

A summary of the roundtable discussion on the role of wire transfers in making low-value payments

May 16, 2006

The Federal Reserve System's Payments System Policy Advisory Committee has an ongoing program to discuss payments system developments and barriers to innovation with the payments industry and relevant payments system participants.¹ As part of its program, the committee hosted a roundtable discussion with industry leaders on the role of wire transfers in making low-value payments. The roundtable discussion was held at the Federal Reserve Bank of New York on May 16, 2006. During the discussion, eleven industry experts representing commercial banks, nonbank financial institutions, nonfinancial corporations, traditional payment system operators, and alternative payments service providers gave the committee a variety of perspectives on the role of wire transfers in making low-value payments.²

Wire transfers are widely used for making large-value payments by both financial and non-financial organizations. Today wire transfers underpin the most important money and capital markets in the United States and provide the benchmark for speed and security in making large-value payments. The discussion at the roundtable focused on the use of wire transfers for making relatively low-value payments by consumers and businesses as well as the alternatives for making these payments. During the discussion, participants noted the advantages of using wire transfers, including factors encouraging the use of wires for low-value payments. They also described drawbacks of

¹ The Federal Reserve's Payments System Policy Advisory Committee provides the Board with a view of developments in both wholesale and retail payments at a time of significant overall change in the U.S. payments system and helps coordinate Federal Reserve work involving domestic and international payments and settlement systems. The members of the committee are Donald Kohn (chair), Vice Chairman, Board of Governors of the Federal Reserve System, Timothy Geithner, President of the Federal Reserve Bank of New York, Randall Kroszner, Governor, Board of Governors of the Federal Reserve System, Cathy Minehan, President of the Federal Reserve Bank of Boston, Michael Moskow, President of the Federal Reserve Bank of Chicago, Gary Stern, President of the Federal Reserve Bank of Minneapolis, and Kevin Warsh, Governor, Board of Governors of the Federal Reserve System. Patrick Barron, First Vice President of the Federal Reserve Bank of Atlanta, is a liaison member of the committee.

² The organizations represented at the roundtable were Ameren, Bank of America, Cash Edge, The Clearing House, Federal Express, Fidelity Investments, JPMorgan Chase, McGraw Hill, Morgan Stanley, UBS Financial Services, and Visa.

sending and receiving low-value wire transfers. The participants, however, did not focus solely on wire transfers; they also discussed other methods for making low-value electronic payments. This document summarizes the participants' discussion of these topics.

Background

The two main wire transfer systems in the United States are the Federal Reserve Banks' Fedwire Funds Service (Fedwire) and The Clearing House Interbank Payments System (CHIPS).³ In 2005, an average of 528,000 wire transfers valued at about \$2.1 trillion were sent over Fedwire each day. Approximately two-thirds of these transfers were for less than \$100,000.⁴ The average value of a wire transfer sent over Fedwire was around \$3.9 million and the median value was roughly \$35,000. In 2005, CHIPS processed an average of approximately 285,000 transactions valued at about \$1.4 trillion each day and reported a proportion of low-value payments similar to that of Fedwire.⁵

A number of roundtable participants confirmed that their organizations use wire transfers to make a significant number of relatively low-value payments. The participants agreed there is no single best method for making low-value payments. The participants noted that the automated clearing house (ACH), checks, credit cards, debit cards, and wire transfers are all used to make low-value payments. When choosing a particular payment method, organizations or individuals typically consider their requirements for a given payment (such as convenience, cost, and urgency) and select the payment type that best meets those requirements. If, for example, an organization

³ The Fedwire Funds Service, owned and operated by the Federal Reserve Banks, is a real-time gross-settlement system in which participants initiate funds transfers that are immediate, final, and irrevocable when processed. Participants that have an account with a Reserve Bank may use the Fedwire Funds Service to send and receive payments. CHIPS is a bank-owned real-time final payments system. Funds transfers made over CHIPS are final and irrevocable when released by the system for settlement.

⁴ For the purposes of the roundtable, any wire transfer for less than \$100,000 was considered a "low-value" payment.

⁵ A similar proportion of low-value wire transfers have been observed in other G10 countries such as Canada and Great Britain, suggesting that this phenomenon is not unique to the United States.

considers urgency to be a key factor, a wire transfer may be ideal for making a low-value payment. If a payment is less urgent, lower cost alternatives such as the ACH, if it is available to the sender, may be well-suited for making the payment.

Although the organizations represented at the roundtable were aware that they used or processed wire transfers for a variety of purposes and with a large range of dollar-values, after conducting analyses in preparation for the roundtable, most participants expressed surprise at the large number of low-value wire transfers handled by their organizations.

Factors encouraging the use of wire transfers for low-value payments

As part of the discussion, the participants provided some insight into why their organizations use wire transfers. The participants discussed a variety of characteristics—such as speed and irrevocability—of wire transfers that lead their organizations and their customers to use wires for low-value payments.⁶ The participants also spoke of a number of factors, including habits, convenience, the types of users, and the types of transactions, that contribute to the use of wires for making low-value payments. They also discussed how the lack of availability of alternatives for rapid, irrevocable payments contributes to wires' use. These discussions highlighted the relative flexibility of wire transfers and illustrated the wide range of circumstances in which low-value wires are used.

Most participants indicated that in many cases the urgency of the payment dictates how it will be made. The interbank transfer of funds over the Fedwire and CHIPS systems can occur within seconds.⁷ Thus, if a payment needs to be made quickly, an organization will often use a wire transfer. Some participants also noted the

⁶ The roundtable participants used the word “irrevocability” to mean that once a wire transfer is processed, it cannot be cancelled or otherwise annulled.

⁷ The total time for transferring funds will depend upon the time it takes the originating party to initiate the transfer, the time it takes a bank to send the transfer to a payment system, the processing time (including the time a payment may sit in a queue), and the time until the beneficiary's bank credits the beneficiary's account or notifies the beneficiary that funds have arrived.

importance of the irrevocability of wire transfers when making important payments. This characteristic of wire transfers reduces the risk exposure, including the risk that a payment might be reversed or returned, of a beneficiary and its bank relative to other types of payments such as checks. Several participants added that because of the irrevocability of wire transfers, parties expecting to receive an important payment and companies dealing with less-creditworthy customers will often require that the payment be made by wire.

Many participants discussed other elements that motivate the use of wire transfers. Several participants emphasized that both originators and beneficiaries of wire transfers feel more assured knowing that they can track a payment using the reference numbers associated with a wire transfer. Both the Fedwire and CHIPS systems assign a unique sequence number to each message as it is processed. The reference number can be used to track a payment if it does not post to the correct account because of an error in the payment instructions. Also, if requested, the receiving bank can often confirm precisely when funds have been received. Further, one participant added that many users perceive wire transfers as a highly safe and secure payment method. A participant from a financial institution stated that customers with high net worth are more likely to initiate wires than other customers. In addition, beside the inherent features of wire transfers, some participants believe that businesses and individuals often send wire transfers out of habit. For example, one participant noted that some customers of its organization are accustomed to sending wire transfers for relatively large-dollar values and simply do not consider using alternative payment mechanisms for smaller payments.

The participants also stated that the convenience and cost of making wire transfers can depend on the amount an organization has invested in automating the processing of wires. For example, organizations, such as large nonbank financial institutions, that make and receive a relatively high number of wire payments have invested in streamlining processes for their customers and their employees. Customers and employees at these firms can be provided with relatively convenient channels, such as Internet browsers, that facilitate the initiation of wires for various payment obligations.

Organizations that employ these higher levels of automation may have greater numbers of low-value wire transfers.

Further, participants raised the issue that for some types of payments, specifically sending and receiving international payments, there are few effective alternatives to wire transfers. Although some international ACH products exist, many organizations find that the infrastructure for making these payments is not sufficiently developed to make the ACH a generally effective method for transferring funds to foreign countries.

Other participants stated that some users' lack of knowledge regarding alternative payment types drives the use of wire transfers for low-value payments. Several participants noted that users are often unaware of the availability of alternative payment types for certain transactions or do not fully understand the attributes that distinguish wire transfers from payments made over other systems, specifically the ACH. The participants generally agreed that banks have weak incentives to market alternatives to wire transfers because they derive more revenue from wire transfers than from ACH transactions.

Drawbacks associated with sending and receiving wire transfers

The roundtable participants discussed two primary drawbacks in using wire transfers to make low-value payments. Many participants mentioned the higher fees for sending wire transfers relative to other payment types. The participants generally emphasized, however, that the most significant drawback associated with the more widespread use of wire transfers by business organizations is the difficulty in automatically linking incoming wires to billing information in internal corporate data systems.

Most nonbank participants mentioned the relatively high cost of sending wire transfers. Originators are assessed transaction fees by banks for processing wire

transfers. These fees vary by bank depending, in part, on the services provided related to initiating the wire transfer.⁸ While the participants noted that fees for wire transfers are higher than for alternative payments, some banks also explained that the value derived from wire transfers such as speed, irrevocability, security, and flexibility justify those higher costs.

The participants focused their most pointed comments on the difficult process of reconciling incoming wire transfers using the remittance information contained in the payment instruction. The participants expressed frustration with the lack of remittance information and of standard formats for including this information. Many participants believe that the lack of standard practices in including remittance information with wire transfers is a key problem for corporations in linking payment and billing information. Some participants noted that originators of wires often fail to include enough information for the beneficiary to reconcile easily the incoming payment with other information in internal data systems.⁹ When specific data regarding a payment, such as additional account or billing information, is not included with the payment, beneficiaries must take extra, often time-consuming, steps to determine this information before posting the wire to the appropriate account in their internal systems.

Some participants pointed out that even when sufficient information is included with a payment, banks typically have different formats associated with fields for including remittance information. The lack of standardized formats, the prospect of incomplete information, and the investment costs of system changes all combine to limit the pace at which organizations deploy systems to electronically integrate payment, remittance, and accounting information.

⁸ The bank's fees likely include the charges to the bank from the wire transfer operator, the marginal internal costs incurred by the bank to process the wire, and a profit margin. Wire transfer operators charge per items fees as well as other fees if the transaction is not sent through electronic channels or if the customer requests specialty services. See <http://frbsservices.org/FeeSchedules/index.html> for a schedule of current Reserve Bank transaction fees for wire transfer services.

⁹ Originators of wire transfers are currently able to include some amount of remittance information in a free-form field when initiating the transaction. This information, however, is not necessary to execute the payment between banks and thus wire transfer system operators do not check the contents of this field and do not have information to verify its accuracy.

The participants did note some limited successes in electronically integrating the receipt and reconciliation of low-value wire transfers with customer accounting information. Some nonbank financial institutions, for example, have been successful in automating the posting of these wire transfers when an individual customer is transferring funds between accounts at different institutions. In such cases the financial institution is able to work closely with a customer on format and data entry. Moreover, a customer's strong interest in the timely and accurate receipt of his or her own inter-account transfer creates a strong incentive to include relevant information. Some nonbank financial institutions are also reported to have enforced their format standards by returning wire transfers with insufficient or non-standard remittance information rather than taking potentially time-consuming steps to apply those incoming wires to the appropriate customers' accounts. To date, however, such special cases as inter-account transfers only highlight the much more complex organizational and behavioral context involved in automating typical corporate remittance payments.

Developing trends and challenges associated with low-value payments

The roundtable participants also shared their views regarding the broader demand for low-value electronic payments, noting that users are increasingly comfortable with electronic payment methods. The participants generally agreed that the barriers to broad user acceptance of electronic payments have been crossed and that the demand for all types of low-value electronic payments, including wire transfers, will continue to grow.

Corporate participants reported that they typically use the ACH to make low-value payments for their firms, with wire transfers being used on an exception basis. One participant also discussed the growing popularity of credit and debit cards as payment mechanisms and the possible increased use of the underlying networks for business payments. Another participant pointed out the growing popularity of Internet-based person-to-person payment options as evidence of growing consumer comfort with

online payments. Other participants discussed developments in the ACH for consumer transactions, specifically the increasing use of the ACH for one-time, nonrecurring payments.

Consumer purchases that were typically made by check, credit card, or debit card at stores, over the telephone, or over the Internet can now be completed using the ACH. Some participants discussed challenges associated with this development. One participant expressed unease that the ACH is being used in ways for which it was not designed. Because ACH payments have until recently been used for recurring payments from trusted sources, one-time ACH transactions initiated through remote channels—over the telephone or Internet—may introduce additional risk into the payment process. Several participants added more generally that developments such as check conversion and one-time ACH payments have created confusion among consumers, particularly regarding their rights with respect to various payment options.¹⁰ In light of consumers' confusion, several participants discouraged the introduction of new payment types.

More broadly, some participants emphasized that the transition towards electronic retail payments, specifically ACH and card payments, has increased the importance of adopting a strategic approach to managing risk. Organizations need to consider not only the financial and business cases for adopting a particular retail payments strategy but also how the risks associated with the strategy will be managed. One participant noted that although the *rate* of fraud associated with electronic retail payments in general appears to have remained stable, the *number* of fraudulent payments has increased along with the number of electronic payments. Another participant called for risk management techniques that look across the entire customer relationship rather than by payment method. The participants do not believe that fraud concerns should discourage organizations from using specific electronic payments. The participants encouraged the continued development of comprehensive risk mitigation strategies to counter risks associated with different payment types.

¹⁰ The checks converted to ACH payments are generally those that consumers write at the point-of-sale or mail to businesses. Information on check conversion can be found on the Federal Reserve's web site at <http://www.federalreserve.gov/pubs/checkconv/>.

Conclusion

The participants did not identify any specific barriers to innovation in using wire transfers and generally agreed that wire transfers are an effective mechanism for making low-value payments. Many participants also noted the emergence of alternatives for individuals to make electronic funds transfers. The participants also discussed what they consider a key area in which wire transfers could be more efficient, namely in handling business remittance information. The committee stressed the importance of working to develop standards in this area, and a representative from the Federal Reserve Bank of New York, which manages the operations of the Fedwire Funds Service, raised the possibility of the Reserve Banks playing a larger role in coordinating with banks, vendors, and other affected organizations to achieve this goal.

Incremental changes to wire transfer systems, such as creating and enforcing standards regarding the inclusion of remittance information, would help some organizations to receive wire transfers more efficiently. The participants generally believe, however, that wire transfers are well understood and that fundamental changes to this payment method are unnecessary. Wire transfers appear to have characteristics that address fundamental needs of users and are likely to play a continuing role in making low-value payments.