

Perspectives on Research Issues in Consumer Behavior

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**Research/Payment Cards Center Conference:
Innovation in Financial Services & Payments
Welcoming Remarks
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Good afternoon and welcome to our Conference on *Innovation in Financial Services and Payments*.

As we are all aware, incredible advances in technology and sweeping changes in regulation have been impacting the financial services industry like never before. These developments are of interest not only to the Federal Reserve, but also to a broad set of industry players, academic researchers, policymakers and the public at large.

In the decades ahead, innovation will revolutionize the payments system. Changes will occur at all levels as both the system itself, as well as its payments providers, transform in structure and scope.

Today, many outside the industry do not yet realize the incredible potential for change presented by new technologies. Inside the payments system, however, one can detect fundamental changes beginning to take shape. These changes are affecting all aspects of the payments process: how payments are made, by whom, and through what service providers.

This shift in payment behavior has been much heralded. Even as far back as the 1970s, industry talk had turned to the bold notion of a future cashless society. Now, that future may be a near-term reality, as a confluence of technological and structural changes are altering the economics --- and the evolution --- of the payments system.

From the perspective of the average retail customer, the growing use of credit cards, ACH, debit cards, and other emerging retail payment vehicles has been a self-reinforcing development. In addition, network effects have encouraged even further growth. Checks and cash are on the wane as the predominant methods of payment in the United States, as they continue to lose market share to more efficient electronic alternatives.

Below the surface, changes at the retail level are even more profound. While the costs of currency have not changed much, the check industry is in the throws of a revolution. What began with truncation now includes such sophisticated innovations as advance electronic presentment, check imaging, digital transfer and electronic archiving of check images. And the future holds only greater advances as we look to the emergence of digital image clearing, electronic check presentment, web-based retrieval by both banks and customers, and even a national archive for check images.

Check processing is not the only aspect of the payments system to undergo re-engineering. New technologies have also allowed non-bank private providers to change the industrial structure of the payment system. Innovation in the industry has created opportunities for non-bank payments processing vendors, and paved the way for joint ventures between banks and tech firms. As a

result, these providers are rapidly gaining market share throughout the retail payments process, as they enter the market in various payments activities. Thus far, such activities have included merchant clearing, ATM ownership and debit retail electronic processing.

Most recently, private sector electronic payments networks have become popular, with Visa and MasterCard playing a leading role. In addition, the emergence of the Electronic Payments Network has attempted to increase its role as an ACH operator.

On the wholesale level, too, the pace of change continues to accelerate. While Fedwire continues to be the industry choice for large payment transfer, the Fed is moving into an era of unprecedented cooperation with alternative private providers. The inter-operability of Fedwire with other systems is increasing, as is the discussion of further expansion of operating hours to overlap with foreign payments systems. Of course, through all of this, the Fed continues its aggressive pursuit of operational efficiencies, which are passed on to our customers through lower prices.

All of these changes have dramatic implications for the structure of payments. This in turn impacts the overall financial system --- including the way in which monetary policy affects the economy. Here at the Fed, these changes raise fundamental questions about our role in the payments system. We must re-examine our obligation to maintain an effective payments mechanism, and to assure that its stability and integrity are intact. We must also look at the interaction between this role and our monetary policy responsibilities.

To address these issues and serve as a source of knowledge and expertise on this important segment of the financial system, we created the Payment Cards Center. The Philadelphia Fed has a vested interest in this area of research. The Third District is home to the credit card industry, with approximately 40 percent of all consumer credit cards emanating from the state of Delaware. Our District also houses some of the leading transactions processors in the non-credit card market, as well as the controlled disbursement arms of major money center institutions.

Consequently, we are the single largest check-processing site in the Federal Reserve System, and an interested party to the ongoing payments evolution. The emerging payments system, and the effect of recent and proposed legislation on payments system mechanics, are clearly crucial issues for us. We also follow closely the ongoing public policy discussions regarding such topics as bankruptcy rights, collateral access, and consumer protection legislation.

Established a year and a half ago, the Payment Cards Center has already made significant progress. Under the direction of Peter Burns, the Center has been invaluable in providing meaningful insights into industry issues. Through an aggressive agenda of research and analysis, forums, and conferences such as this one, the Center encourages collaboration among the perspectives of industry, academia and the public sector.

Cosponsoring today's conference is our Philadelphia Fed Research Department. Headed by Loretta Mester, the Research Department continues to make substantial contributions to the field of economics and to set the standard for economic research. It is interesting to note, although our Bank's Research Department is relatively small compared to others in the Fed System, we rank second System-wide -- following only Minneapolis -- in terms of publications per economist.

I would like to thank both Peter and Loretta for their contributions in bringing this conference together today.

I know we are all anxious to get the program underway, so I will keep my remarks this afternoon very brief. But before I close, let me urge the academics in the audience to take very seriously the issues addressed here today. The payments system has not received the time and attention it deserves on the academic research agenda. I encourage your interest and involvement to fill the void in this critical area of research.

While most economists have avoided the payments system, there are exceptions. Some scholars have stepped into the fray, such as Dave Humphrey here today, Schmalansee, and Terole. We have made great strides in the areas of bank regulation and consumer protection. Still, there is much work to be done. Any such research effort would certainly incite and contribute to the public policy debate.

New theories need to be developed to explain the economic rationale and impact of various transactions media. Credit cards, debit cards, and smart cards are far more complex than our traditional characterization of money. A well-developed theoretical framework to guide private sector participants and public sector supervisors is a pressing task. These are the issues on the agenda of our Payment Cards Center.

This conference is a first step in promoting a rich research agenda – covering many aspects of financial innovation. I hope you share our enthusiasm for increased research in the area and its potential for meaningful economic analysis. I believe that the impressive roster of participants and the compelling list of topics ensure this conference will do just that. We look forward with great interest to the research efforts these issues will inspire.

With that, I would now like to turn our program back to Peter. Let's get started...