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January 2005

**ePayments Put the Paper Check
"Out to Pasture"**

The 2004 *Federal Reserve Payments Study* is out, and in 2003 electronic payments surpassed checks for the first time – 44.5 billion versus 36.7 billion.¹ While the value of checks paid in 2003 still outstripped that of electronic payments, the number of electronic payments from 2000 to 2003 increased at an annual rate of 13.2%, and check usage over the same period declined by 4.3%. More interesting, however, is what the data show about the several forms of electronic payment.

Credit card payments, the most popular and mature form of electronic payment, grew annually from 2000 to 2003 by only 6.7%. Debit card transactions approached the trillion dollar mark, and ACH and debit card activity grew at annual rates of 13.4% and 23.5%, respectively.²

In late 2003, Alan Greenspan, keynoting the Federal Reserve's "Payments System in Transition" conference, predicted that electronic payments would soon exceed the number of checks written.³ In making that prediction, Chairman Greenspan made several important points:

- The use of cash in domestic commerce and the use of checks have declined.
- Electronic payments account for about half of all non-cash payments.
- Electronic payments total 40 *billion* per year, a 5-fold increase in 20 years.

¹ Fed. Reserve Sys., THE 2004 FEDERAL RESERVE PAYMENTS STUDY, ANALYSIS OF NONCASH PAYMENTS TRENDS IN THE UNITED STATES: 2000 – 2003 (2004) <http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf> [hereinafter 2004 PAYMENTS STUDY].

² See Press Release, Financial Services Policy Committee, Conference of Presidents Federal Reserve System, Federal Reserve Studies Confirm Electronic Payments Exceed Check Payments for the First Time, (Dec. 6, 2004) <http://www.federalreserve.gov/boarddocs/press/other/2004/20041206/default.htm> [hereinafter Electronic Payments Press Release] for data summaries.

³ Details of the "Payments System in Transition" conference, and Chairman Greenspan's remarks, are available at <http://www.federalreserve.gov/events/conferences/paysymp/default.htm>.

Check volumes began to decline in the 1990s,⁴ and they will continue to do so. The marketplace is seeking better payments system efficiency – cost reductions and speedier funds availability. The paper check is simply an anachronism.

In a world of declining check volumes, outsourcing items processing is the “smart thing” to do. As volumes continue to decline, processing “consolidators” (including the larger regional and money center banks) are the only industry players that will be able to make the investment in technology and personnel to survive in that low-margin business; and even they will eventually face the inevitable.

Yesterday’s Technology

Last year, 2004, saw Check21 become a reality,⁵ and the banking world did not stop. And, it will not stop. Image-enabled capture, processing and clearing – the objective of Check21 – is not the “future”; it’s not even “today.” Imaging and electronic image-exchange is “yesterday’s technology.” In the 21st Century, full digital capture and clearing is around the corner. Electronic payment – by bank credit card, debit card, ACH and e-check –, the ultimate competitive threat to checks, is already here in now highly significant numbers. Of course, the check will be hard to eliminate entirely, but conversion of checks into ACH transactions at the point of sale and image-enabled clearing will change the familiar landscape.

The “takeaways” are these: In this electronic environment, banks need a reliable and viable payments processor. They can benefit greatly from a processor that can process payments not only in the business climate as it exists right now, but also in the one that is coming.

The Hardship of Accounting

Never ask of money spent
Where the spender thinks it went.
Nobody was ever meant
To remember or invent
What he did with every cent.

--Robert Frost

In 2004, Sarbanes-Oxley, zealous prosecutors and investor activists began pushing for more accuracy, accountability and transparency in company disclosures. Mr. Frost’s accounting principle seems to be as *passé* for 2005 as regulatory accounting was after the S&L crisis.

Happy New Year!

Patriots and Pirates

At the Fed’s payments system conference, Greenspan distilled four internationally-embraced goals for the payments system – integrity, security, reliability and accessibility – into two key public-policy objectives: (1) economic efficiency and (2) safety and public confidence.

The Check 21 Act will help to invigorate efforts to boost payments system efficiency. But the bandwidth to transmit and the disk space to store item images will at some point challenge many, if not all. As sight of the familiar check fades away, even if only at first to the form of a “substitute check” or “image replacement document,” banks and processors will face heightened challenges when most payments data become digital.

⁴ Geoffrey R. Gerdes and Jack K. Walton II, *The Use of Checks and Other Noncash Payment Instruments in the United States*, 2002 FED. RESERVE BULL. 360, available at http://www.federalreserve.gov/pubs/bulletin/2002/0802_2nd.pdf.

⁵ Check Clearing for the 21st Century Act, 12 U.S.C. §§ 5001 et seq. (2000) [hereinafter Check 21 Act].

Risk designs, risk-management practices and payments system resilience are where banks and their data processors must address the public-policy objective of ensuring the safety of and public confidence in the payments system. Outsourcers and their financial institution customers, as a partnership, must embed their relationships with the means to properly manage the new technology.

Privacy

Two themes have emerged in the last few years that focus on this safety and public confidence goal. The first to come was that of information privacy. Even with the enactment in 1999 of the Gramm-Leach-Bliley Act, the public frenzy over privacy has not abated.

In Election Year 2004, patriotic themes abounded. The notion of privacy, and the Constitutional Right to Privacy, has risen to a venerated position in American life today. It is not surprising, then, that when there is talk about personal financial data this “right to privacy” presumptively obtains. The benefits of advancing technology suggest some trade-off between participation and risk of data disclosure. But financial institutions and their data processors must minimize this risk.

Congress’s first comprehensive Federal privacy policy mandates the affirmative and continuing obligation of each financial institution (and, derivatively, its data processor) to respect the privacy of its customers and to protect the security and confidentiality of those customers’ nonpublic personal information.⁶

Financial institutions must adequately address this new Federal policy in their service contracts – the basis upon which each financial institution and its service provider has agreed to do business. Key questions: Who owns the data? Is the security of the data – the information located on physical items, as well as the growing quantity of electronic data – protected? And, they must know as much about their data processors’ businesses as they would know if they performed the services themselves.

USA Patriot Act

Privacy notwithstanding, information transparency has also become patriotic because of the “pirates” – domestic and international terrorists who strike by disrupting safety and security. The USA Patriot Act,⁷ adopted in 2001, was a response to such terror. At least three provisions in the Act – those addressing Anti-Money Laundering (AML) Compliance Programs, Customer Identification Programs (CIP) and Government and Financial Institution Information Sharing – can directly affect outsourcing relationships.

⁶ Gramm-Leach-Bliley Act § 501(a), 15 U.S.C. § 6801(a) (2000).

⁷ Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272, *available at* <http://fl1.findlaw.com/news.findlaw.com/cnn/docs/terrorism/hr3162.pdf> [hereinafter USA Patriot Act].

The USA Patriot Act requires that each financial institution establish an AML Compliance Program. Congress sees money laundering as a means to finance terrorism. The main purpose of the required CIP is to prevent and detect money laundering and terrorist financing. Bank regulatory agencies, however, believe it should also reduce fraud and identity theft involving new accounts. Improved information sharing, both mandatory and permissive, will allow law enforcement to quickly locate accounts and transactions of individuals, entities or organizations that are suspected of terrorism or money laundering.

Banks must ensure that their data processors have the ability, the capacity and the obligation to partner with them in each of these new compliance mandates. Data processors must be responsive as their bank customers implement these new regulatory measures.

Focus

In a world where over half of all retail payments transactions are electronic, and in which the data is digital, less tangible, challenges to comply, and to test and confirm the compliance of service providers, are more difficult. Face it; it's hard to "see" what's going on. In the "Digital Millennium" the zeros and ones are moving at the speed of light through often-virtual "pipes."

The focus must be on policies and procedures, the certainty of their implementation and adherence to them and testing of their effectiveness in achieving the control objectives that those policies and procedures intend.

Recent Client Newsletters

"Data Processors, Forced to Reevaluate Pricing Strategies?" – the December 2004 newsletter – examines the effect of changes in the length of IT agreements and in risk shifting provisions on the pricing strategies of data processors.

The November 2004 newsletter "Offshore Outsourcing – An Inevitability" discusses incorporating risk-optimizing actions, like carefully tailored performance standards, into IT agreements in order to control risks due to offshore activities.

Client newsletters are available at <http://www.carpenterlaw.net/newsletters/archivednewsletters.html>.

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