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Statement by

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I am pleased to appear before this Subcommittee to present the views of the Board of Governors of the Federal Reserve System on the topic of delayed availability. Many banks, savings and loan associations, credit unions, and other financial intermediaries, such as money market funds, have continued to maintain delayed availability policies. That is, they place holds ranging from several days to two or more weeks on funds their customers deposit by check. This practice arises from the institutions' concern for credit risks arising from the return of checks after the proceeds of the checks have been made available to depositors, and it has generated numerous complaints from depositors. Many of their customers are either unaware of the length of the cycle for collection and return, or feel that the risks associated with their deposits do not warrant holds. In the past five years, the practice has generated considerable interest among state and federal legislators, as well as members of the public. Committees of both the House and Senate have held hearings; numerous bills have been introduced in the last two Congresses; and several states, beginning with New York and California, have passed laws restricting the ability of state chartered institutions to delay availability to their depositors.

The delayed availability problem arises from the nature of the check collection system -- a system that requires that a paper check be moved from the payee to the institution on which it is drawn for payment to be made. Approximately 75 per cent of the 40 billion or so checks that are written each year must be transported from the institution of first deposit to the payor institution. Every institution in the collection stream has an interest in moving the check forward as rapidly as possible in order to obtain payment from the payor. This basic incentive has resulted in a forward collection process that is highly automated and efficient. Checks are encoded in magnetic, machine-readable inks with code numbers identifying the payor, the drawer's account, and the amount. These techniques enable the checks to be processed by computer-controlled reader-sorters which sort the checks and send them on their way with great speed and efficiency. The Federal Reserve System and large correspondent banks maintain special transportation networks to link institutions of first deposit and payor institutions. Continual competition among depository institutions that offer collection services assures that this process will continue to be self-improving.

The incentive to move checks as quickly as possible is not, however, present in the return process. In contrast to the forward collection process, where availability to the institution of first deposit depends on when the check will reach the payor institution, the payor and the collecting institutions returning checks will be reimbursed promptly upon return of a check to their prior indorser. Thus, they have no incentive for speeding the return to the institution of first deposit and consequently for making the overall return process more efficient.

This difference in incentives has resulted in a return process that differs markedly from the collection process. In fact, the process of returning an unpaid check from the drawee to the institution of first deposit can fairly be described as the reverse of the efficient forward collection process. Instead of machine-readable characters, there are indorsement stamps that are not only not machine readable, but are often difficult to read manually or even illegible. Instead of computer processing, there is manual sorting. Instead of dedicated transportation facilities, there is widespread use of U.S. mail and other common carriers. As a result, the average return takes approximately three times as long as the average forward transit -- 5.2 calendar days for return as opposed to 1.6 days for forward collection. Further, a significant minority of checks, 15 per cent, take 10 or more calendar days to complete the round trip from the institution of first deposit to the payor and back again.

Since the institution of first deposit does not know the final disposition of a check after it sends it to the next institution in the collection chain unless it is returned unpaid, the institution of first deposit incurs some risk if it allows its customer to withdraw the check's proceeds before allowing sufficient time for the check to be returned. This is true even though less than one per cent of all checks collected are ever returned unpaid.

This analysis has led many, including the Federal Reserve, to place primary emphasis on seeking a solution to the delayed availability problem on expediting the return item process. By reducing the duration of the collection cycle, the time that a depository institution is at risk is also reduced as is the perceived need to place holds on checks. We at the Federal Reserve, who have been charged by Congress with maintaining an efficient payments mechanism, have taken a number of concrete steps to improve the return process and to enable depository institutions to provide more prompt availability. Recently, the Board approved an amendment to regulations governing Federal Reserve check collection services that requires the payor institution to notify the institution of first deposit directly that it has returned a large-dollar check it has received from the Federal Reserve unpaid. This amendment, which took effect last week, will provide the institution of first deposit with information about a check that is being returned much sooner than could be the case if it had to wait for the check to be returned. This change should make a significant improvement to the payments mechanism.

We have testified before about the return item pilot which is being run by the Federal Reserve Bank of Dallas. This pilot has had some success in moving checks directly from the payor institution to institution of first deposit, by-passing the intermediary depository institutions.

The Federal Reserve is also working with private sector groups to seek better solutions to the return item problem. Four Reserve Banks are participating in a pilot program to experiment with check truncation (where the necessary information from a check is extracted and converted to electronic form). The Federal Reserve is also working with a banking industry group to develop a test of an automated return process in which the return item will be placed in a carrier envelope encoded with the routing number of the institution of first deposit and the dollar amount. The envelope with the unpaid check would then be placed in the forward collection stream, taking advantage of all of its efficiencies.

Each of these proposals has certain advantages and disadvantages. One disadvantage of efforts undertaken by the Federal Reserve is that they reach only checks that are collected through the Federal Reserve System. The remaining checks that are not collected through the Federal Reserve will not necessarily benefit from these improvements. Unless the Federal Reserve has the authority to create incentives or require payor institutions to take the steps necessary to expedite the return process, these checks will continue to be returned by the old manual processing methods.

In addition to implementing these techniques, other improvements in the delayed availability situation can be made. One major step would be for all institutions to provide full disclosure to their customers of their availability policies. Several studies suggest that the largest single cause of the problems that depositors experience in this area is ignorance of hold policies -- of their existence and of how they affect individual checks. In addition, depositors are generally unaware of payment alternatives, such as wire transfers, that, although more costly than checks, can provide payees with immediately available funds when used by payors.

Another step that can alleviate the availability problem is for institutions to conduct a more careful evaluation of their hold policies and their customers' credit positions. Such evaluations would avoid the imposition of holds on checks where there is little risk of nonpayment or on accounts where experience shows that little risk is involved. For example, government checks and cashiers' checks deposited by the payee into an established account pose little risk of nonpayment. Long-standing customers who have not abused their accounts are likely to be good for the funds even if a check is returned, and customers with overdraft protection or other credit lines have already been evaluated by their institutions and found creditworthy. Hold policies should be revised to avoid delays in availability where the risk to the institution of first deposit is small.

The Federal Reserve has urged that the delayed availability problem should be resolved through the voluntary efforts of depository institutions. In the policy statement that we issued jointly in March, 1984, with the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board, we stated that "voluntary industry action represents a potential solution to many of the problems caused by delayed availability, without the costs and burdens of a legislative or regulatory approach." The agencies strongly encouraged institutions to review their hold policies, reducing delay periods to the extent possible; disclose their policies to depositors in an effective manner; and refrain from imposing unnecessary delays on all checks.

While some progress has been made, especially in increasing consumer awareness, much remains to be done, not only in the area of consumer awareness, but also in actually providing better availability to depositors.

We have surveyed many of the industry groups with which I had previously met to discuss voluntary efforts to resolve the delayed availability problem. Several of these groups have followed through by encouraging their members to make disclosure and to review their delay policies. They report that feedback from their members indicates improvements in disclosure of availability policies. The Federal Reserve, through its examination of state member banks, is attempting to develop more concrete evidence of the effects of the March 1984 policy statement. The preliminary results of this effort suggest that blanket holds are only imposed by a small minority of depository institutions and confirm that consumers are receiving disclosures as to delayed availability policies either at the time they open the account or the time that the hold is imposed.

Despite the voluntary efforts, surveys of consumer experience with delayed availability problems taken on behalf of the Federal Reserve by the University of Michigan's Survey Research Center have not shown any significant decline in the percentage of families reporting problems. In fact, the 1985 survey showed a slight increase in the percentage of families reporting delayed availability problems over the 1983 survey. Voluntary efforts do not appear to be providing a rapid solution to this problem.

A number of legislative proposals have been made incorporating disclosures, payments system improvements, and availability schedules. Some of these proposals are based on past experience with state legislation. A preliminary review of the experience of states with such legislation indicates that some of the approaches states have taken to the delayed availability problem may be successful if adopted on the national level.

There are three principle approaches to the problem of improving deposit availability that can be derived from the state and proposed federal legislation. These approaches involve disclosure requirements, improvements in the payments system, and mandatory availability schedules. I will address each of these in turn.

1. Disclosures

Mandatory disclosure requirements could ensure that depositors are aware of their institutions' hold policies, minimizing the incidence of checks drawn on uncollected funds with all of the problems that result from such overdrafts. Such disclosure should not, and need not, be complex or burdensome, and could also provide for ready comparison of competing institutions' policies. Thus, disclosures can create competitive pressures to reduce hold periods.

2. Improvements to the Return Item Process

The Board would be assisted in meeting its commitment to work with depository institutions to increase the efficiency of the return item process by Congress providing (a) authority for the Federal Reserve to extend the notification requirement for large-dollar returns to items collected outside the Federal Reserve; (b) adoption of "direct return" provisions that would allow payor institutions to return checks through channels other than the indorsement chain, together with authorization for payor institutions to obtain immediate payment for the checks they return direct; and (c) authority for the Federal Reserve to require payor institutions to complete returns within certain time-frames. With these goals we can expedite the return process and reduce its overall costs, thus reducing risk and providing the foundation for more rapid availability to customers.

I would like to stress, however, that the improvements to the return item process that are feasible in the forseeable future will not be sufficient to improve clearing times to the point of providing for return of the majority of checks within the goals established by some of the legislation that has been introduced. Most of the bills that Congress is considering establish an ultimate goal of availability within a maximum of three business days. The collection cycle cannot be reduced to three business days without a wholesale transition from traditional check collection procedures to electronic collection.

Nevertheless, improvements in the return process are still desirable because they can increase the efficiency and reduce the costs of the return process, and because quicker collection and return will reduce the risks to institutions that give some or all of their customers availability prior to the completion of the collection cycle.

3. Mandatory availability schedules

The Board has given careful attention to the provisions on mandatory availability schedules that are included in most of the bills that Congress is now considering. This analysis has identified some significant adverse consequences of these schedules in terms of risk to depository institutions and regulatory burden that must be balanced against the benefits that they are likely to provide to the institutions' customers. Standardized availability schedules increase the risk to the institution from the return of checks after the mandated hold period has expired. On the other hand, schedules tailored to accommodate fully the return process, while minimizing the risk to the institution of first deposit, also minimize the benefit, in terms of prompt availability, to the institutions' customers.

While depository institutions' risks may be mitigated by appropriate exceptions to the schedules for certain classes of checks or accounts (such as large-dollar checks or new accounts) the institutions can only avail themselves of these exceptions through procedures which could well increase the regulatory burden of administering deposit accounts.

We are also concerned that mandatory availability schedules will become the industry standard, and that those institutions that have better availability will adopt the specified schedule. In most instances, institutions have given prompt availability or have decided not to impose holds on depositors that have established good records. If depository institutions respond to mandatory schedules by limiting availability in this fashion, the net benefit to the aggregate of depositors will be minimal.

Unlike disclosures and improvements to the payments system, which require uniformity from state to state in order to be effective, the most egregious delays in availability which mandatory schedules are designed to correct may be a localized problem that can be dealt with at the state level. Several states have already taken the initiative to adopt such schedules. In view of potential local variations in this problem, state action may well be the most appropriate vehicle for addressing mandatory availability schedules.

The considerations favoring and opposing such schedules are reflected in differing views among the Board members. However, on balance, a majority of the Board is opposed or reluctant to favor the imposition of such schedules.

If, however, the Congress chooses to adopt such schedules, the Board strongly urges that it be provided the flexibility to establish the schedules after consideration of all relevant factors, and that it be provided the flexibility to establish necessary exceptions to the schedules.

I would like to add one final, general point. Any availability schedule adopted should not be tied to improvements to the payments mechanism. As I have already pointed out, any payment system that relies on paper instruments that must be transported from one place to another will not be efficient enough to satisfy the desire for maximum collection and return times of only a few business days. Such schedules are not possible without abandoning the traditional collection process and converting to electronic forms -- an expensive process that requires a long lead time.

Mr. Chairman, to sum up, the Board is prepared to support improving deposit availability through new statutory provisions on disclosure and on expediting the return item process. We would not, on balance, favor a statutory requirement for standard availability schedules.

I would be pleased to answer any questions that the Subcommittee may have.