The migration of consumers from paper checks to credit and debit card networks has been only a part of the story in the area of retail payments. Over the past decade we have also seen a significant change in the competitive environment among payments service providers with consolidation across the industry. While new entrants are providing services on the front or back end of the payments clearing process, the market for clearing payments transactions between senders and receivers is increasingly concentrated, dominated by a few very large providers.

The march toward consolidation has been going on for some time. In 1995, the largest three networks combined controlled approximately 50 percent of the PIN debit volume. That figure rose to roughly 80 percent in a little more than a decade. Perhaps more striking is that over the same period, the number of networks dropped from around 30 to 14.

This evolution is not surprising given the economics—high costs associated with providing a network service that is sufficiently secure, highly available and resilient, and able to connect thousands of banks and credit unions across the United States. This level of market concentration, however, raises serious issues in the areas of pricing, access and security/resiliency. For the benefit of all market participants, from the consumers through the financial institutions, I believe it is crucial that the Federal Reserve consider expanding its role in this area.

In card payments, the Federal Reserve has historically been confined to consumer protection issues. The card networks, which developed privately as tools for accessing bank lines of credit, have long since expanded far beyond their initial role, with electronic payments now exceeding two-thirds of all noncash payments in the United States. Looking more broadly at the overall payments system, this rise in card transactions means a growing share of payments are clearing via an increasingly concentrated market of networks focused on maximizing shareholder profits and not necessarily on ensuring broad access and sufficient levels of security and resiliency.

Among other concerns, this concentration provides significant pricing leverage that works in favor of the networks and has little benefit to consumers or other system participants. Beyond the competition issues, there are also important system resiliency questions. Card market service buyers are not afforded the same safety net as check and Automated Clearing House (ACH) customers, who can rely on the Federal Reserve as an operator in times of crisis. This issue is increasingly important as we see complex systems controlled by fewer operators—a combination that raises the vulnerability of the entire system to “single points of failure.”

To some, the idea of the Federal Reserve taking an active role in electronic payments networks might seem to reverse the usual path of marketplace evolution. Generally, competition between the public and private sector has been in areas where there was a government monopoly and where it was clear competition would bring benefits—parcel shipping is perhaps the most visible example. A move by the Federal Reserve to compete with the card payment networks would bring another participant into a business where exceedingly
high entry costs block the emergence of new competitors, but it would also have numerous additional benefits.

Historically, the Federal Reserve’s active participation in the payments system has been focused on checks and ACH payments. The Federal Reserve does not seek to maximize its profits, rather it is required by law to recover all related operating costs as well as interest, taxes and return on equity comparable to private sector participants. In addition, the Federal Reserve focuses on improving payments system efficiency and providing financial institutions and their customers broad access to payments products at a competitive price, and in doing so, it provides benefits beyond acting as simply another competitor. For example, the Fed was instrumental in lowering the cost of the payments system by being first to the market with services that enabled financial institutions large and small to take advantage of electronic checks. Also, in times of crisis, the Fed stands ready to make its services available to any financial institution as a reliable alternative to their current service provider.

Finally, of course, there are the benefits of the insights the Federal Reserve obtains by being a provider versus solely a regulator in this important component of our economic infrastructure. In many countries, the central bank carries out its payments system policy mandate by regulating rather than competing in the retail payments market. By participating in the market as a provider, not only does the Fed influence pricing that otherwise might tend toward monopolistic, but also it can gain and share hands on knowledge and insights into the impact of proposed regulations and policies on businesses, consumers and banks that would not be possible with solely a regulatory oversight role. This ability to understand and influence industry standards that promote efficiency in payments processing and ultimately benefit the public, has a long history going back to the introduction of MICR line standards in the early automation of check processing in the 1950s and 1960s. Most recently, we have worked with financial institutions, software vendors and payments processors to improve electronic check clearing processes and standards.

Because the Federal Reserve is charged with promoting the efficiency, integrity and accessibility of the payments system, subject to the constraints of full cost recovery as required by law, we are well-positioned to remain an active provider of retail payment clearing services. Such a role is important in ensuring that we preserve the value that has been derived by our past involvement in such areas as access, efficiency and resiliency. Additionally, there are the important benefits of acting as a safety net, actively participating in setting standards and gaining important market insight. Given the inherent risk in payments, the consolidation of service providers and the increasing reliance on electronic payments, the Federal Reserve’s role as an operator has become even more critical. It is time to expand our role in this market.

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