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Statement by

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Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

of the

United States House of Representatives

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Mr. Chairman, I welcome this opportunity to provide the views of the Federal Reserve Board on the issue of delayed availability, and specifically on H.R. 28, the "Expedited Funds Availability Act." 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 H.R. 28; 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 with respect to the availability of deposited funds at the time an account is opened and when such policies are changed.

H.R. 28, as well as legislation that passed the House last year, also contain a third element -- schedules that dictate the maximum holds that a depository institution may place on the proceeds of deposits. The Board believes that mandatory schedules raise difficult problems in minimizing risks to depository institutions and maximizing consumer benefits, and has felt primary emphasis should be placed on disclosure and payment system improvements. However, the Board does believe that mandatory availability schedules could be a workable component of the delayed availability legislation, although we believe that greater flexibility is required than provided in H.R. 28.

I would like to spend a few minutes discussing two of the elements of the proposed delayed availability legislation -- the Board's authority to regulate the payments system, and the mandatory availability schedules.

Board's Regulatory Authority

The Federal Reserve strongly supports the regulatory authority provided to the Board in H.R. 28. This authority is crucial to the implementation of needed improvements to the check collection and return item mechanism. Today, the Federal Reserve's regulatory authority generally applies only to those checks it clears. While the System 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.

If legislation is passed, 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 given time frame. This would effectively prohibit the use of the mail for return items. The mail is used for over 11 percent of returns, slowing the trip back to the depositing institution by up to several days. This 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. H.R. 28 would provide the Board with the authority to preempt the laws of the three jurisdictions that currently prohibit this practice, 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 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.

Mandatory Availability Schedules

As I stated earlier, we believe that reasonable mandatory availability schedules can be workable. Some states have enacted mandatory schedules that appear to be operating reasonably well.

Unfortunately, in our view the schedules in H.R. 28 are not workable. The schedule to be adopted after three years will encourage check fraud, including kiting. The increased risk of losses as a result of potential fraud would probably lead some institutions to refuse to provide banking services to certain consumers. Finally, legislation should not include detailed and rigid availability schedules, given the complex nature of the check collection system.

Allow me to illustrate these points. The mandatory availability schedule for local checks that is required by H.R. 28 after three years is unrealistically short. Even after making improvements to the check collection system, the schedule would be shorter than the time it would take for most checks to be presented to the payor institution. This will encourage check fraud. Under the mandated schedule, institutions would be required to make the funds available for local checks at the opening of business on the next business day after the check is deposited, although in most cases the check would not be presented at the payor institution until later that day. If this schedule goes into effect, it would be relatively easy to perpetrate a check kite.

All an individual would have to do is to open accounts at two local institutions. Both accounts would be maintained in a proper manner for at least 30 days, in order to satisfy the new account exception in the bill. After that time, suppose the individual writes a check against nonsufficient funds for $5,000 on his account in one institution and deposits it in his account at the other institution on Monday.

Under H.R. 28, the institution in which the check was deposited would be required to make the funds available to the individual at the opening of business Tuesday, thus permitting the individual to withdraw the $5000. However, the check would not be presented to the institution on which it is drawn until late Tuesday morning or in the afternoon. That institution would not know if there were sufficient funds in the account to cover that check until that evening, at the earliest, when it posts checks to its customers' accounts.

On Wednesday, the institution on which the check was drawn would return the check to the other institution. Since that institution would be unable to obtain payment from the individual, it would suffer a loss of $5,000. Other similar schemes involving dozens of institutions could be easily accomplished that would result in significant losses to the banking industry.* While we recognize that this type of activity

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* Attached are two series of charts depicting the timing of the check collection and return item process. The first three diagrams depict the timing of the check collection and return item process under the most ideal situations. The two tables following the charts contain data regarding current return item practices.

can and does occur today and can occur with any mandatory availability schedule, 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.

One step that an institution could take to prevent losses of the nature I described is to be more selective in the consumers with which it does business. Since H.R. 28 does not contain a general judgmental exception to the schedules, it would preclude institutions from protecting themselves against risk of loss at the time of deposit, by placing holds on checks where they believe in good faith that there is a potential for fraud. In response, institutions may take steps to reduce their risk up front in screening prospective accountholders. There is already a significant segment of the population -- 12 percent of families according to a 1983 survey -- which does not have a banking relationship. The schedules in H.R. 28 could result in institutions refusing to provide banking services to an even larger segment of the population.

We believe that the structure of the schedules in H.R. 28 is too rigid. For example, the schedules that would be in effect during the first three years are longer in some cases than is necessary and too short in other cases. We are also concerned about the geographic categories contained in the bill -- local and nonlocal. New York State employs three categories: local, state and out-of-state. Some of our staff believe that a different division would work more effectively: local clearinghouse items, items processed by one Federal Reserve office, and items processed in two Federal Reserve offices. We believe that the geographic divisions should be left open in the legislation and decided by the Board.

The check collection system is a very complex mechanism and it is one that is constantly changing. We would expect changes to accelerate in the future as steps are adopted to improve the return item process and new technologies are introduced. Rigid schedules may not adequately reflect these developments and therefore should not be included in the legislation.

The serious problems that I just described could be avoided. Instead of having a precise schedule in the legislation, the Board urges Congress to authorize the Federal Reserve to establish the schedules. Within a relatively short period of time after the bill is enacted, the Federal Reserve would implement an interim schedule that would, in most cases, be no longer and perhaps shorter than the interim schedules in H.R. 28. Within two to three years a schedule that is shorter than the interim schedule could be implemented after improvements to the return item process are made.

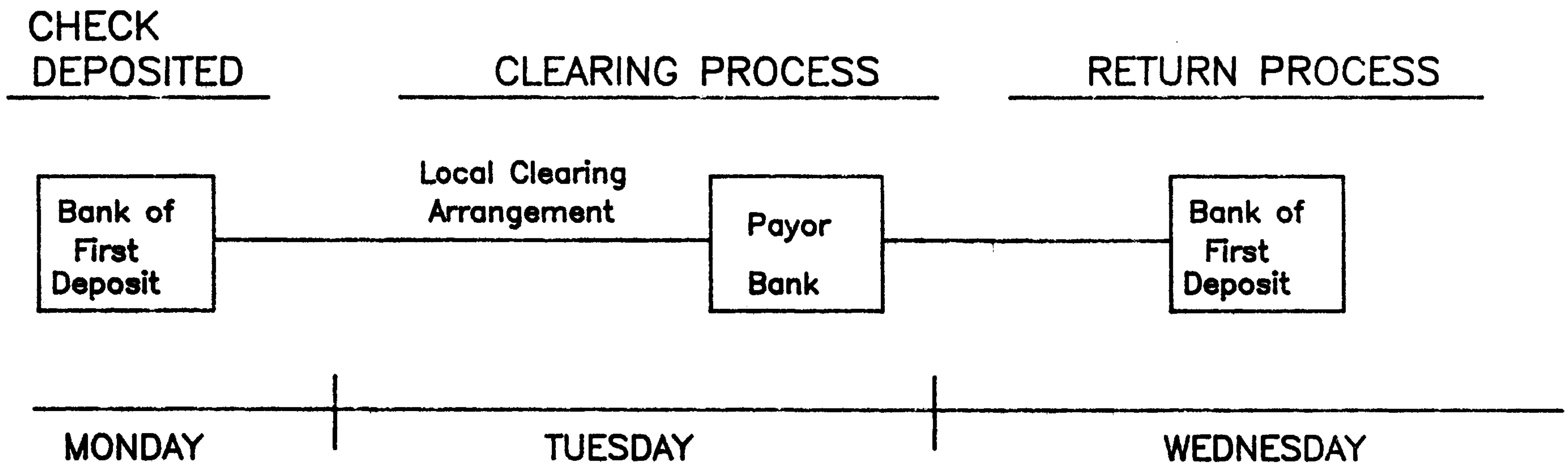
If the Congress believes that it is critical to include a schedule in the legislation, then we would urge that the schedule include only the maximum number of days that the Federal Reserve would be permitted to have in its schedule, leaving flexibility for the Board to establish shorter schedules. We would suggest that the maximum number of days be no shorter than six business days after the day of deposit.

Finally, there are a number of other provisions of H.R. 28 that bear further consideration. For example, we believe that the coverage of the legislation should be limited to consumers. We are unaware of any widespread delayed availability problems in the business community, and including business accounts within the scope of the bill would significantly increase the cost of compliance. The Board is also concerned that the requirement for establishing a Payment System Advisory 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. Finally, the "good faith" amendment, which was in the bill passed by the House last session, is not in H.R. 28. This provision allowed depository institutions to use their judgment in deciding whether a check presents unusual risk and to except such checks from the mandatory schedule. A similar provision is necessary for depository institutions to control check fraud losses. For this reason, we urge the Congress to include a "good faith provision."

In summary, we believe that legislation that requires disclosure, and provides authority to the Federal Reserve to improve the return item process and establish mandatory availability proposals will be beneficial to consumers and ensure that the costs to the banking industry are reasonable. There are a number of other technical amendments to H.R. 28 that we would also like to propose. The Board staff will be glad to work with your staff to develop the most effective legislation for accomplishing these goals. Again, I am pleased to be here today and would be glad to discuss the delayed availability issue in more detail if the members of the Committee desire.

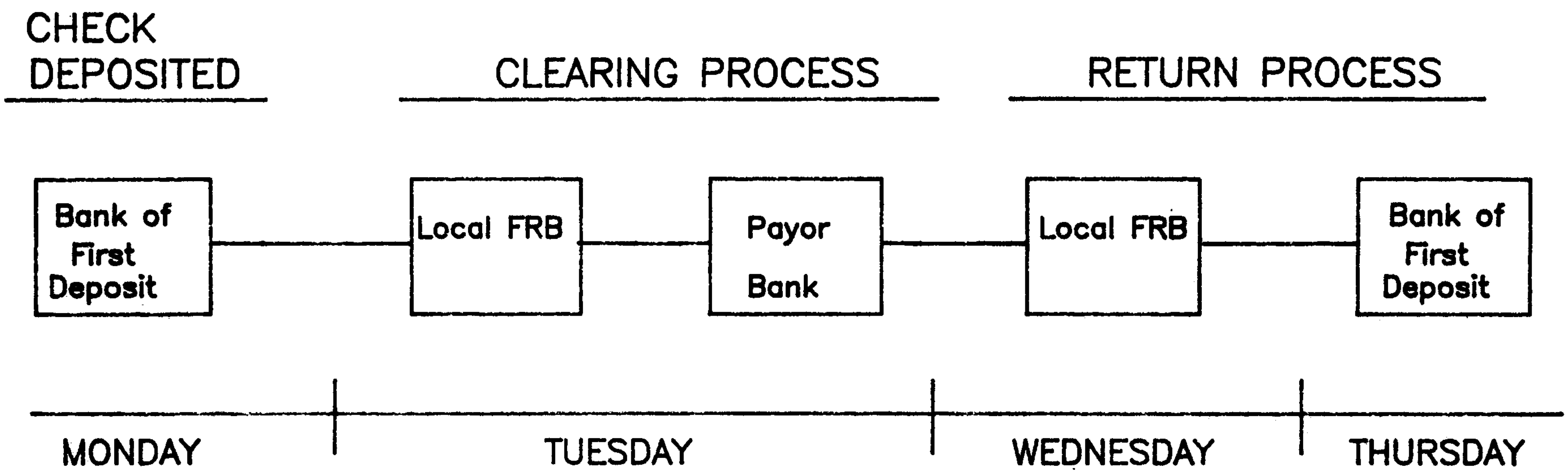
Attachment

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 Office Territory As
Bank of First Deposit



Best case situation.

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

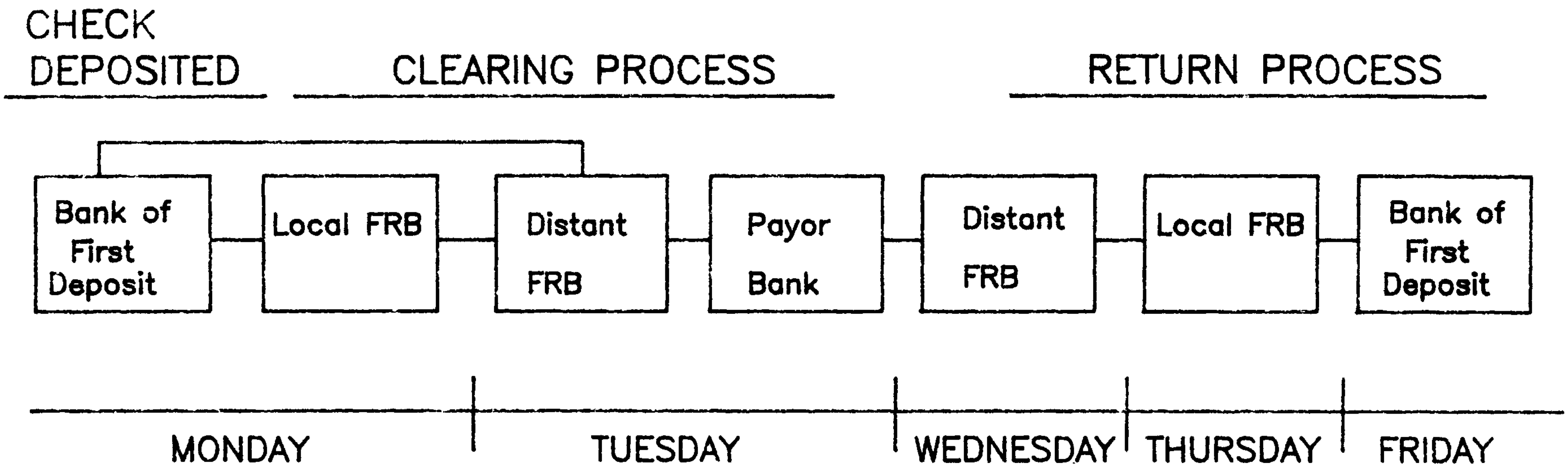
Distribution of Number of Endorsements For Returned Checks

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 Federal Reserve Office Distant from Bank of First Deposit



Best case situation.

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

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