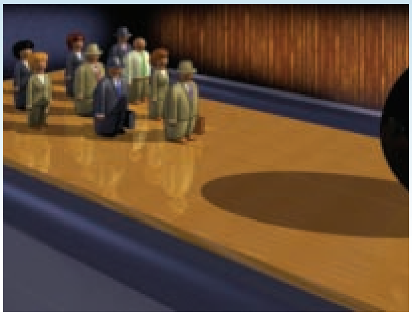


It’s Time to Dump Demand Drafts

George F. Thomas

With the ACH and other electronic solutions now available, paper instruments like demand drafts and remotely created checks serve no purpose other than to drive up risk for banks, consumers, and processors. It’s risk the payments system can no longer afford.

In the early days, before the automated clearing house (ACH) had developed a ubiquitous network, there was no established method for handling monthly recurring payments, especially one that could reach all consumers. So, in the 1970s, New York Life Insurance Co. began offering a payment method called Check-O-Matic. With this method, the consumer would sign an authorization to have his insurance premium paid using what was called a demand draft or remotely created check.

Each month the insurance company would issue an unsigned paper draft for the amount agreed upon and the draft would be presented for payment. This became a common payment method for insurance companies to automatically collect monthly insurance premiums.

But with the launch of the ACH direct-payment option, the demand-draft payment collection was eventually phased out by insurance companies. Today, ACH direct payment is the preferred method of collecting the vast majority of recurring debits, so there is no need any longer for any company to collect recurring payments by demand drafts. Even so, the demand draft remains very much alive, posing risks the payment system can no longer afford.

A demand draft or remotely created check is an unsigned paper instrument used to debit the payer’s bank account with or without specific authorization. Any organization or individual can create a demand draft. All that is required for its use is the bank routing and account number of the individual or company that you want to debit and a statement that the signature or authorization for the debit is on file.

It’s easy to see why the risk of fraudulent use of this payment instrument is very high. And, since it is a paper instrument without a signature, that risk is masked by the billions of signed checks flowing through payment systems.

No Stats on Returns

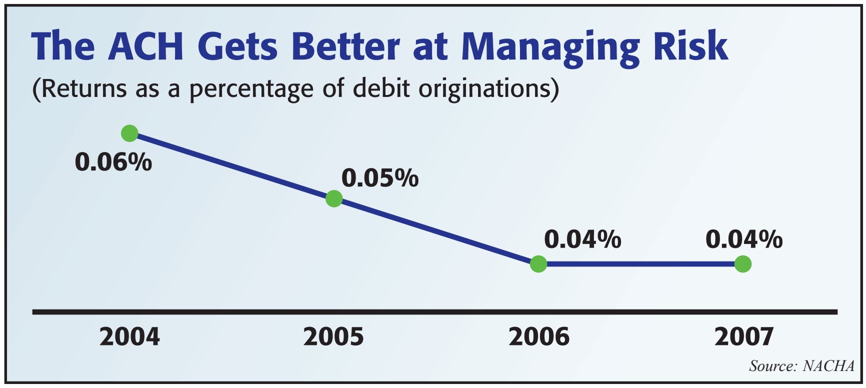
A debit payment instrument is inherently riskier than a credit transfer, since thieves typically do not deposit money into an account. Their primary objective is to take money from consumer and corporate accounts through a debit. A recurring ACH debit or demand draft between known parties has the lowest risk. The primary reason for using ACH for these types of payments is the lower cost and efficiency of not using a paper document.

The risk rises exponentially for *ad hoc* or spontaneous debits, whether they are ACH or paper demand drafts. Using these instruments for Internet or telephone purchases of products and services is extremely risky to the originators and receivers of these payments.

The best payment instrument for these transactions is the credit card because of the extensive risk-mitigation procedures and the sophisticated chargeback systems that have been developed for spontaneous payments.

By contrast, the ACH and paper-check systems were never designed for this purpose. The only acceptable reason for a return beyond the normal return window is that the transaction was not authorized or that it is fraudulent. If an individual was cheated by a telemarketer or a merchant with a defective product, there is no way for the consumer to charge back the transaction other than to claim that it is unauthorized.

So if the risk is basically the same, why is ACH better than paper drafts? The answer is simple: one is electronic and the other is paper. The electronic debit by its nature can be tracked easily when it is returned. NACHA, the organization that sets



the rules for ACH transactions, has exact national statistics supplied by the two ACH operators on how many debits were returned by transaction type and individual reason code (e.g. insufficient funds, account closed, invalid account, and unauthorized).

The paper process makes tracking demand drafts impossible because there is no practical way to know the number of forward demand drafts or the number of returns. There are no available statistics on the return rates for demand drafts because they cannot be automated, and the returns are bundled with the returns of all checks. As a result, the total number of demand drafts returned as unauthorized or fraudulent is unknown.

Abuses by originators of ACH debits can be spotted very quickly, usually within a day, because the ACH operators have automated monitoring tools that can identify, by originator and originating bank, any company that has an unacceptable unauthorized return rate.

What's more, it is much easier to create demand drafts and to deposit them than it is to be approved for ACH origination services. Anyone with a printer that has magnetic-ink capability can create these payment instruments and deposit them through an ATM or at a branch.

Does the Fed Get It?

Little wonder, then, that the demand draft is the preferred method of dishonestly taking money from the accounts of the aged and the poor. Conduct an Internet search for high-risk ACH solutions, and you will find merchant-processing sites that advise merchants in high-risk categories or with high unauthorized-return rates to avoid the scrutiny of the ACH by using demand drafts. Numerous telemarketing scams have used the demand draft to swindle millions of dollars from consumers.

In a letter to the Federal Reserve Board of Governors on May 9, 2005, the National Association of Attorneys General said demand drafts are frequently used "to perpetrate fraud on consumers and that such drafts should be eliminated in favor of electronic funds transfers that can serve the same payment function."

On June 11, 2007, U.S. Reps. Edward J. Markey, D-Mass., and Barney Frank, D-Mass., wrote a letter to Federal Reserve chairman Ben Bernanke expressing their concern about the practice of accepting and processing unsigned or remotely created checks, often generated by fraudulent telemarketers in the names of unsuspecting victims. They cited the fact that the practice is enabling schemes that are draining millions of dollars from the bank accounts of vulnerable Americans, including the elderly and individuals with chronic, debilitating diseases.

Their letter also referred to the opposition to the practice by the

National Association of Attorneys General. And it asked many pointed questions that would be very difficult or impossible for the Federal Reserve to answer, such as:

- Does your agency consider the acceptance of remotely created checks a safe and sound banking practice? On what basis does your agency make this determination?
- Does your agency monitor the amount of fraud associated with remotely created checks? If so, what is the extent of the fraud?
- Has the amount of fraud been increasing or decreasing?
- How does the amount of fraud associated with this activity compare with amount of fraud associated with other products?
- How widespread is the use of remotely created checks in the national economy?

The Federal Reserve cannot accurately answer the statistical questions because, as I pointed out earlier, the answers are unknown. And that is a large part of the problem. Very little is known about the use and abuse of this payment instrument because of the stealthy form it takes.

Canada outlawed the use of unsigned checks (demand drafts or remotely created checks) specifically because of their susceptibility to fraud. How come the bank regulators in Canada get it and ours can't figure it out?

Time for Action

With the technology that exists today, there is no practical reason for continuing the use of demand drafts. In fact, advanced technology makes them more dangerous than ever before. With the advent of new banking products such as remote deposit capture, those individuals attempting to commit fraud can submit unsigned checks without even paying a visit to a branch to deposit them. The remote submission of unsigned checks increases the velocity of items that can be submitted.

Moreover, the use of demand drafts or remotely created checks for Internet and telephone commerce, while not a new practice, is now being promoted. One example is the service recently announced by MyECheck Inc., which markets to online merchants a service relying on remotely created checks. An excerpt from MyECheck's Web site highlights the problem for consumers: "All other 'e-check' solutions are automated clearing house (ACH) transactions. Compared with competitive ACH eCheck transactions, MyECheck items will work with more consumer accounts, will clear sooner, and will provide superior chargeback protection."

The key point here is the chargeback protection. It is hard for a consumer who received a defective product or who was a victim of fraud to get his money back. I sincerely hope that MyECheck has sound "Know Your Customer" and "Know Your Customers' Customers" procedures. (Editor's note: For more on MyECheck's strategy, see page 20).

There are some businesses, such as home-banking bill-payment providers that have large-value items or have limited credit history on first-time users, that use demand drafts to reduce their risks. These organizations believe the check-collection system provides better protections than the ACH, again in the area of consumer chargeback. This is not sufficient justification for using this instrument. The problem can be solved using an electronic solution and other risk-mitigation techniques. It would be rare for consumers to try to defraud these providers, but techniques could be developed between the banks and bill-payment providers to put holds on the accounts as payments are initiated.

A fundamental mission of the Federal Reserve system is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems. Its role is to act for the benefit of the public as a whole, not for that of a few business organizations. Demand drafts create a significant risk to consumers and weaken the safety and integrity of the nation's payments systems. The Federal Reserve Board of Governors should begin the process of discontinuing demand drafts as quickly as possible. The time for tweaking existing regulations is over. The time for leadership and action is now. DT

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Why the ACH Is Safer Than Paper

Trackability The electronic debit by its nature can be tracked easily when it is returned. Statistics exist on how many debits are returned by transaction type and individual reason code (e.g. insufficient funds, account closed, invalid account, and unauthorized). By contrast, there are no available statistics on the return rates for demand drafts because they cannot be automated, and the returns are bundled with the returns of all checks.

Detection Abuses by originators of ACH debits can be spotted very quickly, usually within a day, because the ACH operators have automated monitoring tools that can identify, by originator and originating bank, any company that has an unacceptable unauthorized return rate.

Prevention Anyone with a printer that has magnetic-ink capability can create demand drafts and deposit them through an ATM or at a branch. By contrast, it is much harder to be approved for ACH origination services.