

FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 78-47

April 21, 1978

TO ALL BANKS
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

For some time now, the Bank Administration Institute, American Bankers Association, and Federal Reserve System have been working together, through a group known as the Joint Industry Exception Item Task Force, on a program to reduce the problems and costs associated with interbank cash letter errors. Standardized procedures and forms were developed and their effectiveness measured through a pilot test involving some 80 banks across the nation. Data gathered during this test indicate that all banks, regardless of size, would benefit from adoption of the proposed system. Since a key element in the program is a high degree of standardization, the amount of individual bank savings is dependent on the total number of banks that adopt the proposed methods.

In an effort to acquaint as many banks as possible with the program, the Bank Administration Institute (BAI) is planning a series of half-day training sessions throughout the country, covering the recommended procedures and standardized forms. Each session will be sponsored by a local BAI chapter and many will be attended by Federal Reserve check adjustments personnel. Additional information, including locations of these sessions and individuals to contact regarding details, will be released by BAI soon.

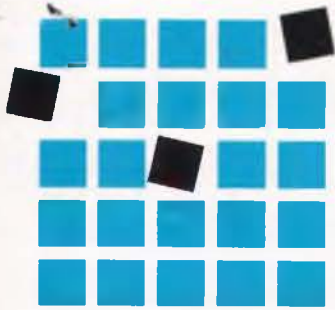
The enclosed reprint of an article written for Bank Administration Magazine by Walter W. Stafeil, BAI Principal Systems Specialist, includes an overview of the considerations and recommendations, as well as the research that led to the development of the standardized procedures and forms. I hope each bank in the Eleventh District will attend one of the training sessions and participate in the program through adoption of the procedures and forms.

Sincerely yours,

Robert H. Boykin

First Vice President

Enclosure



Joint Industry Exception Item Task Force Recommendations

By Walter W. Stafel

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In 1973, nearly three out of every 25 checks written became exception items (MICR rejects, return items and cash letter adjustments). These exception items increased the industry's 1973 total direct check processing cost by 25% or \$285 million. These findings are from a BAI research study which also projected the industry's cost of handling exceptions would grow to \$1.6 billion by 1980 unless actions were initiated to reduce either the volume or processing cost of these items.

BAI initiated a number of studies to investigate possible improvements for the processing of these items. The results were presented at an Exception Item Conference in March, 1976. Based upon the feedback from conference attendees, a Joint Industry Exception Item Task Force (JEITF) was formed to identify and pursue feasible solutions to the exception item problem.

The JEITF was sponsored by Bank Administration Institute, the American Bankers Association and the Federal Reserve System, and was comprised principally of bank operations personnel. It was divided into three working groups, each dealing with a specific area of exception items: Rejects, return

items and adjustments. An overview of the considerations and recommendations of each working group and of the full task force follows.

Reject Working Group

The reject working group investigated five possible solutions to alleviate the problems associated with the handling of MICR rejects.

One solution was for the industry to utilize the regulatory agencies to monitor reject rates. If a bank's reject rate exceeded an established standard, the fact would be recorded and brought to the attention of senior bank management. The working group did not recommend this action because of the difficulty in defining and establishing a standard reject rate for different types of equipment and various methods used to calculate reject rates.

The use of dual or redundant MICR lines on each check was also studied. With two sets of MICR characters, a digit that could not be read in one set might be read in the second set. The cost of placing two MICR lines, the extra reading head needed and the software cost far exceeded the benefits to be gained. Thus, this consideration was eliminated.

The third solution was for each federal reserve bank to produce a monthly report showing in ascending sequence the reject rate for each bank it processed items for. The reject rate would be determined from the cumulative number of items processed and would identify the bank's name.

The working group anticipated that this report would stimulate each bank to improve its perfor-

mance. Another positive effect would be its impact on machine vendors. Bankers would be able to compare the rate from their present equipment to other vendors' equipment, and this would act as an incentive for manufacturers to maintain quality.

The working group recommended that the Federal Reserve Banks issue monthly reject reports. However, the ranking would be eliminated because the assignment of a numerical rank implied a judgment concerning relative performance. The monthly reports would contain the following information:

- Highest reject rate experienced from a bank during that month.
- Lowest reject rate experienced from a bank that month.
- Average reject rate for all banks during that month.
- The individual bank's reject rate experienced by the Federal Reserve Bank during that month.

The Federal Reserve System agreed to produce the report and has completed the necessary programming. At this time most banks in the nation that send items to a Federal Reserve office are receiving it.

The fourth solution studied was in the area of quality control. The working group's initial intention was to create a quality control handbook containing the do's and don'ts of MICR processing. This guideline would assist banks in establishing a quality control function and/or improving the effectiveness of existing quality control units.

After much discussion the working group recommended that all

The Return Item Working Group studied prevention, endorsement, standardization, extended deadlines and automation of return items; the cost, volume and implementation time of each were considered.

banks adopt and implement a quality control program. The handbook was not produced, but a strong recommendation emerged that an industry group be formed to produce these guidelines.

The fifth area of study concerned full MICR line reject repair. Full reject repair is defined as fully reencoding the complete MICR line on "add-on stripes" or "carrier envelopes" for items that rejected during the first pass on automated reader/sorters. Fully repaired items should be able to be read by subsequent high-speed processing equipment and should be no different from the original encoded items. Both are MICR encoded according to check specifications, and each item should have the complete MICR line encoded. While the working group concluded that full reject repair, accepted industrywide, could reduce the cost of processing rejects, it cautioned banks about the disadvantages inherent in the current state of the art.

A number of legal issues are involved with full repair when the MICR line is reencoded. One type of encoding error occurs when the repairing bank misencodes either the routing number or the dollar amount. This type of error is similar to what can happen today. An encoding error in the routing field would cause the item to be misrouted but eventually found. An error in the dollar amount field should be discovered during reconciliation.

The unknown liability occurs when an encoding error happens during the repair of the on-us field. If an erroneous account number is encoded on the repaired item, the possibility exists that the item could be posted to the wrong account. While there are some safeguards in this process—a check digit may cause the item to be unposted, or the error may create an overdraft which might be

discovered while returning the item, or the error might be discovered during check filing—the legal liability is unknown. It is important to note that this error would only effect debits. Credits are not processed by other banks. The working group encourages banks within clearing house associations that have the equipment to repair reject items fully without manual intervention to repair these rejects. However, it cautions participating banks to be alert to the legal issues if an error occurs and to establish agreements for this liability prior to implementing full reject repair.

Return Item Working Group

The Return Item Working Group began its task by identifying four measures that could reduce the effects of return items. The measures studied were prevention, endorsement standardization, extended deadlines and automation of return items. The cost, volume and implementation time of each measure were considered.

The prevention of return items involves aiding banks in identifying accounts that may cause them. By publicizing services that prevent return items, the overall volumes could decrease.

Various techniques were studied: Identification codes, new account services etc. Prevention was not recommended as a national solution, but instead as one that is more effective on the local level. Banks in local areas should participate in various plans to reduce the number of these accounts.

The second measure considered was the standardization of endorsements. A proposal for a standard endorsement specification was drafted that called for the identification of the bank of first deposit, or first encoding bank, on the reverse side of a check in a clear band area. All subsequent bank endorsements would be

placed sequentially in another area on the back of the check through the use of a symbol, with the technology prescribed by the ANSI X-9 Committee.

The endorsement specification was developed as an evolutionary specification. That is, as banks modified their proof machines to place their endorsements in the clear area, the first step toward endorsement standardization would occur. As more banks modified their machines, the current problems associated with identification of the bank of first deposit would be reduced.

If a method for identifying subsequent endorsements is developed through ANSI, the industry could then comply with the specification and a major problem associated with the processing of return items would be minimized.

The third measure studied was the automatic processing of return items. This proposal was to return items directly to the bank of first deposit. All items would be qualified with routing number of the bank of first deposit and the dollar amount. With the use of either add-on stripes, color-coded carrier envelopes or another MICR clear band on the check, the items could be sorted by reader/sorters and then routed through the Federal Reserve's check processing system. The working group determined that, while the concept was appealing, the standardization of endorsements was necessary before it could recommend the entire industry pursue this solution.

The fourth measure studied was the return item deadline issue. A proposal presented at the Exception Item Conference was to extend the present 24 hours from midnight of the day the items were received to 72 hours for nonsufficient fund items under \$25 in value. The proposal to extend the return item deadline offered a significant reduction in cost while

limiting the loss exposure of the paying bank. An overwhelming majority of the participants at the conference indicated support for the proposal and that their banks would cooperate by accepting late returns from other banks in their areas if the proposal were adopted.

A number of factors contributed to the conclusions drawn by the working group; and in some instances they were not related to the statistical data. The reasons included the emotional impact of delaying returns on customers, the marketing policy of different banks and operational control considerations.

After careful evaluation and collection of additional information, it appeared that control problems would be monumental and require costly system changes with a 72-hour deadline. A 48-hour deadline appeared to be more controllable and less costly to implement. The group also considered that, for this proposal to be effective, a larger share of the total NSF volume should be included. The results of the 1974 NSF survey showed that nearly 45% of all NSF items were under \$25 in value and that nearly

80% were under \$100 in value.

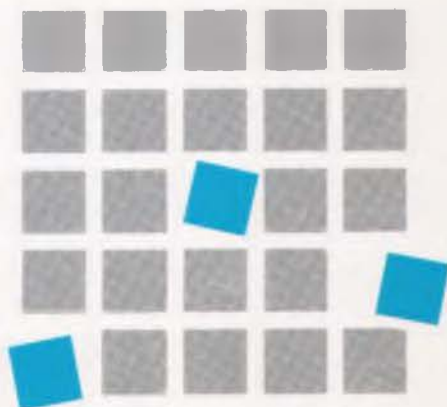
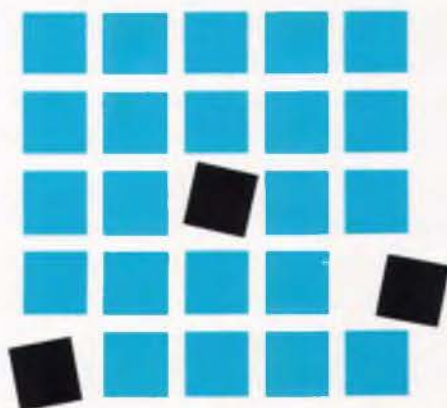
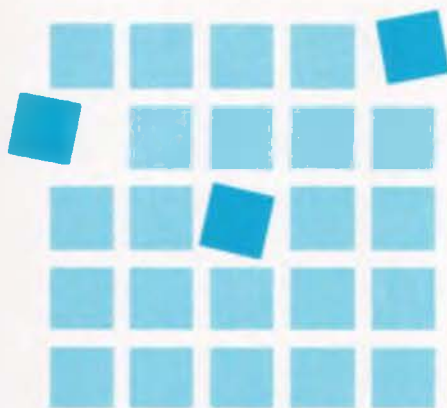
Because of the legal implications of the UCC and Regulation J, this recommendation should be implemented at the local level. The working group encourages local clearing house associations to pursue this recommendation. Clearing house associations electing to amend their deadline rules will find legal support for this action in Section 4-103, paragraph 2 of the Uniform Commercial Code. Since there is no track record in this area, clearing house associations accepting this recommendation are requested to report to the task force the overall effect of the change during the first year.

Adjustments Working Group

The Adjustments Working Group was charged with the responsibility for determining methods of reducing the volume of adjustments (and thereby their related cost to the industry) and proposing standardized adjustments procedures and forms including testing their validity, cost justifying their impact and guiding their implementation on a national basis.

The procedures and forms studied by the adjustments working group had been reacted to and reviewed at the Exception Item Conference. A majority of the attendees felt that the concept of adjustments standardization would be beneficial to the banking industry. After considering the feedback from the conference attendees, the working group reduced the number of procedures originally presented from 12 to seven and the number of forms from 15 to three. The seven procedures and three forms relate to the adjustments caused by interbank errors. The customer/bank procedures and forms were eliminated because they are an individual bank's policy issue.

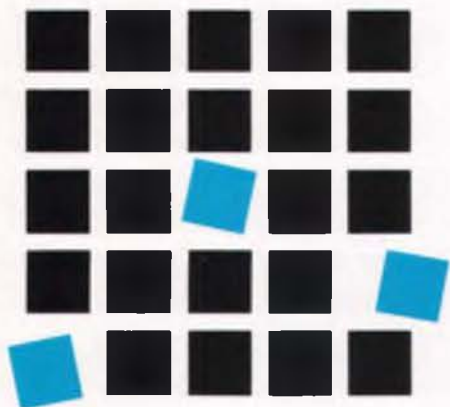
The working group discovered no reliable data to use in studying the impact of adjustments upon banks and upon the industry in total. Statistics were not available to determine the average days an item is outstanding, average dollar value per adjustment, lost investment opportunity to the industry for funds associated with adjustments, rate of backlog increase or decrease, volume in dollar data by classification of adjustments, or



impact on volume and dollars if adjustments are made on a direct debit/credit to a Federal Reserve Bank rather than requesting a debit/credit.

The working group recommended a pilot test to collect the information necessary for comparing the current industry procedures for resolving adjustments with the proposed procedures and forms along with their impact upon adjustments on an industrywide basis.

Eighty banks that participate in BAI's annual Check Collection



Performance Measurement Survey were asked to perform the test. They were divided into two groups—control and test. Control banks processed their adjustments using their current systems and forms. Each bank tracked every adjustment it processed during the test and summarized all adjustments during the reporting period. Test banks tracked every adjustment they processed in the same manner as the control banks; however, their procedures for resolving adjustments were quite different. When test banks resolved an adjustment between another testing bank or through participating Federal Reserve Banks, they followed the procedures revised by the

working group and used the proposed forms. Only when testing banks resolved items between nonparticipating banks and Federal Reserve Banks did they use their current procedures and forms. Prior to conducting the test from the middle of March, 1977 through April 30, 1977, a training meeting was held in Chicago to review the procedures and forms that would be used during the test.

The pilot test yielded a number of measurements with regard to adjustment processing. The analysis indicated that all banks, regardless of size, would benefit by following the proposed procedures and forms.

The average number of days an item was outstanding was 1.6 days less between test banks and 0.7 days between test and control banks. Banks that processed fewer than 2,000 adjustments during the test gained the most benefit.

The adjustment test identified numerous benefits if the procedures and forms were used to resolve interbank differences. Each bank could improve its control of adjustments, install a productivity measurement technique in its adjustment area, improve the interaction between management and adjustment staff and participate in an industry effort to solve the problems by using the standardized procedures and forms.

The standardization would also produce a number of other benefits such as reduction of total outstanding adjustment dollars, reduction in cost of forms, easier training of adjustment staff, standardized manuals, reduction of followup correspondence, reduction of staff to resolve adjustments, and fewer charge backs to customers resulting from a reduction of the number of late charge backs and a reduction of number of items outstanding during reconciliation.

Based upon the information de-

veloped during the adjustment test, the Adjustment Working Group recommended that the industry implement the following six procedures and three forms to resolve differences between commercial banks and Federal Reserve offices:

Procedures

- Free item
- Loose items
- Missing items
- Listing error adjustments
- End point sort adjustments
- Encoding errors

Forms

- Request for claim or debit-credit
- Request for credit-debit
- Loose item notification

The post sending procedure was not recommended. The procedure was designed to eliminate duplicate paperwork during the test. However, it contributed to extra paperwork and increased the number of days an item was outstanding. For these reasons the working group only recommended the procedures listed above.

Conclusion

The task force believes that banks adopting its recommendations will improve their ability to process rejects and return items. Industry improvement will only occur if banks work together cooperatively to solve problems. The industry will continue to be plagued with the complex system presently used to resolve adjustment if only a few banks implement the procedures. If many banks implement them, however, they and the industry in general will achieve benefits. At some point in the future the present complex nature of resolving adjustments can be simplified, and the industry will then be able to direct its attention to solving other industry problems. ■

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