



FEDERAL RESERVE BANK
OF DALLAS

HELEN E. HOLCOMB
FIRST VICE PRESIDENT AND
CHIEF OPERATING OFFICER

DALLAS, TEXAS
75265-5906

January 11, 1999

Notice 99-04

TO: The Chief Operating Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

**Request for Public Comment on a Modification to Regulation CC
and Extension of Comment Period**

DETAILS

The Board of Governors of the Federal Reserve System is requesting public comment on a modification to Regulation CC (*Availability of Funds and Collection of Checks*) that would shorten the maximum hold time from five business days to four for many nonlocal checks. Comments must be received by March 15, 1999, and should refer to Docket No. R-1031.

The Board also has extended the comment period on proposed amendments to Regulation CC that would allow banks that consummate a merger on or after July 1, 1998, and before June 1, 1999, greater time to implement software changes related to the merger. Comments, originally requested by January 4, 1999, must be received by February 1, 1999. Comments should refer to Docket No. R-1027.

Please address all comments to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

ATTACHMENT

A copy of the Board's notice regarding availability of nonlocal checks as it appears on pages 69027-30, Vol. 63, No. 240 of the *Federal Register* dated December 15, 1998, is attached.

MORE INFORMATION

For more information, please contact Don Jackson, (214) 922-5431, at the Dallas Office; Eloise Guinn, (915) 521-8201, at the El Paso Branch; Rene Gonzales, (713) 652-1543, at the Houston Branch; or Herb Barbee, (210) 978-1402, at the San Antonio Branch.

For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

Sincerely,

Helen E. Holcomb

Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington DC 20551. Comments may also be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. on weekdays and to the security control room at all other times. The mail room and the security control rooms are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments will be available for inspection and copying by members of the public in the Freedom of Information Office, Room MP-500, between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in Section 261.14 of the Board's Rules Regarding Availability of Information.

FOR FURTHER INFORMATION CONTACT: Jack K. Walton II, Manager, Check Payments Section (202/452-2660) or Michele Braun, Project Leader (202/452-2819), Division of Reserve Bank Operations and Payment Systems. For the hearing impaired *only*, contact Diane Jenkins, Telecommunications Device for the Deaf (TDD) (202/452-3544).

SUPPLEMENTARY INFORMATION:

I. Overview

As a result of concerns about some banks' practice of delaying funds availability by placing holds on the proceeds of checks deposited into customers' transaction accounts, Congress passed the Expedited Funds Availability Act (EFAA) in 1987 (12 U.S.C. 4001-4010).¹ The EFAA specifies maximum time limits on the holds that banks may place on funds deposited into transaction accounts.

Prior to enactment of the EFAA, some banks had argued that their availability schedules reflected the time needed for the collection and return of checks that were not paid and provided a measure of protection against the risk that the bank could not recover funds from the depositor if those funds had already been withdrawn from the depositor's account. To balance depositors' interest in receiving prompt access to their funds with banks' ability to manage their risks, Congress required the Board to reduce the EFAA's funds availability schedules to as short a time as possible and equal to the period achievable under the improved check clearing system for a receiving depository institution to reasonably expect to learn of the nonpayment of most items for

each category of checks. (12 U.S.C. 4002(d))

The Board's Regulation CC (12 CFR part 229), which implements the EFAA, includes maximum availability schedules for funds deposited into transaction accounts as well as provisions designed to accelerate the check return system. Currently, funds deposited by most nonlocal checks (checks payable by banks located in different check processing regions than the depository bank) must be made available for withdrawal within five business days (five-day availability).² The Board is investigating whether it would be appropriate to define separate categories for various types of nonlocal checks so that it can assign maximum availability schedules to these categories of nonlocal checks. These categories would be designed to preserve hold periods as a fraud-protection tool while providing depositors earlier access to their funds. Analysis of available data suggests that several alternative methods for defining categories of nonlocal checks might reasonably meet the Congressional mandate. Several of these alternatives rely on data collected by the Reserve Banks. One alternative relies on data collected by depository banks that elect to use the full five-day hold period for some nonlocal checks.

The purpose of this notice is to gather information on the potential benefits and drawbacks of this latter alternative for assigning availability schedules to categories of checks because it relies on a self-certification procedure that differs from the approach the Board has previously used in Regulation CC. Based on its analysis of the comments to this notice, the Board will assess the feasibility of this method and may request comment on one or more specific regulatory proposals to modify the nonlocal check availability schedule.

FEDERAL RESERVE SYSTEM

12 CFR Part 229

[Regulation CC; Docket No. R-1031]

Availability of Funds and Collection of Checks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Board requests comment on the potential benefits and drawbacks of a modification to its Regulation CC, Availability of Funds and Collection of Checks, that would shorten the maximum hold for many nonlocal checks. This modification would shorten the availability schedule for nonlocal checks from five to four business days except that a depository bank could retain a five-day schedule for categories of nonlocal checks for which it certifies that it does not receive a sufficient proportion of returned checks within four business days. This proposal is one of several alternative modifications to the nonlocal check availability schedule that the Board is considering. The Board may request comment on this or alternative modifications in a future notice of proposed rulemaking after analyzing the comments received in response to this notice.

DATES: Comments must be submitted on or before March 15, 1999.

ADDRESSES: Comments, which should refer to Docket No. R-1031, may be mailed to Ms. Jennifer Johnson, Secretary, Board of Governors of the

¹ As used in this notice and in Regulation CC, the term bank includes commercial banks, savings institutions, and credit unions. *Depository bank* refers to the bank of first deposit (see 12 CFR § 229.2 (e) and (o)).

II. Background

When Congress established the EFAA funds availability schedules, it attempted to balance banks' concerns about managing their risk with consumers' concerns about the availability of their funds. Congress recognized that banks would be exposed to risks if they were required to make funds available before they had a reasonable opportunity to learn of the return of an unpaid check.

Congress's 1987 Conference Report on the EFAA tied availability schedules to banks' ability to reasonably expect to learn of the nonpayment of a significant number of checks. The Report suggested that if improvements in the check clearing system make it possible for two-thirds of the items in a category of checks to meet this test in a shorter period of time, then the Federal Reserve must shorten the schedules accordingly.³ The Board has considered this "two-thirds test" in evaluating alternative amendments to Regulation CC that would implement the statutory requirement for shortened availability schedules for nonlocal checks.

The Conference Report also recognized that geographic proximity or transportation arrangements between check processing regions would permit the Federal Reserve to provide shorter times than the general schedule for nonlocal checks would require. The Conference Report noted that shorter times would be possible for checks transported between such nearby territories as New York City and Jericho, Long Island, and for checks transported

between banks in cities with Federal Reserve check processing offices, such as banks in Boston and San Francisco.⁴ The Board recognized regional differences in the times needed to return checks in Regulation CC by establishing appendix B-1 under the temporary schedule and appendix B-2 under the permanent schedule.⁵ Appendix B-1 identified Federal Reserve check processing regions in which depository banks were required to make funds from specified nonlocal checks available within four or five business days from the day of deposit, compared with the seven business days otherwise applicable under the temporary schedule. Appendix B-2 provided a similar listing for nonlocal checks for which proceeds must be made available within three business days from the day of deposit rather than the five days otherwise applicable under the permanent schedule.⁶

III. Shortening the Nonlocal Check Availability Schedule

The Board is currently considering whether the check clearing system has improved sufficiently to warrant amending Regulation CC to require that funds deposited by nonlocal checks be made available earlier than now provided. The legislative history does not indicate whether the Board should interpret the two-thirds test precisely, and the EFAA requirement that the Board reduce maximum holds to as short a time as possible in which a bank could reasonably expect to learn of the nonpayment appears to provide the Board with some discretion. The Board

is also exploring various methods that are reasonable and cost effective for defining categories of nonlocal checks for the purposes of determining appropriate funds availability schedules.

A. Returned Check Surveys

The Board drew on data from four surveys to determine whether it would be appropriate to reduce the nonlocal hold period. In 1996, the Board's comprehensive survey of check-fraud losses at banks asked respondents to indicate the proportion of returned checks that they typically received on each business day following the initial deposit of a check (1996 bank survey). In conjunction with that check-fraud study, Federal Reserve staff also collected detailed data from a sample of checks processed during one week through the Federal Reserve Banks (1996 Reserve Bank survey).⁷ In 1997, Federal Reserve staff repeated the Reserve Bank survey for six weeks and thereby increased the number of nonlocal returned checks sampled compared with the prior survey (1997 Reserve Bank survey).⁸ The results of the 1997 survey were generally consistent with those of the 1996 survey. For historical comparison, the Board also reviewed a survey of checks returned through the Reserve Banks conducted shortly after the implementation of Regulation CC (1990 Reserve Bank survey).⁹ The table below summarizes the average nonlocal return cycles observed in the 1990, 1996, and 1997 surveys.

CUMULATIVE PERCENTAGE OF NONLOCAL CHECKS RETURNED WITHIN NUMBER OF BUSINESS DAYS

	1997 reserve bank survey ¹	1996 reserve bank survey ¹	1996 bank survey	1990 reserve bank survey	Percent improvement 1990-97
3 business days	27.8	33.3	32.0	21.0	32.4
4 business days	59.9	64.1	64.9	47.0	27.5
5 business days	82.8	83.3	84.3	73.0	13.4
Number of nonlocal checks sampled	31,646	5,707	² 773	n.a.	n.a.

¹ Excludes outlier observations defined as nonlocal checks that exceed 15 business days. For example, the 1997 survey data exclude 1.6 percent of nonlocal checks sampled.

² Reflects the number of commercial banks, savings institutions, and credit unions sampled. Source: Board of Governors of the Federal Reserve System. See text notes 7, 8, and 9 for sources of data.

In the 1996 and 1997 surveys, over eighty percent of nonlocal unpaid checks were returned to the depository

bank within the maximum availability period of five business days, up from 73 percent in 1990. The percentage of

nonlocal checks returned unpaid within four business days ranged from 60 to 65 percent in the 1996 and 1997 surveys,

³ H.R. Conf. Rep. No. 100-261, at 179 (1987).

⁴ H.R. Conf. Rep. No. 100-261, at 179 (1987).

⁵ Appendix B-1 was removed and appendix B-2 was redesignated as appendix B in 1995 (60 FR 51669, Oct. 3, 1995).

⁶ Locations were included in these appendixes based on an informal survey of the transportation

arrangements that existed when Regulation CC was developed.

⁷ Report to the Congress on Funds Availability Schedules and Check Fraud at Depository Institutions (Board of Governors of the Federal Reserve System, October 1996).

⁸ The 1997 survey was designed to provide a sufficient number of checks to estimate the proportion of nonlocal checks returned within four

and five days nationwide. The sample was not intended to provide statistically valid results between each possible pairing of check processing regions throughout the country (previously unpublished 1997 Reserve Bank data).

⁹ Report to Congress Under the Expedited Funds Availability Act (Board of Governors of the Federal Reserve System, March 1990).

roughly a 30 percent improvement over 1990. Although returns within four days remained slightly below two-thirds, they were close to that threshold. The survey results suggest that it may be appropriate for the Board to reduce availability schedules for all or some categories of nonlocal checks from five business days to four.¹⁰

B. Alternative Approaches

In developing guidelines to identify categories of nonlocal checks that could be subject to shorter availability schedules, the Board sought to define as precisely as possible those check categories returned to the depository bank in fewer than five days at least two-thirds of the time, taking into consideration the practical limitations of the data collection needed to support the categorization. Identifying a large number of categories of nonlocal checks should increase the likelihood that the checks are accurately categorized based on when they are returned. The greater accuracy afforded by a large number of categories would lower the risk that a particular check would have to be made available before it would normally be returned. Similarly, a higher degree of accuracy would increase the probability that customers would receive faster availability for those checks that are normally returned within fewer than five days. Thus, a large number of categories of nonlocal checks should provide a better balance, as sought by Congress, between banks' needs to manage their fraud-loss risk and their customers' interests in having as early access to their funds as possible.

The Board has been exploring alternative approaches for defining appropriately precise categories of nonlocal checks that should receive earlier availability. These approaches range from categorizing the almost 2,000 possible pairs of check processing regions to a more aggregated approach that would group nonlocal checks into only three categories nationwide based on the availability zone (city, RCPC, or country) of the paying bank.¹¹ Each

¹⁰The General Accounting Office (GAO) recently conducted a study to identify, among other things, whether electronic check presentation affects the length of time necessary for a dishonored check to be returned to the depository bank. The GAO concluded that the check return performance of electronically presented nonlocal checks was not very different from that of physically presented checks. (U.S. General Accounting Office, GAO Report, *Retail Payment Issues: Experience with Electronic Check Presentation*, (July 14, 1998)).

¹¹In general, nonlocal checks payable by banks located closest to Federal Reserve check processing offices are returned fastest. Nonlocal checks payable by banks located further away require somewhat more time. The first four digits of the routing number (the routing symbol) on every check

approach recognizes the roles of geographic proximity and transportation arrangements in the check clearing and return cycle. It is not clear, however, what might be the most appropriate (reasonable and cost effective) way to identify those categories of nonlocal checks that should receive earlier availability. Collecting data, however, to support a valid analysis of return cycles for nonlocal checks becomes increasingly expensive and, in some cases, impractical as the number of categories increases.¹²

The Board is considering reducing the availability schedules for nonlocal checks from five to four business days but permitting an individual bank to delay funds availability for a particular category of nonlocal check for five business days if it certifies that it does not receive at least two-thirds of nonlocal returned checks in that category within fewer than five days. This approach would match the bank's actual return experience for nonlocal checks with permitted availability schedules more precisely than any approach that relies on data that the Reserve Banks could collect. Under this alternative, banks that wished to use a five business day availability schedule for a category of checks would be required to conduct their own periodic data collection, based on criteria that would be included in Regulation CC, and to certify that they do not receive at least two-thirds of that category of nonlocal returned checks in fewer than five days.¹³ The bank's primary

identify the location of the paying bank in relationship to the local Federal Reserve office. The locations are organized roughly in concentric circles. City checks are payable by banks located relatively close to a Federal Reserve office, RCPC checks are payable by banks located somewhat further from a Federal Reserve office, and country checks are payable by banks even more geographically remote. Only eight of forty-four check processing regions have country availability zones.

¹²While the alternatives thus far analyzed rely on data collected from nonlocal checks returned through a Federal Reserve Bank, the results of the 1996 bank and the 1996 Reserve Bank surveys suggest that there is little difference between nonlocal return times for checks returned through the Reserve Banks and for all nonlocal returned checks.

¹³If a bank imposes an exception hold on a customer's deposit in accordance with § 229.13, it may extend the time within which it is required to make funds available for withdrawal by a reasonable period. Regulation CC deems a six business day extension of its nonlocal check available schedule to be reasonable; a longer extension may be reasonable, but the bank has the burden of so establishing. This safe-harbor extension would be added to the four-day nonlocal check schedule or to the five-day schedule for those categories of nonlocal checks that a bank certifies are eligible for the longer hold.

A bank that has a policy of generally making deposited funds available for withdrawal sooner

supervisor would be responsible for reviewing the self-certification and supporting data.

Permitting a bank to certify that it qualifies to use five-day availability schedules for some categories of nonlocal checks gives it the flexibility to weigh; (1) the costs of collecting data with which to certify that it should be permitted to hold certain categories of nonlocal checks for five days, (2) the fraud risk associated with its hold policy, and (3) the customer benefits of that policy. If a bank determines, for example, that the administrative cost associated with demonstrating that certain categories of nonlocal checks should be subject to five-day availability and the resulting increased complexity of its availability schedules outweighs the incremental fraud protection, then it could simply adopt a four-day or shorter schedule for all of its nonlocal check deposits.¹⁴

IV. Request for Comment

The Board requests comment on the benefits and drawbacks of modifying Regulation CC to shorten the availability schedule for nonlocal checks from five business days to four unless a depository bank certifies that it does not receive most of its nonlocal returned checks in fewer than five business days. Commenters' overall perspectives on the issues raised in this notice as well as their answers to the specific questions listed below will be useful in the Board's analysis of the alternative approaches to modify the nonlocal check availability schedules. Comments will help the Board balance consumers' interests in receiving access to their funds and banks' interest in minimizing check-fraud losses and will help the Board develop an appropriate method to implement Congress's directive to improve funds availability to match improvements in the check clearing system.

The Board does not plan to implement any changes to Regulation CC's nonlocal check availability schedules prior to the spring of 2000 so that banks can minimize changes to

than required may extend the hold up to the time allowed by the regulation on a case-by-case basis. (Under § 229.16(c), a bank must provide a notice when funds from a particular deposit will not be available by the time a bank generally make funds available for withdrawal.) A bank would be permitted to hold a nonlocal check on a case-by-case basis up to five business days for those categories of nonlocal checks that the bank certifies are eligible for the longer hold.

¹⁴The Board's 1996 check-fraud study found that 70 percent of banks make funds deposited by nonlocal checks available to their customers earlier than Regulation CC now requires. *Report to the Congress on Funds Availability Schedules and Check Fraud at Depository Institutions*, p. 39.

their internal systems during the period surrounding the century rollover.

A. Defining Categories of Checks

For the purpose of assigning availability schedules, the Board is exploring several methods for categorizing nonlocal checks that rely on the check processing region and the availability zones in which banks are located. Because proximity and transportation infrastructure affect the time period needed to present and return nonlocal checks, the Board is considering several possible methods to define categories of nonlocal checks, including:

(a) Pairs of check processing regions, for example checks deposited at banks in the Columbus check processing region and payable by banks located in the Utica check processing region;

(b) The check processing region of the depository bank and the availability zone of the paying bank, for example checks deposited at banks in the Columbus check processing region and payable by nonlocal banks in city availability zones; and

(c) The availability zone of the paying bank, regardless of the location of the depository bank, that is, any check payable by a nonlocal bank located in a city availability zone.

Regulation CC could be modified to define appropriate categories of nonlocal checks for the analysis of return cycles. Alternatively, the regulation could permit banks to define their own categories, perhaps within some guidelines.

1. Should Regulation CC define categories of checks for which a bank could certify that it should be permitted to hold funds for five days? If yes, what categories would be appropriate? If not, should a bank be permitted to define its own categories or select from among a variety of categories?

2. Given the pace of change in the improvement of the check clearing system, how frequently should a bank be required to re-certify that it should be permitted to withhold the funds availability of a category of nonlocal returned checks for five business days? Every two years? Every five years? Some other time period?

B. Bank Hold Policies

3. If this approach is adopted, to what extent will banks use the certification process to continue placing five-day holds on certain categories of nonlocal checks to protect themselves against some check-fraud losses?

C. Data Collection and Statistical Significance

Under the approach being considered in this notice, the Board anticipates requiring banks to use the two-thirds test indicated by Congress to assess whether a category of nonlocal checks at a bank should be subject to four- or five-day availability. Banks that choose to hold some categories of checks for five business days would be required to collect representative data that demonstrates that, for those categories of checks, they do not receive two-thirds of the returned nonlocal checks within four business days.

4. What information should a bank be required to collect to certify that it does not receive at least two-thirds of a category of nonlocal returned checks within four business days? What would constitute representative data for a bank and over what period should it be collected? What procedures would reasonably ensure that a bank appropriately certifies that it is eligible to use five-day holds? Should the same methodology apply to small, medium, and large banks?

5. Do banks currently collect the data needed for certification?

D. Consumer Disclosures

Section 229.16(a) of Regulation CC provides that disclosures reflect the policy followed by the bank in most cases. The commentary to that section provides that a bank may not place a hold longer than the period disclosed. Therefore, a bank that discloses that it generally makes funds from nonlocal checks available in four business days but certifies that it is eligible to use the five-day availability schedule for some categories of nonlocal checks would have to disclose which categories of nonlocal checks would be available in five business days.¹⁵

6. If the proportion of nonlocal checks available in five business days does not represent "most cases," to what extent would the complexity of the disclosure requirement affect a bank's decision to use five-day availability for some categories of nonlocal checks?

7. What amendments to the disclosure rules would assist banks in adopting a policy to hold some categories of nonlocal checks for four days and others for five days as well as assist customers to understand which nonlocal checks

would be available for withdrawal in four days and which in five days? Would it be sufficient to provide detailed information as to which checks will receive four or five day availability only when requested by a customer or prospective customer?

By order of the Board of Governors of the Federal Reserve System, December 9, 1998.

Jennifer J. Johnson,

Secretary of the Board.

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¹⁵In contrast, based on guidance in the supplementary information to the Board's notice adopting the initial Regulation CC, a bank that discloses that it generally makes funds from nonlocal checks available in five business days would have to disclose the reduction in schedules to customers only upon request. (53 FR 19400, May 27, 1988)