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SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

Implementation of the *Check Clearing for the 21st Century Act*

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Introduction

Mr. Chairman and distinguished members of the Subcommittee, my name is Elliott McEntee and I am the President and CEO of NACHA – The Electronic Payments Association. In this testimony, I will report on the adoption in the marketplace of a type of electronic check processing known as check conversion. In check conversion a check that a consumer mails to pay a bill is processed electronically using the same payment network that is used to process Direct Deposit payments. Using an electronic payment network to process a check enables the payment to be processed more efficiently. It also provides the consumer with more protection than if the check was processed in a traditional manner. For this reason consumer acceptance of check conversion has been widespread.

In the testimony I will provide a brief history on the development of check conversion through the ACH Network, explain how it works, compare it with the *Check Clearing for the 21st Century Act* (“Check 21”) enacted by Congress in 2003, and summarize the consumer protection rules.

Background

Before I begin with the first issue, I want to provide you with a brief explanation of NACHA and the ACH Network. NACHA is a not-for-profit association that develops and maintains the operating rules (the “NACHA Rules”) that govern the processing of ACH payments. ACH payments include the Direct Deposit of payroll and Social Security payments, automated consumer and business bill payments, and check conversion transactions. The NACHA Rules list the rights and responsibilities of financial institutions and businesses that process ACH payments, and contain provisions that provide consumer protection. Because the Federal Government follows the NACHA Rules, representatives from the Treasury Department and Federal Reserve participate in developing the rules.

Description of the ACH Network

Last year there were over 12 billion ACH payments made valued at over \$28 trillion. The Federal Government is one of the largest users of the Network. Over 99% of financial institutions in the United States participate in the ACH Network. There are about 5 million

businesses and 145 million consumers involved in ACH payments. There are two Network operators, the Federal Reserve and a private sector clearinghouse, that process payments between financial institutions.

Description of the NACHA Rules

The NACHA Rules work in tandem with Regulation E, the Federal Reserve's regulation that implemented the Electronic Funds Transfer Act of 1978. Regulation E provides certain rights and protections to consumers centered on financial institution disclosure, authorization, and error resolution requirements. The NACHA Rules, which bind together all financial institutions and businesses that use the ACH Network, detail very specific requirements in these areas. For example, under Regulation E a financial institution is only required to conduct a limited investigation when the consumer alleges an error. In contrast, the NACHA Rules require the financial institution to immediately re-credit the consumer's account for the amount of the error and return the incorrect transaction back to the party that made the mistake. NACHA has the authority to impose financial penalties on financial institutions that violate the Rules.

Check Conversion Timeline

The public and private sectors have been working since the early 1970s to promote the use of electronic payments – Direct Deposit being an excellent example. The public and private sectors have also been working since the late 1970s to use existing electronic payment networks to clear and settle the billions of paper checks that were still being written.

These efforts were not successful, mostly due to the lack of a clear legal framework dealing the relationship between checks and electronic payments. Working closely with the Federal Reserve, a legal framework was developed in 2001. That legal framework treats a check that has been converted as if it was always an electronic payment. With that legal framework, consumers have the protection of Regulation E and the NACHA Rules, even when they are writing a check to pay a bill.

In 2000, while testifying before this Subcommittee I discussed a project that was being prepared to test this concept. After the test was completed, NACHA shared the results with Congressional staff and consumer groups.

The interest in using electronic networks to collect checks increased dramatically because of the grounding of all commercial flights after 9/11. The collection of checks relies heavily on air transportation. Today, check conversion is used by the Federal Government, several state and local governments and hundreds of billers. Over 1.2 billion checks were converted last year and we expect this number to increase to over 2 billion this year.

Check Conversion – How it Works

Check conversion begins when a billing company notifies the consumer that it will process checks electronically. In practice, virtually all companies notify the consumer through the monthly account statement. The consumer mails the check to the biller. The biller or its agent (usually a financial institution processor known as a "lockbox") captures the routing and account numbers from the bottom of the check (known as the MICR line for "Magnetic Ink

Character Recognition”), and enters the payment amount. The biller uses this data to create an ACH debit, which is then processed just like any other ACH payment, and usually posts to the consumer’s account the next business day. The biller creates a copy of the check, and then destroys the original to prevent it from being processed a second time. The payment shows up on the consumer’s monthly account statement with the date, amount, and name of the billing company, which is more information than if the check was processed in the traditional manner.

Rules for Check Conversion

Every biller that is going to convert checks must provide clear and conspicuous notice to consumers prior to the receipt of every check. The notice must state that receipt of the check authorizes an electronic/ACH debit to the consumer’s account. Billers must have reasonable procedures for a consumer to opt-out. In other words, if the consumer does not want their check converted and notifies the biller, then the biller may not convert any checks received from that consumer. This is an option that is not provided under Check 21. It would not be feasible under Check 21 to provide such an option as several different parties have the ability to create a substitute check, whereas with conversion only the biller or its financial institution can do the conversion. This creates the possibility that a consumer may opt out of check conversion through the ACH Network, but nonetheless have their check converted under Check 21.

Billers must provide consumers with a copy of a check, upon request. As with any ACH payment to a consumer’s account, the NACHA Rules require a consumer’s financial institution to re-credit the consumer’s account if the consumer reports within a certain timeframe that a transaction was not authorized.

Benefits of Check Conversion

Consumers: Check conversion preserves the choice for consumers who want to continue to pay their bills by check. Check conversion does not require consumers to do anything differently.

Consumers gain the protection of Regulation E and the NACHA Rules, which provide superior protection than when checks are processed in the traditional way. As I just noted, the NACHA Rules give consumers the right to have their account re-credited in the event of an unauthorized transaction. In recent comment letters to the Federal Reserve, four leading consumer groups have endorsed the Regulation E and NACHA protections as superior to those to exist when checks are processed traditionally.¹

When checks are converted, consumers receive more detailed information on their monthly account statements, including the name of the company being paid. With more and more electronic payments replacing checks, such as Direct Deposit, debit cards, and various forms of electronic and online bill payment, consumers’ monthly account statements are coming more and more to resemble credit card statements, where every transaction is easier to identify.

¹ Consumers Union et al to Federal Reserve Board on Regulation J, July 7, 2004:

http://www.consumersunion.org/pub/core_financial_services/001264.html

Consumers Union to Federal Reserve Board on Regulation E, November 1, 2004:

http://www.federalreserve.gov/SECRS/2004/November/20041109/R-1210/R-1210_21_1.pdf

Companies: The main benefit to companies is gaining the efficiencies and cost effectiveness of electronic processing while still offering customers the choice of paying by check. Electronic payments generally cost companies less to process than checks. Maybe the most important, but least understood, benefit is that electronic payments greatly speed up the process of returning payments if there is a problem, such as insufficient funds. When checks are processed traditionally, it can take 1 or even 2 weeks to get the check returned if there is a problem. With check conversion, these returns are often done in just 2 or 3 business days. Not only is this good for the company, but it is also better for the consumer to have these problems resolved more quickly.

The Consumer Experience

In 2004 there were about 1.25 billion checks converted. The consumer opt-out rate is typically 0.1 – 0.25 percent. In October and November 2004, a survey conducted for NACHA found that 69 percent of consumers surveyed responded that they are familiar with the check conversion process. The survey also found that 55 percent of consumers, when given an open-ended opportunity to say anything, had no concerns about check conversion. In the survey, no consumer expressed that they were concerned about checks clearing more quickly.

NACHA's data shows that the insufficient funds rate for check conversion payments is 0.3 percent – lower than that for checks – suggesting the check conversion is not causing more checks to bounce.

The rate at which consumers claim that check conversion payments are unauthorized is 0.0045 percent, which is 45 out of every 1 million, showing that there is no significant problem with proper authorizations or with fraud.

A recent survey of financial institutions conducted for NACHA found that only 1 out of 31 institutions surveyed responded that customer service issues as a result of check conversion were significant.

Taken as a whole, this data is evidence that the implementation of check conversion in the marketplace has been smooth, that the application is high-quality, and that consumers generally accept it.

We are aware, however, of three problem situations that cause confusion or concern among consumers, and can lead to complaints to companies, financial institutions, NACHA, consumer organizations, the media, and to Congress.

The first is when the billing company does a poor job of informing its customers that it is going to process checks electronically, and this can paradoxically cause consumers to call their financial institutions with questions. To address this situation, NACHA organized an industry effort to develop consumer educational materials that billing companies can use at no cost to educate their customers about check conversion. Financial institutions can also use these materials at no cost, in case consumers call them.

The second is that there are a small number of consumers who are very insistent that they don't want anything done differently to their checks, that the checks are their property, and that

no one has the right to do anything with them. No matter how beneficial check conversion is, no matter the better protections available under Federal law and the NACHA Rules, no matter the additional information available on their account statements, a small number of people simply do not want their checks converted. In recognition of this, NACHA revised the rules to require billing companies to have reasonable procedures to allow consumers to opt-out.

The third problem area is manual data entry of the dollar amount of the transaction, which can be a source of errors. The transmission of an incorrect dollar amount is often blamed on check conversion, but the manual data entry has to occur no matter how the check is processed. There is no evidence that data entry errors occur more or less frequently depending on how the check is ultimately processed. In fact, because a consumer has better protection and avenues for redress in the event of errors, it is in their interest that payments are processed electronically.

The Future of Check Conversion and Electronic Check Processing

With check conversion continuing to be adopted in the marketplace, NACHA expects the number of checks converted to reach or exceed 2 billion this year, and to continue to grow for the next several years. Some industry estimates are that consumers still mail 6-8 billion checks a year to pay bills.

It is much more difficult to predict what may happen with Check 21-enabled processing, because it is newer. The early adoption of Check 21 seems to be oriented toward large-dollar corporate checks.

In the long term, we expect that check conversion and other types of electronic check processing will be transitional, as consumers continue to write fewer and fewer checks and switch to various forms of electronic payments. This has already been happening for years at retail with credit and debit cards, and with various forms of electronic and online bill payment (which, incidentally, all have greater protections than checks).

Conclusion

Check conversion is being rapidly adopted in the marketplace. Check conversion is an example of a true “win, win” innovation by providing consumers more protection, and providing businesses and financial institutions the ability to collect checks more efficiently.

Elliott McEntee

Elliott C. McEntee is currently the President and Chief Executive Officer of NACHA – The Electronic Payments Association. NACHA is a nonprofit banking trade association that promulgates the rules and operating guidelines for electronic payments including the ACH Network. NACHA's mission includes the development, promotion and use of electronic solutions to improve the payments system through activities including financial EDI, Electronic Benefits Transfer (EBT), cross-border transactions, bill payments, electronic checks and Internet Council. NACHA also produces marketing collateral and technical publications and provides education services such as conferences, seminars, The Payments Institute, and the Accredited ACH Professional (AAP) program. NACHA is closely affiliated with the National Council for Uniform Interest Compensation (N.C.U.I.C.) which addresses primarily check processing and wire transfer issues. The ACH Network reaches more than 20,000 financial institutions, and about 5 million businesses and 145 million consumers in the U.S.

Prior to joining NACHA in November 1988, Mr. McEntee was an Associate Director on the staff of the Board of Governors of the Federal Reserve System. He was responsible for managing a function that oversees the nation's payments mechanism and financial services the Federal Reserve provides to banks, thrift institutions and the United States Government.

Mr. McEntee is a 1968 graduate of San Jose State University and earned a Bachelor of Science degree in Industrial Relations.