

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. **10308**]
August 11, 1989]

REGULATION CC

Amendments Regarding Bank Payable Through Checks

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

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has adopted two amendments to Regulation CC, which implements the Expedited Funds Availability Act, regarding the treatment of bank payable through checks.

The amendments are designed to help ease the operational difficulties and lessen the risks imposed on banks as a result of a 1988 court order. The court order ruled that payable through checks must be treated as local or nonlocal on the basis of the location of the bank on which they are written rather than the payable through bank.

The two amendments require:

- (1) bank payable through checks to be conspicuously labeled with the name, location, and first four digits of the nine-digit routing number of the bank on which the check is written and the legend "payable through" followed by the name and location of the payable through bank; and
- (2) a bank issuing payable through checks to bear the risk of loss for return of such checks from a nonlocal payable through bank, to the extent that the return from the nonlocal payable through bank took longer than would have been required if the check had been returned expeditiously by the bank on which it is written.

These amendments will become effective on February 1, 1991 and February 1, 1990, respectively.

Enclosed — for depository institutions and those who maintain sets of the Board's regulations — is a copy of the amendments, as published in the *Federal Register* of August 4, 1989; copies may also be obtained from our Circulars Division (Tel. No. 212-720-5215 or 5216).

Questions on this matter should be directed to John F. Sobala, Vice President, Check Processing Function of this Bank (Tel. No. 212-720-6334).

E. GERALD CORRIGAN,
President.

FRASER

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Regulation CC; Docket No. R-0648
Amendments to Regulation and
Official Staff Commentary

[Enc. Cir. No. 10308]

- For this Regulation to be complete, retain:
- 1) Regulation CC Pamphlet, effective September 1, 1988.
 - 2) Amendments effective October 25, 1988; April 10, 1989; and August 10, 1989.
 - 3) This slip sheet.

FEDERAL RESERVE SYSTEM

12 CFR Part 229

[Reg. CC; Docket No. R-0648]

RIN 7100-AB01

Availability of Funds and Collection of Checks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is publishing amendments to its Regulation CC, Availability of Funds and Collection of Checks (12 CFR Part 229). The rule changes will alleviate the operational difficulties and additional risks associated with the acceptance for deposit of bank payable through checks.

EFFECTIVE DATE: The effective date for the amendments to § 229.38 of the regulation and commentary is February 1, 1990. The effective date for the amendments to § 229.36 of the regulation and commentary is February 1, 1991.

FOR FURTHER INFORMATION CONTACT: Louise L. Roseman, Assistant Director (202/452-3874), Gayle Thompson, Manager (202/452-3917), or Kathleen M. Connor, Senior Financial Services Analyst (202/452-3917), Division of Federal Reserve Bank Operations; Oliver Ireland, Associate General Counsel (202/452-3625), or Stephanie Martin, Attorney (202/452-3198), Legal Division; for the hearing impaired *only*: Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: The Board has adopted two amendments to Regulation CC, which: (1) Require bank payable through checks to be conspicuously labeled with the name, location, and first four digits of the routing number of the bank on which the check is written and the legend "payable through" followed by the name and location of the payable through bank; and (2) Place the risk of loss for return of bank payable through checks being returned by a nonlocal payable through bank on the bank on which such checks are written, to the extent that the return from the nonlocal payable through bank took longer than would have been required if the check had been returned expeditiously by the bank on which it is written. The test for expeditious return would be based on the two-day/four-day test in § 229.30(a)(1) of the regulation.

These amendments will become effective on February 1, 1991, and February 1, 1990, respectively.

Background

As adopted in May 1988, Regulation CC provided that checks written on an account at one bank¹ but payable through another bank were to be considered local or nonlocal under Regulation CC and the Expedited Funds Availability Act ("Act") based on the location of the bank designated as the payable through bank. This treatment of "bank payable through checks" was consistent with the scheme set forth in the Act to permit banks to place longer holds on checks that must be sent to nonlocal banks for collection because such checks generally take longer to collect and return than checks sent to local banks for collection and, therefore, could pose greater risks for depository banks. In addition, treating the payable through bank as the paying bank would have facilitated the handling of these checks by depository banks because it would have permitted them to use automated equipment to read the routing number of the payable through bank encoded on a check, which indicates the check processing region in which the payable through bank is located. Availability could have been assigned for the check automatically on the basis of that number.¹

Shortly after the Board adopted Regulation CC defining the payable through bank as the paying bank and thus allowing bank payable through checks to be treated as local or nonlocal according to the location of the payable through bank, the Credit Union National Association ("CUNA") and one of its member credit unions brought suit asserting that this rule was contrary to the provisions of the Act. The suit asserted that such checks, in particular credit union share drafts, should be treated as local or nonlocal on the basis of the location of the bank on which they are written, rather than the location of the payable through bank. CUNA believed that the treatment of bank payable through checks adopted by the Board would have an adverse effect on the acceptability of these checks as a form of payment because most credit union payable through checks would be

treated as nonlocal, even though they would generally be deposited in a bank local to the credit union. CUNA argued that if these checks were generally treated as nonlocal, a large number of credit unions that offer payable through share draft accounts would be disadvantaged.

On July 28, 1988, the U.S. District Court for the District of Columbia ruled that under the language of the Act, payable through checks should be treated as local or nonlocal on the basis of the location of the credit union on which they are written rather than the location of the payable through bank. On August 18, 1988, the Board adopted interim amendments to Regulation CC to implement the court's decision and requested comment on the interim rule pending consideration of a longer term response to the court's interpretation of the Act (53 FR 31290, August 18, 1988). The interim rule applied the court's decision to all bank payable through checks rather than only those written on credit unions.

One hundred fifty-five comments were received on the interim rule. The overwhelming majority of these commenters objected to the treatment of bank payable through checks as local or nonlocal based on the location of the bank on which they are written, asserting that the rule creates operational difficulties and increased risks for depository banks. Many of the commenters suggested various means of addressing these operational problems and risks.

On November 2, 1988, the Board adopted the interim rule, with minor technical changes, as a final rule, and also published for comment proposed amendments to Regulation CC designed to alleviate the operational difficulties and increased risks resulting from the new rule. (53 FR 44324, 44335, November 2, 1988.) These proposed amendments were based on specific suggestions of the commenters on the interim rule and on subsequent discussions with industry representatives and the Industry Return Item Advisory Group, which includes representatives of commercial banks, savings and loan associations, and credit unions. The Board issued the proposals for comment to gain further information concerning whether the proposals were necessary to facilitate compliance with the revised regulation and to improve the check system by speeding the collection and return of payable through checks, and whether they would impose undue burdens on the banks on which bank payable

¹ Regulation CC defines *bank* to include all depository institutions, including commercial banks, savings and loan associations, and credit unions. A *depository bank* is defined as the first bank to which a check is transferred. A *paying bank* is the bank by which a check is payable for the purpose of determining whether a check is local or nonlocal for determining availability.

through checks are written.

The four proposals for which the Board requested comment would:

(1) Require bank payable through checks to bear a routing number in the MICR (Magnetic Ink Character Recognition) line local to the bank on which the checks are written, and to be presentable locally;

(2) Require bank payable through checks to be conspicuously labeled with the name, location, and nine-digit routing number of the bank on which the check is written and the legend "payable through" followed by the name and location of the payable through bank;

(3) Authorize direct presentment to the bank on which the payable through check is written; and

(4) Place the risk of loss for return of bank payable through checks being returned by a nonlocal payable through bank on the bank on which such checks are written, to the extent that the return from the nonlocal payable through bank took longer than would have been required if the check had been returned expeditiously by the bank on which it is written.

Discussion

The Board received a total of 763 comments from the public on the proposed amendments to Regulation CC.² The following table shows the comments received by category of respondent:

Commercial banks and bank holding companies.....	264
Savings and loan associations.....	7
Credit unions.....	451
Trade associations.....	23
Corporations.....	5
Government Agencies.....	3
Members of Congress	10

Generally, commercial bank commenters supported all four proposals, but particularly stressed the need to require that bank payable through checks bear a routing number local to the bank on which such checks are written. Credit union commenters strongly opposed this proposal, as well as the proposal authorizing direct presentment to the banks on which payable through checks are written. Credit union commenters generally did not oppose implementation of the proposal to require bank payable through checks to be conspicuously labeled with specific information related

² This number does not include comment letters from Federal Reserve Banks and duplicate comment letters from the same bank.

to both the bank on which the check is written and the payable through bank and the proposal to shift the risk of loss to banks issuing payable through checks for return of such checks from nonlocal payable through banks, to the extent that the return of a payable through check from the nonlocal payable through bank took longer than would have been required if the check had been returned expeditiously by the bank on which the check is written. A summary discussion of the Board's analysis of each proposed amendment follows.

Require bank payable through checks to be conspicuously labeled with the name, location, and nine-digit routing number of the bank on which the check is written and the legend "payable through" followed by the name and location of the payable through bank. In order for banks to be able to manually identify payable through checks from other check deposits and determine by visual inspection the appropriate hold, rather than rely on the routing number encoded on the check to determine availability, the Board proposed that certain information pertaining to the payable through bank and the bank on which the check is written must be included on the check.

Other than the routing number of the bank on which the payable through checks are written, the information specified in this proposal is currently required by either existing law or Federal Reserve operating circular.³ This proposal would clarify that this information is required and would apply to all bank payable through checks, including those checks collected outside the Federal Reserve. It would also require that such labeling be conspicuous, setting a minimum type size standard. In addition, through inclusion in the regulation, liability for noncompliance would be established.

The Board specifically requested comment on the cost savings and operational benefits to depository banks and the costs to banks using payable through checks that would result from adoption of this proposal. Of the 295 comment letters addressing this issue,

³ See U.C.C. § 3-120, *Engine Parts, Inc. v. Citizens Bank of Clovis*, 92 N.M. 37, 582 P.2d 808, 23 UCC Rep. Serv. 1248 (1978), and *Phelan v. University National Bank*, 85 Ill. App. 2d 56, 229 N.E.2d 374, 4 UCC Rep. Serv. 635 (1967). The Federal Reserve Operating Circular on the Collection of Cash Items and Returned Checks, as revised effective July 17, 1989, states that banks should not send to a Reserve Bank for forward collection a check that "does not set forth on its face the name of the paying bank and a city and state address of the bank that is located in (1) the same Reserve Bank check processing region as, and (2) a Reserve Bank availability zone that provides the same (or slower) availability than the address associated with the routing number in magnetic ink on the item."

214 commenters supported this proposal and 81 opposed it.

The commenters in support of the conspicuous labeling requirement stated that identification would aid in compliance with the availability requirements of Regulation CC. They noted that the additional information could facilitate manual handling of payable through checks, although it would not permit their identification on an automated basis. The Bank Administration Institute stated, "While this proposal would not appreciably reduce risk, it would aid in compliance with Regulation CC hold rules.

According to a recent Bank Administration Institute study, over 80 percent of financial institutions have adopted 'case-by-case' hold policies. Under such a policy, the depository bank applies holds in selected cases, rather than as a general rule. Under a case-by-case policy, the employee placing the hold must be able to identify local and nonlocal checks accurately by visual inspection. Conspicuous labeling as described in this proposal would aid in this process. Full identification of the payable through bank by name and location would also assist in resolving exceptions in interbank check clearings, such as misrouted items." The Independent Bankers Association of America indicated that community bankers would gain immediate operational benefits from this proposal.

A small number of commenters noted that this proposal would prove helpful when processing damaged checks. Wells Fargo Bank, San Francisco, California, stated, "The alternative of printing identifying information on the face of the check helps when dealing with checks where the MICR line is damaged or destroyed * * *." For example, the name and location of the payable through bank may be needed in those cases where the routing number on the check cannot be properly read.

The majority of commenters that supported the conspicuous labeling proposal indicated that they preferred adoption of the proposal to require payable through checks to bear a routing number in the MICR line local to the bank on which the checks are written. Marine Midland Bank, New York, New York, commented, "This alternative is better than no change in the form in which payable through drafts are issued, but it does nothing to reduce the unreasonably high operational costs of identifying bank payable through checks."

Some credit union commenters stated that this proposal was not objectionable provided they would be given a reasonable period of time to handle the

reprinting of their share drafts. The Credit Union National Association generally supported a revised version of this proposal. CUNA commented that "only the first four digits of the credit union's routing number should be required. The additional digits will not facilitate identification of items as local or nonlocal; in fact, they will only further clutter the drawee area and complicate identification by consumers and bank tellers. Inclusion of all nine digits will also promote direct presentment of payable through share drafts to credit unions * * *." The Independent Bankers Association of America supported this proposal, but noted, "Most community bankers indicated that including another nine digit routing number on the face of the check could result in unnecessary confusion for the teller making the identification."

The Board had noted, in its request for comment on this proposal, that an ancillary benefit to requiring that the nine-digit routing number of the bank on which the check is written be printed on the face of the check is that it would provide information needed to establish arrangements for automated clearinghouse (ACH) transfers to or from an account—information that is generally obtained from a check of the customer requesting the ACH service. The Board believed that the identification on the face of the check of the routing number of the bank on which the check is written would facilitate sending ACH transfers to the account-holding bank rather than to the payable through bank, which generally rejects the transfer. A major payable through bank, however, indicated to Board staff that it handles ACH transfers for a number of credit unions for which it also performs payable through processing and that inclusion of the nine-digit routing number of the credit union could cause ACH transfers to be misdirected to the credit union.

Inclusion of only the first four digits of the routing number of the bank on which the payable through check is written would be sufficient to permit depository bank personnel to assign local or nonlocal availability to these checks because these digits identify the check processing region in which the bank on which the check is written is located. This would eliminate the need to refer to a list of cities and towns in the depository bank's check processing region to determine if the location of the bank on which the check is written is local for purposes of Regulation CC. The Board believes that requiring the identification of the entire nine-digit

routing number, rather than only the first four digits, on the face of bank payable through checks would not provide any incremental significant benefits, and has modified the proposal to require inclusion of only the first four digits of the routing number of the bank on which the check is written on the face of the check.

CUNA also stated, "Because of the advantage to consumers, CUNA urges a requirement that the drawee area of all checks contain the first four digits of the drawee's routing number." The Board does not believe it is necessary that the requirement apply to all checks because tellers and consumers can determine local or nonlocal availability by referring to the first four digits of the routing number in the MICR line for all checks other than bank payable through checks.

A few commenters suggested that the Board should specify where the required information is to be placed on the face of the check. The Board has provided in the commentary to § 229.36 that the required information is deemed conspicuous if it is located in the title plate * on the check.

The Board proposed that the rule become effective one year after adoption. A small number of commenters discussed the appropriate effective date for this proposal. Bank commenters either supported the proposed one year implementation period or requested an effective date of less than one year. Credit union commenters generally stated that they would need additional time for their members to use existing check stock and reorder the new checks. The Credit Union National Association stated, "A more reasonable effective date of this proposal would be two years after adoption of the amendment to allow credit union members to use their current supply of share drafts." While on average customers reorder checks annually, additional time would allow for the check printers to make title plates and for credit union members to reorder checks. The Board believes that eighteen months will provide sufficient time for both the manufacture of new plates and check reorders.

The 81 commenters that opposed the conspicuous labeling proposal stated that it encourages manual handling. A number of commenters indicated that they opposed this proposal because they believed that the proposal requiring a local routing number in the MICR line is

* The title plate appears in the lower left quadrant on the face of the check, below the amount line and above the memo line, and generally includes the name and location of the paying bank.

a better solution. First Virginia Banks, Inc., Falls Church, Virginia, stated, "First Virginia does not favor this proposal as it places the burden of recognizing payable through checks on the teller. This proposal invites human error and Regulation CC violations and will only act to delay item processing, because these checks will have to be handled as exception items."

Maryland National Bank, Baltimore, Maryland, stated that this proposal "does not permit the automated processing of payable through draft checks which is critical to maintaining the integrity of the payment system. This would create an indeterminate degradation of customer service at the branch level of financial institutions and a corresponding increase in expenses due to the visual inspection required which would be eventually passed on to the customer."

A small number of commenters discussed the costs of this proposal. These commenters indicated that without the concurrent adoption of the proposal requiring a local routing number in the MICR line, the costs to banks would be prohibitive because they would have to manually process the payable through checks. Bank One, Milwaukee, Wisconsin, stated, " * * * sight review would significantly increase a bank's processing costs because it would require adding employees to the teller proof or transit operation." Bank One estimated \$225,000 per year as "the labor expense we would incur if we have to visually inspect all items deposited, and manually make float adjustments for share draft or payable through items."

A number of commenters expressed concern that the labeling requirement could have an adverse impact on the acceptance of payable through drafts. The Chicago Clearinghouse Association, Chicago, Illinois, commented, "This requirement would make obvious visual distinction between a regular check and a payable through check and would be detrimental to institutions using payable through checks. The distinction may create negotiability problems with merchants and consumers who may not understand the reasons for such obvious labels. Because of the label, some merchants may not honor payable through checks as cash items." The specified information is already required, however, except for the first four digits of the routing number, which is necessary for the depository bank to determine availability. Consequently, the Board does not believe the labeling requirement will cause negotiability problems for payable through checks.

The requirement that specified information be printed on the face of the check does not address the potential risks of bank payable through checks becoming attractive vehicles for fraud because it does not accelerate the collection of payable through checks. Under this proposal, the bank on which the payable through checks are written or its customers would incur costs to reissue its checks. Given an eighteen month lead time, the cost of reissuance should be minimal. This proposal would not require any bank to move its payable through check processing to a different bank.

The Board is adopting an amendment to Regulation CC that would require bank payable through checks to be conspicuously labeled with the name, location, and first four digits of the routing number of the bank on which the check is written and the legend "payable through" followed by the name and location of the payable through bank. This rule becomes effective eighteen months after final adoption.

Place the risk of loss for return of bank payable through checks being returned by a nonlocal payable through bank on the bank on which such checks are written, to the extent that the return from the nonlocal payable through bank took longer than would have been required if the check had been returned expeditiously by the bank on which it is written. Commenters on the interim rule expressed concern regarding the potential risk of losses and increased exposure to fraud for depository banks resulting from the revised rule. They indicated that checks considered local for determining availability should also be considered local for determining whether the checks are returned expeditiously so that the risks to depository banks would not be increased by the revised rule. Two hundred eighty comment letters addressed this proposal. Two hundred twelve commenters supported this proposal and 68 commenters opposed the proposal.

The commenters in support of this proposal stated that it would assign risk in the payment system to the appropriate cause of that risk. The Alamo Savings & Loan Association, San Antonio, Texas, stated, "Even if none of the other proposed amendments are approved, this one must be, because it is inappropriate to allow issuers of 'payable through' checks to accrue the benefits of the definition of local checks from an availability standpoint, but not be responsible for liabilities inherent in the delayed return of unpaid checks from nonlocal 'payable through' banks." The Citizens and Southern Georgia

Corporation, Atlanta, Georgia, commented, "It is reasonable and fair to place the risk of loss on the institution responsible for delaying the return process beyond the time normally required for local checks."

In an effort to determine the risks confronting a large regional bank due to the adoption of the rule establishing the bank on which a payable through check is written as the paying bank for determining funds availability, Sovran Financial Corporation, Norfolk, Virginia, conducted an extensive survey of payable through checks in June and July, 1988. Sovran explained, "From the survey, we determined that Sovran—in the states of Maryland, the District of Columbia, and Virginia would process nearly \$1 billion a year of payable through items drawn on one of the two major national processors of such items. We projected the annual volume of these items to be 10.2 million. Visual inspection of these items disclosed that almost one half are issued by geographically local institutions. However, because the payable through bank—or the processing bank—has the opportunity to return the items to us in the Board's prescribed nonlocal time frame, the question of whether the issuing bank is geographically local is irrelevant. We applied the actual rate of dishonor for these items, which we had tracked over a two year period, to the dollar and volume data gathered. We determined that *at a minimum*, based on a one day delay (we make the funds available to the customer in three days, but we receive the return on the fourth day) our annual exposure from these items would be \$9 million."

The majority of the bank commenters that supported the proposal shifting the risk of loss to the bank on which the payable through check is written recommended that this proposal should be adopted immediately as an interim measure until the proposal requiring a local routing number in the MICR line could be implemented. The Citywide Bank of Denver, Denver, Colorado, stated, "Until such time as (the proposal requiring a local routing number in the MICR line) can be fully implemented, our bank strongly recommends your (proposal shifting the risk of loss to the bank on which the payable through check is written) * * * be instituted for the protection of all depository banks. There does not seem to be a time factor requirement to implement this approach and the cost factor on the norm, would be minimal."

Some bank commenters that supported this proposal expressed concern about the practice of claiming a loss under this proposal. The Chicago Clearinghouse Association commented,

"We are in favor of assigning risk in the payment system to the appropriate cause of that risk, but are concerned about the practicality of claiming a loss under the current proposal. With so many schedules for availability and collection, proving responsibility for loss will be difficult. This makes it unlikely that any but large-dollar losses will be contested. We suggest that a method be developed within the normal return system for a depository bank to claim a loss and receive compensation." Prime Bank, Grand Rapids, Michigan, stated, "The Federal Reserve should take measures to accommodate these banks who have suffered such liability and losses to easily recoup these losses from the payable bank."

Some credit unions expressed limited support for the proposal shifting the risk of loss to the bank on which a payable through check is written. The Family Community Credit Union, Charles City, Iowa, commented that this proposal "is also a proposal that could be workable for credit unions. Either one of these proposals (the conspicuous labeling proposal or the proposal shifting the risk of loss to the bank on which the payable through check is written) would not require the expense, equipment and staff that the other two would require."

The Chase Manhattan Corporation, New York, New York, a major payable through processor, stated, "Of the four approaches the Board has proposed, Chase prefers this approach because it would provide an effective means of protecting depository banks from the risk of loss for return of bank payable through checks without dismantling the present efficient and cost effective payable through system."

Some commenters suggested that the proposal be modified to limit the risk that could be allocated to the bank on which the check is written. The Credit Union National Association generally supported a modified version of the proposal. CUNA commented, "Credit unions should only assume actual direct losses caused by a delayed return from a payable through bank; that is, only losses of amounts that exceed the \$100 next-day availability rule and are under the \$2,500 amount covered by the large-dollar item notice requirements of the Regulation."

Under the proposed rule to shift the risk of loss, the bank on which the check is written would only be responsible for losses that occurred between the time that the check would have been required to be returned if returned expeditiously by that bank and the actual time that it takes to return the check from the payable through bank. If the payable through bank complies with the current

notice of nonpayment requirement for returned checks of \$2,500 or more and the depository bank takes action to minimize its risk upon receipt of the notice, no loss should occur that could be allocated to the bank on which the check is written. If the depository bank takes no action upon receipt of the notice, it may be liable for losses incurred under the liability provisions of § 229.38(a). Thus, the Board does not believe it is necessary to modify the rule to address CUNA's suggestion that liability should only apply to those checks that are less than \$2,500 and thus not covered by the notice of nonpayment requirements.

CUNA also suggested that the allocation of liability be limited to only those amounts that exceed the \$100 next-day availability rule. The Act and Regulation CC require depository banks to provide next-day availability for the first \$100 of the aggregate amount of a customer's check deposits made during a banking day. The proposed rule would only shift the risk of loss to the bank on which the check is written in cases where the loss would not have occurred if the check had been returned under the local time frame. If losses occurred because the depository bank made funds available for withdrawal before it could learn of a local return, such losses would not be shifted to the bank on which the payable through check is written. In addition, because a customer's check deposit may include a mixture of payable through checks and other checks, the Board does not believe it would be appropriate to release the bank on which the payable through check is written from liability for the first \$100 of a day's deposit.

The Board had specifically requested comment on what standard(s) should be applied to determine whether the return from a nonlocal payable through bank took longer than would have been required if the check had been returned expeditiously by the bank on which the check is written. Regulation CC requires banks to return checks expeditiously. It allows banks to utilize two tests to determine whether a check has been returned expeditiously. Under the two-day/four-day test, a check is returned expeditiously if a local check is received by the depository bank on or before the second business day after the banking day on which the check was presented to the paying bank or if a nonlocal check is received by the depository bank on or before the fourth business day after the banking day on which the check was presented to the paying bank. Under the forward collection test, a check is

returned expeditiously if a paying bank sends the returned check in a manner that would ordinarily be used by a bank in the paying bank's community to collect a check drawn on the depository bank. Generally, this test would be satisfied if a transportation method or collection path is used for returns that is comparable to that used for forward collection.

Several bank commenters indicated concern over the practicality of claiming a loss under the proposal, indicating that it would be particularly difficult to prove responsibility for loss under the forward collection test. Several credit union commenters, including CUNA, suggested that both tests be applicable. The Board believes that the two-day/four-day test provides a measurable standard to ascertain whether the return of the payable through check is expeditious. In contrast, the determination of whether return of a check is expeditious under the forward collection test is made based on the manner by which the paying bank returned the check, rather than the time within which the depository bank received the return. Since a payable through bank nonlocal to the bank on which the check is written would not use the same manner of return as that used by the bank on which the check is written to collect checks, the forward collection test could not be used as a standard for expeditious return by the payable through bank.

Bank commenters opposed to the proposal shifting the risk of loss to the bank on which the payable through check is written stated that this proposal does not address the operational problem of identifying payable through checks. Eastover Bank for Savings, Jackson, Mississippi, stated, "Shifting the risk of loss is not enough. This will simply lead to many operational difficulties in identifying these checks and will not aid in reaching the goal of a more speedy check collection and return processing system." First Virginia Banks commented, "First Virginia does not favor this proposal, as it will only serve to increase Late Return Claims, litigation expenses, and does not allow for expedited processing of these items."

A number of credit union commenters that opposed the proposal expressed concern about its implementation. The Southern Nevada State Savings & Credit Union, Las Vegas, Nevada, described this proposal as complicated and unmanageable. It commented, "• • • strict time limits would have to be imposed on the receiving banks as well as a detailed record keeping, timed,

system that would record the flow of the items. Otherwise, anytime there was a DISPUTE for a loss, we've never had one in 20 years, the receiving institution could simply claim a delayed processing schedule. A tracking mechanism would be required."

A small number of credit union commenters stated that they did not think this proposal was necessary. The Navy Federal Credit Union, Merrifield, Virginia, commented, "We are not aware of any evidence of actual losses which would justify the presumed need. Without further justifications, no change to the liability assignments is recommended." A few credit union commenters indicated that the payable through bank should be responsible for the loss instead of the credit union.

The Board is adopting the proposal shifting risk of loss to the bank on which the payable through check is written. The test for expeditious return under this final rule will be based on the two-day/four-day test under § 229.30(a)(1) of the regulation.

The Board also requested comment on the appropriate lead time for implementation of the proposal. Although CUNA indicated that a one-year lead time would allow credit unions that issue payable through drafts sufficient time to modify their insurance coverage to cover any increased risk of loss, CUNA commented that the risk of loss associated with bank payable through checks is virtually nonexistent. On the other hand, many bank commenters indicated that this proposal should be implemented immediately. The Board believes that insurance coverage can be obtained in less than one year. In any event, variations in the effective date of this proposal should have minimal effect on the banks on which payable through checks are written. Therefore, this proposal will become effective six months after adoption.

Require bank payable through checks to be presentable locally and bear a local routing number in the MICR line. Commenters on the interim rule expressed concern about the operational problems posed by the court ruling and interim amendments. They indicated that the Board should require credit unions to encode their own routing numbers on their checks or that of a local payable through bank.

The Board specifically requested comment on the cost savings to depository banks and the costs to banks issuing payable through checks so that the benefits and costs of this proposal could be more fully assessed. Seven

hundred twenty-two comment letters addressed this proposal. Two hundred eighty-two commenters supported this proposal and 440 commenters opposed this proposal.

The commenters in support of the proposal to require a local routing number in the MICR line, predominantly banks, described it as the only practical solution to their operational problems and risk concerns. Several supporters also noted that the proposal would reduce confusion for the consumer. The American Bankers Association stated, "Currently, there is no practical or comprehensible way to describe to a consumer how to distinguish between local and nonlocal checks and payable through checks except to advise them generally to inquire when they deposit a payable through check. The proposal will allow consumers simply to refer to the MICR line to ascertain whether a deposit is subject to a local or nonlocal check hold."

Several commenters in support of this proposal discussed how it relates to the intent of Regulation CC. The Independent Bankers Association of America commented, "We believe that requiring a local payable through bank is most consistent with the Act's linkage between the availability of funds and the time it takes to collect and return a check." Great Western Financial Corporation, Beverly Hills, California, stated, "By requiring bank payable through checks to be presentable locally and bear a local routing number in the MICR line, Great Western believes that the problems associated with the acceptance for deposit of payable through checks will be addressed, the intent of Regulation CC will be upheld and the best interests of the consumer will be served."

Continental Bank, Chicago, Illinois, stated, "Any proposal that does not allow banks to rely on the MICR line will slow the automated check clearing process considerably and thus retard the goals set by EFAA. As the Board observes, payable through checks account for less than 3% of the processed check volume * * *. Any proposal that does not allow a bank to rely on the MICR line will slow down the processing of the 97% remainder of the checks which today are being efficiently processed. (This proposal) not only confirms the axiom, 'if it ain't broke, don't fix it,' it also encourages credit unions to process their items in a manner that will enhance the goals of EFAA. * * * (This proposal) thus places the cost of expeditiously processing payable through checks on the segment of the industry that enjoys the benefit,

and in addition, encourages high speed automatic processing of checks consistent with the goals of EFAA."

Commenters explained that the primary benefit of this proposal would be to eliminate problems in determining proper availability by allowing banks to rely on the routing number encoded in the MICR line. The Bank Administration Institute stated that this proposal is "the most comprehensive solution to the problem. It reduces risk by providing a local clearing and return mechanism for checks that must be treated as local for check holds. It also simplifies compliance because depository institutions would be able to rely on the routing number to identify the local check processing region, either by visual inspection or automated means." First Virginia Banks stated, "First Virginia favors this proposal as it allows for automated processing and expedites the check collection. It will eliminate as much human intervention as possible and allows payable through checks to be handled in mainstream processing and not as exception items."

Without the ability to rely on the routing number to determine whether a check is local or nonlocal and thus determine the appropriate holds, a bank must develop alternative procedures to identify payable through checks and place the appropriate holds on such checks. These procedures include (1) having the teller identify and outsort payable through checks as they are deposited so that holds can be manually applied; and (2) identifying the routing numbers of nonlocal payable through banks * and assigning local availability on an automated basis to all checks destined to these routing numbers.

Bank commenters noted that requiring a local routing number in the MICR line was the only proposal that placed the time and expense of processing payable through checks on the bank on which the checks are written. Branch County Bank, Coldwater, Michigan, commented, "The requirement to make bank payable through checks bear a local routing number is the only one which places the time and expense of processing where it rightly belongs."

Bank commenters stated that it was difficult to estimate the operational cost savings that would result if this proposal were adopted. AmSouth Bank, Birmingham, Alabama, estimated that its annual dollar cost in teller staffing to implement a manual inspection approach to payable through checks would be \$6,607,500. Bank One stated,

* A survey by Board staff identified 65 routing numbers that are used on bank payable through checks.

"There is a cost avoidance (through requiring a local routing number in the MICR line) of about \$225,000 per year. This is the labor expense we would incur if we have to visually inspect all items deposited, and manually make float adjustments for share draft or payable through items." Citicorp, New York, New York, stated, "As for the costs associated with the proposal, it is practically impossible to provide meaningfully accurate figures; it is not unreasonable, however, to project some figures based on the check collection process itself. For the banking industry nationwide (not including credit unions and the processors), Citicorp estimates that it would take a teller approximately two/three seconds to determine whether or not an item is payable through draft and whether or not it is local based on an examination of the check itself. * * * Factoring in the number of tellers employed, their hours, salary, other benefits and the approximate total number of items processed by all banks in the course of a year, we would project a cost figure of five hundred million dollars * * * for the banking community to comply with the regulation as amended as a result of the CUNA suit—absent adoption of the proposed amendments."

This estimate, however, assumes that all banks apply differential holds to deposits of local and nonlocal checks, as permitted in the regulation. According to a study conducted by the Bank Administration Institute, 83 percent of all banks provide immediate or next-day availability with the option to apply holds on a case-by-case or exception basis. The BAI study is corroborated by surveys conducted by trade associations in coordination with the Federal Reserve, which indicated that 75 percent of banks provide immediate or next-day availability with the option to apply holds on a case-by-case or exception basis. Applying case-by-case holds generally entails manual intervention to determine those checks on which holds should be imposed. Thus, the need for a method to apply automated holds appears to be limited to a minority (approximately 20 percent) of banks. Even though only a small number of banks place differential holds, these banks are often large and represent a greater proportion of all checks deposited.

By imposing differential holds for local and nonlocal checks, these banks have indicated a high level of concern about the risk of making funds available for withdrawal before learning whether a check has been returned. The Board recognizes that by not adopting the proposal requiring local routing numbers

for payable through checks, a depository bank electing to grant local availability for all checks drawn on the routing numbers of nonlocal payable through banks would increase this risk by granting local availability for checks that would not be subject to the local schedules under the regulation. In addition, banks applying differential holds are subject to litigation risk and could be liable for exceeding the maximum availability schedules if they do not grant local availability for a payable through check bearing a nonlocal routing number. Inaccurate assignment of availability could result when a teller makes errors in outsourcing payable through checks or when the bank fails to accurately identify all nonlocal banks acting as payable through banks for local banks. The Board believes that a depository bank can control these risks through its diligent application of the process it chooses to use in applying holds to assure that it grants local availability for payable through checks issued by local banks.

Commenters in support of the proposal requiring local routing numbers also indicated that they would receive faster availability and incur lower collection costs for payable through checks drawn on local banks under this proposal than they can receive when sending the checks to the nonlocal payable through bank for collection. Suntrust Service Corporation, Orlando, Florida, stated, "Current volume from Suntrust Service Corporation Florida Operations to just the New York and Minneapolis share draft processors is approximately 6,500,000 items per year at a cost over \$20,000.00 per year for transportation expenses."

Some bank commenters noted that this proposal would limit delayed disbursement. These commenters indicated that the credit unions using nonlocal payable through banks have an unfair float advantage over other banks. The Litchville State Bank, Litchville, North Dakota, commented, "For the credit unions to have special treatment is to give the banks and savings and loans unfair treatment. Please make the laws the same for all." The president of the Citizens Bank of Oviedo, Oviedo, Florida, commented, "I think it should be illegal for any financial institution to carry its clearing account on the other side of the country so they can take advantage of float."

Payable through banks have indicated that many collecting banks receive availability for payable through checks drawn on a nonlocal payable through bank equivalent to that for checks collected locally by sending the checks

directly to the nonlocal payable through bank. The payable through banks indicated that these "direct send" arrangements can only be cost effective for the collecting banks when sufficient volumes are being delivered to one presentment point and that maintenance of the payable through system is necessary to achieve these critical volume levels.

The majority of the banks commented that the potential risk of loss and increased exposure to fraud is also difficult to quantify. Bank of America stated, "The greatest potential savings, however, would not be operational. It would result from the reduced exposure to fraud losses * * *. While we have not attempted to estimate the fraud potential, as the processor of an estimated \$850 million per year in payable through share drafts, our exposure is evident." Florida National Bank, Jacksonville, Florida, commented, "This proposal would eliminate the likelihood that these checks would become vehicles for check fraud. It would reduce the collection time, reduce overall float, as well as reduce the risk for depository banks."

The 440 commenters that opposed the proposal, predominantly credit unions, indicated that requiring payable through checks to bear a local routing number in the MICR line was totally unacceptable and that its burden and high costs would far outweigh any benefits. Several commenters questioned the justification for the proposal. United States Senators Rudy Boschwitz and David Durenberger commented, "The Federal Reserve has yet to demonstrate that a drastic step such as local MICR number is necessary in order to address perceived problems with the payable-through system. There are other solutions that should be explored before destroying a system that works well for credit unions." The Arizona Credit Union League, Inc., Phoenix, Arizona, stated, "There is no evidence that the proposed changes are warranted. Indeed there are no cases of fraud or embezzlement on record that suggest problems with the payable through system to the degree suggested by the proposed regulations." CUNA commented that this proposal would "reduce efficiencies of the check collection system by creating thousands of additional endpoints."

Commenters expressed concern that this proposal could lead to the dismantlement of all national and regional payable through systems and thereby result in the loss of the efficiencies gained through economies of scale achieved from these systems. They explained that the payable through

share draft program was initiated as a means for credit unions to provide a checking system to their members at a reasonable cost. Many credit unions stated that they are able to provide checking services only through the use of payable through processors, which provide efficient processing at a cost much lower than in-house processing. The Sherwin-Williams Employees Credit Union, Chicago, Illinois, stated, "Credit unions on a national or regional payable through program should not be forced to abandon their cost efficient, truncated system. This system has worked well for almost 15 years and has allowed thousands of credit unions to offer share drafts to millions of their members." The Alpena Alcona Area Credit Union, Alpena, Michigan, commented, "The dismantlement of the payable through system would deprive members of a viable service, and at the same time increase the operational costs of the credit union—all without significant advantage." The Motorola Employees Credit Union, Schaumburg, Illinois, stressed that it chose Travelers Express as its payable through processor because the payable through program is both efficient and economical. It noted that it would be too costly to convert to in-house or local processing or to arrange for local intercept points.

Commenters expressed concern that local processors would not be able to provide the truncation services currently provided by the major payable through processors. They described the current truncation system as very cost efficient. H&E Telephone Federal Credit Union, Rochelle Park, New Jersey, noted that it previously used local banks to clear its checks but switched to a national processor that was superior. Problems with its local bank included: "(1) The return of actual checks to us which resulted in a mountain of paper and work to organize data; (2) poor reporting capabilities and longer time lags for information availability; and (3) more costly service charges."

Credit union commenters cited two costs of implementing the proposal requiring local routing numbers on payable through checks. First, credit unions and other banks issuing payable through checks would be required to either convert to in-house processing or establish a local presentment point for their payable through checks. They commented that these alternatives would be so costly that the continued share draft service would not be cost effective and would result in their imposing excessive fees on their members. Many commenters stated that an in-house system would not be economically feasible because of their

small size and volume. The IBEW Federal Credit Union, Knoxville, Tennessee, commented that conforming "to the proposed amendments would be cost prohibitive due to increased processing costs, risk involved, and additional staff and data processing needs."

The City of Huntington Federal Credit Union, Huntington, West Virginia, indicated that a local bank estimated that it would charge approximately \$30,000 per year to process the credit union's share drafts, compared to an annual charge of approximately \$10,300 assessed by Chase Manhattan Bank to perform similar services. Another credit union estimated that current share draft account fees charged to credit union members would triple if the credit union closed and they were forced to use local banks. A third credit union with 850 share draft accounts indicated that its per account cost would increase an estimated \$41.41 annually as a result of this proposal. A credit union that uses the Travelers Express payable through draft processing service stated that its average per item cost is \$.06 and the time required to receive and post accounts is less than one hour per day. This credit union estimated that this proposed amendment would require the purchase of additional equipment costing approximately \$20,000 and the addition of one staff person at approximately \$15,000 per year.

Commenters also noted that a second type of cost associated with the proposal is the cost of reissuing checks to customers. In addition to the cost of reissuing check stock, a change in routing number requires the additional cost of dual processing during the transition period when the processor must process checks with both the old and new routing numbers. The cost associated with dual processing will vary based on the time required to replace check stock. The Board believes that banks can minimize this time through diligent instruction to its customers in reordering and using new checks. These costs would either be borne directly by the customer, who would have to pay for new check stock, or indirectly by the customer through increased service charges imposed by the bank that bore the cost of replacing the check stock.

In addition to the cost/benefit analysis, the Board considered the competitive implications of this proposal. This analysis included competitive factors vis-a-vis credit unions vs. commercial banks. Credit union commenters indicated that because this proposal has the effect of

limiting a credit union's choice of payable through bank, its adoption could prompt local banks to raise their fees. In addition, many credit unions believe that local banks may not have the incentive to keep costs down for the credit union issuing payable through checks because many of these local banks are competing for the same customer accounts as those held by the credit union. The Redford Township Community Credit Union, Redford, Michigan, stated, "This proposal would eliminate most of the competition which is a healthy situation for cost control."

Some credit unions indicated that they had no local processing options. The Fort Harrison VAF Federal Credit Union, Fort Harrison, Montana, stated, " * * * there is no Montana-based processing point at this time and one could not be set up within the one year deadline." The Jackson USDA Federal Credit Union, Jackson, Mississippi, commented that "there are no banks in the state of Mississippi that we know of that will process share drafts for credit unions." The manager of the Jackson USDA FCU contacted two local banks about processing share drafts and was informed that their market studies indicated there would be insufficient credit union share draft volume to make the share draft processing profitable.

Other comments indicated that the competitive issues between commercial banks and credit unions are broader than the issues raised by these payable through check proposals. Bank commenters indicated that the credit unions' tax-free status and liberal common bond restrictions give the credit unions an unfair advantage in competing for customers, which is only exacerbated by the credit unions' ability to issue payable through checks.

Commenters also noted that this proposal would have an anti-competitive effect on consumers by limiting choice of bank. The majority of small credit unions that commented on this proposal indicated that they would have to discontinue their share draft programs if the proposal were adopted because they would be unable to finance the increased human and equipment resource requirements. They expressed concern that they would no longer be able to offer a low cost checking alternative to lower income customers. The Pennsylvania Mennonite Federal Credit Union, Scottsdale, Pennsylvania, stated, "In this day when the U.S. Congress is considering 'lifeline banking' and providing basic financial services that ordinary people can afford, we find it incongruous for a major organization such as the Federal

Reserve System to mandate regulations which will either increase the cost of these services to our members or result in their discontinuance altogether."

The Newark Aerospace Federal Credit Union, Heath, Ohio, commented, "A lifeline no service charge share draft account might no longer be available to many of our members because of increased cost. If we could not afford the necessary equipment, 2,200 members would lose their share draft accounts and be forced to open checking accounts at banks. Recent reports indicate the average checking account costs the consumer close to \$200 annually." Congressmen Frank Annunzio and Bruce Vento stated, "We believe the Board has consistently failed to balance the adverse effects such a proposed amendment will have on the medium to small credit unions and their life-line services, such as share drafts. Instead the Board cited unsubstantiated allegations of fraud and operation difficulties as its basis for requiring such a proposed amendment to Regulation CC."

Credit unions and payable through processors noted that this proposal would have an anti-competitive impact by limiting processing choice. The Dearborn Federal Credit Union, Dearborn, Michigan, stated, "Dearborn Federal believes that every credit union should have the right to choose the most efficient and cost effective system available." The Chase Manhattan Corporation stated, "If this approach were implemented, the Federal Reserve System with its extensive processing facilities and resources in every check processing region would have a competitive advantage over private sector providers in offering a national truncation service."

The Board believes that provision of truncation services by the Federal Reserve Banks and other private sector providers should help facilitate the payable through system by expediting the delivery of check information to the payable through bank, thereby allowing the payable through bank to provide more efficient, cost-effective payment services to credit unions. The Federal Reserve encourages private sector participation in providing truncation services, and the Reserve Banks developed their truncation service in coordination with private sector truncation service providers through the National Association for Check Safekeeping, which has expressed an interest in supporting the payable through system by means of truncation.

A few commenters noted that this proposal could be difficult to enforce

because some credit union members order their own drafts from printing companies and they would be individually responsible for ensuring that their drafts have the proper routing number in the MICR line. A small number of commenters identified as another potential problem that some members would be reluctant to throw away unused drafts even if new drafts were issued free of charge.

The National Association for Check Safekeeping (NACS) proposed an alternative to this proposal. NACS proposed use of the 8000 series of routing numbers to identify checks that are payable through a bank nor located in the same check processing region as the issuer of the check. NACS noted that the only current use of the 8000 series is for travellers checks.

Under the NACS proposal, the first digit of the routing number would be the number 8, identifying the 8000 series. The second and third digits would identify the check processing region of the bank on which the check is drawn. These two digits could be the number 01 through 48, identifying one of the 48 Federal Reserve check processing regions. The fourth and fifth digits would identify the check processing region of the payable through bank. Again, the two digits could be 01 through 48 identifying a check processing region. The sixth, seventh, and eighth digits would identify the particular payable through bank(s) within each check processing region. The ninth digit would be the check digit.

NACS stated, "Depository banks could easily examine the 8000 series number and determine two things. Banks can determine where to send the check for collection and the funds availability to assign. Only banks using payable through processors in another check processing region will be eligible for an 8000 series routing number." Use of the 8000 series of routing numbers would enable banks to use automated equipment to read the MICR line to assign funds availability. Several commenters urged the Board to first research the NACS proposal further if the Board planned to adopt the proposal to require that payable through checks bear a local routing number in the MICR line. If the NACS proposal was determined to be an effective alternative, the commenters urged the Board to issue the proposal for public comment to determine whether it could provide the same benefits to depository banks as the local routing number proposal without disrupting the national payable through system.

Board staff discussed the NACS proposal with industry representatives,

equipment vendors, and check processing staff at the Federal Reserve Banks. Equipment vendors indicated that use of the 8000 series would require equipment upgrades at collecting banks, and that purchase and installment could take up to two years. Federal Reserve Bank staff indicated that this proposal could impact sort patterns, memory capacity for look-up tables, and processing schedules.

Adoption of the NACS proposal would also require reissuance of all payable through checks. Because the Board is adopting the conspicuous labeling requirement at this time, later adoption of the NACS proposal would require banks issuing payable through checks to reissue their checks twice. Two reissuances would be costly and burdensome for these banks and their customers.

Adoption of the NACS proposal would only benefit the approximately 20 percent of banks with blanket hold policies. The proposal would not provide incremental benefits to the large majority of banks that generally offer same-day or next-day availability. The NACS proposal would, however, impact all collecting banks because they would have to upgrade equipment to process these checks. Since this proposal would only benefit the minority of banks with blanket hold policies and would be burdensome for credit unions and collecting banks, the Board believes there is not sufficient justification to issue the NACS proposal for public comment.

Sovran Financial Corporation also suggested an alternative to the proposal requiring payable through checks to bear a local routing number in the MICR line. Sovran recommended that the "Board consider setting a specific time limit—two years—by which all issuers of payable through items wishing to obtain better acceptability for their items in the local marketplace must convert to using a local paying agent for the items, and to ensure that the items bear the routing number of the local paying agent. Those institutions which believe the costs of increased acceptability outweigh the benefits will still have the opportunity to use a distantly located payable through bank, but collecting banks will also have the opportunity to grant nonlocal funds access to depositing customers for these items." The Act does not give the Board the authority to lengthen the availability schedules, which would be the result of this proposed alternative.

Travelers Express Company, Minneapolis, Minnesota, recommended two alternatives to the proposal requiring a local routing number in the

MICR line. Travelers suggested using position 44 in the MICR line to identify whether payable through checks are local or nonlocal. The Board believes that, while it would be possible to use position 44 to identify whether or not a check is a payable through check, manual intervention would still be necessary to determine whether such check is local or nonlocal. Thus, this alternative would provide only marginal benefit to depository banks and should not be pursued at this time.

A second suggestion by Travelers Express was to implement "a requirement that payable through banks notify their local Federal Reserve of every routing number that includes items that would be considered local. The Fed could then publish a directory of these numbers. This would permit automation for the vast majority of the items at issue." As previously indicated, Board staff developed a list of 65 routing numbers that are used on bank payable through checks. The Board believes that, because banks may begin to offer or discontinue payable through services at any time, maintaining the accuracy of such a list and disseminating updated information to all depository banks would be difficult.

Some commenters discussed the appropriate lead time for implementation of the proposed requirement that bank payable through checks bear a local routing number in the MICR line. The majority of the commenters noted that the proposed one year implementation time period was too short. Oak Ridge Government Federal Credit Union, Oak Ridge, Tennessee, commented, "My only suggestion would be that the implementation date be extended from 12 to 24 months. Any credit union that has gone through the conversion process already will tell you that it is impossible to accomplish in 12 months, and that is *after* the decision is made. The decision whether to go with a local third party processor or in-house can take 3 to 6 months."

The Board did not find reason to believe that the benefits of implementing the proposal to require payable through checks to bear a local routing number in the MICR line outweigh the reported costs of implementation, and thus is not adopting this proposal.

Authorize direct presentment to the bank on which payable through checks are written. Currently, the law is unclear as to whether a bank payable through check can be presented directly to the bank on which it is written or whether such checks must be presented to the payable through bank. Expressly

permitting such checks to be presented directly to the bank on which they are written would enable banks to have such checks collected and returned locally, and thus would avoid delays in collection and return that might occur when the depository bank sends the checks to nonlocal payable through banks.

The Board specifically requested comment on the cost and operational burden of this proposal on banks that use payable through checks, the potential cost savings to depository banks, and the appropriate lead time for implementation of this proposal if adopted. Six hundred thirty-seven comment letters addressed this proposal. One hundred seventy-two commenters supported the proposal and 465 commenters opposed it.

The commenters in support of this proposal commented that direct presentment would minimize the potential for fraud. National City Corporation, Cleveland, Ohio, commented, "To the extent that the proposal is employed, it would allow banks to determine the collectibility of checks/drafts in less time than otherwise would be the case, thereby reducing the risk of loss." The majority of the commenters that supported the direct presentment proposal indicated that they preferred the adoption of both the proposal requiring a local routing number in the MICR line and the direct presentment proposal.

A number of commenters indicated that they would like to have the option of direct presentment but did not indicate if they would actually present directly to the bank on which the checks are written, rather than to the payable through bank, if this proposal were adopted. The Chicago Clearinghouse Association stated, "The Association supports direct presentment of payable through items to the paying institution as an optional method of collecting such items * * *. In many cases, the option of direct presentment would be effective for speeding the forward collection process. However, we recognize that some collecting banks may not wish to exercise this option."

A small number of commenters suggested that the Federal Reserve should facilitate direct presentment. The United States League of Savings Institutions stated, "Having the Federal Reserve make direct presentments overcomes the cost prohibitiveness of having individual depository banks making a presentment. Concentrating payable-through check volume at District Federal Reserve Banks makes this direct presentment alternative much more feasible." Continental Bank

commented, "Our support for this option is also contingent on the Fed expanding its current fine-sort option to facilitate the direct presentment of payable through checks to the 'paying bank'. If this Fed expansion is not achieved, there would be no economical way to get the payable through checks presented directly to the individual credit unions."

Bank commenters noted that direct presentment would be used primarily by banks that have both the resources to perform this function and the volume to justify the expense. The Key State Bank, Owosso, Michigan, commented, "Allowing banks to present the items directly to a local credit union is only practical if sufficient volume allows a separate 'break out' of these items and ample capacity in the bank's equipment is available for a separate sort of these items."

Commenters noted that direct presentment would be useful in the case of large-dollar checks. The Bank Administration Institute commented, "Direct presentment does make sense, however, in the case of large dollar items. It is not uncommon for banks to single out large dollar checks for special handling. By presenting these items directly, a bank can often reduce float by accelerating the collection of funds. It also allows banks to determine the collectibility of items more quickly, reducing the risk of loss."

A small number of commenters noted that adoption of this proposal would simply clarify current law that provides that bank payable through checks can be presented directly to the credit union. The American Bankers Association stated, "Currently, old case law and Article 3 of the Uniform Commercial Code (UCC) might suggest that a 'drawee bank' (payor bank) may properly refuse to pay a check made payable through a particular bank when the check is not presented to the drawee by that bank. However, we believe that section 4-204(2) of the UCC * * * already authorizes collecting banks to send items directly to the payor bank. The Board should resolve this ambiguity by stating that banks may present directly to the bank on which the check is written."

The credit union commenters that opposed this proposal indicated that they did not have the operational capabilities to handle direct presentment. The Salt River Project Federal Credit Union, Phoenix, Arizona, commented, "Permitting depository institutions to present a payable through share draft directly to credit unions for payment will create additional operational problems, especially for

small credit unions. Many do not have the personnel nor the cash on hand to respond to direct presentment. They also do not own the equipment to handle direct presentment, and would be reduced to the equivalent of clearing all share drafts by hand! This was the reason the payable through system was set up in the first place, to allow credit unions to offer a transaction account, without the costly capital investment in personnel and equipment. The proposed changes would destroy their ability to offer transaction accounts by destroying the system that allowed them to offer those accounts in the first place."

The Credit Union National Association commented that this proposal would "dismantle the credit union payable through system, thereby eliminating share draft accounts for members of 1,500 to 2,000 small credit unions. Many small credit unions that could afford a local processing option would be put out of the share draft business because they simply cannot handle direct presentments. (Many of them are not capable of handling their own on-us items without depositing them in another financial institution.)"

A number of credit union commenters discussed the cost implications of direct presentment. The Billings Health Affiliated Federal Credit Union, Billings, Montana, stated, "I have 3 full time employee's (sic), including myself, who handle 2,500 members. We could not begin to do the direct presentments. Expenses involved would be a new safe which would run about \$8,000 to \$10,000.00. A new staff person at \$12,000.00 per year and any expenses incurred through purchase of new electronic equipment. My net income YTD for 1988 is \$20,699.04. I am sure you can see that to make the required staff increases and equipment purchases would just not be feasible. We would most definitely have to drop our program."

A few credit union commenters discussed the transportation costs of this proposal. The Missouri Credit Union League, St. Louis, Missouri, commented, "If this proposal is adopted, credit unions receiving a direct presentment from a depository bank would have to arrange for timely delivery of these items to the payable through processor. Besides being a logistical problem it also creates an economic burden. At a minimum, checks would need to be sent by overnight courier service since timely delivery is a key issue. This would result in a minimum daily cost per credit union of approximately \$14. The daily cost to Missouri credit unions would be \$1,400 under this method. For large cash letters,

credit unions would need to consider 'next flight out' arrangements. The daily cost for this type of courier service would be \$1,000."

The majority of the credit union commenters stressed the same reasons for opposing the direct presentment proposal as they used in explaining their opposition to the proposal requiring a local routing number in the MICR line. These commenters cited the cost, lack of operational capability, and the potential dismantlement of the national payable through program if this proposal were adopted. These reasons are more fully articulated in the discussion of the proposal requiring bank payable through checks to bear a local routing number in the MICR line.

Bank commenters opposed to this proposal commented that this proposal does not facilitate the assignment of availability on an automated basis. The Maryland National Bank commented, "Although we conceptually support (the direct presentment proposal) * * * we could not support this option in terms of an actual implementation for the following reason: Again, this option would not permit the automated processing of the credit union drafts. We believe that any option which may require special nonautomated check handling will only weaken the check collection system." The Bank of Boston, Boston, Massachusetts, stated, "The Bank believes that this proposal is unworkable since it does not relieve depository institutions from the onerous task of manual identification of bank payable-through drafts."

Bank commenters also noted that direct presentment was only feasible for large organizations because the majority of banks would not receive enough share draft volume from one credit union in one day to make direct presentment worthwhile. The Alamo Savings Association of Texas commented, "This is not a practical alternative because of the transportation and settlement systems that would have to be developed to accommodate such direct presentment."

A small number of bank commenters discussed the cost implications of the direct presentment proposal. Provident National Bank, Philadelphia, Pennsylvania, commented, "It is also not a feasible alternative because of the large number of credit unions and the costs associated with direct presentment (transportation, cash letter processing and transaction costs). In addition to these costs are the costs associated with the manual outsourcing of items and the manual intervention in those systems used to assign availability to customer deposits."

The Sovran Financial Corporation stated, "* * * to operationally effect direct presentment, we must manually sort through checks (in the case of one major payable through bank, some 30,000 items per day) to separate out those drawn on local institutions. To preserve some semblance of an audit trail, the items drawn on the distant payable through processor, would have to be rerun on our high speed check sorting equipment, and another cash letter created. The smaller groups of items drawn on individual local issuing institutions would similarly have to be rerun. Depending on the internal cost structures of individual banks, the incremental per-item cost to rerun these items could range from \$0.005 to \$0.012 cents per item pass. We estimate, given current annual volumes of payable through drafts cleared through one major national payable through processor, that reprocessing these items would cost us approximately \$70,000 per year—excluding any forward presentment fees that we might also incur. Reconciliation and adjustment costs due to errors following from such a manually intensive endeavor would rise as well." Bank of America estimated that the cost of sorting the checks manually for direct presentment would be \$800,000 per year.

Very few commenters commented on the appropriate lead time for implementation of this proposal. Suggested time frames ranged from immediately upon adoption of the amendment to three to four years after adoption.

The Board believes that there is not sufficient justification to clarify by regulation that a bank payable through check can be presented directly to the bank on which it is written. Therefore, the Board has not adopted this proposal.

Miscellaneous Recommendations. A number of commenters suggested alternatives other than the proposals issued by the Board. A small number of commenters noted that they disagreed with the Board's decision not to appeal the court ruling and urged the Board to appeal the ruling. First Pennsylvania Bank, Philadelphia, Pennsylvania, stated, "* * * we urge the Board to reconsider their previous position on this matter and to appeal the Federal court ruling concerning the treatment of payable through checks."

Some commenters recommended that the Board should seek amendments to the Act. The United BN Credit Union, St. Paul, Minnesota, stated, "Save the taxpayers money by sending your proposals for comment to all Congressmen and suggest they amend

the law. They could amend the law to say checks drawn on local banks are local checks and checks drawn on nonlocal banks are nonlocal checks, PERIOD." The Board supports an amendment to the Act that would amend the definition of "originating depository institution" to mean the branch of a depository institution on which a check is drawn or through which a check is payable. If this amendment were enacted, the payable through bank would be defined as the paying bank in the regulation for the purpose of determining whether a payable through check is a local or nonlocal check.

A number of commenters requested the Board to require that bank payable through checks be deposited with a special deposit slip in order to receive local availability. Marine Midland Bank commented, "If the proposal to MICR encode a routing number which is local to the paying bank is not adopted by the Board, Marine would request the Board to consider permitting banks to require that bank payable through checks be deposited in person with a special deposit slip to a bank employee in order to get availability according to the schedule for local paying banks, if the paying bank is not in the same check processing region as the payable through bank." This would require an amendment to the Act because, under the Act, the Board does not have the authority to lengthen the availability schedules by requiring the use of special deposit slips as a condition for providing local availability to certain payable through checks.

A small number of commenters recommended that the Board should document the fraud, if any, caused by payable through checks and, if necessary, suspend the regulation for payable through checks. The Missouri Credit Union League commented, "Since the Fed has the authority to suspend the Regulation for certain classes of items, this appears to be more than adequate protection for the participants in the check collection system. Rather than be proactive without cause, a more prudent approach is to be reactive with cause."

The Independent Bankers Association of America recommended "that the Board adopt an amendment to Regulation CC requiring credit unions with payable through share draft programs to respond on a timely basis, to all inquiries from depository banks on items over \$500." A similar proposal was issued for public comment in December 1987, which would require banks issuing cashier's or teller's checks or certifying checks to respond to such inquiries. Several commenters on that

proposal indicated that the provision would not protect depository banks completely because many forgeries and counterfeits would go undetected. They also noted that depository banks would not know where to direct the inquiry within the paying bank to obtain reliable information, or may not be able to contact or receive a response from the paying bank within a reasonable time. Therefore, the Board does not believe this proposal should be issued for public comment.

A number of credit union commenters requested that the Board delay consideration of these proposals to allow sufficient time to evaluate the effects of Regulation CC on the check collection system. CBI Oak Brook Federal Credit Union commented, " * * * give the new system a year to function and gather some facts and figures on nonlocal payable-through-bank returns. There might be better ways to solve this liability problem in the future (if it exists) than the proposals that have been made." A number of depository banks have expressed concern about their ability to comply with the revised regulation, and the Board believes it is appropriate to adopt amendments at this time.

Final Regulatory Flexibility Analysis

The Regulatory Flexibility Act (5 U.S.C. 601-612) requires an agency to publish a final regulatory flexibility analysis when it promulgates a final rule. Two of the requirements (5 U.S.C. 603(a) (1) and (2)) of a final regulatory flexibility analysis, (1) a succinct statement of the need for, and the objectives of, the rule and (2) a summary of the issues raised by the public comments in response to the initial regulatory flexibility analysis, a summary of the assessment of the agency of such issues, and a statement of any changes made in the proposed rule as a result of such comments are contained in the supplementary material above.

A third requirement of a final regulatory flexibility analysis (5 U.S.C. 604(a)(3)) is a description of each of the significant alternatives to the rule consistent with the stated objectives of applicable statutes and designed to minimize any significant economic impact of the rule on small entities which was considered by the agency, and a statement of the reasons why each one of such alternatives was rejected. As described in the above preamble, the Board included in its initial proposal several alternative rules, and requested and received comment on the cost and risk associated with each alternative for all affected entities, both

large and small.

After considering the comments and the costs and benefits of the various alternatives on the affected entities, the Board adopted a final rule which it believes will have the minimum impact on small entities, generally credit unions, while still achieving the objectives of the rule. The reasons for the Board's final determinations are more fully described above. The Board did not, however, either propose or adopt an exemption from coverage for small institutions that use payable through checks. The purpose of the rules published today is to alleviate the operational difficulties and risk associated with the acceptance of payable through checks by depository banks. This purpose would be defeated if the rules did not apply to small institutions that use payable through checks because the operational and risk problems for their checks would remain.

List of Subjects in 12 CFR Part 229

Banks, banking; Federal Reserve System.

For the reasons set out in the preamble, 12 CFR Part 229 is amended as follows:

PART 229—AVAILABILITY OF FUNDS AND COLLECTION OF CHECKS

1. The authority citation for Part 229 continues to read as follows:

Authority: Title VI of Pub. L. 100-86, 101 Stat. 552, 635, 12 U.S.C. 4001 et seq.

2. In § 229.36, the heading is revised and a new paragraph (e) is added to read as follows:

§ 229.36 Presentment and issuance of checks.

(e) *Issuance of payable through checks.* A bank that arranges for checks payable by it to be payable through another bank shall require that the following information be printed conspicuously on the face of each check:

(1) The name, location, and first four digits of the nine-digit routing number of the bank by which the check is payable; and

(2) The words "payable through" followed by the name and location of the payable through bank.

This provision shall be effective February 1, 1991, and after that date banks that use payable through arrangements must require their customers to use checks that meet the requirements of this provision.

3. In § 229.38, paragraph (d) is redesignated as paragraph (d)(1), a new heading is added to paragraph (d), and a

new paragraph (d)(2) is added to read as follows:

§ 229.38 Liability.

(d) *Responsibility for certain aspects of checks—(1)* * * *

(2) *Responsibility for payable through checks.* In the case of a check that is payable by a bank and payable through a paying bank located in a different check processing region than the bank by which the check is payable, the bank by which the check is payable is responsible for damages under paragraph (a) of this section, to the extent that the check is not returned to the depository bank through the payable through bank as quickly as the check would have been required to be returned under § 229.30(a) had the bank by which the check is payable—

(i) Received the check as paying bank on the day the payable through bank received the check; and

(ii) Returned the check as paying bank in accordance with § 229.30(a)(1).

Responsibility under this paragraph shall be treated as negligence of the bank by which the check is payable for purposes of paragraph (c) of this section.

4. Appendix E—Commentary to Part 229 is amended to read as follows:

a. Section 229.36 is amended by revising the heading and adding a new paragraph (e).

Appendix E—Commentary

Section 229.36 Presentment and issuance of checks

(e) *Issuance of payable through checks.* If a bank arranges for checks payable by it to be payable through another bank, it must require its customers to use checks that contain conspicuously on their face the name, location, and first four digits of the nine-digit routing number of the bank by which the check is payable and the legend "payable through" followed by the name and location of the payable through bank. The first four digits of the nine-digit routing number and the location of the bank by which the check is payable must be associated with the same check processing region. (This section does not affect § 229.36(b).) The required information is deemed conspicuous if it is printed in a type size not smaller than six-point type and if it is contained in the title plate, which is located in the lower left quadrant of the check. The required information may be conspicuous if it is located elsewhere on the check.

If a payable through check does not meet the requirements of this paragraph, the bank by which the check is payable may be liable to the depository bank or others as provided in § 229.38. For example, a bank by which a

payable through check is payable could be liable to a depository bank that suffers a loss, such as lost interest or liability under Subpart B, that would not have occurred had the check met the requirements of this paragraph. The bank by which the check is payable may be liable for additional damages if it fails to act in good faith.

b. Section 229.38 is amended by redesignating the first three paragraphs of paragraph (d) as paragraph (d)(1); by adding a new heading to paragraph (d); by adding a new paragraph (d)(2) to follow newly redesignated paragraph (d)(1); and by revising the last paragraph of paragraph (d) to read as follows:

Section 229.38 Liability

* * * * *

(d) *Responsibility for certain aspects of checks.*—(1) * * *

(2) *Responsibility for payable through checks.* This paragraph provides that the bank by which a payable through check is

payable is liable for damages under paragraph (a) of this section to the extent that the check is not returned through the payable through bank as quickly as would have been necessary to meet the requirements of § 229.30(a)(1) (the 2-day/4-day test) had the bank by which it is payable received the check as paying bank on the day the payable through bank received it. The location of the bank by which a check is payable for purposes of the 2-day/4-day test may be determined from the location or the first four digits of the routing number of the bank by which the check is payable. This information should be stated on the check. (See § 229.36(e) and accompanying Commentary.) Responsibility under paragraph (d)(2) does not include responsibility for the time required for the forward collection of a check to the payable through bank.

Generally, liability under paragraph (d)(2) will be limited in amount. Under § 229.33(a), a paying bank that returns the amount of \$2,500 or more is not returned through the payable through bank as quickly as would

have been required had the check been received by the bank by which it is payable, the depository bank should not suffer damages unless it has not received timely notice of nonpayment. Thus, ordinarily the bank by which a payable through check is payable would be liable under paragraph (a) only for checks in amounts up to \$2,500, and the paying bank would be responsible for notice of nonpayment for checks in the amount of \$2,500 or more.

Responsibility under paragraphs (d)(1) and (d)(2) is treated as negligence for comparative negligence purposes, and the contribution to damages under paragraphs (d)(1) and (d)(2) is treated in the same way as the degree of negligence under paragraph (c) of this section.

By order of the Board of Governors of the Federal Reserve System, July 28, 1989.

Jennifer J. Johnson,

Associate Secretary of the Board.

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