

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 10210
December 8, 1987]

PROPOSALS TO IMPLEMENT THE EXPEDITED FUNDS AVAILABILITY ACT

Overview of the Board's Proposals

*To All Depository Institutions, and Others Concerned,
in the Second Federal Reserve District:*

The Board of Governors of the Federal Reserve System announced, on December 3, 1987, the adoption of a series of proposals designed to implement the provisions of the Expedited Funds Availability Act, which becomes effective on September 1, 1988. A copy of the complete text of those proposals was mailed yesterday to the chief executive officer of each depository institution in this District. In making the announcement, the Board of Governors issued the following statement:

The Federal Reserve Board has issued for public comment a proposed new regulation to carry out provisions of the Expedited Funds Availability Act.

Comment should be submitted to the Board by February 8, 1988. Because of the lead time needed by banks to comply with the new law, the Board said it would be unable to extend the time for comment beyond the 60-day period.

The proposed regulation, designated "CC," would:

1. Spell out details of the requirements in the Act that banks — defined as all depository institutions — provide that a customer's deposit be available for use within stated time periods; that banks disclose their availability policies to customers; and that banks accrue interest on deposits not later than the day they receive provisional credit for the deposits.
2. Require that banks return checks in an expeditious manner and use a standard endorsement.

Other proposals issued by the Board would amend Regulation J, which governs Federal Reserve Bank check collection services, to conform to the new Regulation CC and provide for new Reserve Bank services to facilitate compliance with the new law and proposed regulation.

The Act goes into effect on September 1, 1988.

Congress adopted the Act after expressing growing concern about delayed availability — the length of time that some banks place on checks deposited in customer accounts before funds can be withdrawn.

Under a temporary availability schedule written into the law, a bank must make the proceeds of local checks available for withdrawal by the third business day following deposit. For example, the

proceeds of local checks deposited on a Monday must be available for withdrawal on Thursday. A local check is one deposited in a bank located in the same Federal Reserve check processing region as the paying bank.

The proceeds of nonlocal checks must be made available for withdrawal under the temporary schedule by the seventh business day following deposit.

On September 1, 1990, these time periods will be reduced — to two business days for local checks and five business days for nonlocal checks.

Banks are also required to provide disclosures to new customers prior to opening an account, to existing customers, and to any person upon request. Disclosures also are required on preprinted deposit slips, at branch locations, and at automated teller machines.

The Board is also seeking public comment by April 8, 1988 on proposed longer term initiatives to improve the check system, such as machine-readable endorsements, electronic clearing zones and image processing.

Under both the temporary and permanent schedules, deposits by cash, electronic payments, and certain categories of checks including Treasury checks, cashiers' checks, certified checks, and tellers' checks must be available for withdrawal on the business day after the day of deposit.

Because of the broad interest in this subject, an "overview" of those proposals, which constitutes the first section of the Board's notice that has been submitted for publication in the *Federal Register*, is printed on the following pages. A copy of the complete text of the proposals (362 pages) can be obtained from the chief executive officer of your institution, or from the Circulars Division of this Bank (Tel. No. 212-720-5215 or 5216).

Comments on the Regulation CC and Regulation J proposals and on the proposal on Federal Reserve Bank services must be submitted by February 8, 1988, and may be sent to the Board of Governors, as specified in the notice, or to John F. Sobala, Vice President of our Check Processing Function; comments regarding the Board's proposal on the implementation of long-term improvements to the check collection system must be submitted, in the same manner, by April 8, 1988.

In view of the significance of these new rules to depository institutions in this District, this Bank will be conducting seminars designed to increase the understanding of the proposed changes. Details as to seminar dates, times and locations will be announced shortly.

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

[Docket No. R-0620]

Regulation CC

12 CFR Part 229

Availability of Funds and Collection of Checks

Regulation J

12 CFR Part 210

**Collection of Checks and Other Items and Wire
Transfers of Funds**

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rules.

SUMMARY: The Board is publishing for comment a proposed new rule (Regulation CC) to implement the Expedited Funds Availability Act. The proposed rule sets out the requirements that banks and other depository institutions make funds deposited into accounts available according to specified time schedules and that institutions disclose funds availability policies to their customers. The proposed regulation also establishes rules designed to speed the return of unpaid checks.

The Board is also proposing to amend its existing Regulation J, which governs the collection of checks and other

items by Federal Reserve Banks, to conform that regulation to the new standards proposed in Regulation CC.

DATE: Comments must be submitted on or before February 8, 1988. No extension of time for comment will be provided.

ADDRESS: Comments, which should refer to Docket No. 0620, may be mailed to the Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551, Attention: Mr. William W. Wiles, Secretary; or may be delivered to Room B-2223 between 8:45 a.m. and 5:00 p.m. All comments received at the above address will be included in the public file, and may be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT: For information regarding Subparts A and C of Regulation CC and Regulation J, contact Joseph R. Alexander, Senior Attorney, Legal Division (202/452-2489).

For information on §§ 229.10 through 229.14 and 229.19 through 229.21 of Subpart B of Regulation CC, contact Louise L. Roseman, Assistant Director, Division of Federal Reserve Bank Operations (202/452-2789).

For information on §§ 229.15 through 229.18 of Subpart B of Regulation CC, contact Gerald P. Hurst, Senior Attorney, Division of Consumer and Community Affairs (202/452-3667).

For the hearing impaired only: Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3254).

SUPPLEMENTARY INFORMATION: The Expedited Funds Availability Act, Title VI of Pub. L. 100-86, requires banks and other depository institutions (collectively referred to as "banks" in the proposed regulation) to make funds deposited into accounts available to depositors within time periods specified by the Act and to disclose funds availability policies to their depositors. The Board is given responsibility to prescribe regulations to implement the Act. The Act also provides the Board with broad authority to adopt regulations to improve the check processing system so that checks may be cleared and, if necessary, returned within the funds availability schedules mandated by the Act.

The Board is today requesting comment on a series of proposals, Docket Nos. R-0620, R-0621, and R-0622, that will exercise its responsibilities under the Act. Docket No. R-0620 consists of a proposed regulation (Regulation CC, 12 CFR Part 229) that will clarify the definitions of the Act, provide detailed rules to facilitate compliance with the availability and disclosure requirements, and make several substantive changes to the current law on the collection of checks to encourage faster return of unpaid checks, thus minimizing the losses that could result from compliance with the availability schedules. Docket No. R-0620 also proposes several changes to the Board's current Regulation J (12 CFR Part 210), which governs the collection of checks and other items by Federal

Reserve Banks, so that it conforms to the new standards adopted in Regulation CC.

Docket No. R-0621 requests comment on proposed new services to be offered by the Federal Reserve Banks to assist in the new check collection rules established in Regulation CC. Docket No. R-0622 requests comment on some possible services that the Federal Reserve is studying as well as longer-term improvements to the nation's check collection system.

OVERVIEW

Delayed availability -- the holds that some banks^{1/} place on checks deposited into their customers' accounts before the funds may be withdrawn -- was a subject of growing concern in the Congress for a number of years. Many argued that the holds placed by many banks were unduly long, and that depositors have a right to prompt access to their funds. Banks that impose holds responded that their availability schedules reflect the time needed for the collection and return

^{1/} The proposed Regulation CC terminology corresponds with the terminology of the Uniform Commercial Code, with some modifications. "Bank" is defined to include all depository institutions. A "paying bank" is the bank on which the check is drawn. In the case of payable through drafts, the payable through bank is the paying bank. A "returning bank" is an intermediary bank handling a returned check. A "depository bank" is the bank in which the check was first deposited. (See § 229.2 of the proposed Regulation CC for the complete definitions of these terms.)

of checks dishonored by the paying bank and provide 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.

The Congress concluded that federal legislation was required to address delayed availability practices and passed the Expedited Funds Availability Act (the "Act") (Title VI of the Competitive Equality Banking Act, enacted on August 10, 1987). The Act seeks to ensure prompt availability of funds and to expedite the return of checks; the Board is directed to issue regulations to implement the Act, which becomes effective on September 1, 1988.

The Act includes specific and detailed provisions requiring banks to: (1) make funds available to their customers within specified time frames, (2) pay interest on interest-bearing transaction accounts not later than the day the bank receives provisional credit, and (3) disclose their funds availability policy to their customers. These statutory provisions provide the Board with little flexibility in developing rules to implement the Act's requirements.

The Act requires that cash deposits, wire transfers, and certain check deposits that Congress believes pose little risk to the depository bank, such as Treasury checks and cashier's checks, be made available for withdrawal by the business day after the day of deposit. The time when the depository bank must make other check deposits available for

withdrawal depends on whether the check is "local" or "nonlocal" to the depository bank. A local check is a check deposited in a depository bank that is located in the same Federal Reserve check processing region as the paying bank. A nonlocal check is a check deposited in a different check processing region than the paying bank. There are a total of 48 Federal Reserve check processing offices in the United States, and the territory served by each office constitutes a region.

Under the temporary schedule that becomes effective on September 1, 1988, a depository bank must make the proceeds of local checks available for withdrawal by the third business day following deposit; that is, the proceeds of local checks deposited on a Monday must be available for withdrawal by the following Thursday. The depository bank must make the proceeds of nonlocal checks available for withdrawal by the seventh business day following deposit; that is, the proceeds of a Monday deposit must be available for withdrawal by Wednesday of the following week. On September 1, 1990, these time periods are reduced. At that time, proceeds of local and nonlocal checks must be available for withdrawal by the second and fifth business day following deposit, respectively. Special rules are provided for cash withdrawals, deposits at nonproprietary automated teller machines, and deposits made in banks outside the continental United States.

Although the proposed improvements to the check system will accelerate the return of most checks, many checks will not be returned to the depository bank by the time funds must be made available for withdrawal under the temporary schedule -- a number that will increase when the permanent schedule becomes effective. In order to reduce the risk to banks from making funds available to customers before learning that the check has not been paid, Congress provided several exceptions to the availability schedules. When a bank invokes one of these exceptions, it may extend the hold on its customer's account beyond the statutory schedule. Nevertheless, the Board must establish limits on the additional hold that may be placed on checks subject to these exceptions.

The statute requires banks to disclose their availability policies to their customers and inform their customers that deposited funds may not be available for immediate withdrawal. Banks are required to provide disclosures to new customers prior to opening an account, to existing customers, and to any person upon request. In addition, disclosures are required on preprinted deposit slips, at staffed locations where consumers make deposits, and at automated teller machines. Banks must also provide notice to their customers whenever their availability policies change.

The Act gives the Board authority to make improvements in the check collection and return system in order to shorten the time within which depository banks learn of the nonpayment

of checks, and thereby reduce the number of situations when the bank will be required by law to make funds available to its customers before it learns a check has been dishonored. The Board's authority is broad and general, and extends to checks that are not cleared through the Federal Reserve System. Previously, the Federal Reserve generally had the authority to regulate only those checks it collected.

Upon enactment of the Act, Board staff formed a Steering Committee to develop proposals to implement the law's requirements. The Steering Committee consists of representatives from three Divisions of the Board's staff and three Federal Reserve Banks. In developing these proposals, the Steering Committee considered: (1) costs to the banking industry, businesses, and consumers; (2) the ability of banks to select from several alternative approaches to comply with the Act and the Board's regulation; (3) the ability of the private sector and the Federal Reserve to provide services to expedite the return of unpaid checks; and (4) the extent to which the improvements to the check collection system reduce risk.

In developing the proposals, Board relied heavily on input from the private sector. The Board staff discussed the proposal with the Consumer Advisory Council and the Return Item Advisory Committee, which is a joint Federal Reserve/banking industry group. In addition, the staff met on over 20 occasions with representatives from consumer groups, banking and corporate trade associations, and individual banks. Two

consulting firms were retained to assess the effect of certain aspects of its proposals on the banking industry. Many of the major concepts underlying the proposal have been suggested by the private sector.

The proposed Regulation CC (12 CFR 229), Availability of Funds and Collection of Checks, contains three subparts. Subpart A defines terms and provides for administrative enforcement. Subpart B specifies schedules within which banks must make funds available for withdrawal. Subpart B also includes rules regarding exceptions to the schedules, disclosure of funds availability policies, and payment of interest. Subpart C includes rules to expedite the collection and return of checks. These rules cover the means by which the paying and returning banks must return checks to the depository bank, authorization of direct returns, notification of nonpayment of large-dollar returns by the paying bank, check indorsement standards, and other related changes to the check collection system.

Subpart A -- Definitions

The Act defines a number of terms, many of which required little additional clarification in the regulation. Nevertheless, the definition of two terms in the regulation are significant. The Act applies to deposits in transaction accounts, but does not precisely define the term. The Board proposes to define "account" in terms of a transaction account

as described in the Board's Regulation D (12 CFR 204.2(e)). The Board believes that using the transaction account definition in Regulation D -- a definition already familiar to banks -- will avoid confusion about the coverage of the regulation and is consistent with the statute. The Board proposes that the definition of "account" exclude correspondent accounts; that is, accounts held by a bank at another bank.

The definition of "paying bank" in the regulation is critical in determining whether a check is local or nonlocal, as well as determining the duties of the various parties to expedite returns. The Board proposes to define paying bank to include payable through banks for the purposes of the requirements of the regulation. As a result, payable through drafts that often are used by credit unions and insurance companies are considered local or nonlocal checks based on the location of the payable through bank. In addition, the payable through bank would be subject to the prompt return requirements imposed on paying banks, and thus would be required to return checks one or two days faster than may be the case today. The Board believes that this definition most accurately reflects the statutory requirement that schedules be based on where the check is sent for collection -- the location of the payable through bank -- and not the location of the organization on which the check is drawn.

Subpart B -- Funds Availability and Disclosure Requirements

Availability schedules. The proposed regulation reflects the availability schedules provided in the Act. Thus, deposits of cash and electronic payments, as well as certain checks deposits, including Treasury checks, state and local government checks, and depository checks, must be made available for withdrawal on the next business day. Longer schedules are provided for other checks, based on whether the checks are local or nonlocal. The following charts depict the schedules for these checks. The Board proposes that: (1) the application of the schedules to certain categories of checks be clarified; (2) the schedules for certain nonlocal checks be shortened; (3) the holds that can be placed on deposits subject to an exception provided in the Act be limited; and (4) the effect of this regulation on depositors' rights to withdraw cash be clarified.

The Board proposes that certain additional categories of checks not specified in the Act be subject to the requirement that funds be made available on the business day following the day of deposit. Checks issued by Federal Reserve Banks and Federal Home Loan Banks, as well as U.S. Postal Service money orders, are not explicitly addressed in the Act, but do not present greater risk of loss to banks than do other checks for which the Act mandates next day availability.

The Act directs the Board to reduce the statutory schedules for any category of checks where most of the checks

would be returned in a shorter period of time than provided in the schedules. The Board proposes that the schedules be reduced for certain nonlocal checks that are subject to more prompt processing and return, where significant improvements can be made to the Act's schedules.

The Act and regulation provide certain exceptions to the availability schedules for higher-risk deposits. The Act states that the hold placed on deposits subject to an exception "shall not exceed a reasonable period of time as determined by the Board." The Board proposes that a bank be permitted to extend the schedule by no more than four business days when an exception is invoked. These four additional business days should provide adequate time for the depository bank to learn of the nonpayment of virtually all checks that are returned.

In addition, the Board proposes to clarify that bank policies limiting the amount of cash a customer may withdraw on any given day are not affected by the Act. Small banks have expressed concern that the Act could be interpreted to prohibit such policies. These restrictions are usually due to limits on the amount of cash that some small banks may keep on hand at any one time for insurance or security reasons. The regulation, however, would not supersede any common law or other duty to make funds available for withdrawal by cash.

Disclosures. The Act requires banks to disclose their specific policy with respect to when a customer may withdraw funds deposited in an account. The regulation, as a general rule, requires banks to provide customers with an initial

disclosure of the bank's availability policy that allows the customer to determine when a deposit will be held and for how long.

Numerous banks normally provide their customers with same- or next-day availability for almost all deposits and only impose holds in special circumstances, determined on a case-by-case basis. In many cases, the banks provide the customer with notice of the delay at the time the deposit is made.

Banks with such policies may find it difficult, if not impossible, to develop a specific disclosure that would allow the customers to determine whether a particular deposit will be delayed and the length of the delay, as required generally by the Act. The nature of these banks' policy essentially precludes such a disclosure. In order to disclose to the customer when deposited funds will be subject to a delay in availability, these banks may find it necessary to discontinue the practice of imposing holds on a case-by-case basis, and instead begin routinely to delay availability on specific types of checks (essentially adopting an automatic or blanket delay policy). The Board believes that such a result would not be in the interest of bank customers. Also, banks would incur substantial costs not only in making disclosures, but also in developing and implementing new availability policies.

The Board proposes that the regulation include alternative disclosure requirements for banks that only delay availability beyond the next business day on a case-by-case basis. Banks with case-by-case policies would be permitted to meet the initial disclosure requirements by disclosing that, while their policy is to give same or next-day availability, the bank may at times impose longer delays. In other words, the bank need not adopt and disclose a policy that allows the customer to determine whether a specific check is going to be delayed prior to presenting the check for deposit. A bank that chooses to take advantage of this alternative must still provide availability within the time limits established by the regulation. In addition, at any time a deposit is held, the bank must give a notice to the customer that indicates when the deposited funds will be available for withdrawal. This notice need not give a specific reason for the delay, unless the hold will exceed the time periods in the schedules.

Relation to state law. The Act provides that state laws supersede federal law if they result in faster availability. One reading of this provision is that any exception to a state availability schedule that is narrower than the federal law must be viewed as superseding the federal exceptions. The Board believes that this result is unwieldy and results in a complex set of legal rules. Therefore, the Board proposes that exceptions to a state availability schedule that address the same situation as the federal exceptions be

preempted even if the exception might, under some circumstances, result in faster availability of a particular deposit. However, if state law provides for a shorter hold for a certain category of checks than is provided under federal law, that state requirement will supersede the federal provision.

Subpart C -- Regulatory Initiatives to Expedite Returns

In contrast to the high-speed automated processing involved in the forward collection of checks, the check return system is a slow, labor intensive operation. The return system generally involves manual processing that relies on visual inspection of the indorsements on the check, rather than machine-readable information, to determine where the return should be sent. In contrast to checks handled for forward collection, which are processed on high-speed equipment at a rate of 100,000 per hour, returned checks are processed at a rate of only 1,000 per hour. In addition, returns are often transported by mail, rather than by courier, further slowing their trip to the depository bank. Finally, a check is generally returned through each of the banks that collected the check, although this may not be the most efficient path to route the return.

Under the current check collection system, many checks that are returned would not be received by the depository bank until after the time funds must be available under the temporary schedules in the Act. The number of returned checks

that do not reach the depository bank before funds must be made available under the Act will increase with the implementation of the permanent schedules in 1990. Currently, according to a study by the Bank Administration Institute (BAI), the average time for a check to be collected and returned is 6.8 calendar days. Approximately 40 percent of returned checks take seven days or longer to complete the collection and return cycle and 15 percent take 10 days or longer. (Return Items Study, Final Report, prepared for the Bank Administration Institute by J. D. Carreker and Associates, Inc. (May 1985) "BAI STUDY") Under the temporary schedules, the proceeds of local checks must be available for withdrawal on or before the third business day after deposit and the proceeds of nonlocal checks must be available for withdrawal on or before the seventh business day after deposit. Under the permanent schedule, proceeds of local checks must be available for withdrawal on or before the second business day after deposit and proceeds of nonlocal checks must be available for withdrawal on or before the fifth business day after deposit. Approximately one-third of the checks handled by the Federal Reserve Banks would be considered nonlocal under the Act.

It is difficult to relate the data collected by the BAI to the statutory schedules because the BAI data are based on calendar days rather than business days and do not differentiate between local and nonlocal checks. Nevertheless, it is clear that large numbers of checks will be returned after

funds must be made available for withdrawal under the schedules in the Act. The requirement to make funds available for withdrawal before many checks are returned exposes banks to risks if the proceeds of check deposits are withdrawn and the checks are subsequently returned. Further, the requirement to make funds available for withdrawal before some checks are likely to be returned may encourage check fraud. In recognition of these risks, the Act provides for certain exceptions to the statutory schedules and, in section 609(b), provides that the Board shall consider a number of proposals to improve the check processing system to speed the collection and return of checks. (12 U.S.C. 4008(b)). Further, section 609(c) of the Act (12 U.S.C. 4008(c)) provides that:

(c) REGULATORY RESPONSIBILITY OF BOARD
FOR PAYMENT SYSTEM. --

(1) RESPONSIBILITY FOR PAYMENT
SYSTEM. -- In order to carry out the
provisions of this title, the Board of
Governors of the Federal Reserve System
shall have the responsibility to
regulate --

(A) any aspect of the payment
system, including the receipt,
payment, collection, or clearing
of checks; and

(B) any related function of
the payment system with respect to
checks.

(2) REGULATIONS. -- The Board
shall prescribe such regulations as it
may determine to be appropriate to
carry out its responsibility under
paragraph (1).

Under this Board authority, the Board believes that it is appropriate to propose changes to the way that checks are collected and returned by both the Federal Reserve Banks and other banking institutions in order to speed the collection and return of checks and to improve the efficiency of the check collection system. Subpart C of the regulation contains proposed rules designed to reduce the risk to depository banks resulting from the prompt availability requirements of the Act. In many cases, these regulations modify provisions of state law applicable to the collection of checks, including the Uniform Commercial Code as enacted in the various states. The proposals in Subpart C: (1) expedite returns to the depository bank; (2) expand the requirements for notification of large-dollar returned checks; and (3) provide banks with the ability to reduce the number of returned checks. These proposals are accomplished by modifying duties of the paying bank, returning bank(s), and the depository bank in the return process. In arriving at these proposals, the Board considered each of the proposals listed for Board consideration in the Act.

Section 609(b) of the Act (12 U.S.C. 4008(b)) provides that:

(b) REGULATIONS RELATING TO
IMPROVEMENT OF CHECK PROCESSING SYSTEM. --
In order to improve the check processing

system, the Board shall consider (among other proposals) requiring, by regulation, that --

(1) depository institutions be charged based upon notification that a check or similar instrument will be presented for payment;

(2) the Federal Reserve banks and depository institutions provide for check truncation;

(3) depository institutions be provided incentives to return items promptly to the depository institution of first deposit;

(4) the Federal Reserve banks and depository institutions take such actions as are necessary to automate the process of returning unpaid checks,

(5) each depository institution and Federal Reserve bank --

(A) place its endorsement, and other notations specified in regulations of the Board, on checks in the positions specified in such regulations; and

(B) take such actions as are necessary to --

(i) automate the process of reading endorsements; and

(ii) eliminate unnecessary endorsements;

(6) within one business day after an originating depository institution is presented a check (for more than such minimum amount as the Board may prescribe) --

(A) such originating depository institution determine whether it will pay such check; and

(B) if such originating depository institution determines that it will not pay such check, such originating depository institution directly notify the receiving depository institution of such determination;

(7) regardless of where a check is cleared initially, all returned checks be eligible to be returned through the Federal Reserve System;

(8) Federal Reserve banks and depository institutions participate in the development and implementation of an electronic clearinghouse process to the extent the Board determines, pursuant to the study under subsection (f), that such a process is feasible; and

(9) originating depository institutions be permitted to return unpaid checks directly to, and obtain reimbursement for such checks directly from, the receiving depository institution.

The proposals contained in Subpart C either implement or are closely related to many of the proposals listed in the Act, and the Board is studying many of the other proposals as potential longer-term improvements to the check collection system. The Board's proposals are more fully described below.

Expediting returns. A number of the regulatory proposals are designed to speed the return of checks to the depository bank. Today, the paying bank's duty of prompt return is limited to dispatching a returned check by its

"midnight deadline."^{2/} The proposal places an additional duty on the paying bank to return the check to the depository bank in a manner similar to the efficient manner used to collect a check deposited in the paying bank and drawn on the depository bank. Generally, the paying bank would be required to dispatch returns using the means of transportation used to dispatch checks for forward collection. (This duty is similar to the third proposal listed in the Act.)

To facilitate prompt returns, the paying bank would not be required to return a check to the bank that presented it. Instead, the paying bank could return a check directly to the depository bank or to a Reserve Bank or other bank providing check return services. To encourage direct returns, the depository bank would be required to pay for returns on the day of receipt. (This proposal is similar to the ninth proposal listed in the Act.)

Today, many banks do not dispatch their returned checks by courier with the checks that are being sent for forward collection, if the courier leaves after midnight. Instead, they mail their returns by their midnight deadline in order to meet their legal responsibility under the U.C.C., but

^{2/} The Uniform Commercial Code requires a paying bank to dispatch checks it is returning unpaid by midnight of the next banking day following the banking day on which the checks were presented for payment.

by doing so delay the completion of the return process. The proposed regulation encourages the use of couriers to handle returned checks by allowing banks to dispatch returns after midnight if the returns will be received by the next bank that day.

The proposed regulation imposes duties on returning banks that are similar to the duties imposed on the paying banks to expedite the return process. A returning bank must handle a returned check as expeditiously as a check handled for forward collection.

One way to speed the return process is to prepare the returned check for automated processing by high-speed equipment. Returned checks can be automated by either the paying bank or returning bank by placing the return in a carrier envelope or by placing a strip on the bottom of the check, and encoding the envelope or strip with the routing number of the depository bank, the amount of the check, and a special returned check identifier. Automated returns allow for far more efficient processing by returning banks. The proposed regulation facilitates the preparation by returning banks of automated returned checks by providing an additional business day to the bank's time for prompt return. (This proposal is similar to the fourth proposal listed in the Act.)

One of the obstacles to efficient processing of returns is the lack of uniformity in depository banks' indorsements. Today, clerks often have difficulty determining

the bank to which the check will be returned. The indorsements on the back of the check are often faint, blurred, incomplete, and overlapping. Under the proposal, this difficulty would increase since many checks will not be returned through the same banks that handled the checks during forward collection. The determination of a remote depository bank would often be difficult if its indorsement were not readily distinguishable from the other indorsements on the check.

Therefore, the proposal requires the depository bank to provide specific information in its indorsement, including its nine-digit routing number. In addition, the depository bank's indorsement must be readily identifiable through the use of a unique color ink and by placement in a specified area on the back of the check. Subsequent indorsements may not be in the same color, or be placed in the same location as the indorsement of the depository bank. (This proposal is similar to the fifth proposal listed in the Act.)

Notification of nonpayment. Even with improvements to the check return system, the depository bank will not receive all returned checks by the time it must make the proceeds available to the customer for withdrawal. The depository bank's risk is larger in the case of large-dollar returns. Therefore, the Board proposes to require paying banks to provide notification of nonpayment for all large-dollar returned checks.

Notification of large-dollar returns is now required only for those checks collected through the Federal Reserve. The proposal expands the large-dollar notification requirement to include all checks of \$2,500 or more, regardless of the channel through which they were cleared. In addition, the proposal reduces the time period within which notification must be provided. Under the proposal, the paying bank must ensure that notification is received by the depository bank by 4:00 p.m. (local time of depository bank) on the second business day following presentment. Federal Reserve regulations currently require notice to be received by midnight on the third business day following presentment. (This proposal is similar to the sixth proposal listed in the Act.)

Reducing the volume of returns. The Board proposes extending the paying bank's midnight deadline for low-dollar checks. Over one-half of all returned checks are in amounts of \$100 or less. Many depository banks routinely redeposit that portion of these returns that are returned due to insufficient or uncollected funds (or direct the Federal Reserve to redeposit the checks on their behalf) in an effort to obtain payment. On average, over 60 percent of these redeposited checks are paid on the second presentment. A significant number of returned checks could be eliminated entirely if the paying bank held low-dollar checks several days beyond its midnight deadline. This concept has received the long-standing support of several banking industry trade groups. The proposal

permits a paying bank to hold checks of \$100 or less for two business days beyond its midnight deadline in an effort to secure payment.

Regulation J Amendments

Changes are also proposed to Regulation J so that it conforms to the proposed requirements of Regulation CC, Subpart C. Regulation J governs the collection and return of checks by Federal Reserve Banks.

Proposed Federal Reserve Bank Services (Docket No. R-0621)

Returned check services. In order to achieve the objectives of the proposed regulatory requirements to speed the return of checks, it is essential that the Federal Reserve Banks and private-sector correspondent banks provide new return services. The Board proposes a wide array of Reserve Bank services to facilitate bank compliance with these requirements. The Board anticipates that a number of correspondent banks will offer similar services.

Several of the proposed service changes are designed to facilitate direct returns permitted in proposed Regulation CC. Under the proposal, Reserve Banks would accept and process any returned check; today the Federal Reserve only accepts returned checks that it collected. The Federal Reserve would return checks directly to the local depository bank, bypassing any intermediary collecting banks in the indorsement chain. A depository bank may designate its correspondent bank or service bureau as the location to which the Federal Reserve should send

that bank's returns. Reducing the number of banks handling a returned check will shorten the length of time required for the return process. The Federal Reserve Bank of Dallas is conducting a pilot program of the direct return process, which indicates that, in the case of 43 percent of local returned checks handled by the Bank, at least one collecting bank in the forward collection indorsement chain is bypassed by delivering the return directly to the depository bank. (This proposal is similar to the seventh proposal listed in the Act.)

Reserve Banks would accelerate their processing of returned checks. New returned check deposit deadlines are proposed that are similar to the deadlines for checks handled for forward collection. By September 1988, local returns will be processed on an overnight basis and dispatched with the forward collection checks the next morning. In contrast, today the returns are processed during the day and dispatched one day later. Nonlocal returns that have been automated for high-speed processing by the paying bank or a prior returning bank will be processed and dispatched to the second Reserve Bank office on the night of the day the Reserve Bank received them. Most other nonlocal returns will be automated by the Reserve Bank and sent to the second Reserve Bank office the following night. Today, both Reserve Bank offices manually process the returned check, which adds an extra day to the return process.

Currently, the Federal Reserve does not explicitly price returned checks; instead, the costs of handling returns are incorporated in the Reserve Banks' forward collection fees. The Board is proposing to price returns explicitly, imposing returned check fees on the paying or returning bank depositing returns with the Federal Reserve. Under this proposal, return costs cannot be recovered through the Reserve Banks' forward collection fees as they are today, since some returned checks handled by the Federal Reserve will not follow the same route that they followed in the process of collection, and thus may not be subject to the Reserve Banks' forward collection fees. In addition, paying and returning banks could deposit returned checks with the Federal Reserve in various ways that result in different costs being incurred by the Reserve Bank. For example, automated returns would be less expensive for the Federal Reserve to handle than nonautomated returns. Reserve Banks would initially charge a fee for returned checks that have been prepared for automated processing similar to that charged for similar checks handled in forward collection. A higher fee would be charged for "raw" returns that require manual processing. The Board estimates that the charge for returned checks that require manual processing will range from \$0.25 to \$1.00.

The proposal also addresses modifications to the Reserve Banks' notification services for large-dollar returns. Reserve Banks will offer same-day notification services for all

large-dollar checks to facilitate bank compliance with the proposed requirements to provide notice of nonpayment for all large-dollar checks within shorter time periods. The Board proposes that beginning on January 1, 1989, any depository bank that has an on-line electronic connection with the Federal Reserve be required to receive large-dollar notifications electronically.

Cost of proposed services. Reserve Banks have provided preliminary estimates of the costs of offering the proposed new returned check services. They have projected that the proposed initiatives would require an additional 1988 capital expenditure of approximately \$15,000,000, and additional 1988 operating expenditures of approximately \$15,000,000. The costs of providing these services will be recovered by the Reserve Banks through the fees assessed for the services.

Truncation and extended MICR capture services. The Board proposes expansion of the Federal Reserve's truncation pilot program to a permanent service. In truncation, the physical checks are not delivered to the paying bank; instead, the MICR-line information on the checks is captured and presented to the paying bank electronically. The benefits of truncation include expeditious check processing and return and a reduction in the number of times the paper check is handled. Truncation may also create savings in transportation costs, and storage, equipment, and personnel costs for the paying bank.

Initially, it is proposed that the Reserve Banks offer truncation services to interested local paying banks. However, the benefits of truncation increase as checks are truncated earlier in the collection process. Therefore, the Board believes that after more experience is gained, Reserve Banks will be able to provide inter-bank truncation services; that is, truncation at the Federal Reserve Bank of first deposit. One Reserve Bank is now engaged in inter-bank truncation on a pilot basis under the rules of the National Association for Check Safekeeping. (The truncation proposal is similar to the first and second proposals listed in the Act.)

The Board also proposes a service that offers many of the same benefits of truncation without stopping the flow of the paper check -- the extended MICR capture service. Under this service, which is now provided on a pilot program basis, Reserve Banks would deliver payment information by electronic transmission or magnetic tape, provide returned check and retrieval services, and deliver the checks to the paying bank several days later using less time-critical transportation.

Extended MICR capture would provide the paying bank and its customers an opportunity to test all aspects of the truncation services without giving up receipt of the physical check. The benefits of extended MICR capture are not as great as those of truncation; however, extended MICR would serve as a stepping stone for developing broader acceptance of truncation.

For a further discussion of these services see Docket R-6021, Federal Reserve Bank Services.

Longer-term initiatives (Docket No. R-0622). In addition to these proposed initiatives to expedite returned checks, which would be implemented by September 1988, the Federal Reserve is also exploring various new technologies to improve the check system in the longer term. One such effort involves testing of digitized image processing in a high-speed environment to determine the feasibility of using this technology to transmit check images to the paying bank and the depository bank, and also as a substitute for microfilming checks.

Further, the Board is requesting comment on a variety of initiatives, including: (1) the feasibility of a machine-readable depository bank indorsement, possibly by inclusion of a bar code of the nine-digit routing number, to facilitate further automation of returned check processing; (2) the feasibility of an electronic clearinghouse concept; (3) the feasibility of establishing electronic clearing zones, in which all banks in a specified area agree to accept electronic presentment of their checks; (4) further actions that should be considered to address delayed disbursement practices of certain corporations and banks; (5) an alternative method of preparing returned checks for automated processing that does not require the MICR-encoding of the returned check with the amount and routing number of the depository bank; and (6) concepts for several potential future Federal Reserve services to depository

banks, specifically, a service to ascertain the authenticity of cashier's, certified, and teller's checks and a service to communicate information regarding returned checks to depository banks prior to the physical delivery of the checks. (The electronic clearing-house proposal is based on the eighth proposal listed in the Act.)

Impact of the Proposal

Cost impact. The requirements of the Act and the proposed regulation will result in several benefits to the public. Transaction account customers will be given specific information on when funds will be made available for withdrawal, which should help them better manage their accounts. In addition, many customers will gain earlier access to their funds. However, it is difficult to quantify these benefits.

The overall cost impact on the banking industry may be quite significant. The disclosure and funds availability provisions in the Act may result in higher operating expenses, lost investment income due to earlier withdrawal of collected balances, and increased bad check losses. It is also difficult to estimate the cost impact of these changes.

On the other hand, the improvements to the check collection system may actually reduce overall bank costs. The proposed regulations would change the duties of the paying bank, returning banks, and depository bank, and would require modifications to the operations of each bank in the return

process. Initially, these new initiatives may increase costs. Some of these costs are one-time transition costs, such as the costs to the depository bank to modify its check processing equipment to comply with the new standard indorsement. Other costs are ongoing, such as costs for expedited handling of returns at returning banks.

However, the proposals in the aggregate have the potential for substantial longer-term cost reductions in the return process. Returns will be received by the depository bank more quickly than they are today, reducing the bank's risk from providing prompt availability of funds to its customers. The number of returns may be significantly reduced due to the authority granted to paying banks to extend their midnight deadline for small-dollar returns. The regulation's availability and disclosure requirements may also result in reduced returns because funds may be made available for withdrawal sooner and customers would know more precisely when they may withdraw funds from their accounts. The proposal would encourage more direct exchange of returned checks, reducing the number of intermediary banks involved in the return process. Most importantly, the new indorsement standard should, over the long term, reduce the cost of return processing by facilitating the more efficient processing of returns. Future enhancements to the indorsement standard would allow all parties in the check collection system to automate completely their return processing.

Competitive impact. An important factor considered in the development of the regulatory framework for expedited returns and related Reserve Bank services was the impact on competition in the check collection system. The public has benefited from the competitive environment that has existed between the Federal Reserve and correspondent banks, and among correspondent banks in providing check collection services. The Board has sought to ensure that the proposed regulatory requirements and Federal Reserve service offerings were designed to provide options to banks in the return process and to facilitate a competitive environment.

Although a number of the Reserve Bank services proposals -- such as acceptance of any returned checks, the explicit pricing of returns and corresponding decrease in the forward collection fees, and direct return by the Federal Reserve to the depository bank -- may have significant competitive implications, it is difficult to determine what that impact would be. For example, lower Federal Reserve check collection fees could make the Reserve Banks' forward collection check services more attractive, and acceptance of all returns could increase return volume. On the other hand, a bank that uses the Federal Reserve for both forward collection and return services may experience an increase in its total charges for check services. In addition, the acceptance of universal returns by the Federal Reserve has the potential to result in a reduction of Federal Reserve forward collection

check volume, since returns are often viewed as nuisance items in the collection process that have deterred banks from competing for forward collection volume.

Correspondent banks will have the opportunity to compete with the Federal Reserve in providing returned check services. For example, approximately 4,000 banks that do not collect checks through the Federal Reserve currently mail returned checks to their Reserve Bank. Under this proposal, these paying banks may deliver these returned checks along with their forward collection checks to their correspondent bank, rather than establishing separate transportation to deliver their returns to the Federal Reserve. This practice could result in additional volume of returned checks for correspondents.

For a further discussion of these initiatives see Docket R-6022, Proposals for Long-Term Improvements to the Check Collection System.

Educational Efforts

During the public comment period, Federal Reserve Banks plan to conduct seminars designed to increase the understanding of depository institutions regarding the implications of the Act and better prepare the public to comment on the Board's proposed regulations and operating issues. Reserve Banks will sponsor another series of seminars after approval of the final regulations by the Board to assist the industry in preparing for the regulatory and operational

changes to be effective on September 1, 1988. In addition, Federal Reserve staff is working closely with various industry groups as they prepare to offer similar seminars to their constituencies.

Summary of Proposals

The Board is issuing for public comment the following proposals to implement the provisions of the Expedited Funds Availability Act:

(1) Docket R-0620, Proposed Regulation CC and Amendments to Regulation J, which

(a) requires banks to provide for availability of deposits within specified time periods, to disclose their availability policies to customers, and to begin to accrue interest on deposits to accounts not later than the day they receive provisional credit for the deposits; and

(b) requires banks to expedite the return of checks, including authorizing direct return, and requires the depository bank to use a standard indorsement.

This docket also includes amendments to Regulation J, which governs the collection of checks by Federal Reserve Bank so that it conforms to the proposed rules to expedite the return of checks.

(2) Docket R-0621, Federal Reserve Bank Services, which proposes Reserve Bank services to facilitate bank compliance with the proposed requirements to expedite returns

and improve the check collection system, including expansion of Reserve Bank check truncation and extended MICR capture services from pilot programs to permanent services.

(3) Docket R-0622, Proposals for Long-Term Improvements to the Check Collection System, which requests public comment on longer-term initiatives to improve the check system.