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Statement by

Wayne D. Angell

Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Affairs

Committee on Banking, Housing and Urban Affairs

of the

United States Senate

February 5, 1987

Mr. Chairman, I welcome this opportunity to provide the views of the Federal Reserve Board on the issue of delayed availability, and specifically on S. 344, the "Fair Deposit Availability Act of 1987." We share your frustration with the check hold practices of some depository institutions and with the inefficiencies of the return item process. Therefore, we are eager to work with you and the Committee to devise a legislative remedy to the delayed availability problem. I am personally sympathetic with the goals of S. 344; my family experienced some of the problems faced by many consumers when we moved from Kansas to Washington last year.

Legislation addressing the delayed availability issue should contain two essential elements. First, additional regulatory authority is needed to make improvements to the check collection and return process, thus reducing or eliminating the risk to depository institutions of making funds available more promptly. Second, there is a strong and straightforward case that depository institutions should clearly disclose to consumers their policies if they delay availability of deposited funds.

S. 344 also contains a third element -- schedules that dictate the maximum holds that a depository institution may place on the proceeds of deposits. The Federal Reserve Board believes that mandatory schedules raise difficult problems in minimizing risks to depository institutions and maximizing consumer benefits. We have felt primary emphasis should be placed on disclosure and payment system improvements. However, the Board does believe that availability schedules could be a workable component of the delayed availability legislation. S. 344 contains the basic elements to achieve an effective availability schedule.

Expedited Funds Availability

Availability schedules should be designed so as not to encourage check fraud, by basing the schedules on the time normally needed to clear and return checks. Although this time period is currently lengthy, it can be shortened to provide for relatively prompt availability schedules if the Board is given additional authority to implement initiatives to expedite the check collection process.

The Board is concerned that requiring availability before the receiving institution can reasonably be expected to learn of the return of an unpaid check will encourage check fraud, including kiting. It would be relatively easy to perpetrate a check fraud under a system where institutions are required to make funds available to customers before there is any opportunity to learn of nonpayment.

If an individual knows that funds must be made available before a check can be returned, all he would have to do is to open accounts at two local institutions. Both accounts would be maintained in a proper manner for sufficient time to satisfy any new account exception. After that time, suppose the individual writes a check subject to the availability schedule against nonsufficient funds on his account in one institution and deposits it in his account at the other institution.

If the schedules are too stringent, the institution in which the check was deposited would be required to make the funds available to the individual depositing the check before learning that the item will be returned unpaid. If the individual withdraws the funds and leaves before the check is returned, that institution would be unable to charge the check back when it ultimately receives the return item, and it would suffer a loss for the amount of the deposit. Similar schemes involving dozens of institutions could be easily accomplished.

While we recognize that this type of check fraud can occur today, requiring funds availability before the completion of the normal collection and return cycle will tend to encourage this type of check fraud. This is not to say that mandatory schedules must accommodate the return of all checks, but rather that the schedules should not be designed so that individuals can rely on obtaining availability before the check is returned.

If mandatory availability schedules are adopted, the

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* Attached are two series of charts depicting the timing of the check collection and return item process. The first two tables contain data regarding current return item practices. The following four diagrams depict the best case timing of the check collection and return item process. With improvements to the check collection system, these times could be achieved for a substantial portion of the checks collected; however, handling errors or delays in transportation would result in longer collection and return times for some checks.

current check collection and return cycle must be shortened in order to provide the most expeditious availability to consumers while limiting the risk of increased check kiting. Federal Reserve authority to make needed improvements in the check system is crucial to accomplishing this objective, as well as to improve the check collection system generally and thereby reduce the risk to institutions from returned checks, even if those checks are not covered by mandatory availability schedules. Today, the Federal Reserve's regulatory authority generally applies only to those checks that it clears. While the Federal Reserve has devoted significant attention to improvements in the return item process, our lack of regulatory authority has lessened our effectiveness to make significant progress in this arena.

legislation is passed, under section 5(b) of S. 344 the Board would propose several initiatives to improve the return process. One such initiative that the Board might propose would be to require the payor institution to return checks to the institution of first deposit within a specified time frame. This requirement would effectively prohibit the use of the mail for most return items. The mail is now used for over 11 percent of returns, slowing the trip back to the depositing institution by up to several days. This requirement would expedite returns at relatively little cost to the industry, but would be effective only if it were applicable to all checks, regardless of how they are cleared.

This initiative could also entail permitting institutions to return checks directly to the institution of first deposit, bypassing intermediate endorsers. This practice is not authorized by three jurisdictions, but section 5(b) would provide the Board with the authority to preempt the laws of these jurisdictions, thus making the use of direct returns feasible on a widespread scale.

A further initiative involves the automation of return items through the use of the same efficient mechanism used to collect checks. A recent test of this concept by the Federal Reserve, the American Bankers Association and seventy five depository institutions proved quite promising, reducing the time to return checks by an average of more than one third. However, the cost of this program falls on the institution that is returning the check, while the benefits of the expedited return accrue to the institution of first deposit. Therefore, its use is not likely to be widespread without the Federal Reserve having the authority to create incentives for payor institutions to participate in the program.

These examples illustrate the steps that could be taken to accelerate the return of checks, if additional regulatory authority were granted to the Board. This authority should be sufficiently broad to enable the Board to consider not only the specific initiatives contained in the legislation, but also additional proposals, perhaps not envisioned today.

With these improvements to the check collection system, a relatively prompt availability schedule would be possible. A schedule of no longer than four intervening business days, with an additional business day added when determined necessary by the Board, would be workable. Therefore, to the extent that the schedule in section 5(b) of S. 344 is based on business days, it sets a realistic goal for availability of all checks. Because many local and regional checks are collected more promptly, the Board would adopt more expeditious schedules for the large majority of checks. Under this schedule, depositors seeking to perpetrate a fraud would not be able to rely on obtaining availability before the check is returned.

If the Board implemented the expedited availability system under section 5(b), it would have the authority to establish only very limited exceptions to the schedules. However, even under an expedited system, not all checks will be returned within the time frames established for availability. Therefore, it is important that any mandatory availability schedules adopted contain adequate authority for the Board to establish exceptions, not only for instances where the institution has specific reason to doubt the collectability of an individual check, but also for those classes of checks that may impose increased risk, even though the individual check raises no particular suspicion that it is uncollectible. For example, it may be necessary to provide an exception for foreign checks, since the receiving institution will not learn of the nonpayment of these checks within the time frame established in the bill. Similarly, general exceptions for new accounts, large dollar deposits, and other types of checks as recognized in section 5(c) of S. 344, may also be warranted.

In summary, the expedited availability approach taken in section 5(b) of S. 344 provides the needed authority for the Federal Reserve to improve the check system, and provides the Board with sufficient flexibility in setting the availability schedules so as to not encourage check kiting schemes. However, it is essential that these schedules allow for exceptions for limited classes of checks, as provided in section 5(c)(2) of S. 344. With the addition of these exceptions, and certain other technical changes, we believe that the approach taken in section 5(b) would ensure that customers obtain prompt availability on the funds they deposit, without exposing depository institutions to significant risks.

In contrast, the approach taken in section 5(c) of the bill, which calls for availability at the time of provisional credit, subject to broad exceptions, would likely result in increased check fraud, since institutions would be required to provide availability before any opportunity to learn of the return of the unpaid item. In addition, this alternative does not give the Board the authority to expedite the check system, and thus does not address one of the underlying causes of the delayed availability problem.

Disclosures

As I stated earlier, disclosures are an essential element in any delayed availability legislation. However, we believe that the disclosure provisions in S. 344 can be made more flexible, particularly for those institutions that do not routinely place holds on deposits. For example, an alternative could be provided for these institutions, in which notice would be required when a hold is placed on a given deposit that falls within one of the exceptions of the bill. This notice requirement would be in lieu of the disclosure requirements. This approach would significantly lessen the compliance burden on institutions that, except in rare situations, do not delay availability. For institutions that do regularly place holds on their customers' deposits, the disclosure requirements set forth in S. 344 would apply.

Further, the Subcommittee may wish to also consider limiting the disclosure requirements to consumer accounts. Providing the required disclosures for all corporate accounts would be a very complex undertaking, since the availability of deposits is often tied to the level of required clearing balances and other account terms. Corporate accountholders are typically far more familiar with their institution's availability schedules than are consumer accountholders. Even with this limitation, a number of small businesses may, as a practical matter, still be given the disclosures required by the bill. Given the potential civil liability for failing to follow the requirements for consumer accounts, many institutions would likely simply treat small business accounts as consumer accounts to avoid a time-consuming process of distinguishing between the two.

Finally, there are a number of other provisions of S. 344 that bear further consideration. Under the bill, the Board's authority to make payment system improvements could be construed to expire after 48 months. The Board should be given continuing authority to make further improvements to the check system, and to modify the availability schedule if warranted by these improvements. The Board is also concerned that the requirement for establishing an Expedited Funds Availability Council may slow rather than facilitate payment systems improvements. The Council would duplicate the responsibilities of several other groups, such as the Consumer Advisory Council, which are already in existence. In addition, there are other technical amendments we would like to propose. The Board staff will be pleased to work with your staff to develop the most effective legislative remedy to the delayed availability problem.

In summary, we believe that legislation that requires disclosure, and provides authority to the Federal Reserve to improve the return item process and establish availability schedules will be beneficial to consumers and ensure that the costs to the banking industry are reasonable. Again, I am pleased to be here today and would be glad to discuss the delayed availability issue in more detail as the members of the Subcommittee desire.

Attachment

Distribution of Average Collection Times For Returned Checks

Average Days From Date of Deposit To Date of Return	Percent of Return Items	Cumulative Percent
1	1%	1%
2	4%	5%
3	12%	17%
4	10%	27%
5	15%	42%
6	17%	59%
7	14%	73%
8	8%	81%
9	4%	85%
10+	15%	100%

Source: BAI Return Item Study, 1985

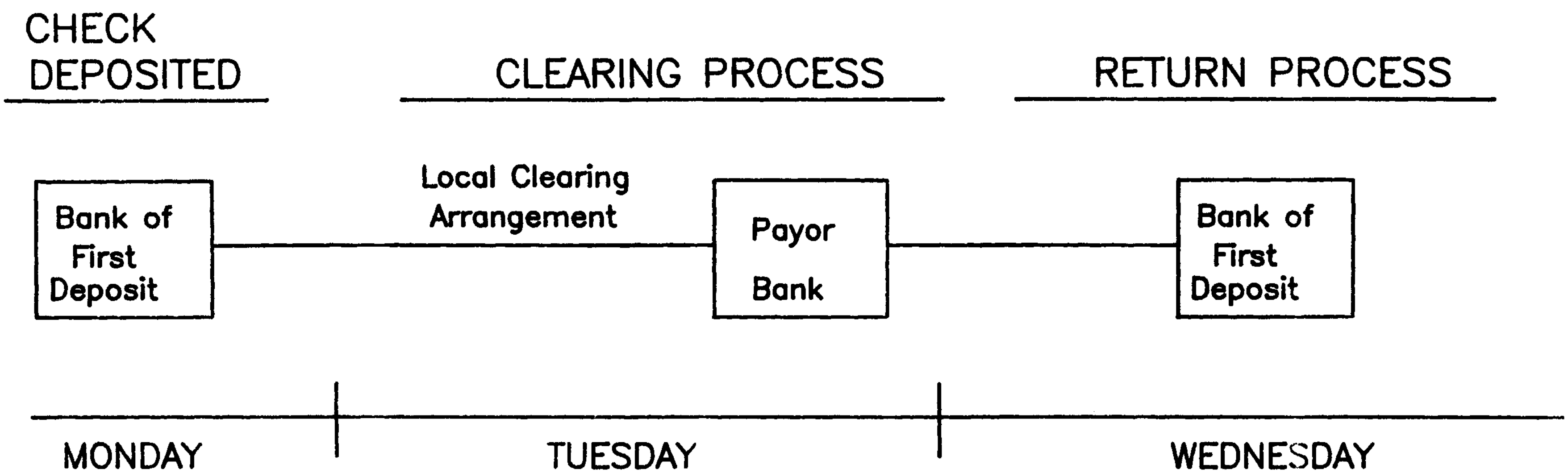
Distribution of Number of Endorsements For Returned Checks

Number of Endorsements	Percent of Return Items
2	4.0%
3	52.0%
4	30.5%
5	10.7%
6+	2.7%

Percent Returned Via Mail -- 11.45%

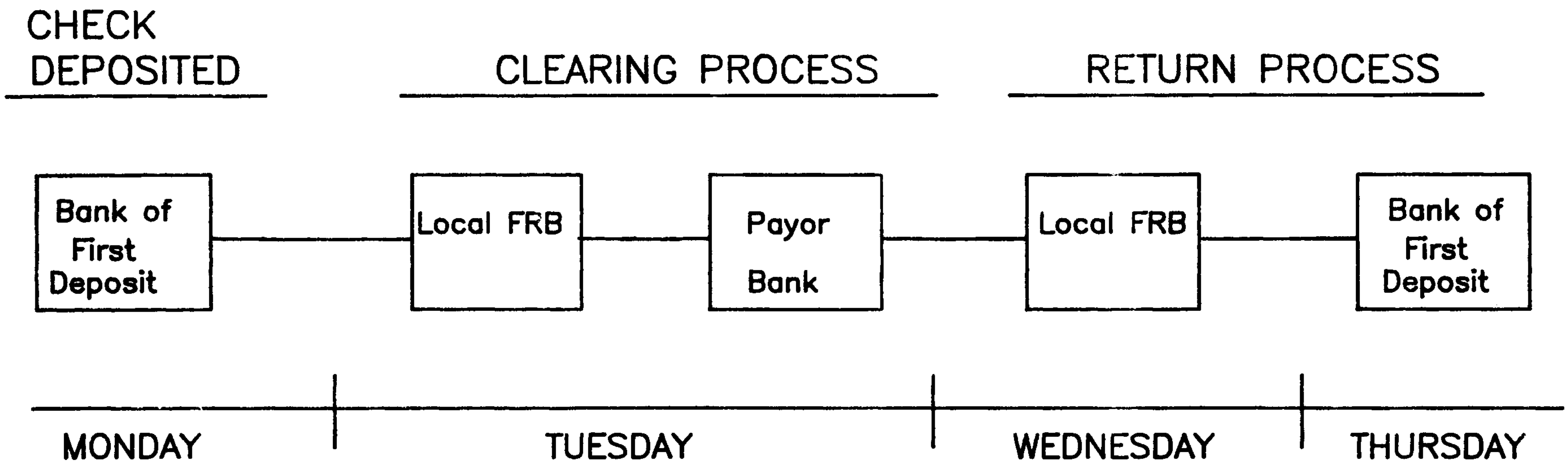
Source: Industry/FRB Return Item Test, 1986

Check Drawn on Payor Bank Located in Same City As Bank of First Deposit
(Two Clearinghouse Banks)



Best case situation.

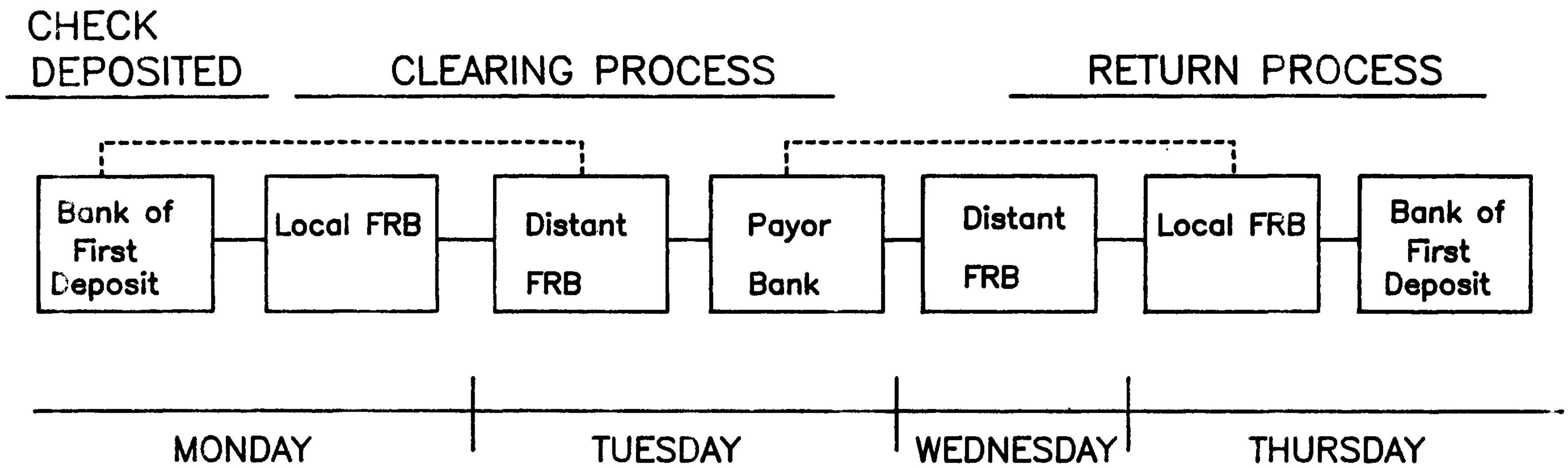
Check Drawn on Payor Bank Located in Different City But Same Federal Reserve Territory As Bank of First Deposit



Best case situation, after implementing improvements to the return item system.

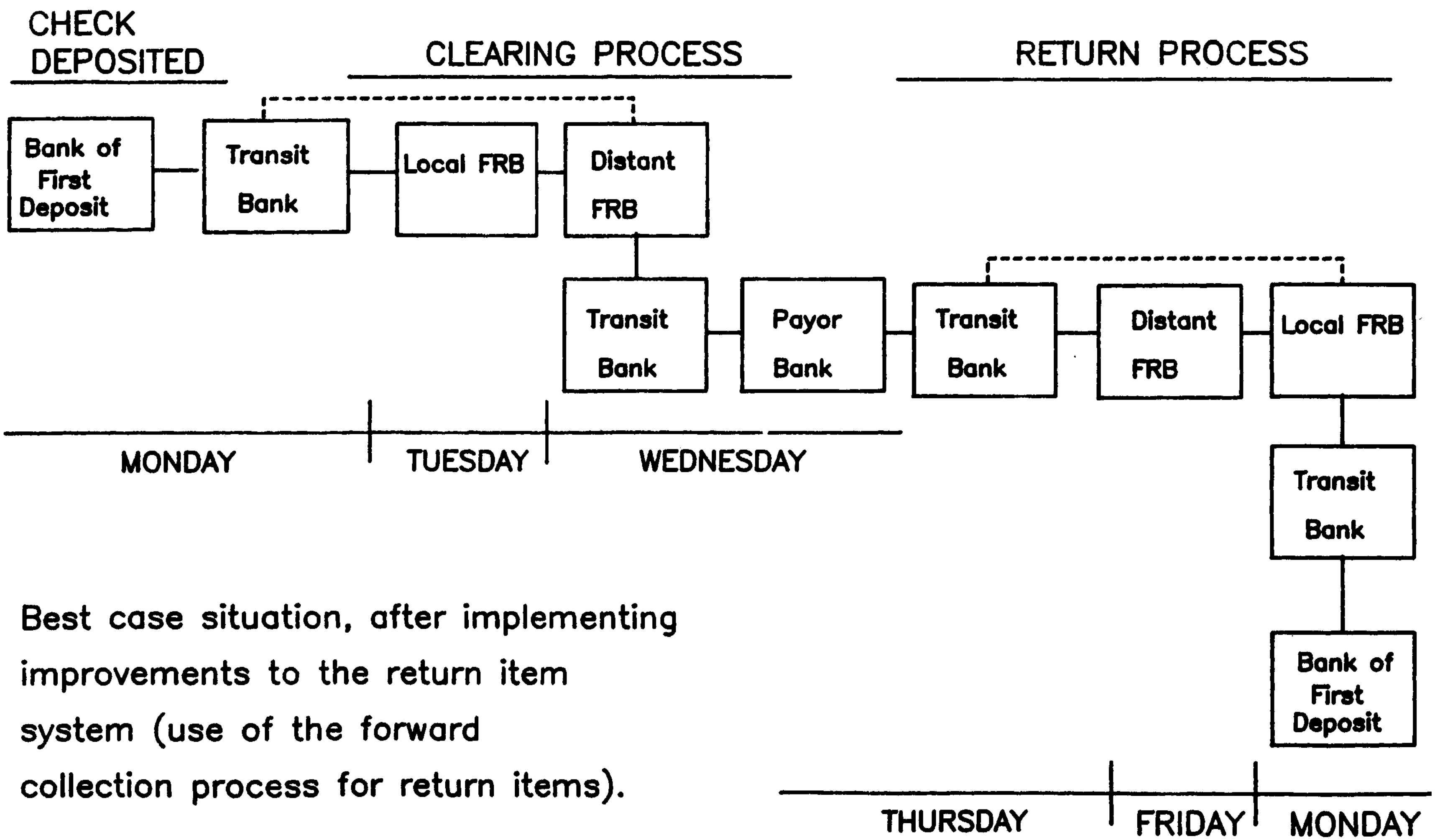
Additional days will be added to cycle if a correspondent bank or country bank are involved.

Check Drawn on Payor Bank Located in Federal Reserve Territory Distant from Bank of First Deposit



Best case situation, after implementing improvements to the return item system (use of the forward collection process for return items).

Check Drawn on Payor Bank
Located in Federal Reserve Territory
Distant from Bank of First Deposit
Both Serviced by Correspondents



Best case situation, after implementing improvements to the return item system (use of the forward collection process for return items).