on the passage of the Check 21 Act in 2002.

A safe and efficient payment system also needs to be accessible, because payment services are most valuable when you can pay anyone regardless of where balances are held. The ultimate success of any effort to modernize the U.S. payment system depends on adoption across the entire banking industry. Therefore, in considering the Federal Reserve's provision of payment services, Congress took steps to try to ensure access to services across the country. As a result, Congress specifically tasked the Federal Reserve with taking into account an adequate level of services nationwide when providing and setting fees for payment services.[8] The United States has a highly complex banking system with more than 10,000 depository institutions spread over wide areas with differing payment needs.[9] Over 4,800 of those are community banks.[10] In many areas, particularly rural areas, community banks may be the primary providers of banking services for individuals and small businesses. Community banks are, therefore, essential in ensuring access to safe and efficient payment services in towns, cities, and rural communities nationwide so that payments can move across the country regardless of geography—from here in the South, to the Midwest, and coast to coast.

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[8] The Monetary Control Act of 1980 requires in part "due regard to competitive factors and the provision of an adequate level of such services nationwide . . . ."

[9] Including both FDIC-insured commercial banks and savings institutions and federally insured credit unions. See FDIC, *Quarterly Banking Profile, Third Quarter 2019* (volume 13, number 4), https://www.fdic.gov/bank/analytical/qbp/2019sep/qbp.pdf#page=1; NCUA, *Industry at a Glance* (quarter ending September 30, 2019), https://www.ncua.gov/files/publications/analysis/industry-at-a-glance-september-2019.pdf.

[10] See FDIC, *Quarterly Banking Profile, Third Quarter 2019* (volume 13, number 4), https://www.fdic.gov/bank/analytical/qbp/2019sep/qbp.pdf#page=1.

Community Banks and Payment System Innovation

A diverse banking system where institutions of all sizes are able to innovate and meet evolving customer needs is essential to ensure access to safe, efficient, and modern payment services for communities across the nation. At the Federal Reserve, we support the responsible use of technology and innovation to transform the financial system and reduce frictions and delays, while preserving consumer protections, data privacy and security, and financial stability. But as technology continues to advance, the intricacies of our digital world become more complex, and I believe we can help ensure that banks are well positioned to take advantage of these technology advancements and innovations. Like the rest of the financial industry, community banks are investing in new technologies and innovations to meet the growing expectations of their customers. With their considerable understanding of local needs, community banks are able to put these kinds of innovations to use in meeting the specific needs of their communities. At the Federal Reserve, we are actively engaging with the banking industry to encourage responsible innovation in the community-banking sector.

But I also firmly believe that we cannot just say community banks need to engage in responsible innovation, we need to empower community banks to do just that, and I am committed to working with my colleagues to realize this objective. I believe it is our responsibility as a payment service provider and supervisor to ensure that our nation's evolving financial system works for community banks. Because by empowering them to provide modern and innovative services to their customers, we also ensure that Americans across the country can make payments safely and efficiently.

First, as a provider of payment services, the Federal Reserve has a long history of supporting community banks. We have long-standing relationships with, and the nationwide infrastructure to provide services to, thousands of community banks across the country. While the existing payment infrastructure provided by the Federal Reserve has generally served community banks and the nation's economy well, advances in technology have also created opportunities to modernize these payment services. Collectively, these efforts will create a modern payment infrastructure that provides community banks the ability to meet customer expectations in offering innovative services with the same effectiveness and efficiency as other providers. This in turn will provide consumers the ability to better manage their financial lives by accessing accounts when and where they choose and providing more flexibility to manage money and make time-sensitive payments.

To start, the Board has supported changes to existing Federal Reserve services. For example, at the end of last year, the Board announced changes to support adoption of an additional same-day ACH window available later in the day. When it was adopted in 2015, same-day ACH allowed for faster processing and return of recurring, low-cost payments such as payroll and bill payments. This additional window will help to make the benefits of same-day ACH more broadly accessible. More specifically, it will allow banks and their customers, particularly those located outside the eastern time zone, to use same-day ACH services during a greater portion of the business day.

Our modernization efforts do not stop with existing services, though. The FedNow℠ Service, announced last August, will create a new payment infrastructure for institutions of all sizes to offer innovative faster payment services. Community banks in particular were strong supporters of developing the FedNow Service. Many of them emphasized that the Federal Reserve's long-standing policy commitment to promoting nationwide access would result in a service that is accessible to banks of all sizes. They felt that this in turn would ultimately increase the long-term likelihood of being able to offer faster payment services in their communities. Community banks continued to voice strong support in response to our most recent request for comment on the design of the FedNow Service. At the same time, they raised a number of important issues, including interoperability, time to market, and use of volume-based pricing. These issues are important to community banks, and as such, they are important to me. I intend to work with my colleagues so that the FedNow Service meets the needs of community banks and their customers. I hope that you will continue to engage with us, continue to provide your feedback, and continue to be patient as we undertake this effort to develop the FedNow Service. Because with your input, I believe the Federal Reserve can continue its long history—which started with bank notes and checks, then continued with ACH—of providing infrastructure that supports the independence and success of community banks for the long term.

It is also important to understand that technology advancements affect more than just the payment infrastructure behind-the-scenes. Innovations in consumer and other end-user experiences, such as those facilitated by fintech firms, can also transform the way that consumers interact with their financial institutions, offering community banks additional opportunities to serve their customers in the future. For instance, I have previously discussed how working with fintech firms may offer community banks potential partnerships that leverage the latest technology to provide customer-first, community-focused financial services and provide customers with efficiencies, such as easy-to-use online applications or rapid loan decisionmaking. These kinds of strategic partnerships harness the indispensable knowledge and trust that community banks have built with retail customers and local small businesses. For example, we have seen community banks experience significant growth after partnering with fintech companies to offer checking accounts for online investors, personal loans, and debit cards. We have also seen such partnerships increase efficiency in service offerings, such as significantly reducing loan approval processing time. We expect that the efforts to modernize our payment infrastructure that I outlined earlier, such as FedNow, will serve as a foundation for this kind of innovation to flourish, and will support new opportunities for community banks and the communities they serve.

Of course, new technology is also subject to many of the traditional risks banks have managed in the past with more-traditional consumer services, and implementation of new technology should be driven by banks' business strategies and customer needs. Ultimately, banks remain responsible for conducting due diligence and understanding the risks faced by their organization. But technology advances quickly, and new developments inevitably raise new questions. That is why I believe that the Federal Reserve also needs to take steps as a supervisor to ensure our nation's evolving financial system works for community banks.

First and foremost, it is essential we continue to meaningfully engage with stakeholders on these issues. For example, we recently launched an innovation web page (www.federalreserve.gov/innovate) that will serve as an accessible central hub for stakeholders interested in learning about and engaging with the Federal Reserve on innovation-related matters.[11] The web page can serve as a starting point for members of the industry to engage with Federal Reserve specialists, submit questions, and request in-person meetings. We also announced a series of "fintech innovation office hours" across the country. The first of these was held just yesterday here in Atlanta, and some of you may have even had the opportunity to participate. These are also an important opportunity for us to learn, and I encourage you to provide your feedback. For community banks and their potential fintech partners, I hope that these sessions will serve as a resource to meet one-on-one with Federal Reserve staff members with relevant expertise, discuss fintech developments, share specific projects, and ask questions. They also provide us an opportunity to hear directly from banks and fintech companies about challenges to innovation.

Another important area of focus for me is community banks' relationships with their vendors and third-party service providers. As a former community banker, I am acutely aware that community banks are often reliant on outside service providers and vendors to access new technologies and provide payment services. I also know that supervisory expectations in these areas can be challenging, and I have experienced it myself. There are several things I believe we can do to help provide clarity and transparency, reduce confusion, and simplify and remove some of the burden community banks face in this area.

First, in order to give community banks a better picture of what success in due diligence of third-party providers looks like, and where it begins and ends, I believe that we should release more information on its necessary elements. This change would

[11] See https://www.federalreserve.gov/aboutthefed/innovation.htm.

provide clarity and assist community banks in completing their work. In particular, I believe that regulators can provide more clarity on the types of questions that should be asked of a prospective third-party provider and our view of a satisfactory answer. I also believe our guidance should explain what due diligence looks like for a potential fintech partner, because the standards applied to other third parties may not be universally applicable. Potential partnerships are not one-size-fits-all. Every bank has different objectives, and guidance should reflect some supervisory flexibility so that we do not impede prudent, strategic partnerships between community banks and potential partners. Regulators should especially support partnerships that combine the strengths of community banks and fintech companies, which have a track record of success. I also believe the Federal Reserve should allow banks to conduct shared due diligence on potential partners. If several banks use the same third-party service provider and are open to collaborating, they should be allowed to pool resources instead of duplicating one another's work. These approaches would not only have the benefit of increasing clarity and transparency for community banks, but could also be beneficial for fintech companies that hope to become third-party providers.

Second, clear and transparent guidance is most helpful when it is consistent. I have previously discussed my view that guidance on third-party relationships should be consistent across banking agencies. No one benefits when banks and their potential partners or other vendors have to navigate unnecessary differences in guidance between agencies. To that end, the Federal Reserve is in the process of working with the other banking agencies to update our third-party guidance. As part of this process, I believe that the banking agencies should all have consistent expectations for third-party relationships, and that the Federal Reserve should, as a starting point, move toward adopting the Office of the Comptroller of the Currency's guidance.

Third, I believe we can improve transparency with regard to our supervision of third parties. Through our service provider supervision program, we regularly conduct exams of many third-party service providers. While we make the outcomes available to banks that are clients of a supervised service provider, I believe we can go a step further to increase transparency by also making information that may be useful about our supervision of key service providers available to banks. This could take a number of forms, such as being more transparent about who and what we evaluate. Of course, moving forward in these areas requires careful consideration and interagency collaboration, and I have asked our staff to work with other agencies to develop and propose workable options for giving banks the benefit of the knowledge that supervisors have about their potential providers in an appropriate manner.

Finally, I believe regulators and supervisors have a role to play in ensuring that regulatory burden is tailored to bank size, risk, complexity, and capacity. Knowing the burden that third-party monitoring in particular can present to employees of the smallest banks, I have also encouraged Federal Reserve staff to consider options for further tailoring our expectations for community banks with assets under $1 billion in this area.

Collectively, I view these as important steps to improve the ability of community banks to manage their third-party relationships effectively. By doing so, I believe we will be able to better support the ability of community banks to access innovative new technology and offer modern services to customers.

Looking Ahead

The kinds of advances in technology we are discussing here today present challenges and opportunities for banks of all sizes, including community banks. Investments in new technology are likely to create implementation costs, and payment system innovations are no exception. Testing new technology, upgrading software and processing systems, and integrating new systems with existing systems will require banks to incur costs and dedicate resources to implementation. Community banks in particular may incur additional costs, for example to extend operating hours in order to facilitate payments during nonstandard business hours.

However, technological advances also present opportunities for community banks to continue serving their neighbors, and payment services are a key component of this. Since I joined the Federal Reserve, I have been on the road a lot, visiting Federal Reserve Districts and talking to bankers, consumers, and community groups. I have been struck in particular by stories I have heard about younger generations of Americans moving back to rural areas. These individuals may be returning to their hometown or moving out of urban centers, but they still have the same expectations for services like those that may be offered by larger banks with nationwide footprints. Technological developments, like the payment system modernization efforts we have discussed today, allow banks across the country to meet these customer expectations and provide payment services on a competitive basis.

I believe the Federal Reserve is uniquely positioned as a provider of payment services and as a supervisor of banks to ensure that our nation’s evolving financial system works for community banks. As a provider of payment services, our efforts to modernize the nation's payment system through services like FedNow and same-day ACH will ensure community banks and their customers have access to today's financial technology nationwide. As a supervisor of banks, we can support responsible innovation by reducing regulatory burden where we can, clarifying expectations, and improving the ability of community banks to manage their relationships effectively. Collectively, I believe these efforts will help support a community banking sector that is well positioned to thrive and offer modern, innovative services to their customers. By providing such services, community banks can help ensure all Americans can make payments safely and efficiently regardless of their location and that families across the country have access to financial services that are so important to their success and the success of our communities in today's age of advancement.