

THE PAYMENTS SYSTEM'S ROLE IN AN EVOLVING DISTRICT ECONOMY

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Dramatic advances in worldwide research and development are generating new payments system techniques. Virtually every week we see media accounts of advances in smart card technology, home banking, or banking on the Internet. As these new technologies emerge, central bankers around the world face a similar challenge—how to generate and champion prudent techniques for making high-risk cross-border payments.

An equally critical challenge faces Tenth District financial institutions—how to remain important players in a changing payments arena.

Currently, the payments system is still primarily the province of banking. But banks must change to remain an integral part of the payments system.

Debate continues on whether the banking industry will keep its franchise for operating the payments system, or lose market share as it has in the areas of deposit taking and loan origination. Currently, the payments system is still primarily the province of banking. But banks must change to remain an integral part of the payments system.

A NEW COMPETITIVE ENVIRONMENT

While no one can predict the future, it is clear that the nation's 10,000 banks will see increasing competition from nonbanks to supply payments services. Banking trade journals repeatedly feature companies like Microsoft, First Data Corporation, Checkfree, Intuit, Cybercash, or telecommunications companies as they aggressively work to develop new payments techniques.

As bank customers become more involved in the global marketplace, they are demanding more sophisticated payments services. Banks, from the largest to the smallest, must continue to prove to their customers they are payments experts. New expertise will be essential to effectively advise clients on payments alternatives and to offer the products that best fit the changing strategic needs of their clients.

Amid this changing marketplace, banks across the nation are consolidating. Still, the heritage of locally owned banks in the Tenth District remains strong—with some 2,300 financial institutions needing access to payments mechanisms in order to serve their communities and customers.

As most people would agree, the large banks have the resources and sophistication they need to compete in a global economy. But are the thousands of community banks in this country ready to compete with both large banks and nonbanks?

This question is compounded by another change in the new payments environment—electronic payments initiatives like those driven by the U.S. government. For instance, the Electronic Federal Tax Payment System (EFTPS) put into effect last year mandates that most employers' tax payments be made electronically. And new legislation (the so-called EFT 99) will require the federal government to make nearly all of its payments electronically by 1999.

ENSURING INTEGRITY, EFFICIENCY, AND ACCESSIBILITY

None of the nation's largest banks are headquartered in the Tenth District. In light of this, we at the Kansas City Fed believe our role is to serve and advise our regional banks as they adapt to emerging payments system innovations. In carrying out this role, our payments system mission is to assure the integrity, efficiency, and accessibility of the nation's payments mechanisms. A number of efforts are under way to achieve these goals.

Safety is paramount when establishing a payments system structure. As payments have become more and

more electronic, we have become experts in safety measures such as data encryption. We have also worked with banks to help them employ fraud prevention techniques. And, as always, our bank examiners are on the alert for payments practices that may be risky.

Enhancing payments efficiency is also a vital goal—both for our own operations and those of our banking constituents. After several years of significant investment in new technologies, our efficiency gains are beginning to pay dividends. For instance, we have significantly reduced the fees we charge for check processing and ACH services.

We at the Kansas City Fed believe our role is to serve and advise our regional banks as they adapt to emerging payments system innovations.

We will see even further efficiency gains as the payments system becomes more electronic—a move that is especially important for the continued viability of remote banks. Currently, the Kansas City Fed is electronically presenting checks to more than a third of the depository institutions we serve.

As a leader in the Federal Reserve System's efficiency efforts, the Kansas City Fed emphasizes equipping Tenth District financial institutions with the ability to send

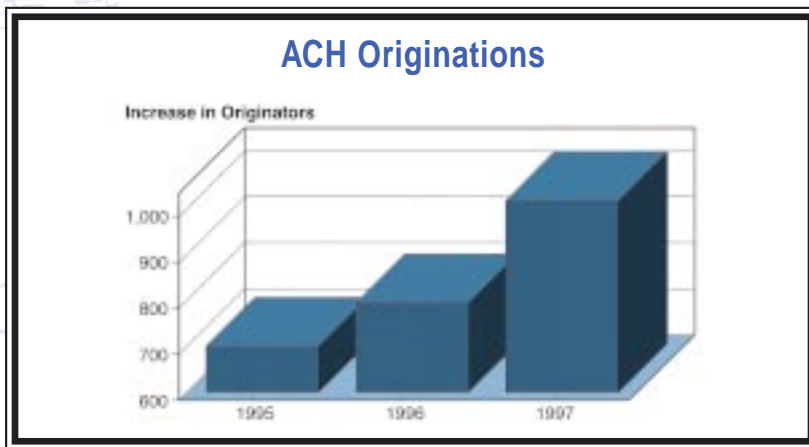
as well as to receive ACH payments. Institutions have been receiving these payments for a number of years, but until recently ACH origination was largely the province of large banks. Today, we have more than 1,000 institutions originating ACH payments in the Tenth District.

In addition to promoting safety and efficiency, automated payments should provide greater accessibility to banks. Some banks would say that the Federal Reserve's most important job is to ensure that all financial institutions have access to the payments system. This is especially true in the Heartland, where so many banks are hundreds of miles from the nearest major metropolitan area. We try to ensure accessibility in many ways, but none is more important than working to automate payments.

Perhaps the most powerful tool we have to automate payments and overcome remoteness is Fedline. An inexpensive, PC-based communication network, Fedline enables the 1,150 depository institutions connected to it to send and receive funds transfers and ACH.

We are continually expanding Fedline to meet the needs of our banks. For example, in 1997 we began work to increase the networks' capabilities to accommodate electronic data interchange (EDI) transactions. EDI will enable financial institutions, regardless of size, to decipher a computer payment message, such as an invoice, and translate it into a form that can be used by corporate customers.

Of course, advanced technology is beneficial only to the extent that it can be understood and used by those who need it. The Federal Reserve is not the only entity to provide advice on accessing and using the new payments system, but we are an important contributor, especially to community banks. And, we remain committed to helping these institutions take advantage of this new and exciting payments environment.



Previously the province of large banks, today the number of institutions originating ACH payments is steadily increasing. In 1997 alone, the Tenth District added 258 new originators.

Enis Alldredge is a senior vice president and head of the Operations Division, which includes responsibility for cash services, check collection, electronic payments, and securities as well as customer relations and support for Tenth District offices. He also has oversight responsibility for the Bank's branch offices in Denver, Oklahoma City, and Omaha. He is a graduate of the University of Nebraska and the Graduate School of Banking at the University of Wisconsin.