The Role of the Federal Reserve in the Payments System: Discussion

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It is certainly a pleasure for me to participate in this special program dedicated to Frank Morris. Frank was one of many Federal Reserve Bank of Boston officials who did a great job of influencing the improvement of the payments system in the United States. I would include in that list the two gentlemen on my left, Bob Eisenmenger and Paul Connolly, as well as Jim MacIntosh, who was First Vice President before Bob. And, of course, Cathy Minehan, the current President.

I face several challenges in discussing the Connolly/Eisenmenger paper. First of all, I should give an unbiased view, and that is going to be difficult to do because I spent twenty years working in the Federal Reserve System in the payments area, and I am a great admirer of the System and many of the individuals who work there. Second, in my current job, one of my responsibilities is to promote the interests of the private sector, the automated clearinghouse (ACH) operators and the check clearinghouses. And those organizations do disagree with the Federal Reserve from time to time. Third, and perhaps the biggest challenge, I only have ten minutes to discuss a forty-nine-page paper.

The paper does an outstanding job of summarizing the role of the Federal Reserve in the payments system, especially in check collection and the ACH, but it raises three very important questions. First, has the Federal Reserve's operational role in the payments system represented good public policy? Second, what should the Federal Reserve do over the course of the next three to five years to improve the payments system? And third, how should the Federal Reserve prepare for the future, that is, the next five to ten years? This is especially a concern because electronic

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commerce will have a bigger impact on the payments system and the banking industry will be more concentrated than it is to date.

Let me try to answer the first question for you. From reading the paper it is natural to conclude that the Federal Reserve has done a lot to improve the nation's payments mechanism. As Eisenmenger mentioned in his summary, the Fed eliminated nonpar check collection, which was a big burden on the nation's economy years ago. The Federal Reserve also improved the check collection system in general. Today, about 95 percent of all checks are collected overnight, and the Fed has often been the first to introduce automation and air couriers to speed up the collection of checks. The Federal Reserve has dramatically reduced the cost of collecting checks. Today it costs just pennies to collect an interbank check, even a check deposited on the East Coast and drawn on a bank on the West Coast.

The Fed also limited the use of remote disbursement, which was an abusive practice in the check collection system in the 1970s and early 1980s. The Fed helped develop the ACH system, which is saving the economy billions of dollars today. It has successfully implemented the pricing requirements of the Monetary Control Act, and I believe the payments system is more efficient today than in the past as a result of those activities.

The payments system in this country used to be three-tiered. You had the Federal Reserve on top, then the correspondent banks, then the thrift institutions and nonmember banks. For the most part, the middle layer has been cut out, the middleman is gone. Now some of the large banks that pay my salary today would disagree, but I believe that as a result of our cutting out that middle layer, we have a more efficient payments system. So, the answer to the first question is "Yes." The Federal Reserve's active involvement in processing payments has represented good public policy.

Now let us turn to the second question. The Connolly/Eisenmenger paper contains a summary of the major conclusions and recommendations of the Rivlin Committee report, which is acting as a road map for the Federal Reserve as it makes improvements in the payments system. In my view, that paper contains one very important conclusion: that we should move to greater use of electronic payments. And when checks are still written, we should process those check payments using electronic technology, that is, present those checks electronically to the paying bank. Two other major recommendations are that the Federal Reserve should remain active in the payments system from an operational standpoint and that the Federal Reserve ought to work with the private sector to prepare for the future.

I think the Federal Reserve should take a somewhat different approach from the one laid out in the Rivlin Committee report and summarized in the Connolly/Eisenmenger paper, however. Up to this point, the strategy that the Federal Reserve has emphasized has been to improve the payments system by improving operations of the Federal Reserve Banks. That may not work as well in the future, for a couple of reasons. Because of bank consolidation, more and more payments are on-us transactions, not interbank payments, so the operational role of the Federal Reserve Banks will influence a smaller percentage of payments. I would not be surprised if three, four, five years into the future, about 50 percent of all payments are on-us, not interbank, transactions.

Also, other networks are playing a bigger role in the electronic payments business—the debit card networks, the credit card networks—and Federal Reserve operational improvements to its own services have no impact on those networks. So, let me suggest a few things that the Federal Reserve ought to consider for the immediate future, the next three to five years.

I think the Federal Reserve ought to spend some resources on promoting check safekeeping. Check safekeeping is the procedure whereby the paper check does not go back to the check writer in the statement at the end of the month. About 40 percent of customers in the United States are on check safekeeping; in many other countries, it is 100 percent. And check safekeeping is the foundation of electronic check presentment, truncation, and electronic check conversion.

I think the Federal Reserve ought to spend more resources on promoting electronic payments in general, not just ACH transactions but debit card transactions, for example. The Federal Reserve System spends about two to three million dollars a year promoting the use of the ACH network. That is a great deal more than they spent about five years ago but a very, very small amount of money when you compare what the credit card networks and the debit card networks spend. Visa spends hundreds of millions of dollars a year promoting its credit card. Now, I am not suggesting that the Federal Reserve sponsor the Olympics or the Triple Crown horse racing events, but I do think the Federal Reserve needs to spend a lot more resources in promoting the use of electronic payments in general. I know this is going to be a real challenge, because it represents a big departure from what the Fed does today, plus the fact that the Monetary Control Act still requires the Federal Reserve to match revenues with costs, but I would like to see the Federal Reserve consider those things.

Now, let us look at the future going out five to ten years. Here I believe the Federal Reserve really faces some more difficult questions and more difficult challenges, because I think the Fed wants to make sure that whatever it does in the payments system represents good public policy. What problems will be out there in the payments system that would justify the Federal Reserve playing an active operational role? Remember, bank consolidation will have a big impact on the payments system. Electronic commerce will also have a big impact on the payments mechanism, and check volume is declining. Our best guess is that check volume will be about 2 to 3 percent less this year than last, and that the decline will continue. And the checks that remain will be processed and presented electronically.

Another question is, what is the likelihood of a market failure in this more electronic payments system, and would it justify a Fed operational role? If the Fed did reduce or eliminate its operational role, could it quickly resume such activities if a market failure did occur? I know these are challenging questions. I have no answers for the Fed right now, but I do think these are important questions to focus on, if the Federal Reserve is to continue to ensure that its role in the payments system meets a good public policy test.