The Good, the Bad, and the Risky:
U.S. Payments System Faces Significant Change

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Introduction

As leaders of your organizations, you face lots of uncertainties every day. But come with me on an experiment our Fed economists like to call a "counterfactual." There's one aspect of our economic lives where we have a lot of certainty and confidence. To understand this assertion better, take yourself back to early this morning. When you woke up, did you think about your employees' paychecks being deposited into their bank accounts on time? Did you worry about your business's cash management function and whether your treasurer was getting the best return on monies coming in that don't have to go out for a while or even until tomorrow? At a personal level, were you afraid your bank hadn't made the automatic payment on your mortgage so that you wouldn't face a late fee?

Chances are you didn't think about any of those things when you woke up. And you shouldn't have, because every one of those scenarios involves the nation's payments system—a key piece of the bedrock of your business, your life, and our economy. You take it for granted, because it works well. A smoothly running payments system is important to you and your business, but typically it's not something you have to give a lot of time or thought to—at least not until now.

Today, I'd like to talk a little bit about this less well-known aspect of our economy, whose good performance has benefited us all as both consumers and in our professional roles as managers who must get bills paid on time and who need to count on our customers and clients paying us on time.

My basic story is this. The excellent U.S. payments system is undergoing some significant changes—some good, some that pose new risks, and some that could turn out to be for the bad. I want to assure you that the Federal Reserve is doing its part to maintain all the good things about the payments system while encouraging innovation and improvement. We're working to identify and guide the industry to manage the risks that come with rapid changes. Our goal now, as always, is to foster a market-based payments system that is safe, fast, efficient, and broadly accessible.

But ultimately it will be up to you as the business users of payments services to become more aware of these changes, the risks they might pose, and the advantages they might bring. It's also up to you to let your payments provider know what your business's needs are and ultimately to make the best decisions for your own organization.

So let me start with a brief history and description of the U.S. payments system. Then I'll talk about the changes afoot and how the Fed is addressing them. I'll end by outlining what you need to be thinking about.

Overview of the U.S. payments system

While cash is still a common payment method for consumers and business— especially for retailers—for decades, the primary ways that organizations make and receive payments have been by check, wire transfer, and the Automated Clearing House (ACH) system. The Fed plays a major role in each of these, as well as in cash. We do so, in part, as a provider of payments services to stay current with the market and to serve as a catalyst for greater efficiency, reliability, or accessibility when the infrastructure is not there for the market to lead such change. In fact, much of my own career has focused on what we call the retail payments system—checks and ACH—and in the past decade I've been intimately involved in changes that are occurring in these payments mechanisms.

Checks: We can count on the Fed and private check processors that clear checks to do so very quickly and at par—or, in other words, at full face value. That was not always the case, though. When the Fed was founded, two in five banks were nonpar. That meant they imposed an "exchange fee" to pay checks submitted to them for collection by banks outside their local trading area. It effectively made the check worth less than its face value, introducing considerable uncertainty into any business transaction that involved that type of payment.

The Fed began offering check services when Reserve Banks were established in 1914 because Congress wanted to solve that dysfunctional payments system practice.

Fedwire was the world's first real-time gross settlement system, set up in 1918. Fedwire transfers large dollar payments among Federal Reserve offices, depository institutions, and federal government agencies. That means you can make near-real-time payments, which can help your business more effectively manage cash flow.

Automated Clearing House, or ACH: The Fed helped establish ACH in the early 1970s, and the Atlanta Fed played a leadership role. ACH provides an electronic alternative more efficient than checks for some transactions. The U.S. Treasury was also a catalyst, working to move Social Security and tax payments more efficiently. The focus in the early days of ACH was on recurring transactions—for example, mortgage and utility payments as well as payrolls. In the last decade, however, ACH has become a rail for one-time payments as well, with significant growth happening in web-initiated payments.

Check 21: Fast forward to the year 2003 and a huge change in the payments system: something we call Check 21. In the wake of 9/11, it became clear that relying on paper-based check clearing was no longer acceptable. On 9/11 and in the days immediately following, the movement of paper checks between financial institutions came to a virtual standstill, as airplanes were grounded and truck transportation reached its limits. At that time, tens of millions of checks written in the U.S. each day were physically transported overnight among Federal Reserve offices and commercial banks using an extensive network of air and truck transportation. Things had to change [to move these items] much faster.

Check imaging, enabling electronic processing of checks, had been in use but on a small scale. In addition to building the necessary IT infrastructure [to support widespread check imaging], the Fed helped to draft a new law, approved by Congress in late 2003, which took effect a year later. The law gave banks the option to change their paper check processing system into one that's almost fully automated. Virtually all of them did. A substitute check or electronic image can be presented to the paying bank. Now, you can still pay by check, but almost all paper checks are truncated and move through the banking system electronically, making them faster, more efficient, and more reliable. That can benefit your business.

It also affected ours. For example, the building we're in used to be one of 46 check processing centers. On an average night, this branch handled about three-and-a-half million items. Now, across the entire Fed system, there's just one processing facility, which handles only 15,000 paper items each night. The change took six years, and that part of our business went from 5,500 employees down to 500.

At the start of the twenty-first century, just under 42 billion paper checks were processed. Looking at the decade in three-year stretches, that number came down to 37 billion…then 30 ½…then 24 ½, according to the 2010 Federal Reserve Retail Payments Study.

Nowadays, you don't even need to go to the bank to deposit a check. Take a picture of it with your iPhone, send it out, and you're good to go. Quite a big change, and there are some big reasons for that trend to continue. Of course, part of that change occurred because Americans are writing fewer checks as alternative payment instruments like ACH and debit cards have become more accepted and new payment instruments have emerged. In fact, chances are there's a debit card in your wallet right now, and you're using it regularly.

At the start of the twenty-first century, there were just over 8 billion debit card transactions a year. Once again, looking at the decade in three-year stretches, that number soared to more than 15½ billion, 25 billion, then almost 40 billion.

The drivers of change

So now let's look at the changes afoot that I mentioned earlier. There are at least three, and possibly four, significant drivers in the marketplace that are transforming the way payments happen.

The first and most familiar driver of this transformation is new technologies. Computers, mobile phones, and powerful data networks let us send and receive payments in new ways. Accessing our savings via a mobile device or a card enables payments and related data to move farther and faster than we could have imagined a decade ago.

Driver number two—and associated with the new technology—is the emergence of new, nonbank players in the payments business. PayPal might be the most widely known example of this trend, but there is an explosion of new payments service providers that capitalize on the newest technologies. Some sell their services through banks. Some provide payments services that go around traditional bank-to-bank payments channels.

The third driver of change is globalization. Business is becoming more global—something that's well known to the residents of Jacksonville, with its massive port and growing international airport. To support the globalization of the economy, the payments system must evolve to support the complexity of cross-border relationships.

A fourth driver is still in the wings. As we look ahead, the new Consumer Financial Protection Bureau [CFPB] will have broad power in financial services, and it appears that consumer protection is likely to play a major role in shaping emerging payments methods.

Security challenges

Traditionally at the Fed, we've looked to manage financial risk in the payments system by accelerating the collection of payments. However, new risks are emerging through the electronic vehicles used to accomplish faster clearing.

Some of these [include] software hackers, identity theft, denial of service attacks, and data breaches at financial or other institutions. These emerging and growing cyber threats make it tough for end users to know how secure the payment service provider's network is.

New players

Historically, the movement of payments was accomplished largely by financial institutions or their agents. As I mentioned, advances in technology have brought new players to the payments space. In many cases, these players have fostered innovations which hold great promise. In others, these players have introduced new risks to the system with little direct risk to themselves. The payments system is only as strong as its weakest link. As users of the systems, it's important for all of you to fully understand the types of organizations you are using to serve as your payments providers.

Regulatory challenge—Dodd-Frank

The Dodd-Frank regulatory reform act is imposing many fundamental changes on our financial system, in response to the financial crisis we experienced. While not a major focus of the act, several provisions affect the payments system and the Fed's role in it.

Well known is the Durbin Amendment requiring the Fed to set interchange fees that banks charge their customers. Those have now been set, but consumers [and] the retail and banking industries are all still working out how they respond to changes in cost structure. The act also establishes a role for the Fed in regulating financial utilities, the big interchange networks and institutions.

And Dodd Frank created the CFPB, which has broad authority to require fairness and transparency in payments that touch consumers.

All these changes will demand more of you as business (and nonprofit and educational) originators and receivers of payments to figure out how to reposition you own institution's transactions. I'm in no position to provide an answer to all of you or even to one of you.

ACH services grow, too

Meanwhile, remember that growing debit card [usage]? For ACH, it's much the same type of story. Starting again at the beginning of the century, and going in three-year-intervals over the decade, you can see the trend clearly. In the year 2000, there were just over 6 billion ACH transactions, then almost 10 billion, then more than 14½ billion, then just over 19 billion.

It's easy to see why this is happening.

ACH is a fast, easy, and secure way to move payments of all kinds. It can help you manage cash flow, at low cost. ACH is also data rich. It not only provides a means for exchanging value, it can also include information related to the payment. This information can be used to drive efficiencies in areas like the accounts payable or receivable functions that support payments in your organization. And the Fed is working to make that better. We're innovating, working on speed and reach of our payments, retooling our systems with modern technology. Better, faster, more efficient, farther reach—that's the bottom line.

Conclusion (and why you should care)

In closing, I hope I've shed a little light on an aspect of our economy that has been working very well for a long time, and why that's been so. I also have some action steps for you and your business.

First, now is the time for you to develop a future vision about how you make payments. What are your needs here? What works for you and your business? I'm guessing they're the same things the Fed wants: better, faster, more efficient, less fraud, farther reach.

Second, work with your financial institutions to let them know what you need from a payments perspective. Would you benefit from faster, maybe even intraday settlement of transactions, or does early notification of what is settling when meet your needs? Do you prefer to push credit payments from your account to the receivers or are you supportive of having trading partners push debits to you? There are no right or wrong answers here, and different circumstances may cause you to employ multiple approaches. The message is simply to think about how the payments system can help you achieve your goals and to work with your payment provider.

We at the Fed will work with financial institutions and other players to improve the system in ways that will meet your needs. With more payments being moved electronically, consider the impact to you and your business if you could not clear payments for a week. The Fed stands ready to carry out our broad public service role, but it’s through your dialogue with your financial institutions that we at the Fed connect with you as a consumer or a business executive.