Payment Electronification and the Law: Why Not Dump the Paper?

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Most Payments <u>Are</u> Electronic, Funded from the DDA

- About 30% of DDA-funded payments (by count) were paid by paper (70% electronically) in 2009*
  - The trend is toward increasingly electronification and decreased use of paper checks
  - For consumers, this trend is driven by increased comfort with non-check payment mechanisms (increasingly debit v. credit payment methods)
  - Businesses see fewer options to replacing paper checks, because of security concerns and because of the rich business data that can be transmitted with checks (average check size and total check dollar volume increased from 2011 to 2012 even as the number of checks processed declined)
- Likely, the biggest bang for the buck in promoting electronification is finding a substitute for business-to-business paper checks
- One solution for electronifying business-to-business payments is the EPO

*Source: 2010 Federal Reserve Payments Study

What Is an Electronic Payment Order?

- There is no legal definition because these instruments do not exist as a matter of recognized law
- Working definition: a payor-created item that bears all the characteristics of a check but that is never printed
  - Bears the electronic signature of the maker;
  - Includes the same data as is available on a paper check (information about the payee, MICR line data in MICR font, etc.)
- Other definitions exist, but carry additional complexities (e.g., payee-created items (remotely created payment orders (RCPOs), which present questions/challenges of due authorization)
- EPOs are deposited for collection today (against the requirements of BOFD deposit agreements and check processing rules) because they are indistinguishable from deposited check images

What's the Difference Between a Remotely Created Check and an EPO?

- An RCC is "a check that is not created by the paying bank and that does not bear a signature applied, or purported to be applied, by the person on whose account the check is drawn" (Reg. CC)
  - RCCs typically are created by the payee, (hopefully) with the authorization of the payor
  - Like checks, RCCs must have been printed to be eligible for forward collection under check processing rules (whether presented in paper or electronic form)
  - RCCs carry enhanced risk relative to checks and EPOs because they do not bear a drawer signature
- An EPO is a payor-created item that bears all of the appearance characteristics of a paper check, including drawer signature
- RCPOs (RCCs that are never printed) faces similar concerns as EPOs for lack of legal certainty
  - An EPO could be created by the payor, sent electronically to the payee and then printed by the payee prior to deposit (or imaging), creating a payee-printed check that meets the legal requirements of a "check"

Do We Need the Paper?

- Legally, yes, for the item to constitute a "check" that is eligible for deposit with the BOFD and for processing (as an image) over check processing rails and under check processing laws/rules
  - Under UCC Art. 3, a "check" is "a written instruction to pay money signed by the person giving the instruction," where "written" requires "reduction to tangible form"
  - Regulation CC incorporates UCC definitions and references "original checks" and "substitute checks," where the "original check" is "the first paper check issued with respect to a particular payment transaction"
  - Federal Reserve Bank processing rules/requirements (OC 3), and ECCHO rules, incorporate requirements that images/electronic items be captured from "checks" (paper items)
- Practically, probably not, so long as appropriate protocols are established to mitigate the risks associated with all-electronic items

Is Requiring Paper Justified?

- There are legitimate concerns/risks associated with elimination of the paper step prior to deposit of an image/electronic item for forward collection through check clearing channels
  - Security/Fraud Risk
    - Electronic signatures applied to EPOs may be lifted and used by fraudsters
    - Paper check stock includes security features (e.g., watermarks) that do not exist in electronic templates
  - Legal Uncertainty and Consumer Protection
    - The existence of paper, even if momentarily, distinguishes “checks” and their images from electronic fund transfers (particularly ACH transactions)
    - Regulatory arbitrage for consumer payments – the EFTA/Regulation E conundrum
      - If EFTA/Regulation E does not apply to consumer-created EPOs, consumers would be denied protections afforded to them when initiating ACH entries (including check conversion) or using a debit card to initiate an EFT
      - As the law stands today, EPOs are not “checks” excluded from EFTA/Regulation E coverage, even if processed through check clearing channels
    - Business-to-business EPOs would not face this same issue (at least not the same degree)
      - EFTA/Regulation E only apply to transactions funded from a consumer account
      - There would still be rules arbitrage opportunities (ACH Rules v. check processing rules)

Addressing EPO Risk Through Regulatory Change

- Security/Fraud Risk
  - EPOs require (electronic) signature of maker
    - Many corporate checks already apply digitized signatures to paper checks
    - Image control features (e.g., transmittal of EPOs as secure PDFs) can mitigate this risk
    - However, digital signatures can be more difficult to authenticate (no pressure points, less reproducible when verifying signature validity)
  - EPO templates can carry security features approved by the paying bank
    - Require use of an approved, security template
    - Carry a digital counter or other security mechanism
  - Require the creation of EPOs within a secure environment accessible only after user authentication
- Legal Certainty and Consumer Protection
  - Check processing rules (including OC 3) can be updated to create certainty between banking system participants exchanging EPOs
  - Consumer EPOs can be prohibited or will likely be subject EFTA/Regulation E (regulating the relationship between consumer originating the EPO and the consumer's bank) absent legislative change

Options for Legitimization of EPOs (Legally Speaking)

- Change the law (particularly the definitions under Regulation CC) to allow EPOs to fall within the definition of "check"
  - Requires deviation from UCC unless UCC is amended
  - Likely doesn't avoid the EFTA/Regulation E issue because EFTA/Regulation E excludes transfers by "check, draft or similar <u>paper</u> instrument"
  - Would avoid adoption of rules by Fed and image exchange networks that deviate from check law
- Leave the law alone and change the rules (e.g., change OC 3 to allow for submission/processing of noncash items that were never printed)
  - Perhaps easier to avoid formal legislative/regulatory change
  - Doesn't avoid the EFTA/Regulation E issue (unless rules exclude consumer items)
- Leave exchange of EPOs to bilateral agreements between parties
- Are legal issues really the reason EPOs are not more prevalent?
  - Legal uncertainty is not the friend of payments
  - Another case for payments law harmonization?

Is the Effort Required to Legitimize EPOs Worth It?

- If we want to reduce the inefficiencies of paper, perhaps.
  - Consumers still write checks for large purchases (e.g., down payment on a car) and where modern electronic payment methods still aren't fully viable (e.g., to pay the babysitter)
  - Businesses (particularly small businesses) still write checks
    - Checkwriting integrates with small-business financial management software (e.g., QuickBooks)
    - Checks can communicate important data not so easily communicated through alternative electronic payment options (e.g., remittance detail)
    - Checks avoid perceived risks of sharing bank account details and providing debit authorization necessary to pay via ACH debit
- Market innovations to drive consumers and businesses away from paper checks and check-like payment instruments exist, but checks persist
  - Payment Cards, Digital Wallets and P2P Services (PayPal, ClearXchange, Popmoney)
  - NACHA corporate payment types (CCD/CTX), P-Cards, Syncada, MasterCard Payment Gateway