President's message

A central role in payments

When lawmakers designed the Federal Reserve System a century ago, they envisioned a central bank that would serve as a source of financial stability, provide a safety net in times of crisis and support the growth of the U.S. economy. To fulfill these roles, the Federal Reserve necessarily played a central role in the U.S. payments system.

While the Federal Reserve was initially concerned with clearing checks, technology has evolved over the past 100 years to offer consumers and businesses better ways to pay. During these years of change, Congress has continued to turn to the Federal Reserve to ensure payments improvements are universally available and that the entire system remains safe and secure.

A look back at the historical issues the Fed has faced throughout its evolution as a payments system operator, regulator and leader provides important context for the current discussions over the central bank's future role and responsibilities in this critical mission area. Many of these issues are highlighted in a new book from the Federal Reserve Bank of Kansas City: *Highways of Commerce: Central Banking and the U.S. Payments System*.

Interestingly, several of the core questions about the payments system today—including "Who bears the costs of operating the system," and "What is the proper role of a central bank"—are remarkably similar to the issues banks, consumers, businesses and policymakers faced even before the Federal Reserve was established.

Moving checks

In the late 19th century, retail payments in the United States largely relied on the movement of checks. The process of clearing and settling these pieces of paper was a risky and expensive endeavor for the banks, consumers and businesses involved in everyday commerce across the country.

To help cover this risk and expense, many banks assessed fees on the checks that passed through their institutions, and as a result, consumers and businesses often did not receive the full face value, or "par" value, of a check they deposited. In an attempt to avoid these so-called exchange fees, banks often sent checks through a complicated network of correspondent institutions that agreed to honor checks at par value. This practice resulted in lengthy delays between when a check was credited to a bank account and its final settlement as a check could travel through dozens of different banks located hundreds of miles apart.

This delay, known as check float, constituted a "serious danger to banking liquidity or solvency," noted Rep. Carter Glass of Virginia, one of the Federal Reserve Act's authors. Glass and others decried the "fictitious balances" that float created throughout the banking system. The Act's Senate sponsor, Robert L. Owen of Oklahoma, also felt this issue should be addressed by equipping the new central bank with the ability to clear payments on behalf of disconnected banks. Such an institution would provide a "much

higher velocity to the great credit system of the United States," and improve financial stability.

In its final form, the Federal Reserve Act called for a number of regional Reserve Banks to be located across the country that would decentralize power as well as serve as regional clearinghouses for member banks. The Federal Reserve's founders felt the Reserve Banks, by working together to clear checks at par, would establish the first truly national clearinghouse in the United States and would help lower costs and remove obstacles throughout the payments system. As Glass said in a speech a day before the Act was signed into law, the Federal Reserve's new payments responsibilities would "tear down these tollgates upon the highways of commerce."

An ongoing challenge

While Glass, Owen and others had high hopes for the Federal Reserve's ability to improve the speed and efficiency of the payments system, those within the central bank faced a daunting challenge, and the Federal Reserve Act provided little guidance for how the Reserve Banks should carry out their payments mandate. It was, as the Board of Governors noted in its first annual report in 1914, a problem "of great novelty" that "calls for the application of a high degree of technical skill."

The Board of Governors was determined to eliminate exchange fees on checks throughout the entire banking system, and during its first few years, the Reserve Banks spent an incredible amount of resources working to convince banks to honor checks at their full face value. However, this initial effort led to controversy. The Federal Reserve's experience in the early 1920s in Nebraska and elsewhere provides a colorful example of the public backlash that resulted.

Armed agents from the Kansas City Fed's Omaha Branch, and elsewhere, visited non-member banks in rural Nebraska towns in an effort to persuade these institutions to stop charging exchange fees. When a bank refused, the agents would collect a large number of checks written on that institution and then present them all at once at the bank's counter for immediate cash payment. This practice effectively drained a bank of its cash reserves, and in some cases, threatened a bank's survival if it did not have enough cash on hand.

Soon, bankers who were targeted by the Federal Reserve's heavy-handed tactics complained to their elected officials, who held hearings and passed resolutions demanding the Federal Reserve account for its actions. The Federal Reserve Banks soon found themselves mired in state and federal lawsuits. After several court cases and heated rhetoric from bankers and businesses on both sides of the controversy, the issue was resolved with a 1923 Supreme Court decision that upheld state-chartered banks' right to charge exchange fees. The Federal Reserve ended its aggressive methods, and small banks in some rural areas continued to charge exchange fees until 1980.

A collaborative approach

The Federal Reserve's experience during this era was proof that change in the payments system would require the cooperation of

other participants. As a result, the Federal Reserve began to pursue a more collaborative approach with the banking industry, businesses and consumers. This led to significant improvements in the payments system in the mid-20th century, such as the use of magnetic ink (MICR) on checks, greater standardization across the banking industry and other technology improvements, such as automated sorters, that vastly improved efficiency.

By the late 1970s, it became clear that the Federal Reserve's leadership was needed once again. Hundreds of member banks were leaving the Federal Reserve System in an attempt to escape the Fed's reserve requirements and other regulations on savings and checking accounts. This was affecting the Fed's ability to conduct monetary policy, and Chairman Paul Volcker and others pushed for a solution that would level the regulatory playing field while also significantly changing the payments landscape.

Under the Monetary Control Act of 1980, all financial institutions would be required to meet the Federal Reserve's reserve requirements. At the same time, the Federal Reserve would be required to price its payments services and make them available to all institutions rather than providing them for free to member banks only. The passage of the Act meant the Federal Reserve would now compete with other institutions for check-clearing and other services, resulting in efficiency gains for the entire system.

As the payments system continued to evolve over the next several years, the Board of Governors in 1996 established a commission, led by Vice Chair Alice Rivlin, to develop a plan for the Federal Reserve's future role. Working together with bankers, consumers, merchants and others, the commission found there was overall support for the Fed to continue its role as a payments system operator and regulator. But, the commission also identified areas where the Federal Reserve needed to improve, particularly when it came to preparing for a more electronic payments system.

Soon after the Rivlin Commission's final report, it became clear that the payments system was transitioning from paper to electronics. In 2003, the Federal Reserve led the way by pushing for the passage of Check 21. This legislation modernized the way checks were cleared and settled by making an image of a check equivalent to the original paper version. The result was reduced transportation costs, a faster settlement process and improved efficiency overall.

More recently, the issue of interchange, or the fees that banks charge merchants on each payment card transaction, became the focus of a heated debate in Congress. As with other issues in the payments arena, Congress turned to the Federal Reserve by mandating the central bank set a "swipe fee" limit for debit card transactions. This issue remains controversial today, but Congress' directive that the Federal Reserve regulate this fee reflects the public's expectation that the Fed continue to play a role in the payments system.

A strategic plan for the future

Last year, the Federal Reserve took a next step to foster coordination, and where appropriate, drive payments system

improvements. A paper issued in September 2013 sought comments from consumers, financial institutions, merchants, trade groups, payment networks and processors, software vendors and many others, with the goal of developing a plan for making the payments system faster and more responsive for end users.

Throughout this process, the Federal Reserve has identified a number of desired outcomes, including a ubiquitous, faster electronic solution for business and personal payments, improvements in cross-border payments to and from the United States, and enhanced payments safety and security so that the public's confidence in the system remains high. I encourage you to visit www.fedpaymentsimprovement.org for information on these initiatives.

Since the Federal Reserve's founding, Congress has looked to the central bank to take steps to facilitate cooperation to address network or coordination challenges that otherwise impede innovation, efficiency and other public benefits.

Industry collaboration and engagement is essential to any enduring strategic improvements to the U.S. payments system. This is an exciting time as the Federal Reserve prepares for the next steps in the payments system's evolution. I am looking forward to seeing what the future holds for the central bank and a next generation payments system.

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President George is a member of the Federal Reserve's Financial Services Policy Committee, which oversees the strategies and operations of the Reserve Bank's product offices and the provision of Federal Reserve financial services to depository institutions and the U.S. Treasury. An electronic version of the book *Highways of Commerce: Central Banking and the U.S. Payments System* is available from the Kansas City Fed's website, www.KansasCityFed.org.