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Responding to change in U.S. and global payments

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This is my first trip to Chile, and a few days ago I took a tour of your beautiful capital city. I was most impressed by Santiago's vibrant public spaces and the level of commercial activity. As a visitor, in short, I have a distinct impression that Chile enjoys a strong and healthy business climate. This prosperity also is evident in the economic data and reports, and I would submit that Chile's commercial success reflects well on the good work of your independent central bank and your sound policies with regard to payments and financial services.

Today, I would like to speak about some of the key issues in the U.S. payments system while trying to address the increasingly global nature of financial services. After my prepared remarks, I will be glad to answer your questions and discuss payments, financial services or central banking in general.

As a visitor from the United States, I am here in a collegial spirit, and I certainly don't want to try to sell you on the virtues of the U.S. payments system. While our system has some advantages, there are certain aspects of the U.S. approach to payments that I would not recommend emulating. I hope that you will find my account of payments in the United States useful as you develop your policies. In turn, I hope to gain some insights from your policies that may lead to a more effective payments system in the United States.

This is an opportune time to speak because so much about the business of payments is changing. As is happening in Chile, the payments system in the United States is moving quickly from paper to electronics, and in both our countries this development presents many difficult and exciting new issues.

The importance of payments in central banking

A few moments ago, you were told about my role with the Federal Reserve Bank of Atlanta and the Federal Reserve System's Retail Payments Office. In addition to having a

complex and somewhat decentralized structure, the Fed also has broad responsibilities in our country, similar to your Superintendency and Central Bank combined. You might be asking, why is the central bank of the United States playing a leadership role in payments? That is a valid question, and let me try to respond because I believe the answer underscores our role as central bank policymakers.

A recent report by the Committee on Payment and Settlement Systems of the Bank for International Settlements effectively describes how a national payment system is essential to both the financial stability and the monetary policy goals of a central bank. Let me take just a moment to share with you a key passage of this report, and I quote: “By linking financial institutions together for the purpose of transferring monetary claims and settling payments obligations, a payment system becomes a channel through which financial risks can be transmitted across financial institutions and markets. In promoting a safe and efficient national payment system, central banks limit the prospect of financial contagion through this channel.” This report goes on to note that safe and efficient payments systems are also critical to effective implementation of monetary policy, and it describes a sound payments system as a “precondition” for monetary policy transactions.

So I hope you can see how payments are crucial to monetary policy and overall economic health. And while central bankers have a fixed mission, I strongly believe we also need to be flexible when it comes to strategy and tactics. New technologies and ideas are constantly reshaping our market economies, and I view keeping up with change as crucial to the job of any good central banker.

Checks in transition

Let me illustrate my point by talking for a little bit about check usage, which I know is a familiar topic in Chile. Consumers and businesses in both Chile and the United States rely on the check as a method of payment. In our country, around 36 billion checks are paid each year, but that number has begun to decline. The Fed acts as a processor of checks for financial institutions. And to cope with this flood of paper, the Fed contracts with private sector air carriers to fly paper checks between Federal Reserve offices so that checks can be settled and returned to the originating bank. This is not always possible as weather delays and other factors can often delay the collection of paper checks. For this and many other logistical reasons, the Fed for many years has tried to introduce new and better ways of enabling consumers and businesses to make payments.

By embracing change and pursuing a disciplined approach of research, development and experimentation, I believe the Fed has gained invaluable knowledge and better positioned our payments system for the future. These efforts, we believe, are now beginning to make a positive impact. A study completed in 2003 revealed that the total number of electronic transactions for all of 2003 was more than 44 billion, compared with some 36 billion checks. So, for the first time ever in the United States, the number of electronic payment transactions surpassed the number of check payments. This is an important milestone that I have described as a tipping point, or a fundamental shift in the way Americans make payments.

So what has the Fed done to adjust? Well, one initiative that you may have heard about is the Check Clearing for the 21st Century Act, or Check 21, which became law in 2003. Basically, this legislation facilitates the move to electronic check collection by allowing collecting banks to stop the flow of paper by creating electronic images of the check. But Check 21 does not require paying banks to accept electronic images for payment. Consequently, such banks can require an intermediary to convert the image back to a paper document called a substitute check, which is the legal equivalent of the original check. While somewhat inefficient in the short term, this approach allows banks to move to electronics on the collection side while work continues on the ability to receive images.

Presently, the Fed processes on average some 500,000 substitute checks per day through Check 21 with dollar values in excess of \$7 to \$8 billion. To put this in perspective, Check 21 amounts to about 1 percent of the total volume of 50 million checks per day that the Fed processes.

By 2008, we expect about half of all U.S. financial institutions to have the capability to send and receive checks via Check 21. But looking to the long term, there are some unanswered questions about the role of Check 21 as image technology continues to advance and check volume keeps declining at a rate of about 5 percent per year. Some banks are taking a wait-and-see attitude, and I do not fault those who choose not to invest in technology to receive electronic images—as long as they're open to something better coming along later. The substitute check is, in my opinion, not the ultimate solution for efficient electronic payments, and we continue to experiment with other payments technologies that have the potential to speed backroom processing. For instance, there are exciting possibilities with converting certain types of consumer to business payments from paper checks directly to ACH debit payments. More than 2 billion such conversions will take place this year. So, while Check 21 may not address all of the many logistical concerns with check clearing, I believe the legislation represents a big step forward and

gives us a solid foundation for more efficient check payments over the long term, which is a Federal Reserve objective.

For any payments initiative to become successful, it must pass one critical test: It has to save or make money for the financial institutions that are organized to make a profit and are ultimately accountable to shareholders. That is a high standard because banks in the United States face relentless pressure to cut costs, and the need to adopt new technologies and other methods of improving efficiency has never been greater. Historically, the U.S. financial sector has been fragmented with many small institutions serving local markets. But that has changed somewhat with deregulation and improved technology, and in recent years we have seen the development of larger multinational banks while the number of commercial banks has declined from more than 12,000 in 1990 to about 7,600 in 2004.

I expect those numbers still seem large here in Chile, where market forces have driven a consolidation trend resulting in 25 commercial banks, although I'm told there are more than 2,000 financial cooperatives in Chile. But in the United States every day new banks are created as others are purchased and subsequently consolidated. The U.S. financial services industry is very dynamic, and as you might expect the Fed has made substantial changes to keep pace with our customers. Instead of operating as independent entities when it comes to payments as we have done in the past, the 12 Reserve Banks in the United States collaborate more and more as a national network to improve efficiency. For instance, the Fed is in the process of cutting its number of check-processing locations from 45 in 2002 to 22 next year. For an organization geared to stability, these changes have not been easy. But they are essential to our long-term success.

Challenges ahead

With a more streamlined organization, the Fed has not only lowered costs, but we have positioned our organization to respond more quickly and decisively to the changes in the marketplace. Still, we face many challenges. And chief among them is information security. Identity theft is a big concern, and you may have heard about recent thefts of credit card information and personal data. According to a 2004 survey, 75 percent of U.S. banks reported losses from check fraud, and that figure in recent years has been increasing. The Fed works closely with law enforcement and other government agencies to ensure that consumers and businesses are protected from thieves. And, as I'm sure you're aware, fraud is not just limited to the United States. Information theft and payment fraud is increasingly organized, sophisticated and global. I know financial institutions are working hard to upgrade internal security measures,

and I expect that central banks around the world will need to cooperate actively and become more aggressive in efforts to build a payments system that is not only efficient but also secure.

Another challenge that we face in the United States is on the legal front. Our retail payments laws are antiquated, difficult to interpret and hard to change. Both technical innovation and the role of non-bank participants in U.S. retail payments systems have evolved much more quickly than the law has changed. Given our country's complex legal climate, the Fed has tried to encourage payments experimentation wherever the current legal structure does not prohibit innovation, while supporting only those legal changes that are clearly necessary. From the point of view of the Retail Payments Office and the Reserve Banks, you might say we take a practical approach to innovation. Financial institutions in the United States have a big stake in improved payments processing because this back-end function is very expensive, and greater efficiency can lead to dramatically lower operational costs and improved profits. As a result, a slow and painful transition from paper to electronic payments is what we want to avoid, so we've worked to encourage progress, wherever it serves the marketplace.

Progress in payments

In addition to the developments with Check 21 and check-imaging technology, the U.S. government had made substantial progress in moving its benefits payments programs from a paper to an electronic format. The Electronic Benefits Transfer program known as EBT has been an effective way to provide food stamp payments electronically to millions of Americans. The U.S. government uses many innovative ways of making payments electronically to personnel around the world. Also, the federal government's Social Security program has done an effective job of providing pension payments electronically, in the process lowering processing costs and ensuring a more accurate delivery of funds.

And I'm pleased with the progress of the Fed's Automated Clearinghouse method of payment, or ACH. As I'm sure you're aware, ACH enables businesses and consumers to inexpensively send money to each other, similar to your CCA. ACH volume increased about 17 percent in 2004 and today accounts for more than 11 percent of all noncash payments, totaling more than 9 billion transactions worth some \$22 trillion.

Now that ACH is gaining traction in the United States, the Fed is moving ahead with efforts to spread its reach. The Fed has extended ACH to Canada, and we've made inroads into Mexico with a new service that we've branded "Directo a Mexico." We believe this service has great potential because of the growing volume of remittances sent by Mexican nationals living in

the United States to relatives in their home country. And it provides a valuable service for a growing segment of our population who are not traditional banking customers.

Banking accessibility is a challenge in the United States, and I know this topic is familiar to bankers in your country. Many of the people who send money from the United States to Mexico do not have bank accounts, and financial institutions have struggled to convince unbanked customers to deposit their hard-earned money in what are perceived as large and impersonal financial institutions. At the Fed, we encourage banks to serve a broader segment of the population, but the issue in the United States is complex, especially with the many new rules put in place following the terrorist attacks of September 11, 2001.

Confronting change

Wherever we live, we cannot escape change as international boundaries disappear and new ideas and financial products take root. For example, Internet banking has evolved in the United States to the point where a broad segment of the banking population expects easy and immediate access to Web-based banking services.

And outside the traditional banking sector, the Web-based payments service Paypal has quickly emerged as a major player in international payments, handling 9 percent of U.S. and 5 percent of all global e-commerce transactions. With about 71 million accounts, Paypal is now targeting large merchants, competing directly against banks for the business of processing credit card payments. Provided there are adequate controls to prevent fraud and other risks, I view financial innovations such as Paypal not as a threat but as an opportunity with the potential to foster a stronger and more vibrant financial services industry.

With Chile on the forefront of the global economy, your financial services landscape will no doubt evolve. I am told that one of the issues you face is the rapid growth of non-bank credit cards and the movement of department stores into retail credit in Chile. I would very much like to hear your comments and concerns in this area.

In the United States, merchants also issue credit cards to customers, but this credit is mainly underwritten by existing banks, which makes it possible for bank examiners to monitor what is happening. Certainly, the United States' marketplace for credit has been active. In recent decades, consumers have increased their use of revolving credit just as the volume of installment credit from retail stores and personal financial companies has declined. Today, consumers in the United States have many options for credit in a financial services marketplace that is crowded with new products.

Given these pressures, I believe the best approach for central bankers is to stay abreast of progress and wherever possible try to anticipate the marketplace. Personally, I believe the most hazardous course is to stand still and expect tomorrow to be the same as yesterday. We cannot ignore the future of payments, which is already unfolding in Korea, Finland and other places, where people often use mobile phones to make purchases. There's every reason to believe wireless and many other new and convenient transaction methods will take root in the United States, Chile and elsewhere.

Of course, change involves risk, and we must remember the importance of public confidence in our ability to provide a safe payments system. But let me add that the old way of shuffling around paper to make payments carries its own set of drawbacks in the way of security, with few corresponding benefits in efficiency. I believe it is imperative that businesses have the freedom to develop new ways of making payments, and it is incumbent on us as regulators and policymakers to encourage innovation without unnecessarily impeding progress. By way of example, the Fed recently has focused particular attention on minimizing risk and fraud in ACH. As ACH expands to include electronic payments via the Web and by telephone, we are actively monitoring payments and providing valuable payments information to banks as part of our new ACH risk management service.

Eventually, I believe the market largely will determine what succeeds, but that does not mean that everything familiar to us today will become obsolete tomorrow. I've already mentioned the decline of check volume. A large segment of the U.S. population loves to use checks and they will no doubt remain an important element in our payments system. Check writing is not going away—nor are other expedient forms of payments. Cash continues to grow in volume, and even the world's oldest payment system, barter, is thriving. Barter is making a comeback through Web sites that allow the efficient exchange of goods and services. Old ideas continue to evolve as consumers and businesses evaluate the growing number of choices of the marketplace.

What's driving developments in financial services is technology. Some 40 years ago, a young engineer named Gordon Moore predicted that computing power would double approximately every 18 months. Over the years, "Moore's Law" has withstood the test of time, and I wanted to mention this informal technology benchmark because I believe it helps to explain the swift and sometimes unsettling pace of change in our economy.

What does this rapid pace of change mean for us as regulators and central bankers who are responsible for keeping payments running smoothly and preventing shocks that could hurt the economy? I'm a realist who recognizes the many risks we face. But I'm also an optimist who

believes that central bankers are creative enough to overcome our challenges and devise new and better ways of doing things.

Let me close by sharing with you some thoughts from business consultant Peter Drucker, who makes a distinction between a fad, which is something that people talk about, and change, which is something people do. Drucker continues, and I quote: “If you start out by looking at change as threat, you will never innovate. Don’t dismiss something because this is not what you had planned. The unexpected is often the best source of innovation.”

In our business, it’s always wise to expect the unexpected, and I think we all agree that electronic payment is not a fad—it’s a fact. And I believe we would all do well to heed Drucker’s call to stay open to change and embrace innovation as the most direct path to a bright future. I look forward to working with you on building a safer and more effective payments system for our increasingly interconnected world. Thank you for your time and attention, and at this point I welcome your comments and questions.