

The Role of Central Banks in Retail Payments: The Central Bank as Operator Commentary

Joshua Peirez

We've heard a lot about the different roles the Fed and other central banks can play in terms of being a facilitator, an operator and/or overseer. In our case here in the United States, and in some other markets, I would also add one other—examiner—which creates an acronym I quickly came up with, FOOE (phooey), which frankly is what I feel a lot of times in dealing with different parts of central banks.

I've previously had the opportunity to comment on the Fed's role as overseer and facilitator, and have met with many examiners. However, this is my first opportunity to directly talk on the subject of a central bank as an operator of a system. For that, I am thankful. It's actually the first time I've been forced to think about that in a very meaningful way, and the paper did a great job in sparking my thoughts.

Let me start by saying that in thinking about the Fed as an operator, it caused me for the first time to realize I'm actually talking about a competitor of mine. That is an interesting shift, because I usually don't treat my competitors with quite the deference with which I tend to treat my overseer or facilitator. We laugh, but that is to some extent the crux of the problem of competing with the entity that also oversees you.

I would also say, and I think this has proven true in the check clearing system, and to a lesser but still significant extent in the automated clearing house (ACH) system here in the United States as well as in other markets, to some extent for that very reason as well as reasons of scale, that when you do see a central bank step in as an operator, you end up with some quasi-government-type monopoly. It is extremely difficult to get your head around how you are going to compete with someone who is setting the rules and can just change them, should you come up with great innovations that harm their business.

I want to take a second to talk about my role at MasterCard these days, because it is relevant to the discussion we are going to have here. I'm responsible

for our innovation in new areas, so I look at things like mobile, person-to-person payments and e-commerce, as well as bill payment relevant for ACH and check purposes in particular, and areas like cardholder controls, which are the ability to give cardholders the types of things we've been talking about, such as alerts, the ability to set their own spending preferences, receive information, etc. I'll go into some more depth on that.

Let me also say I have rewritten my entire remarks this morning after listening to the session yesterday and this morning to try to comment on and bring to bear some of my thoughts on what has been said so far.

There were a few shocking things for me from yesterday. The first is I found myself vehemently nodding in agreement with Professor Carlton for the first time in many years, because I agree wholeheartedly with a very healthy degree of skepticism around "complex analyses leading to ambiguous results" and using that for purposes of policymaking.

The problem is, when he says that, he means that about the arguments made on the other side. I would posit that the arguments are complex with ambiguous results on both sides of many of these issues. It is an area that is extremely difficult to come in and regulate or to run a business in. Just assuming what you would like to be true and then acting based on that is a very dangerous way to make policy and is unfortunately what I believe we've seen in many markets.

To extend that quite a bit, the other thing Professor Carlton said that I found quite correct was that you really have to look at the results. Once again, you have to look at the results in both directions. So when I look at results on things like efficiency, when I think of Rich's comments here about making sure we cover all players in the space and that we do provide services to everybody equally, I look at the fact that we as an industry have more cards, more merchants, more transactions every year and substantially so. We have more markets around the world we open up. We have more competitors coming into the space now than ever before. Technology has really enabled that. I wasn't sure how to take Dan Hesse's comments yesterday as to whether he was looking to play with us or compete, but that is another area we obviously look at.

Most importantly, we have to be sure there are great innovations coming. I am going to hit on this point quite a bit. It is not innovation for innovation's sake. It's innovation for the benefits it brings. It is exactly what competition and free markets are aimed at creating and what government-run monopolies make sure do not get created.

With that, I want to turn quickly to the comments Harry Leinonen had to say yesterday in response to my question on consumer choice and what role that played. I was struck because his answer very much goes to the crux of how one feels about this space. His answer was, to some extent, and I'm paraphrasing—Why would you ask about consumer choice? That doesn't seem to be a relevant question.

A payment is just a way of connecting one account to another, so why do you need many of them, and what does choice have to do with it?

Frankly, that is the core question. If you don't care whether consumers have a choice, and if you don't think consumers should have the ability to make different decisions (and when I say consumers, I mean merchants as well) about how they pay for things and how those payments are processed, then it is quite easy to conceive of a government-run payments system that is the only one that exists; it doesn't have to change or adapt over time, it doesn't have to drive costs down, and it doesn't have to come up with innovations.

However, if you believe as I do, consumer choice is paramount, and it is paramount because of all the new payment types that are brought into the system through the new choices that are given to consumers. We heard Dickson Chu talk about the things PayPal has done to penetrate new merchant segments. I'm not sure about the 15 percent figure, Dickson. We can talk about that offline, but there is a large segment of smaller merchants online, which are serviced only by what PayPal has brought to bear. That innovation would not have existed in a public-only world, and that was enabled by our rails initially—not by government rails, even though they are now pushing them the other way.

It really boils down to how you feel about consumer choice as paramount to actual decisions being good. In that sense, I was struck by some of the comments about the fact that people here don't think consumers make good choices or don't know how to make good choices, or maybe consumers don't really know what's good for them. I ultimately do believe in the power of consumers, at least over time, to know and to decide what is good and what works for them when presented with the right options. And, yes, transparency is important in that regard.

You end up with inferior, less-optimal products like our U.S. check clearing and ACH systems when you do not have private-sector entities pushing innovations and pushing consumer choice and consumers deciding what wins as the paramount reality. I'll come back to that in a bit, but I do take great faith in consumers and their wisdom about what they want. To think otherwise is to make a mistake and discredit the power of the individual to truly understand what's good for them.

I also want to say that to me it is not “just a payment.” We've heard a lot of times, “Well, it's just a payment.” But it's not. It is all the things that go with it. The last discussion on security really struck me, because one of the things I haven't actually sat in a Fed conference about, and would love to be in a Fed conference about, is consumer ease of use. You can have really secure products no one will use, because they are impossible to use. You have to start with something that is easy for a consumer and beneficial to a consumer, then you can talk about how to best secure it. But you have to start with what is easy and beneficial to a consumer. And I'll get to my points on security in just a second.

Now turning specifically to Rich and Stu's paper, let me start by saying there is one thing in there I wholeheartedly agree with, which is the arcane nature of the Uniform Standards Commercial Code. I thought that was a great observation. I am not sure the Fed has any authority to do anything about that, but if you do

I also agree with about 90 percent of the comments in the paper, in terms of the high burden that should be met before there is public-sector involvement in operating a system. I just don't agree that burden has actually been met, and I probably would disagree with many of the conclusions around the particular circumstances that led to the creation of the check clearing and ACH systems, which would be the subject of a fact paper that I might turn in separately rather than using my time here to go through.

All of the arguments for why an operator role is justified in my mind boil down to things that are really part of the facilitator or overseer role, not the more critical question of whether to get in and compete with private-sector entities. Checks were a great example. The fact that checks have gone electronic in the last few years is great. The fact that they didn't go electronic for the 90 years or more before that to me represents the abject failure of the system as set up. If there were private-sector entities—whether it was one or many operating in that space—you would have seen checks become electronic way earlier, as you did with the paper in the card system as was discussed yesterday.

We saw that efficiency as an opportunity to drive down our costs, because we were not pricing based on being able to recover costs plus a margin. We were pricing based on value. So we have to drive down our costs and drive up our value. We have to do both things, not simply do whatever we want and then come up with a formula to cover that plus a margin. That is the discipline the private sector brings to a particular innovative space.

The next thing I would say is that, frankly, if the private sector were running the check clearing system, it probably would have come up with a debit-card-type system way earlier. It would have been an obvious thing to do. Even today, the fact that you have electronified the back-end of it is great; the fact that you still have to write a check is a massive problem.

The ACH has been done slightly better. However, there are still—and Dan Eckert pointed this out—some real fraud issues there. Additionally, there are some real timing issues. The fact that you don't have real-time authorizations, and that you don't have guarantees in that regard, are real problems to the greater adoption.

I want to make one other point here. What I find to be very powerful is the fact that, whenever we're at these conferences, it always comes down to "cheap or free is good"—somehow that's efficient—rather than "cheap or free is bad." You look at one particular thing, rather than the whole system. Of course, if two things do exactly the same thing, it is better that it be cheaper, but you have to make sure you understand the question.

As I was sitting here yesterday, I decided to use my iPhone to look up a definition of the word “efficient,” because I wasn’t really sure we were all saying the same thing. Just a quick show of hands: Who thinks they know what “efficient” means. Nobody? And who thinks they know what “cost-efficient” means? I decided to avoid all economic definitions, because apparently to define efficient or cost-efficient in economics takes 100 pages. So I went to a much quicker source. Webster’s dictionary definition of “efficient” is “productive of desired effects, especially productive without waste.” Okay?

Then I said, “Okay, well what does ‘cost-efficient’ mean?”

Oddly enough, that is actually not a phrase. It does not exist according to Webster. They turn it into “cost-effective,” but it basically means “economical in terms of tangible benefits produced by the money spent.” So it doesn’t actually mean “free or cheap.” It means whatever you’re spending, you are being productive in what you create from it. Spending more for a better product is perfectly efficient and perfectly cost-effective, as much so as spending nothing on something that creates very little benefit. That gets lost in this discussion, and I want to point it out.

Industries ripe with innovation show the cost-effectiveness and the efficiency of what we do. We have an electronic authorization and clearing system. We have fraud tools that are quite good, notwithstanding the last discussion. We are still seeing on a global level, basis points of fraud. As a percent of overall transactions, that is still among all-time lows on a global basis, just as well as here in the United States, relative to what we saw years ago. Yes, the criminals are on the rise, as they do cyclically become. We will catch up with them and overtake them. The Fed does have a good role to play there in helping us get there faster, but we will get back there.

I talked about inControl—another great innovation. This is something MasterCard has on a proprietary basis, giving cardholders the ability to set their own controls—how much they spend in various merchant categories, getting alerts by e-mail or text message when they actually exceed one of those spending categories or whenever else they determine they would like to get them. For security purposes, inControl also allows a cardholder to create a single-use account number that only exists for one transaction and then goes away. So if it is the subject of a data breach, it cannot be reused by the criminal who steals it. There are great innovations with chip, with contactless, with mobile, with e-commerce, which would not exist but for our systems, person-to-person payments and transit.

We heard a little bit from Bob yesterday about taxis. I saw an interesting article in *The New York Times* last week about New York City taxis. They’re seeing tips up about 20 to 30 percent when people use cards versus cash, which is obviously a great benefit to them. They are not complaining as much as they were when the card systems first came out. They don’t say it doesn’t work when you try to pull out a card anymore. They actually will take the card now.

These are things that have been enabled by contactless capabilities—transit systems and subways. So the question, Harry Leinonen, of why consumer choice matters and why it's not just from one account to another, is why you can't go in a transit system and use your account of choice to make a payment. We need to get to the point of enabling that.

We run an at-par clearing system in the bill-pay space. Quite frankly, it's really hard to justify investing or innovating in that space, because we're competing with the ACH and check clearing systems. It is very, very difficult—as some people have pointed out—to price differently, because the Fed has set a benchmark price. Some would argue that's good. I would argue that's bad, because we have not created innovation in the bill-pay space that would make those payments more efficient, meaning they would get the desired outcome. They would be more effective. They would be faster. They would be more guaranteed. They would be more beneficial to the consumer.

As I am out of time, I am going to rush ahead and say, I think there is no doubt that the private sector achieves the very things that would indicate that maybe there is a failure requiring the public sector to step in. There is, in my mind, no integrity issue, because in spite of 9/11, the economic meltdown of last year, and many, many bank failures, we have not failed to clear a single transaction. We have not had a single bank failure that we couldn't manage with the protocols we had put in place to manage them.

Yes, at the wholesale level, there is absolutely a role for a central bank, but at the retail level we have covered it quite well. Costs are fair, in my view, and I know many of you disagree with that. I am not going to argue they're cost-based, but I am going to argue they are very much value-based and way cheaper than the value all of you receive from them. We bring tremendous value that often gets understated. Free or cheap is not efficient or cost-effective. It is just free or cheap. Okay? Many of you may like to buy a cheap car, dishwasher, or whatever. You should do that, but you should also have the option to buy the more expensive one.

The check clearing system, if it were efficient or cost-effective, would have led to debit or e-check way earlier. That actually required an act of Congress, not the operator innovating in that regard. To think of Congress as being the impetus for innovation is a real struggle for me.

I talked about many of the particular things there, so I want to say I think Stu had it right in his 2008 paper when he said the Fed's decision at the early stages of credit card development not to clear credit card slips through its check clearing operations helped spur the private sector to ultimately create an advanced electronic solution for the clearing of credit card transactions, which was a positive outcome in terms of efficiency. I would like to see the Fed make similar decisions to promote efficiency by letting the private sector be the ones to innovate, as that is what they do best. Truer words could never have been spoken, and I would heed us all to follow those words.

One last point as I conclude: I want to address the fact that there have been some people talking about collaboration, which someone equated to collusion. I just want to say that at MasterCard we independently set our rules, we independently set our prices, and we do it based on what we think is most effective, efficient, and cost-effective for our system. And we do it independently. We hear as much noise from issuing banks as we hear from merchants about our pricing decisions—sometimes more. Yes, one side thinks it's too high and the other side thinks it's too low. We do look at things like security, how we promote one side versus the other, and how we place incentives in the right place, we do all those things. To see the Fed play a role in helping have better information on which to make those decisions would be fabulous. However, I would hate to see the Fed supplant its decision making for that of the free market.

