

Conference Wrap-Up

Bruce J. Summers

I would like to compliment the conference organizers in having conducted a conference that has produced an abundance of light and a minimum of frictional heat. I think Stu Weiner laid that out as a success criterion in the beginning, and he has admirably achieved it. My task has been to summarize the conference, to provide perspectives on the material.

First of all, I am going to offer some perspectives from a public policy standpoint on the construction of the conference, if you will, the background leading up to the conference itself. That's the *ex ante* part.

Then, I've tried to identify some of the key themes that were identified both by the presenters and the discussants during the course of the conference. Part 2 of the talk is going to be an attempt to identify those themes. What I did coming in is try to crystallize five key questions that deal with consumer choice, market incentives, clearing and settlement, system risk, and the role of the central bank in retail payments. That is the organizational construct I used that will constitute the second part of my remarks in terms of organizing the themes I've tried to identify. I'll be the first to admit I'm not comprehensive, and I'm sure I've overlooked some important thoughts.

Starting with perspective, and my own priors, the conference underscored that integrity and efficiency are public policy concerns. They show up on the agenda. I'll offer a couple of thoughts to support that. From a U.S. perspective, we have an estimated \$225 billion in noncash payments made each day, and those constitute payments in a national economy where up to 70 percent of the gross domestic product is attributable to retail payments. Just small nuances in the efficiency of the operation of the payments system can have a very significant impact on the functioning of a modern economy like that.

Second, a premise that efficiency depends on public confidence and trust—that was a key theme here and it is also underscored in some research I happen to be involved in with a couple of the Federal Reserve Banks, including Chicago and Philadelphia. The heavy lifters behind that research—Dick Porter and Bob Hunt—have been here at this conference as participants. So, that is research yet to be produced.

And, finally, let me emphasize a point about the popular press keeping at the forefront of our attention issues involving retail payments. Unfortunately, the news is not good in the retail and the financial press. This point was made several times during the conference. So, there is a lot of intrinsic risk simply associated with public perceptions and perceptions of the press with respect to the efficiency and integrity of the retail payments system.

It is really important to be able to agree on the use of key terms when we talk about the role of the central bank in the payments system and to try to clarify the terminology used in the conversation. I want to define three retail payments system domains. First, rules and standards where scheme owners are active; payments instruments, which are referred to several times in this conference as the front-end or service-provider domain; and then clearing and settlement mechanisms (CSMs), a term I borrowed from the European Central Bank taxonomy for defining a component of the payments system, the back-end or the operator domain. When we talk about the role of the central bank, we want to be really clear where it is the central bank would play.

Who are the actors? Consumers are certainly on the demand side, but on the supply side, service providers to consumers on the front-end, the operators on the back-end and then the policy authorities. This is where oversight falls. I want to underscore (and this came up in their conversation, too) policy authorities are in two broad groups: self-regulatory organizations in the private sector and then public authorities, which include central banks as overseers but a lot of other authorities too—supervisors, consumer protection, fair trade, and so on.

It's hard to focus explicitly and solely on the role of the central bank when it comes to policy authorities. And I'd add in legislatures, parliaments, or, in the United States, Congress. So if there is a void to be filled, if policy authorities and self-regulatory organizations aren't doing the job, that void is going to be filled, and it could be by the legislative arm.

I cast a perspective on policy considerations, *ex ante* to the Kansas City conference, just by looking at the agenda, and the perspective I gathered coming here looking at the agenda was we would learn a lot about consumer needs. We would learn a lot about the nature of the markets in retail payments systems—the two-sided markets with externalities where incentives are crucial to good outcomes.

We would talk about the clearing and settlement mechanism, where there is a good deal of concentration but the change taking place is creating opportunity

now for new entrants. We would talk about bad actors being able to exploit the scale economies in these systems to scale up fraud to a massive level, potentially at least and hypothetically.

And then we would talk about the nature of public policy development. It's very hard to do, and, as evidenced by our conversation, the role of the central bank in public policy development is at least open to some debate.

This is not the only payments system conference this year looking at the landscape. There was one earlier in Cape Town, South Africa, which I happened to have had an opportunity to attend. It also focused on the global landscape for payments systems, so I had some perspectives—priors, if you will—that I brought with me to the conference, based on the Cape Town conference. At least one or two of you I know attended as well. These are *ex post* takeaways because the conference is over. By the way, you can readily access the proceedings of that conference by going out to the World Bank homepage, www.worldbank.org/paymentsystems, and there is a summary of the themes for the landscape conference in Cape Town. In Cape Town, we talked about diverse and dynamic consumer needs, and we talked about the public in two groups: the well-served public and the poorly-served public. There was a big focus on the needs of the unbanked public. I expected to hear a lot about that on this program, but we really didn't talk much about that.

I am going to provide an example here that's close to home: the venue of the conference being the United States. From recent prior Fed conferences on the retail payments system, people estimated there are 70 to 80 million people in the United States alone who are underbanked. That is an astonishing figure. That is larger than many countries, right? So it seems strange to me in a way that somehow you jump to the conclusion you have to go to an undeveloped economy to get into issues involving the needs of the underbanked. But here, right in our own backyard, in an important, developed country, you have that issue.

A takeaway from Cape Town: Costs and incentives tend to be misallocated, and government authorities are in a very interventionist mode on a national and an international basis globally. Nonbanks are in the vanguard of change. Where the action is, in terms of innovation in payments systems, tends to be principally in the nonbank space. We picked up on that here in Kansas City.

Finally, central banks tend to be the principal overseers in payments systems, but by no means are they the exclusive public authorities that are active in this space. Then, rounding out Part 1 in perspectives, I have some personal perspectives I want to share with you. My priors and my biases, at least subliminally perhaps, lie behind what I captured as key themes of this conference.

First of all, when you look at where the issues tend to percolate up in retail payments systems, it seems to me that principally on what we call the front-end, the marketplace for consumer services, we see issues involving access, pricing, security, and consumer protection. That would tend to be the magnet for public policy attention.

Second, my personal view is that systemic consequences of fraud and risk in the payments system tend to be underappreciated. Maybe I'll have another comment or two to make on that when we talk about the conversations here at this conference.

Third, agreeing with what has come before, such as Cape Town, nonbanks—but especially telecommunications companies—are playing an extremely prominent role, and they tend to be vertically integrated service providers. When we talk about telecommunications companies' entry, it's the infrastructure that's carrying all the streams of data, but they are also the front-end service providers, providing the new payments services. At least that is the way this is starting to emerge globally. This raises all kinds of not necessarily bad, but interesting and profound questions with respect to vertical integration regarding the delivery of payments services by nonbanks.

Compared with central bank operations, oversight tends to be the more direct, flexible, and powerful approach to achieving public policy goals. I simply observe central bank oversight in the retail payments space is on the rise. I would assert operations tend to be on the decline.

Finally, and again pertinent to the venue of the conference in the United States, the Federal Reserve Board, which is the entity that's lodged with the legal authority to conduct supervision and oversight, evidences minimal interest in payments system oversight. There is an important point we didn't capture or articulate here related to this that I'll circle back to at the end.

Let me get now into Part 2 of my attempt to capture some of the main themes in the conference. First of all, with respect to consumer needs, we heard from Dan Hesse that people want anywhere, anytime services including banking and, broadly speaking, real-time account maintenance. The kind of real-time service we have in telecommunications is strongly desired.

I observed that our deliberations during this conference appear to have left consumers out. Market incentives and economic theory in two-sided markets are very complex; they don't really provide clear answers, and it's prudent to be very wary. Our speakers said that. We also learned the theory needs to be validated empirically, but my observation is systematic data are not yet available, and it's going to be a long time until they are.

For whatever reasons, we have theory, we have data that indicate price and cost incentives appear to be largely hidden from consumers, and they tend to distort behavior. In principle, a strong takeaway for me is cost transparency is a good thing. A relatively safe public policy program would be based on removing barriers to cost transparency.

In clearing and settlement, back-end concentration gives rise to monopoly protection of market franchises. We heard it manifested in seemingly subtle ways: the unwillingness to pursue standardization and to facilitate portability of bank account numbers. Those are essentially barriers to market entry.

Looking ahead, we need cooperation in a procompetitive, coordinated environment, including a lot more than just things. We heard it is not just about things anymore.

For system risk, this is a short list of issues because I don't think we stepped up to the question of systemic risk larger than a business problem. I did hear the case can be made the banking industry is facing the equivalent of an oil spill. That's pretty bad, but I noted it sure is a lot less worse than a nuclear meltdown, right? I think we still want to explore and probe the problem of the question because it is so important. What if there is something bigger at stake in terms of being able to scale fraud massively in the payments system?

We heard a key central bank theme about the types of risk in the payments system. They were focused on outsourcing. Then we heard a lot about the capital intensity of establishing networks in an interesting sort of way. To make enhancements to security, you must tinker with what exists, as opposed to spending a huge bundle of money that can't be justified on a return-on-equity basis with respect to new investment.

Finally, I'll make three points on the role of the central bank that interestingly didn't come up in the last session. I gleaned these from conversations leading up to our last session on the role of the central bank. If there is a public will that drives competition and innovation, people admitted it might include a so-called public option for an active operational role by the central bank. (I simply add parenthetically if you are an advocate of the public option, I would find a different name for that because it is dead on arrival if you call it that.) We heard there needs to be a national conversation led by the Fed, perhaps with respect to the baseline security standard we expect to be deployed in the payments system. We heard there should be a stronger role for the central bank in consumer protection or the federal bank should play a stronger role in consumer protection, security standards, and oversight of nonbank actors taking on bank-like roles. And I don't think we should interpret that as being as sinister as it might sound.

We heard in the last session from the Fed speakers, Rich and Stu, there are synergies between operations and development of public policy. We also heard a strong case for the role of payments system oversight, and we drew out in the conversation that payments system oversight by central banks needs to be extrapolated internationally because retail is really a global business.

I am going to conclude with a final comment. That is, there is something we didn't capture here that is specific to the unique jurisdiction of the venue of the conference in the United States with respect to what I'm going to call "the dilemma" the Federal Reserve faces in retail payments system oversight.

I see the dilemma this way: Traditionally the Federal Reserve has played a very strong and I would say effective, credible role. Give the Fed a lot of credit. Historically that's an arguable point, and I am sure I could get an argument on that here,

but I would argue it. And my sense is the Board of Governors, which has explicit legislative authority to conduct oversight, is limited by this authority to oversight of the 12 Reserve Banks. Until 10 or 15 years ago, the payments system was check and ACH. I would assert the Fed, because of the role of the Board in terms of oversight of the Reserve Banks and also because of the high hurdle rate established by law, basically has confined the Reserve Banks to the check and ACH business, not the payments system business. The dilemma is, if the Board of Governors evidences minimal interest in oversight of the retail payments system and the footprint of the Fed is really compressing now, the Fed has itself in a corner with respect to the nature of its role and how effective it will be.

General Discussion

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Mr. Burns: I loved that “dilemma” part because I’ve been thinking about this for a number of years. So what is the way out of here? This is a question of how do you get the Reserve Banks, to the extent that’s desirable, involved in a broader view of the retail payments system? So, we have the Reserve Banks participating in an FOMC-type of an environment, a monetary policy set. They are involved in various aspects of central bank governance through the offices of the president and so on and all these various committees. How can that be extended into the retail payments oversight environment?

Mr. Summers: I don’t think I have an authoritative answer to that question. I would say—and I welcome others to bring their thoughts forward—there is a standard model now for the exercise of payments system oversight. Ron did a terrific job of outlining how that standard model is deployed, not in a utopian sense, but in a very practical, hands-on sense. I would simply offer there isn’t a lot of competition to get into the check business today, right?

When you look at the trends in payments systems, the way I interpret the data, ACH is not the fastest growth area today. So, it could be that the Fed could continue to play a very effective role in those limited spaces and still take on an active oversight role. But it has to be very, very careful in doing so.

One thing we didn’t talk about is the pitfalls of being an overseer and an operator. I won’t go into it, and I won’t open that Pandora’s Box now, but there are real challenges.

Any other observations on that question that was raised?

Ms. Masi: Just a qualification on a much stronger role of the central bank in consumer protection, because in Europe several central banks do not enter into consumer protection because they are overseers and so they have to care about the efficiency and safety of the system as a whole, which might sometimes be in contradiction with defending only one stakeholder, which is the consumers.

Mr. Summers: You're highlighting the potential contradictions and the difficulties in being a consumer protection agency and an effective overseer as a central bank. Maybe that helps explain why there is diversity in this public policy space.

More than one person from the private sector at this conference identified a fairly strong demand for some type of intervention on the part of the Fed as the central bank and as an overseer of the payments system in the United States, either with a light hand or with a heavy hand. Then there was discomfort expressed for the invisible hand, which is the currently defined role.

I would observe that with the Dutch central bank—we saw it here—the objects of oversight are listed, and they include retail payments systems. You can go out to the Federal Reserve Board website and the objects of oversight are listed, and I don't think they include retail payments systems. I just think there is an issue there. I would encourage bilateral or multilateral dialog with the authorities to make sure that's not an overlooked matter.

Mr. Berndsen: I want to respond to your question about the systemically important payments system and other systems. What I didn't allude to in my talk is that we internally distinguish between two types of goals. The first one is systemically important. Then, you have a direct link to financial stability. If financial stability is at stake, you have a systemically important payments system and that is a different type of goal of oversight than the other one I talked about, which is system-wide risk for retail payments. Yes, you don't have the financial stability aspect, but you have the aspect of creating big disturbances in the economy or directly to hurt consumers. But we can distinguish between those two types of goals.

Mr. Moore: We're looking at ways of oversight and maybe a light touch. There have been a lot of worries about systemic risk and worries about the security of the system.

It was telling that you mentioned worries about journalists bringing up the issue. Part of the reason why journalists feel compelled to do this is because a lot of the information on incidents when they happen is kept hidden from public view as much as possible. This leaves us in a situation to speculate what the magnitude of the risk is. Perhaps a good role for the Fed—or for some government organization—is to start collecting data on the incidents and frauds we are seeing and tracking that over time.

There are other countries that are doing this to one degree or another—the UK Payments Association does it and the Bank of France does it. If we can move toward a situation where we are collecting and disseminating aggregated information on fraud rates, we can have a rational response public policy-wise further down the line. At this point, it is still a fairly light-handed approach.

Mr. Summers: Transparency is good.

Mr. Bolt: To me, it seems there is still this problem of regulatory capture in the sense that if the central bank is also a player in the payments landscape, but at the same time—and I think Josh alluded to that—is also the overseer, then it is not completely obvious to me that is a conflict of interest. On the one hand, if you are player in the same area, you can always hope the authority is credible and completely trustworthy. On the other hand, the other parties could always accuse a central bank—if it's also doing something in the payments business—of regulating, overseeing, or making changes that affect the other players in the game.

So, there is always this tension between regulation and being a player yourself in the payments landscape. You have to be careful, I guess.

Mr. Summers: I certainly take that point. Thank you very much.

