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Statement by

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before the

Subcommittee on Consumer Affairs

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

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I am pleased to appear before this subcommittee to present the views of the Federal Reserve Board on S. 573 -- the "Fair Deposit Availability Act of 1983." This bill addresses the practice of depository institutions prohibiting a depositor from withdrawing funds represented by a newly deposited check for some period. This is often referred to as "delayed availability." The bill requires disclosure of an institution's policy regarding delayed availability, calculation of interest from the time the institution receives provisional credit for a check deposited into an interest-bearing account, use of standard endorsement procedures, and prompt notification of a decision not to pay because of insufficient funds or other reasons.

Although the Board's surveys of consumers and the recording of consumer complaints do not indicate that a majority of consumers have frequent problems with delayed availability, our information does not indicate that the problems are in any way trivial. The problems caused by delayed availability range from minor inconvenience, to service charges for checks written before deposits are deemed "good," to hardships caused by the depositor's inability to use needed funds. Two states, New York and California, have already passed legislation on the subject. These laws, which go further than S.573, not only require the disclosure of "hold" policies, but also direct state officials to establish, by regulation, what constitutes reasonable delays under different circumstances.

I have changed residence enough to understand the concerns that have been expressed about certain delayed funds availability policies, and am sympathetic to the problems that customers, particularly new depositors, can experience. As I see it there are two situations giving rise to problems -- those instances in which the practice is not disclosed in advance, and those times when an institution's policy can be construed as so inflexible or unreasonable that it imposes an undue hardship on its customers.

In considering the question of delayed funds availability, it is important, however, to recognize that the practice in some form is inherent within the structure of our check payment system. Since the passage of the Monetary Control Act of 1980 there has been considerable impetus within the financial industry to arrive at greater efficiency in the collection of checks. Notwithstanding this progress, it still takes up to two days for an institution to receive provisional credit for a check. In addition to this delay, it may take several days longer for a check that is not honored by the paying institution to be returned. Without going into the details of that system, which are outlined in Attachment A, these delays give rise to the argument that institutions are exposed to risk of loss in releasing funds before allowing for the time for an unpaid check to be returned. As long as the payments system involves the movement of paper checks from one point to another, there will be delays in the check collection process that may justify an institution delaying availability of funds to some depositors on some items to protect against such risks.

In conjunction with our responsibilities under the Monetary Control Act, the Federal Reserve has made a number of operational changes in our check collection operations, several of which offer the promise of accelerating collection. These include improving our transportation system to speed the physical movement of checks and establishing later hours during which institutions can deposit checks for collection and for us to present them for payment. We have also proposed a program to accelerate collection of checks drawn on high dollar volume institutions located in cities remote from a Federal Reserve check processing office. This proposal would prevent the delays in collection arising from shifts in check clearing volume away from institutions located in cities with a Federal Reserve check processing office. Although it is our belief that these new procedures can greatly benefit the efficiency of checks as a payments mechanism, it is too early to tell the extent to which these changes will positively affect industry practices in regard to delayed funds availability.

Though I believe there is some justification for some of the practice of delayed availability, I also believe that there is a need for financial industry action, and for additional operational improvements which could alleviate much of the problem. Specifically, I am encouraged by a recent call by industry groups, such as the American Bankers Association, for voluntary action on the delayed funds issue by their members. The president of the ABA has written all member banks urging a written policy concerning delayed funds availability, and disclosure of that policy to customers. In addition, the ABA has provided institutions with a model policy and disclosure form.

As an example of possible additional operational improvements now being pursued, we are pleased with the early results of a pilot program of the Dallas Federal Reserve Bank with regard to processing returned checks. This pilot program will help to determine the feasibility of establishing a nationwide service for the direct return of unpaid checks to the institution of first deposit, thereby shortening the chain of institutions in the return process and accelerating funds availability. A nationwide system for prompt return of checks would provide a framework for institutions to provide faster funds availability to their customers.

Disclosure

There are two reasons for promoting greater disclosure of funds availability policies. The first is simply the fairness of alerting the public to practices which may affect them adversely. The second is the impact that disclosure can have on the practice itself. As institution management formalizes its policies and prepares disclosures, it is likely to reexamine the necessity and reasonableness of existing practices.

Of course, the reasonableness of a particular institution's policy with respect to delaying availability is difficult to determine. Many factors go into an institution's or a bank employee's decision to delay availability and the length of the delay. Some institutions with short or no delays compensate for their risk of loss through increased service charges. Some institutions may establish blanket hold policies for certain categories of checks as the most operationally efficient hold policy. Other institutions may place holds on an individual basis, a more costly, but also generally a more equitable procedure. Whether or not an institution's policy can be considered reasonable is best left up to its customers and the discipline of the marketplace. But this requires that customers be informed about their institution's policy. Without disclosure by management, customers will not be able to judge the reasonableness of policies, and competition in the marketplace will not be able to impact the decisions of individual institutions.

In contemplation of the recent action by the ABA, and in order to provide a benchmark for measuring the effectiveness of this effort, the Board conducted a survey of consumers in March of this year to determine the level of consumer awareness of their institution's policy and the incidence of consumer problems with delayed availability. Attachment B summarizes the results. We plan to conduct a similar survey next year to measure any increase in awareness as a result of the ABA's suggestion. In addition, we are considering conducting a survey of financial institutions sometime next year to determine the number of institutions that are, in fact, disclosing their policies. The information from these surveys will be valuable in determining whether the banking industry has responded to the challenge of voluntarily dealing with the issue and whether disclosures, if made, result in an improvement in consumer awareness.

Of course, the problem of delayed funds is not limited to commercial banks. It involves all types of institutions, including credit unions, savings banks, savings and loan associations, and money market mutual funds. The effectiveness of a voluntary disclosure program will ultimately depend on the willingness of other industry groups and associations to encourage their members to also make voluntary disclosures. It would be our hope and it has been our advice to the industry that they pursue their efforts with all due speed. If successful, these efforts will be the most effective answer for customers in allowing them to determine whether their institution's policies are reasonable and, if not, allowing them to take action to avoid problems.

Federal Reserve Program

The Federal Reserve Bank of Dallas is currently conducting a pilot program to test the feasibility of the Federal Reserve System returning a dishonored check directly to the bank of first deposit rather than back through each step in the initial collection route. It includes having the Federal Reserve provide wire notice to the last endorsing institution of nonpayment of checks in the amount of $2,500 or more during the first phase of the pilot, and in a later phase directly to the institution of first deposit. Direct returns could provide the framework for enabling depository institutions to provide faster availability to their customers. (Attachment C contains a more detailed discussion of the Dallas Return Item Project.)

The Dallas project is, however, currently limited to providing direct return of certain checks originally collected through the Dallas Reserve Bank to certain banks in the Dallas Reserve District and there may be operational and legal obstacles to expanding the pilot further. For example, five states and the District of Columbia do not permit the direct return of checks. The Federal Reserve is contacting the appropriate officials in those states to explore the possibility of stimulating changes in their laws to permit direct returns. If the results of the Dallas pilot demonstrate that direct returns will enhance payments mechanism efficiency and these state laws continue to be an obstacle, federal legislation could be appropriate to enable direct returns to be implemented on a nationwide basis.

Even if a nationwide system of direct returns can successfully be implemented, it is still somewhat unclear whether such a system would automatically result in better availability for the institution's customers. For example, if a direct return approach is to be effective in providing a framework for improved funds availability, it may have to be universal. That is, even if some or even most returned checks are sent back directly and quickly, if others are not, the institution of first deposit will not know in advance which items will be returned directly and which will be returned by the present indirect, time-consuming manner. As a result, institutions may be reluctant to provide the earlier availability that the direct return concept may facilitate. Because of this potential problem, an incentive may need to be established for institutions to use the direct return system or some method instituted to minimize the risk of loss to the institution of first deposit. Although many of the issues of operational and practical feasibility of direct returns are still unknown, the Dallas pilot should provide a great deal of information that will be useful in providing answers to questions on delayed funds availability.

Conclusion

In conclusion, the Board is very sympathetic to the need for disclosures by institutions to their customers. However, the industry is currently involved in efforts to accomplish this and we think the voluntary industry action should be given a chance to work. We know from experience that disclosure laws are easy to conceptualize but far more difficult to implement and, to the extent laws like this may impose unnecessary costs by forcing industry activity into a few approved formats, the customer may ultimately be the loser.

In the next year we will be gaining additional experience with our pilot project to speed up the return item processing, and will be in a better position to gauge the extent to which this program may ultimately reduce the delayed funds problem. Perhaps a federal disclosure law will ultimately be necessary, but given the industry's recent first step toward self-correction of the problem and this pilot program, we suggest that the Congress defer adopting formal legislation until an assessment can be made of their effectiveness.

The delayed funds problem should diminish as customers become more familiar with alternative forms of payments other than checks. Many payments, especially those that recur regularly such as salary, dividends, and Social Security, can be received through automated clearing houses, and others can be handled as wire transfers. We believe that electronic payments represent a more efficient, faster, and more reliable means of payment than paper transfers. We just published for comment several proposed enhancements to the automated clearing house service and are inviting the public to comment on how we can improve this service further. In essence, electronic payments are the only real solution to the problem of delayed availability. The Federal Reserve continues to be committed -- as it has been in the past -- to promoting the efficiency of the nation's payments mechanism through the development of electronic payments.

The Check Collection System

The check collection system in the United States frequently involves many handlings of a check between its deposit in one depository institution and its payment by the payor depository institution. Checks deposited to accounts in the same institution at which they are to be paid account for about 30 percent of all checks written. The remaining 70 percent of the checks must be collected by sending them to:

- a correspondent bank;1/
- a Federal Reserve office;2/
- a check clearinghouse;3/
- the payor depository institution directly; or
- some combination of the above (the most likely alternative).

Most checks are collected within one or two business days and the bulk of the remaining checks are collected within three business days. The actual time required depends on the number and location of intermediary institutions involved and whether problems are encountered, such as mechanical breakdowns in transportation or sorting equipment, human error, or bad weather. Upon receipt of the check, the payor institution deducts funds equal to the amount of the check from the balance in the drawer's account if the check is properly drawn and endorsed, funds are available, and there is no stop payment

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1/ A correspondent bank is any depository institution that provides services and holds balances for other depository institutions.

2/ Federal Reserve Banks process approximately 35 percent of all checks written.

3/ A check clearinghouse is usually an association of depository institutions which may serve many needs of its member institutions including the exchange or clearing of checks.

order. If any of these criteria are not met, the payor institution sends the check back to its immediately prior endorsing institution. When a payor institution returns a check, it must do so by midnight of the banking day after the banking day it receives the check.

The process whereby the unpaid check is returned to the institution of first deposit is, at the present time, quite complex and slow. Article 4 of the Uniform Commercial Code, which has been adopted in all states, governs check clearing, including the return of unpaid items. Most of the state laws include a provision that permits the payor or collecting institution to return a check directly to the institution of first deposit. Several factors, however, discourage the use of the direct return procedure. Several states have not adopted the U.C.C.'s direct return provision.[4/] If either the institution of first deposit or payor institution is located in one of those states, the payor must obtain the institution of first deposit's agreement to a direct return -- itself a costly and time consuming process. Further, if the institution of first deposit and payor institutions do not have accounts with each other or with a mutual correspondent, it may be difficult for the payor to get a refund for the check; under such circumstances, it is far simpler to return the check to the presenting institution and charge back the amount. Because of these factors, institutions almost universally return dishonored checks to the immediately preceding institution in the collection chain. Thus, if several institutions were involved in the clearing process, each of these institutions will also handle the check as it is returned to the depositor.

4/ All states except Nebraska, Nevada, New Jersey, Oregon, Wisconsin, and the District of Columbia have adopted the optional provision of the U.C.C. allowing direct return of dishonored checks.

Although the processing of return items is the reverse of the original processing for collection, this process is much more labor intensive. The machine readable coding at the bottom of the check allows for collection routing through the use of computer controlled high speed check sorters. A check being returned, however, must be processed manually because each endorsement stamp on the back of the check must be read to determine the institution to which the check should be returned. These endorsements are not machine readable. As a result, return routing might typically require twice as much time as collection routing. For example, a check requiring two days to be delivered to the paying institution might require four additional days to be returned to the institution of first deposit.

Approximately 1 percent of all checks the Federal Reserve collects--about one-half million checks per day--are returned unpaid. Unfortunately, at the time a check is first deposited, there is no way of knowing whether it will be paid or returned.

Correspondent institutions and the Federal Reserve grant depository institutions credit for checks that they receive for collection using an availability schedule which reflects the normal processing and transportation time involved. However, reflecting the uncertainty regarding a check being paid or returned, the credit granted is provisional, and the institution receiving the credit must be prepared to give it up immediately should the check be returned unpaid. Likewise, depository institutions' depositors must also be prepared to make restitution of any funds credited to their account should a deposited check be returned unpaid. This is true, even though a delay in availability may have been imposed and even though that delay period has expired and the customer no longer has the funds in the account.

Summary of Survey Research Center Survey of Consumer Experience with Delayed Funds Availability

Introduction

Several questions probing consumer experience with delayed availability of funds deposited in checking, savings, and money market deposit accounts were included in the March 1983 Survey of Consumer Attitudes conducted by the Survey Research Center (SRC) of the University of Michigan under the Board's contract with SRC. This summary reports the results of the March survey and compares the March data with results from similar surveys conducted during 1977 and 1981.

Summary

The March 1983 survey indicates that the large majority of deposit account holders did not have delayed availability problems in the past few years. Of the respondents who had problems, few reported that the problems occurred frequently; most indicated that delayed availability problems occurred very infrequently.

The proportion of deposit holders with frequent delayed availability problems has not increased since 1981, while the proportion of deposit holders reporting occasional problems decreased slightly. Respondents to the 1983 survey were less likely to report that the problems were associated with new accounts than respondents to the November 1981 survey.

One-quarter of deposit holders reported that they have accounts at financial institutions that have delayed availability policies. Many of these respondents learned about the policy when they had problems, but most learned about the policy from a written disclosure, verbally from the teller, from a friend or relative, or some other way. The remaining three-quarters of deposit holders reported that the institutions where they have accounts do not have delayed availability policies or that they did not know whether any of the institutions where they have accounts have such policies.

Reported Problems With Delayed Availability of Deposited Funds

Eleven percent of respondents to the March 1983 survey who had checking, savings, or money market deposit accounts reported problems with delayed availability of deposited funds in the last few years (Table 1). However, only 2 percent of deposit holders indicated that they had delayed availability problems frequently (once a month or more). In comparison, 20 percent of deposit holders responding to the August and November 1981 Surveys of Consumer Attitudes and 12 percent of checking account holders responding to the 1977 Consumer Credit Survey reported delayed availability problems. Four percent of deposit holders in 1981 and 2 percent of checking account holders in 1977 said that delayed availability problems occurred frequently.1/

Experiences With Delayed Availability Problems

In 1983, two-thirds of the respondents who reported delayed availability problems indicated that the problems occurred once a year, only one or two times, or one time only in the last few years (Table 2). Forty-three percent

1/ In 1977 and 1981, respondents were asked whether delayed funds availability policies caused them to have problems frequently, sometimes, hardly ever, or never. Respondents to the November 1981 survey were also asked to indicate whether the problems occurred once a month, once a year, only one or two times, or some other number of times. Most respondents who reported frequent delayed availability problems said that the problems occurred once a month or more.

of the respondents who had problems said that the problems occurred because they were unaware of the policy. Other reasons mentioned included record keeping mistakes by respondents, errors by financial institutions, and out of state checks. Fifteen percent of respondents with problems indicated that the difficulties were with new accounts. Sixty-three percent of respondents with problems contacted the financial institution about the problem. Of these, nearly half reported that the institution was helpful in solving the problem.

Responses to questions about the frequency and reasons for delayed availability problems in the November 1981 survey were nearly identical to those in the 1983 survey. However, problems were more than twice as likely to have been with new accounts in 1981. In addition, respondents to the November 1981 survey discussed the problem with the financial institutions more often and were more likely to report that the institution was helpful in solving the problem.

Awareness of Delayed Availability Policies

The 1983 survey contained additional questions on awareness of delayed availability policies. Twenty-five percent of the deposit holders responding to the survey reported that they have accounts at financial institutions that have delayed availability policies; 64 percent reported that the institutions where they have accounts do not have delayed availability policies. (Table 3). The remaining 12 percent of deposit holders said that they did not know whether any of the institutions where they have accounts have delayed availability policies. Of the 147 respondents who reported having accounts at institutions with delayed availability policies, 46 percent learned about the policy when they had problems, 19 percent were informed verbally about the policy by a teller, 13 percent learned about the policy from a friend or relative, and 12 percent received a written disclosure. The remainder reported various other ways of learning about the policy.

Table 1

Reported Problems With Delayed Availability
of Deposited Funds, 1977-1983

	Number			Percent of deposit account holders		
	1977 1/	1981	1983	1977	1981	1983
Had delayed availability problems	257	243	68	12	20	11
Had frequent delayed availability problems 2/	32	44	13	2	4	2
Did not have delayed availability problems	1809	961	532	88	80	89
Total	2066	1204	600	100	100	100

1/ Question asked only of checking account holders.

2/ In 1977 and 1981 response to question was frequently had problems. In 1983 response to question was had problems once a month or more.

Table 2

Experiences with Delayed Availability Problems, 1981 and 1983

	Number		Percent of respondents who had delayed availability problems	
	1981	1983	1981	1983
Frequency of delayed availability problems				
Once a month or more	25	13	18	19
Few times a year	2	5	1	7
Once a year	21	8	15	12
Only one or two times	54	30	39	44
One time only	19	7	14	10
Other	17	5	12	7
Not ascertained	1	0	*	0
Total	139	68	100	100
Reasons for problems				
Unaware of policy	56	29	40	43
All other	75	36	54	53
Do not know, not ascertained	8	3	6	4
Total	139	68	100	100
Whether delayed availability problem was with a new account				
Yes	46	10	33	15
No	89	56	64	82
Do not know, not ascertained	4	2	3	3
Total	139	68	100	100
Whether institution was helpful in solving the problem				
Yes, helpful	57	20	41	29
No, not helpful	38	23	27	34
Did not discuss problem with institution	43	25	31	37
Not ascertained	1	0	1	0
Total	139	68	100	100

*Less than 0.5 percent

Table 3

Awareness of Delayed Availability Policies, 1983

	Number	Percent
Institution has a delayed availability policy		
Yes	147	24
No	381	64
Do not know	72	12
Total	600	100
How respondents learned about policy		
Had problem	68	46
Received written disclosure	18	12
Verbally from teller	28	19
Friend or relative	19	13
Worked at financial institution	7	5
All other	5	3
Not ascertained	2	1
Total	147	100

Attachment C

The Dallas Return Item Pilot Project

The Dallas return item pilot, which began on February 24, 1983, consists of the following three phases:

Phase I

Under Phase I the Dallas Federal Reserve Bank began separately charging the payor institution for processing returned checks collected originally through the Federal Reserve. In addition, the Dallas Reserve Bank began notifying the last endorsing institution by wire that such checks of $2,500 or more were being returned unpaid.

Phase I demonstrated the operational feasibility of separately charging and providing wire notice for return items collected originally through the Federal Reserve System. Additionally, Phase I of the pilot program has been favorably received by payor institutions within the Dallas Federal Reserve District.

Phase II

Phase II consists of two stages. The first stage will begin shortly and continue through the end of 1983. During this stage, the Dallas Reserve Bank will continue processing and charging payor institutions for return checks previously handled by the Federal Reserve and continue to provide wire notifications. In addition, in this stage the Dallas Reserve Bank will do the following:

> In the case where both the returning institution and the institution of first deposit are located within the Dallas Federal Reserve District, the Federal Reserve will return the item and provide wire notification of large dollar items directly to the institution of first deposit.

- To encourage automation of return item handling, the Dallas Federal Reserve Bank will offer a special price for return items which have been specially prepared for processing on an automated basis.

In the second stage of Phase II, the Dallas Reserve Bank would expand the pilot to include checks collected originally outside the Federal Reserve if both the institution of first deposit and the returning institution are located within the Dallas Federal Reserve District. Prior to beginning the second stage, the Dallas Reserve Bank will obtain written agreements from collecting institutions within its District (with which the Bank has an account relationship) to accept returned checks collected originally outside the Federal Reserve and to pay for these items in immediately available funds.

Phase III

Phase III would open the pilot to all items. Where the bank of first deposit is located outside the Dallas Federal Reserve District; the check would be returned to the Federal Reserve office serving the institution of first deposit.