FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 79-33
February 27, 1979

REMOTE DISBURSEMENT PRACTICES

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

There is printed on the following pages a copy of the Board of Governors' press release concerning remote disbursement practices. The Board's Staff Report to Congress, referred to in the press release, is attached.

Remote disbursement involves arrangements between a bank and a customer (frequently a corporation) designed expressly to delay payment of the customer's checks. For example, in such an arrangement, a bank customer making most of its payments in Pennsylvania might make payments by checks drawn on a bank in Oregon. Recipients of these checks may suffer a delay in receiving credit in their accounts.

If any questions or comments arise with respect to remote disbursement practices, please contact Larry J. Reck, Assistant Vice President at this Bank, Ext. 6337; Robert W. Schultz, Assistant Vice President at the El Paso Branch, (915) 544-4730; Vernon L. Bartee, Assistant Vice President at the Houston Branch, (713) 659-4433; or Thomas H. Robertson, Assistant Vice President at the San Antonio Branch, (512) 224-2141.

Sincerely yours,

Robert H. Boykin

First Vice President

Enclosure

FEDERAL RESERVE

press release

For immediate release January 11, 1979

The Federal Reserve Board today made public a statement of policy concerning the practice known as remote disbursement and announced a course of action intended to discourage such abuse of the check collection system. At the same time the Board sent to Congress a status report on Federal Reserve efforts to eliminate the practice.

Remote disbursement involves arrangements between a bank and a customer (frequently a corporation) designed expressly to delay payment of the customer's checks. For example in such an arrangement, a bank customer making most of its payments in Pennsylvania might make payments by checks drawn on a bank in Oregon. Recipients of these checks may suffer a delay in receiving credit in their accounts.

The Board has the following principal concerns with respect to remote disbursement:

--It can expose both the bank involved and recipients of the remotely disbursed payments to risks of loss -- that they may not be aware of -- during the deliberately prolonged clearing time.

--Consumers and small businesses -- who may not be in a position to negotiate better payment terms -- may be denied prompt access to funds due to them.

--Remote disbursement could result in unsafe or unsound banking practices if the customer's funds at the remote disbursing bank are not sufficient to cover the customer's checks (that is, if settlement procedures between the customer and the bank are not on an "immediate funds" or "collected balance" basis). This would result in unsecured extensions of credit by the bank to the customer. Such extensions of credit might not be warranted as a matter of loan policy. In the case of small banks, such loans might exceed the legal limit for lending to any one customer.

The Board gave the following policy guidance:

The Board believes the banking industry has a public responsibility not to design, offer, promote or otherwise encourage the use of a service expressly intended to delay final settlement and which exposes payment recipients to greater than ordinary risks. The Board is calling on the nation's banks to join in the effort to eliminate remote disbursement practices intended to obtain extended float.

There is no intention to discourage corporate disbursement arrangements with banks that provide for improved control over daily cash requirements, provided that these arrangements do not result in the undesirable effects noted above. Banks should provide the cash management services needed by their customers through the use of payments methods that facilitate prompt funds availability to payment recipients and that protect banks from unnecessary risk.

To provide incentives to banks to design and use payment methods that are in keeping with the public interest the Board has adopted a plan consisting of the following actions:

--Direct telephone or personal contacts between members of the Board, or Reserve Bank Presidents, and the chief executives of banks and bank holding companies believed to be offering remote disbursement services. To date these contacts have been very successful in obtaining voluntary bank action to terminate the practice.

--Review by bank examiners of settlement procedures between banks and their customers. Bank examiners have been alerted and directed to pay particular attention to the check services offerings of banks to their customers.

--Implementation of a late deposit "package sort"[1/] option for check clearance at all Reserve offices. This option is intended to make it possible for banks around the nation to accelerate collection of checks drawn on remotely located collection points.

--Consideration of the need, desirability and feasibility of regulatory or legislative moves to designate remote disbursement as an unfair banking and business practice, to change the Federal Reserve credit availability schedule for remotely disbursed checks or to require final settlement for payments within normal collection times including limitation on the use of depository transfer checks.[2/]

The Board Staff's Report on Remote Disbursement is attached.

1/ Package sorted checks are checks sent to the Federal Reserve for collection, pre-sorted and packaged by the name of the banks on which the checks are drawn. This simplifies and speeds check clearance by the Federal Reserve.

2/ A pre-authorized check drawn on the customer's account in another bank.

REPORT ON

REMOTE DISBURSEMENT

The term "remote disbursement" refers to the practice of disbursing funds by checks that are drawn on banks remotely located from the recipient of the check in order to maximize the amount of time between deposit of the check by the recipient and payment for the check by the originator.

Recipients of remotely disbursed checks and collecting banks, including the Federal Reserve, are being denied availability of funds to the extent that funds would be available earlier if the transaction had been consummated by a check that could be collected more readily, or by alternative payment means. On this latter point, the reliability, finality, security and timeliness of the available bank-to-bank wire transfer services, including the automated clearinghouses, represent a more desirable means for effecting large dollar value transfers than the check, particularly when remote disbursement is involved.

The practice of remote disbursement has been under study at the Federal Reserve for some time and the staff has arrived at the following conclusions:

1. Remote disbursement unnecessarily delays payment to check recipients who rarely are able to determine the manner in which payments are made to them.

Recipients of remotely disbursed checks may be exposed to risk of loss associated with the longer clearing time Perhaps the best example of this risk was the case involving American Beef Packers, Inc., which case was the subject of recent Congressional hearings resulting in the enactment of legislation to require next-day final payment for livestock transactions.

American Beef Packers paid for cattle purchased from farmers in the midwest with checks drawn on a bank in Oregon. When the company went bankrupt, the checks were dishonored. Actually, payable through drafts were used in lieu of checks by this company but banks treat such drafts as checks and the public is generally not informed of nor concerned with the technical differences. During Congressional hearings, the point was frequently made that the length of time required for clearing and return of the drafts probably caused much of the loss to the draft recipients. Specifically, the longer clearing time may have affected the collectability of some of the drafts, and the combination of the longer clearing and longer return times delayed identification and claim of assets (livestock).

Because check recipients are generally not aware of the risks associated with remote disbursement and are not in a position to negotiate an alternative payment instrument (such as more readily collected checks, currency, or wire transfer), the Board believes that the banking industry has a responsibility not to encourage or even offer a service that is intended solely to delay final settlement and that thereby exposes check recipients (particularly individuals) to greater risks.

The Board is not discouraging corporate disbursement arrangements with banks that provide for improved control over daily cash requirements provided that the purpose of such arrangements is not to delay the collection of funds to the disadvantage of the payee or other participants in the payment system. Banks should provide the cash management services needed and demanded by their customers using payment methods that facilitate rapid collections, assure the prompt availability of funds to payment recipients, and protect banks from unnecessary risks.

2. Remote disbursement has undermined efforts by the banking industry and the Federal Reserve to improve the speed and efficiency of the check clearing system.

While the qualitative effects of remote disbursement have been identified and described, the Board has previously indicated that quantitative measurements of these effects would be very helpful. Accordingly, we have explored various means of measuring the impact of remote disbursement on the check collection system. We have concluded, however, that such measurements would be extremely difficult and expensive to obtain for the following reasons:

1. Cost. The Federal Reserve Banks process over 50 million checks per day. Any attempt to monitor payment patterns in such a large universe would require a great deal of manual labor with no guarantee of accurate data.
2. Sampling Errors. Sampling techniques used to detect and analyze remotely disbursed items could be subject to significant error and thus render the data meaningless.
3. Third Party Data. Collection of remote disbursement data would inevitably involve collection of data regarding payment patterns of some check originators. Such information, it was felt, should not be collected and analyzed no matter how worthwhile the purpose.

Although the effects of remote disbursement on the check collection system have not been measured, the Board believes that the effects of the practice are significantly adverse and well understood.

First, remote disbursement has affected traditional private sector check clearing arrangements, with the result that the collection of some items has been slowed. Traditionally, collecting banks have arranged with various banks to open correspondent/respondent accounts for the purpose of clearing checks. Some banks offering remote disbursement services refuse to open such correspondent/respondent accounts or to accept "on us" checks except through Federal Reserve channels. Thus, all checks drawn on these banks must clear through the Federal Reserve, which slows the collection of some items.

Additionally, we believe that remote disbursement is responsible for some of the increase in Federal Reserve float that has occurred in recent years. Remote disbursement is an abuse of the Federal Reserve's policy of deferring credit for a maximum of two business days. This policy was intended to provide the nation's financial institutions and the public with a reliable and predictable flow of credit for checks. For some time such a policy created minimal float because the relatively few items that could not be cleared in two days had a small dollar value. However, we believe that remote disbursement has increased the number of items in this category and has increased the average dollar value of such items. The Federal Reserve System insulates collecting banks from the full effects of remote disbursement by sharing some of the float associated with the longer collection time. While the adverse float effects of remote disbursement are shared, the favorable float effects usually accrue solely to the check issuer.

3. <u>Certain types of remote disbursement arrangements may affect the safety and soundness of the banks offering such arrangements.</u>

The Board's staff believes that certain settlement procedures sometimes used by banks offering remote disbursement services could expose the banks to considerable risk of loss. While such losses can occur in theory, no instances have been discovered by examiners since this possibility was called to their attention, and the Board knows of no such losses.

The specific procedure under scrutiny involves a bank's acceptance of a means of deferred settlement for the remotely disbursed checks it receives and pays for its customer. The means of settlement could include any method of payment on a deferred basis, but it normally involves the use of a check prepared by a bank drawn on another bank at which the customer has an account. These checks are in common use and are called Depository Transfer Checks (DTC).

If the collected funds balance of the bank's customer, in all accounts at the bank, is less than the amount of settlement required, and if settlement is deferred, the bank is extending credit to its customer. At small banks the amount of such unsecured credit to a single customer or in the aggregate may be excessive in relation to the bank's size.

One category of risk results from the time limits imposed by the Board's Regulation J and the Uniform Commercial Code for initiating return of unpaid cash items. Under Regulation J, if a check or draft is received from the Federal Reserve, the bank is required to settle on the day of receipt with immediately available funds and to initiate return of all types of unpaid cash items not later than midnight of the day after receipt. The provisions of the U.C.C. are similar, but differ slightly in the case of specific types of cash items. If a bank has an arrangement to settle with its customer on a deferred basis using, in particular, a DTC, that bank would normally have exceeded the time period for return of items received from the Federal Reserve and possibly other collecting banks by the time the DTC could be processed, presented, and returned in the current check collection system. Each day required for the normal clearing and return of the settlement DTC exposes the bank to another day's clearing of remotely disbursed checks.

The Board's staff has provided information to bank examiners at the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Reserve Banks. The examiners have begun to review settlement procedures between banks and their customers involved in remote disbursement in cases in which the bank customer uses "payable through" drafts, zero balance demand deposit accounts, or a delayed settlement for any third party payment instruments that are paid by the bank as demand or cash items.

Efforts to deal with the situation

To promote the development and use of payment systems that meet the needs of bank customers while at the same time protecting banks from unnecessary risk and assuring prompt availability of funds to check recipients, the Board has adopted a plan consisting of the following actions:

1. Continuation of a program begun in 1978 involving direct telephone or personal contact with the chief executives of major banks and bank holding companies known to be offering remote disbursement services to corporate customers to request their cooperation in eliminating remote disbursement practices. Thus far these contacts have been very successful.

2. Continued review by bank examiners of settlement procedures between banks and their customers.

3. Adoption of a "package sort" option for the clearance of checks at all Federal Reserve offices. This program will provide later deposit deadlines for checks that are presorted and packaged by the name of the banks on which the checks are drawn. This option will make it possible for banks around the nation to accelerate collection of checks drawn on remotely located collection points.

4. Consideration of the need, desirability, and feasibility of regulatory or legislative moves to (a) designate remote disbursement as an unfair banking and business practice, (b) change the Federal Reserve credit availability schedule for remotely disbursed checks, or (c) require final settlement for payments within normal collection times including limitation on the use of depository transfer checks.