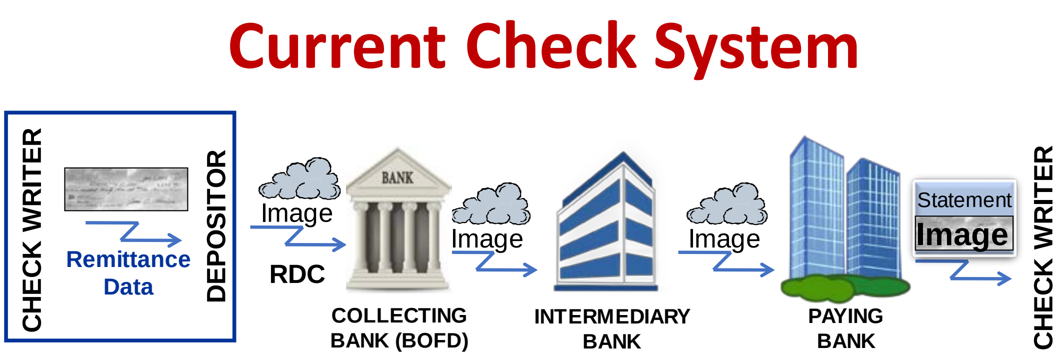
Electronic Payments Stifled by Reg J, by David Walker[1]

The proposed regulatory changes to Regulation J (Reg J) will eliminate the potential user savings of tens of billions of dollars each year, by denying users the choice of a more efficient payment system. The recently proposed changes to Reg J include the creation of a new barrier that would limit the choices available to users of the check payment system. This artificial barrier goes against the Fed's revised objective of focusing on the efficiency of payments from end-user to end-user rather than its historic focus on bank to bank efficiencies. Reg J provides the Fed with authority to perform certain services for financial institutions. Specifically, Reg J addresses check clearing and check return services offered by the Fed's Retail Payments Office (RPO) out of the Atlanta Fed and Fedwire services offered by the Fed's Wholesale Product Office (WPO). For the purposes of this writing we will address only the check clearing services.

The proposed new barrier is the prohibition of Electronically Created Items (ECIs) from inclusion in the payments approved for processing through the Federal Reserve. An ECI is defined by Regulation CC, as of July 1, 2018, as "an electronic image that has all the attributes of an electronic check or electronic returned check but was created electronically and not derived from a paper check." The Request for Comment period for Reg J ended May 13, 2018.

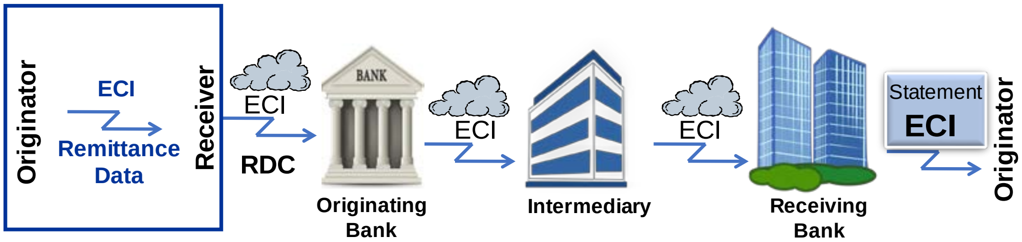
Following the successful, joint efforts of the Federal Reserve and the private sector to pass the Check 21 Act, the check system evolved in record time from an all paper-based payment system to an all electronic-based payment system, at least between financial institutions (FIs).



Currently all that remains of the old paper system is to write the check and deliver it to the payee. Both steps are outside of the FI to FI exchange. ECIs would allow the end to end users of the check system to create and receive electronic payments with the characteristics of check images and be processed through the existing check system. By eliminating the last of the paper steps, the check system would become an all-electronic payment system.

[1] Published as All My Papers Newsletter, June 2018 at https://allmypapers.com/newsletter-june-2018/.

Electronically Created Items



The Federal Reserve is an important player in the check payment system. According to Check Image Central (www.checkimagecentral.org), in November of 2017, the Fed cleared 43% of all transit checks, checks deposited with one FI and drawn on another. With the proposed prohibition of ECIs, banks can be expected to be reluctant to offer products that might not work for 43% of transit checks. Additionally, in that same month the Federal Reserve handled 68% of all unpaid returned checks. If the private sector were to develop a forward collection option for ECIs, the return of two thirds of those items would be problematic, effectively denying the value of ECIs to check users by discouraging the use of ECIs in the forward collection process.

Today, ECIs are already flowing through the check payment system in despite the Fed's non-suppport. This ECI flow does not have the security of agreements between all parties in addition to the lack of support from the Fed. The most common alternative to ECIs requires that once electronic payments are created by the user, they are then printed and imaged before entry into the check payment system as check images. This is inefficient, creates additional risk to all parties and moves the expense associated with the paper payments from one party to another.

Consumers have many acceptable options other than checks for most of their payments, but businesses continue to primarily use paper checks even in the presence of other available options.

The Fed's proposed Reg J prohibition of ECIs creates a contradiction between the Fed's stated commitment to improving the end-user to end-user experience by creating obstacles to the achievement of that goal.

There are two potential alternatives to ECIs. One is for check users to continue to use paper checks without the benefit of the large savings possible with electronic payments. The other is for users to transition, at significant expense, to options that have not been generally acceptable to them for more than 30 years.

The best option would be for the Fed to avoid creating artificial, regulatory barriers to the enhancement of payments, to encourage market forces to determine what is most acceptable to the users and to support the market in achieving a faster, safer and more efficient payment system.

[The next newsletter will address in more detail the value of ECIs and other related considerations.]