
FRBSF WEEKLY LETTER

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Legislating Funds Availability

Nearly everyone has been inconvenienced at one time or another by a banker's decision to place a "hold" on a deposited check. Consumer activists have criticized this practice of delayed availability, as it is called, and support for legislation regulating it has been growing. (A hold on a check prevents the depositor from withdrawing part or all of the deposit for periods ranging from several days up to three weeks.) California, Massachusetts and New York have already enacted laws that limit the duration of check holds. Similar legislation is under consideration in several other states and in the U.S. Congress where Rep. St Germain (D-RI) has introduced the "Expedited Funds Availability Act."

Bankers contend that such legislation may expose the industry to an increased risk of loss from returned checks. Moreover, they argue that unregulated competition within the banking and thrift industry gives depositors the option of shopping around for institutions with the most lenient hold policies and will produce a more efficient balance between processing costs and the frequency of holds than will legislation. Nevertheless, growing support for a legislative approach to the problem of delayed availability is forcing the industry to consider operational changes in the check clearing process. These changes are costly, however, and will likely increase costs to users of payments services — including depositors.

A problem of credit risk

Payment by check is a widespread practice in this country. Once a bank or thrift institution accepts a check for deposit, it must obtain payment — investable funds — from the institution on which the check is drawn. Until the funds are collected, the deposit cannot be invested by the bank, and any use of the deposit by the depositor (if allowed by the bank) amounts to a loan against the uncollected deposit. These "loans" are usually of very short duration since 99 percent of all checks that are presented for payment are collected within three business days.

The banking industry has adopted fixed "availability schedules" based on average collection times to enable the institution that originally

accepts the check to determine when collected funds will be available for investment. According to these schedules, a check deposited on any given business day is collected by the bank that accepted the check on the next business day if it is drawn on another institution in the same city. If the check is drawn on an institution in another part of the country, it is collected on the second business day following the day of deposit.

Since banks receive credit for collected checks in one to two business days, why do they impose holds of much longer duration on some checks deposited with them? Consumer activists maintain that this practice enables the banking (and thrift) industry to profit from the free use of depositors' funds. Bankers argue that holds are necessary to protect banks against the risk of loss associated with returned checks. Moreover, they point out that most institutions pay interest from the day of deposit regardless of the status of hold, even though funds will not be collected for a few days.

Approximately 400 million checks are dishonored and returned to the bank that accepted the check for deposit each year owing to problems such as insufficient funds, improper endorsements, or improper encoding. Half of these returned checks ultimately are uncollectable and a loss to the bank or the depositor. Under the present system, all interbank check collections are considered provisional — that is, subject to reversal if the check is dishonored and returned. Because the return process is not automated, however, there is no standardized schedule by which the institution that sent the item for collection can determine whether an item will be returned as uncollectable. In fact, returned checks frequently can take up to three weeks to wend their way back through the check clearing system. In the meantime, if the institution has advanced funds to its depositor, it may suffer a loss.

Given the risks inherent in accepting checks for payment, banks clearly have incentives to adopt conservative (stringent) hold policies, particularly since a check might be returned unpaid at a much later date. In practice, however, most banks are

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very selective in their use of holds, and try to balance efforts to reduce risk against efforts to retain customers who otherwise might take their business to institutions with more lenient hold policies. As a result, the decision to place a hold on a deposited check depends primarily on the bank's evaluation of the credit risk any given check poses for the institution. Such an evaluation weighs factors including the length of time the depositor has been a customer, the size of the check, the identity of the drawer, and the location of the institution on which the item is drawn.

In fact, a substantial proportion of banks and thrift institutions apparently do not place holds on deposited checks. This is particularly true in less populous areas where bankers are generally well-acquainted with their customers. However, even in California, an average of only four in 10,000 checks are subject to holds according to a survey conducted by the State Banking Department. Moreover, a survey conducted in 1983 for the Federal Reserve System found that almost 90 percent of the individuals questioned did not experience delays in availability.

Legislation

Although depository institutions seldom resort to delayed availability, legislation governing the practice has been enacted in several states and may be enacted at the national level this year. Typically, such legislation places limits on the number of days a depository institution can hold the funds for various categories of checks. For example, funds-availability regulations in New York and California and Congressman St Germain's proposed legislation require that funds from deposited checks not be delayed more than two business days (three days in St. Germain's bill) for local checks and three to four business days for nonlocal checks drawn on other banks within the same state. The New York regulations also require that out-of-state checks be cleared in six business days, while California's regulations and the proposed national legislation allow eight to nine days.

Moreover, all three establish separate hold periods of no more than one business day for the following items: checks of \$100 or less and checks drawn on the U.S. government or the respective state and local governments. Finally, each establishes certain exemptions that are designed to protect depository institutions from undue risk. In California's

regulations, for example, deposits in excess of \$5,000, items deposited in new accounts, and items the depository institution doubts (in "good faith") will be collectable are exempt from the regulations.

The industry's options

Rep. St Germain has been highly critical of the banking industry's failure over the last several years to make improvements in the check clearing system. In part, the industry's reluctance has reflected the high cost of doing so. Speeding up the return item process involves substantial outlays, which, in light of the rather small expected loss from return items, may not be economically justified. Indeed, given currently available technology, the practice of selectively imposing holds on deposited checks probably represents the least costly approach to the return item problem.

The looming specter of legislation, however, has provided incentive for the industry to address the return item problem directly. In doing so, the industry has several options: direct notification, direct return of unpaid items, and automation of the return item process. With direct notification, an institution that dishonors a check would directly notify the institution where the check was first deposited. The actual item (the check) would be handled as before, but the depositing institution would need only to hold the deposit until the notification deadline had passed to protect itself against losses. As a result, hold periods could be reduced substantially.

In fact, for checks collected through the Federal Reserve System, notification of nonpayment of large dollar checks is required. Although banks did not always follow this procedure in the past, the Fed has adopted a new rule, effective October 1, 1985, establishing notification deadlines for all large-dollar items (\$2,500 or more) and providing for the imposition of substantial penalties for non-compliance.

The new regulation requires that notice of nonpayment must be given such that it is received by the institution where the check was first deposited within two business days following the day on which the paying institution is required to decide whether it will dishonor the check. This means that, in most cases, notice must be received on Friday for an item presented to the paying institution

on Tuesday. The penalty for noncompliance is liability for any loss that is incurred on the item by the depositing institution.

This new rule should reduce the duration of hold periods — at least for the items that are cleared through the Fed's check clearing system (only 35 to 40 percent of all checks are cleared through the Fed). This achievement will not be without cost, however. In addition to the start-up and overhead costs associated with this change in procedures, banks will incur rather substantial per item costs connected with the direct notification of each returned check.

Although banks are free to choose any means of providing notice that meets the deadline, it is likely that they will opt for a reliable (and possibly expensive) means, such as certified mail, telephone or electronic wire. One estimate of the costs of providing such notification by telephone and by wire are \$4.25 and \$2.25, respectively. (These figures are based on the Fed's charges for this service.) Of course, compared with the potential liability associated with failure to provide proper notification, these charges seem small. However, they are very large indeed when compared with the few-cents-per-item cost of clearing a check through the Federal Reserve system.

Another approach to the return item problem is the direct return of dishonored items. This approach would "short-circuit" the return-item process by requiring the institution on which the item is drawn to return it directly to the institution where the check was first deposited and not to the intermediate endorsers that also handled the check. A pilot project testing this approach is currently underway in the 11th (Dallas) Federal Reserve District. Although the results are promising, nationwide adoption of this approach would entail considerable changes in current processing systems, as well as changes in the laws of several states that currently do not permit the direct return of dishonored items. St Germain's bill addresses this latter obstacle by overriding these restrictions.

Automation of the return process is yet another possible solution to the problem. However, the current nonstandardized way checks initially are routed and endorsed by each intermediate bank generally requires manual handling of return items

to identify the proper routing. One glance at the back of a cancelled check displaying the time-stamp endorsements of several banks should indicate why it is time-consuming to determine which banks need to handle any given return item and in what order. The American National Standards Institute (ANSI) has developed a uniform endorsement standard, which, if adopted by the industry, would permit greater automation of return items by specifying the way in which each intermediate bank can stamp a check. Adoption of the ANSI standard, however, entails the purchase of new check processing equipment for many institutions and is therefore unlikely in the near future.

One western bank has advocated the use of special envelopes for return items that could be processed with the equipment that is now in use. Such an approach appears promising because it allows automation of return items without the considerable expense of new equipment. The approach, however, is untested except on a very limited basis.

The outcome

The banking industry has been criticized for a number of years for its policy of delayed availability to minimize the risks associated with returned checks. Critics have argued that the industry should, instead, speed up the return process and eliminate the need for lengthy hold periods. The industry has not, until now, attempted to do so largely because the costs of speeding up return items apparently have not outweighed the benefits associated with reduced risk. Compared with the overwhelming number of checks that are collected each year, the risk from the small number that is returned is small and may have been most efficiently handled through the present system of credit risk evaluation and selective holds.

Now, because of legislative pressure, bankers are devoting considerable resources to the problem of delayed availability. As a result, it is likely that changes will be made in the way that return items are handled, and these changes will permit greatly shortened check hold periods. It is also likely that check processing costs will increase significantly. What remains unclear is whether consumers will find the new regime worth its higher costs.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding	Change from	Change from 8/01/84	
	7/31/85	7/24/85	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	193,177	1,187	11,324	6.2
Loans and Leases ^{1 6}	174,756	976	11,755	7.2
Commercial and Industrial	51,434	158	1,571	3.1
Real estate	63,804	161	3,152	5.1
Loans to Individuals	35,109	170	6,155	21.2
Leases	5,397	7	348	6.8
U.S. Treasury and Agency Securities ²	11,590	187	— 252	— 2.1
Other Securities ²	6,831	24	— 179	— 2.5
Total Deposits	199,126	3,914	8,787	4.6
Demand Deposits	48,354	3,483	2,531	5.5
Demand Deposits Adjusted ³	30,565	394	1,386	4.7
Other Transaction Balances ⁴	13,797	223	1,319	10.5
Total Non-Transaction Balances ⁶	136,975	209	4,936	3.7
Money Market Deposit Accounts—Total	44,968	84	7,022	18.5
Time Deposits in Amounts of \$100,000 or more	37,770	74	— 2,877	— 7.0
Other Liabilities for Borrowed Money ⁵	22,350	1,073	933	4.3
Two Week Averages of Daily Figures	Period ended 7/29/85	Period ended 7/15/85		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	67	55		
Borrowings	19	106		
Net free reserves (+)/Net borrowed(-)	47	— 51		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change