

Central bank perspectives on nonbanks in the payments system

The retail payments system is certainly undergoing fundamental change. It is dynamic, coming from a variety of sources, and it is significant. It also is no coincidence that nonbank firms are a significant part of this change and have become increasingly prevalent throughout the world's payments system.

In this context, the task for the central bankers—and we have varying degrees of oversight responsibility for the retail payments system across the world—is to understand the opportunities, benefits and costs of an evolving market-driven payments system, and then to balance the benefits of such a system against public goals of assuring a sound, stable and safe payments system globally.

The Federal Reserve's mission is to promote a payments system that is efficient, accessible and safe. I would start out my comments by saying, as a general point, nonbank companies have had a positive influence in the areas of efficiency and access around payments. By helping to introduce new technologies and products, entering new markets, and tapping into the economies of scale and scope, nonbanks are enhancing the efficiency in the payments system. By offering payments services that

frequently transcend geographic restrictions, for example, by facilitating online payment options, nonbanks are enhancing, on balance, consumer access.

What about the impact on risk? The growing importance of nonbank firms also introduces new sources

of risk to the system and raises important questions around how these risks would be managed in an ever-changing payments environment: the role of regulation versus self-regulation.

Examples of recent payments system risk issues, which many people here have mentioned already, are TJX Company's more than 45 million transaction records captured away, and pharmacy cards that represented a means and an introduction to fraud.

Certainly, public confidence in the ability of the payments system to manage new risk is at the core of an effective payments system over time. If private incentives to manage risk are weak, or if they tend to fail under stress, then too often



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This is a transcript of a speech Thomas M. Hoenig, president of the Federal Reserve Bank of Kansas City, delivered May 4 in Santa Fe, N.M., at the Bank's conference "Nonbanks in the Payments System: Innovation, Competition and Risk."

The conference brought together three principal audiences—industry participants, academics and public authorities—for an exchange of views and thoughts as nonbanks continue to become prominent in payments systems around the world.

Among the issues addressed:

- *What activities do banks and nonbanks perform in payments?*
- *How has rising nonbank participation affected product innovation and market competition in the payments industry?*
- *Do banks and nonbanks compete on a level playing field?*
- *Is the current supervisory framework over bank and nonbank payment service providers adequate to control risk?*
- *What role should public authorities play in overseeing retail payments in light of changing technologies and changing industrial structures?*

Speakers and panelists included representatives from Google, PayPal, the European Central Bank, the Reserve Bank of Australia and the Dutch Central Bank as well as a number of commercial banks and international universities.

Conference papers are available at www.KansasCityFed.org.

payments crises ensue. And the central bank, or some public entity, must intervene at significant cost. That is what we wish to avoid.

With that in mind, I would like to raise just three questions of how the central bank's role might evolve as we move forward with payments.

- The first is to ask about the adequacy of oversight for nonbanks in terms of the regulatory environment;
- The second is the central bank's role relative to the industry's ability to self-regulate, which is important and has been mentioned;
- And the third is the central bank's role as a participant in the payments system, which varies across the world but is an important question.

First, is the current supervisory and regulatory framework adequate? The problem is, as has been demonstrated here, we are mining the data now and we are still trying to gather enough information to really understand where we ought to be putting the regulatory elements of the evolving payments system. Because it is changing so rapidly, we need to understand the frequency and significance of payments



nonbanks *in the* payments system

system disruptions. Understanding data breaches, how they are coming from their sources and how they are evolving, is important to us if we are going to begin to propose regulatory schemes.

At a minimum, we should do more work in terms of assessing the effectiveness of our own regulatory framework for banks, and now for nonbanks, given the magnitude of the changes in the payments system since the framework was originally established.

Some of the following factors are important to consider:

- Nonbanks have increased their presence in all aspects of the payments system and are relied on by banks themselves as critical providers of processing.
- Nonbank firms provide certain services and operate in a concentrated market, so operational disruptions in a single firm may have widespread disruptions. For example, nonbanks run two of the top three debit card networks in the United States. The third—Visa's InterLink, when it becomes public—will put 80 percent of PIN debit transactions in the hands of those institutions.
- Nonbanks play significant roles in access and have a vast amount of consumer and

business payments-related data that need to be protected and secured. In addition, the Internet provides criminals new avenues for stealing sensitive consumer data. I am sure we have all heard enough reports of transactions that have been compromised to know how significant and important that is.

- Nonbank firms are subject—and this is important—to different, and certainly in some cases, less oversight than the banking firms in terms of the prudential supervision that takes place on-site. Retailers and other nonbanks are not subject to the Gramm-Leach-Bliley Act and its requirements to protect customer payments data in the same way as banks. Instead, nonbanks are covered in our country under the Federal Trade Commission safeguard rule, which, in many cases, is an after-the-fact approach to taking care of these issues. We do have, in terms of the supervisory oversight, some access to payments processors through the technology services providers—if a bank is using an outside processor then the primary regulator can go in and check that provider to assess whether they are following prudential standards for processing and protecting that data. That is far less oversight than the bank itself receives.



While financial institutions' supervisory agencies use a risk-based approach in their oversight of nonbank payments processors, there remains a sizable gap in coverage. For example, we look at about 90 of these nonbank processors and, by some measures, there are literally hundreds of those operating that are not receiving the same kind of oversight that banks, or those subject to the technology services provider provisions, receive.

Accordingly, while we need to be cautious about taking supervisory matters where they are not needed, the kinds of questions these incidents raise warrant careful consideration as we consider evolving supervisory frameworks.

When I say that, I also want to acknowledge that further consideration does not necessarily mean imposing a bank-like supervisory framework over the nonbank industry. The question that logically follows is whether, in the context of the changing risk profile of retail payments, the industry can self-regulate. Can the incentives be aligned properly to make sure we don't need a whole new set of regulations? How do we define and guide regulations so they are most effective? Where can we rely on incentives?

Certainly, experience has shown that with the right incentives, a market or an

industry can attempt to self-regulate and, within certain boundaries, can be successful. Markets naturally resist outside constraints and that, in and of itself, encourages effective self-regulation. This pertains not just to nonbanks but to all payment providers. There are certainly examples of this.

We have heard a lot of discussion here of PCI rules, which are credit card network data security standards, in relation to Visa. Central banks themselves can play an important role in facilitating the industry's efforts to promote safety and manage risk as well as promote efficiency. Examples include rules set around the National Automated Clearing House Association (NACHA). This conference itself is designed to increase the information and perhaps allow the industry to find new ways or discover new incentives to self-regulate.

The Federal Reserve also is involved in some of the ANSI (American National Standards Institute, which coordinates a voluntary standardization system) rule writing. Thus the effort to establish rules can be joint between the central bank and industry, which safeguards and protects the payments system and better assures it runs effectively.

Finally, in the context of past experience, I would raise the question of whether central banks should be participants in emerging

Innovation competition *and risk*

payments systems. Central banks have in the past and continue today to have a role in the broader payments system. Central banks can enhance safety, as well as efficiency and access, by being a direct participant in the payments industry where it serves a purpose. Central banks around the world, for example, are importantly involved in large-value wholesale transactions. Central banks are also involved in some elements of the retail payments system.

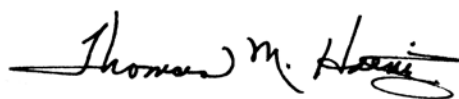
The Federal Reserve, of course, has a role in the checks system and in the automated clearinghouse (ACH) system, where it serves as one of two operators to provide a good level of safety, efficiency and access for a growing number of retail payments.

Given this experience and the uncertainties of today's global environment, questions are being raised regarding whether central banks might also participate in electronic retail payments networks.

Should, for example, the central bank operate an ACH network as a switch of last resort? Could such a network accommodate other electronic payments, such as credit and debit transactions, to clear settlement if there is a crisis? Would such a move inhibit or encourage competition or innovation, efficiency and access? Would it provide for a better understanding of emerging yet

unknown challenges, such as fraud issues, thereby mitigating risk and encouraging safety? Would it be available in the event of an economywide disruption such as 9/11? Such questions, I agree, are difficult but worth thinking about while we have the time to think about them and before we are forced in unfortunate circumstances to try to figure it out on the run.

There is much to be said. I have enjoyed the last day and a half and have learned a great deal. We, as central banks, need to be thinking more about how the market is emerging; where, in those few instances when the market may fail, we have a role in regulating that market; and where central banks might have a direct role as well.



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