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IMPLEMENTATION OF THE CHECK CLEARING FOR THE 21st CENTURY

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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IMPLEMENTATION OF THE CHECK CLEARING FOR THE 21st CENTURY

Wednesday, April 20, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:15 p.m., in Room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] Presiding.

Present: Representatives Bachus, Tiberi, Feeney, Hensarling, Neugebauer, Price, Sanders, Maloney, Watt, Waters, Ford, McCarthy, and Baca.

Chairman BACHUS. Good afternoon. The subcommittee will come to order.

Today we are focused on the implementation of Check 21, which facilitates the movement of checks through the payment system by making it easier to transport check images electronically between banks.

This legislation passed the House of Representatives on June the 5th of 2003. It was called the Check Clearing For the 21st Century Act, or as we refer to, Check 21, and it actually passed by a vote of 405 to 0. It was signed in the law by the President October 28th of that year. So it has been coming up on 2 years, or a year and a half, but actually only became effective, I think, 6 months ago. So today's hearing was requested by Representative Frank, Representative Sanders and Representative Maloney, and a host of others, but primarily the three of you all. And it also is a priority of Chairman Oxley and myself, because we are all concerned about—because of issues which have been raised since the passage of Check 21.

Check 21, I believe, is an innovative measure which aims to modernize the Nation's check transportation system by providing an interim step toward the electronic movement of checks. Although the goals of Check 21 are significant, the Act itself has a relatively narrow focus, making substitute checks legally equivalent to original checks, thereby facilitating electronic check presentment.

This change in law was necessary because most banks, aside from some of the larger ones, didn't have the resources to accept electronic check images. These banks will now be able to request that a substitute check be created in lieu of electronic image, which can then be processed like a traditional paper check.

Over 36 billion checks are processed annually through the payment system in the United States. The vast majority of these checks are physically transported from one bank to another for payment. This system has historically relied on the steady flow of air and ground transportation in order to ensure that the checks are presented to paying banks in a timely manner. That way of doing business has been in practice for more than a hundred years, and the technology that is being used today dates to the 1950s.

Perhaps the most dramatic example of the need for this legislation was demonstrated in the aftermath of September 11th. As everyone remembers, for approximately one week, planes were not allowed to fly. This prohibition extended the flights carrying checks through the payment system. Over the course of that week, billions of dollars afloat built up in the system, and the Federal Reserve was forced to come up with alternative methods for transporting checks. One of the primary goals for Check 21 was to ensure that if there were future problems with the Nation's transportation system, the financial system and the payment system within it would continue to function.

It is important to note that the consumer protections under current check law continue to apply under Check 21, in fact, Check 21 goes further, and in that legislation, we granted additional protections through an expedited recredit if a customer asserts that an electronic check or substitute check was improperly charged against their bank account. In addition, the legislation requires banks to provide warrantees for substitute checks, and to indemnify customers for losses resulting from the receipt of a substitute check rather than the original one.

Since the enactment of Check 21, there has been some confusion—and this is probably the most important part of my statement right here—since the enactment of Check 21 there has been some confusion as to the impact this law has had on consumer accounts. The reality is that Check 21 is still in its infancy. Of the 50 million checks processed by the Federal Reserve every day, there are only about 400,000 digital image or substitute checks being handled daily. In fact, I think, Director Roseman, you give a number in your testimony that matches pretty much that figure. So less than 1 percent of our checks are being electronically cleared today, or about 1 percent.

The vast majority of those checks are still physically transported from one bank to another for payment.

This is less than 1 percent of all checks. What has occurred—and this is where the confusion comes in—what has occurred at about the same time is an increase in ACH transactions appearing on consumer bank accounts at a time when the publicity surrounding Check 21's enactment was at its peak. The result was that many consumers believed that the ACH transaction on their statement is actually a Check 21-related transaction. It has nothing to do with Check 21, it is ACH. I hope today we can clear up some of the confusion of what Check 21 does and does not do, as well as learn more about ACH transactions and whether we have a problem there.

Because there has not been widespread adoption of Check 21 to date, there has not been a significant reduction in the time it takes

to clear checks. The Federal Reserve expects Check 21 to become widely used by the private sector by 2008. In addition, Federal Reserve is required, under Check 21, to study the impact of the new law on the U.S. Payment systems to determine if there are reductions in the time periods that it takes to clear a check.

If the Federal Reserve finds that the time period for clearing checks is reduced, then it must also reduce the permitted hold times that banks may place on checks. Chairman Oxley and I have been concerned that banks would reduce check processing times without reducing hold times. Accordingly, Chairman Oxley, Congressman Hart and Congressman Tiberi and I have sent a letter to the Banking Trade Associations urging them to provide customers timely access to their funds as check processing times are reduced.

As the time period for transportation of checks are reduced by greater electronic processing, simple fairness would seem to dictate that consumers should also realize the benefits of quicker credit for their deposits.

Let me close by saying what we said in our letter to the Trade Association. Holding a deposit to ensure its safety and soundness is reasonable, but holding a deposit in order to profit from the interest is completely unacceptable. The latter practice prevents consumers from realizing the benefits of their own assets while creating an illegitimate revenues straining for financial institutions. It unfairly penalizes consumers, and should be eliminated from the U.S. Payment system.

With having said that, I see no evidence that we are seeing that today. What I do see is that people are having ACH payments deducted, and that is causing a problem because it is reaching their account quicker than their customary experience.

The chairman now recognizes Mr. Sanders, the ranking member of the subcommittee, for any opening statement that he would like to make. And I did hear today that Senator Jeffords is retiring, so I really didn't expect him to be here, I thought he would be up in Vermont. We welcome you to the hearing.

Mr. SANDERS. Thank you. And Mr. Bachus, thanks very much for holding this hearing, we appreciate your listening to people on this side of the aisle.

And this hearing is dealing some major problems that have arisen as a result of the passage of the Check Clearing Act for the 21st Century.

As a result of Check 21, banks are now able to process checks electronically, reducing to minutes or hours the time it takes for the money to be deducted from the check writer's account. This will allow banks to save an estimated $2 billion each and every year in paper processing costs.

Mr. Chairman, as you may recall, when we were considering this bill, I and some other members expressed major concerns that there were absolutely no requirements in that legislation for banks to pass along those savings to consumers in terms of lower fees; but it gets worse. Not only will consumers see no savings as a result of Check 21, but according to the consumers union at the Consumer Federation of America, as a result of Check 21, consumers will bounce an estimated seven million more checks a month and

pay an additional 170 million in monthly bounced check fees. That is because they did not require—we did not, as a Congress, require banks to change the length of time the banks can hold deposited checks before making the funds available to consumers, up to 2 days for local checks, 5 days for non-local checks, and 11 days for checks over $5,000.

For example, if consumers deposit their paychecks on Friday, they can't safely write checks for this money until the following Tuesday without the possibility of having their check bounce. If consumers deposit checks late in the day on Friday, banks can make them wait until Wednesday to use the money to pay their bills. If their paycheck comes from a nonlocal bank, their bank can make them wait a full week, 5 business days plus one weekend. Banks can even make consumers wait through two weekends if they deposit checks on a Friday after the bank's cutoff time. This is unfair. To correct these problems, I am a proud co-sponsor of the Consumer Checking Account Fairness Act, which was introduced by Congresswoman Maloney, and I am sure in a moment she will be talking about some provisions in that legislation.

Mr. Chairman, the bottom line is that consumers should be entitled to the same advantages as banks when it comes to check clearing. But Mr. Chairman, this is just one of a myriad of predatory lending tactics being perpetrated by the banking industry. The unfortunate fact of the matter is that today's modern day loan sharks are no longer lurking on street corners, but they are taking advantage of consumers in many, many other respects. So we have a problem here. And I thank you very much for your willingness to call this hearing, and I return the microphone to you.

And I apologize for stepping out, but you mentioned the reason why, and I will be back later.

Chairman BACHUS. Thank you.

And Ms. Maloney.

Mrs. MALONEY. Thank you so much, Chairman Bachus, for holding this hearing, which we requested, and I am glad that we are holding it to address the issue arising from the evolution towards electronic funds transfer in the banking and financial services industry.

According to the Federal Reserve study, over 55 percent of all transactions are now electronic. Last year Congress gave that trend a boost by passing the Check 21 Act, which allows banks to clear checks electronically without meeting a prior agreement with the other banks involved. Banks and the Fed argued that this bill will enable them to realize efficiencies of cost and speed, and improve on cost to consumers. This committee fully supported that goal. The United States is way behind much of the developed world in terms of the speed and efficiency of our banking system.

However, I am concerned that while withdrawals by paper checks and increasingly electronically are becoming instantaneous, deposits including cash, paper checks and electronic transactions are still subject to long deposit holds set by the Fed about a quarter of a century ago and was outlined by Congressman Sanders. This creates a structural imbalance which disfavors consumers and is not good public policy.

I have introduced a bill, and I have also written to the Fed, along with my colleagues on this issue. My bill is H.R. 719, the Consumer Checking Fairness Act, to address this imbalance, and I hope this committee will move this legislation forward. But I also hope that financial institutions and banks themselves will take steps to address the issues created by the rapidly increasing move to electronic funds transfer, and invest willingly on their part in the technology necessary to speed up deposits as well as checks.

And I hope to hear from our witnesses that banks are taking steps to address these problems. And I welcome the speakers today, and thank you for having the hearing.

Chairman BACHUS. Thank you. Ms. McCarthy or Mr. Baca. Either of you wish to make an opening statement?

Mr. BACA. Yes.

Chairman BACHUS. Mr. Baca, you are recognized, the gentleman from California.

Mr. BACA. Thank you very much, Mr. Chairman. I would also like to thank the witness for being here today to testify in the implementation of Check 21, and let us know what the status and how it is implemented and how it works, and then also look at any flaws, if there are any flaws, and what flaws need to be corrected as well.

I was proud to vote for Check Clearing 21 Century Act in year 2003. Congress realizes that this legislation would provide a way for banks and consumers—and I will state for banks and consumers—to take advantage of new technology for the purpose of convenience, while also assuring stability of our payment system. By enacting this law, we are accepting the fact that times are changing. We all have to realize that one day, future generations may never learn what a paper check is, although we need cross and balance.

Early into the 21st century, we will also discover that there are growing pains—and those are the pains that we need to answer and questions that we hopefully will address—in accepting new and more convenient ways of banking. As we work through the implementation of Check 21, I hope the Congress will do what it can to limit the negative—and I state the negative effects these growing pains may have on our consumers. And that is a concern for all of us, and that is the reason for having this hearing.

Check 21 allows checks to clear faster, which may be positive, may be negative, which also is convenient for banks, merchants and creditors, but we have not yet perfected allowing consumers to benefit from the same convenience. We must look at whether banks should adjust the amount of time they hold on check deposits—which is something I hope we will consider—and how soon it can be done. We must learn how to decrease the effects that our country's shift towards electronic payments may have on our poorest consumer, and who must count every penny to make ends meet.

A lot of times, many of them live paycheck to paycheck, they don't balance their checks on time, and sometimes when it clears and the effects it has on them, so hopefully we can look at this.

Until the electronic conveniences of Check 21, these consumers will rely on the float period for all of the transaction. The poor may be the most affected by the possibility of dual debits where a check

is presented twice for payment, and sometimes these families cannot afford them, and then what additional charges will be done with them as well is very much our concern.

I hope to hear these and other concerns addressed during the testimony today. I look forward to the discussion today on how to improve the implementation of Check 21 and provide convenience and benefits equally to all who may enjoy them.

Thank you very much, Mr. Chairman. I yield back the balance of my time and look forward to our hearing.

Chairman BACHUS. I am told no other member has an opening statement, so at this time, we welcome Ms. Louise Roseman, Director of the Reserve Bank Operations and Payments Systems with the Federal Reserve Board of the United States. We welcome you, Ms. Roseman, for an opening statement.

STATEMENT OF LOUISE ROSEMAN, DIRECTOR, DIVISION OF RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

Ms. ROSEMAN. Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee, I appreciate this opportunity to discuss the initial implementation of Check 21.

As background, I thought it would be helpful to first review the trends and the use of checks and electronic payments. It was only 2 years ago, for the first time ever, that businesses and consumers began making more payments electronically than by check. In the past decade, the number of check payments in the United States has declined by more than 25 percent, from roughly 50 billion in 1995 to less than 37 billion in 2003, and the rate of decline has been accelerating in recent years.

In contrast, electronic payments have tripled during the same period. This is a dramatic shift in the way payments are made in this country, and is resulting in a less costly payment system. The declining use of checks is only part of the story. Although Americans will continue to write checks for many years to come, the way these checks are collected will evolve substantially as a result of Check 21.

This very important law, which was enacted with the strong leadership of this committee, is laying the foundation for substantial improvements in the check collection system. Like other significant operational or technological changes, the adoption of electronics in the check system will be gradual. The check collection system did not change materially last October 28th when Check 21 took effect. To date, relatively few banks have begun to take advantage of the opportunities it provides. The Federal Reserve Banks have been among the industry leaders in making use of the Check 21 authorities, but thus far, as the chairman mentioned, their Check 21-related volumes are relatively small, less than 1 percent of the 50 million checks the Reserve Banks process each day. Clearly, this is an evolutionary, not a revolutionary process.

For the banking industry to fully leverage the efficiencies Check 21 makes possible, additional steps must be taken. For example, banks must invest in new technologies and adjust their operations to make best use of them. They must also ensure that their systems work with those of other banks. As banks improve these capabilities, they can reduce their reliance on air and ground transpor-

tation, and on paper check processing, thereby reducing their operating expenses.

While the pace at which these changes will occur is not certain, I believe that a decade or so from now our check collection system will look much different than what it does today. Though we will likely still be writing checks, I expect that their number will be substantially lower, and that most of them be will be collected electronically.

Turning to the issue of check holds, the Federal Reserve Board has been monitoring these ongoing developments in our check collection system to determine when changes to the funds availability policies may be appropriate.

The Expedited Funds Availability Act, which Congress enacted back in 1987, sets the maximum permissible holds that banks can place on check deposits based on two factors; one, the desirability of providing customers with timely access to their funds, and two, the need for banks to manage their risk of check fraud.

In the Expedited Funds Availability Act Congress directed the Federal Reserve Board to reduce the maximum check holds for a category of checks, for example, nonlocal checks, based on when banks can reasonably expect to learn of the nonpayment of most of those checks. We take these responsibilities very seriously. While we have not yet seen sufficient improvements to justify reducing the hold period, the Board will reduce the availability schedules when we find that there has been sufficient improvement in the check collection and return times.

It is important to recognize, however, that many banks routinely provide faster availability to their customers than the law requires. Moreover, many consumers have also been getting faster access to funds over the last several years as a result of the Federal Reserve Banks' initiative to reduce their check processing infrastructure in the face of declining check volumes.

When Congress passed the Expedited Funds Availability Act, it defined local checks as checks where the bank of first deposit and the paying bank are both located in the same Federal Reserve check processing region. Therefore, as the Reserve banks combine some of their check processing regions, some checks that were once considered non local are now or will in the future be defined as local, subject to the shorter 2-day holds.

Turning to consumer issues more generally, the Federal Reserve is actively working to provide accurate information about the changing way payments are made, including Check 21, as well as another different process, electronic check conversion, which is often confused with Check 21. We have published several consumer brochures and placed additional information on our public Web site that explains what Check 21, substitute checks, and electronic check conversion are all about.

I would like to conclude by stressing how important Check 21 is to the future of the U.S. Check system. I believe this law will prove to be a catalyst for major change. Ultimately Check 21, as well as electronic check conversion, will facilitate the move to a more efficient and more electronic U.S. Payment system.

In a competitive banking system such as ours, bank customers share in the benefits resulting from efficiency gains, and we expect

that bank customers will likewise share in the gains that will accrue over time from the implementation of Check 21. And as warranted by improvements in the check system, the Federal Reserve Board is committed to reducing the maximum holds banks can place on check deposits for the further benefit of consumers.

I would be pleased to answer any questions that you may have. Thank you.

Chairman BACHUS. Thank you, Ms. Roseman.

[The prepared statement of Louise Roseman can be found on page 84 in the appendix.]

Chairman BACHUS. Let me first go to Mr. Neugebauer.

Mr. NEUGEBAUER. I assumed the chairman was going to ask his questions first.

Chairman BACHUS. I apologize. I was going to let some of the members—I will ask one question, and then I will yield to you.

Mr. NEUGEBAUER. Thank you.

Chairman BACHUS. Some have claimed that by reducing float in the check processing system, Check 21 will lead to sharp increases on the number of checks drawn on insufficient funds, allowing banks to collect large overdraft protection fees from consumers. Is this a legitimate concern in your view?

Ms. ROSEMAN. We haven't seen any evidence that that has happened. Actually, experience to date has shown that most checks that are being collected differently, due to the Check 21 authorities, are typically checks that don't involve consumer accounts. For example, within the Federal Reserve Banks, when I mentioned that less than 1 percent of the checks collected rely on the Check 21-related authorities, the average size of those checks is about $14,000. So we are talking mostly about business checks here so far. That is going to change in the future.

One of the things that we have tried to do with our consumer education effects is to emphasize the point that consumers should have the money in their account when they write checks. When you write a check, that check is payable on demand. So you shouldn't be able to rely on the fact that there is a certain delay between the time you write a check and the time that it is posted to your account. This is something that I think is important for consumers to recognize. But as we reduce the float in the payment system, we are also increasing the efficiency of the payment system.

Chairman BACHUS. Okay. Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you. You stated in your testimony that you all have been reviewing the hold times and have not found any evidence that there is a need to reduce any of those at this time; is that correct?

Ms. ROSEMAN. That is true at this time. I expect that that will not always be true in the future. I think as the implementation of Check 21 really picks up speed, hopefully we will see sufficient improvements to warrant reducing the holds, but that has not happened yet.

Mr. NEUGEBAUER. Is the reason that you have not made a decision to reduce those hold times is that you believe that these current minimums are at a level that you are protecting the bank's ability to protect themselves against overdraft or insufficient checks?

Ms. ROSEMAN. That is true. That is what Congress was looking at when they legislated check holds, and really the standard that they asked the Federal Reserve Board to look at in determining whether it was appropriate to reduce the maximum hold periods. We only have authority to reduce those holds when we find for a particular category of checks, the bank of first deposit will learn of the return of most of those checks in a shorter period of time. We don't have the authority to reduce check holds unless that standard is met, and thus far it hasn't been, but hopefully in the future it will be.

Mr. NEUGEBAUER. I was really surprised by the tremendous drop in just a relatively short period of time in the number of checks that are in the system because I remember in my old banking days, back in the—whatever—that, you know, that was a big part of the bank's operation, the checks clearing. Do you attribute a lot of that to—is that coming from online banking, or is that coming—where is the reduction? I guess credit cards would be another, but what do you think the largest contributor to that is?

Ms. ROSEMAN. I would say that within the last decade, the largest contributor has been the explosive growth of debit cards; they have replaced a great number of check transactions.

Also, as you mentioned, credit cards have been growing at a slower, but still strong rate. And ACH transactions have also been growing at double digit rates each year. So increasingly a lot of consumers are not only getting their payroll deposited directly, but also they are having recurring payments like their mortgage payments or utility payments or insurance payments withdrawn from their account automatically through the ACH systems. So all of those contribute to the decline in check volume.

Mr. NEUGEBAUER. And you mentioned the future of Check 21 was an evolutionary process. I remember another evolutionary process that was initiated back in the 1970s, and it was called an ATM card, and it took a little while for that to catch on. Do you feel like things are progressing? Is there some things that could be done to encourage more of the financial institutions to get involved in Check 21?

Ms. ROSEMAN. Actually, I think that the banking industry has been paying a great deal of attention and investing a lot of money in building up the capabilities to be able to use the Check 21 authorities. But as we learned with the Federal Reserve Banks, the software needed to do this is pretty complex, it requires a lot of testing with their counterparties. So there are some things that you need a period of time to be able to implement and have run smoothly. But I don't think it is a lack of interest or preparatory work on the part of the banking industry, I think within the next year or two, we will see a lot greater use of Check 21 authority than we do right now.

Mr. NEUGEBAUER. Is the technology getting better? Are there more companies involved in developing the technology, or is it just one or two?

Ms. ROSEMAN. Many third-party vendors that provide software to banking industry have been developing capabilities within their software to be able to leverage the Check 21 authorities. So once an increasing number of vendors have completed that software

work and made that software available to their banking customers, I think we will see a big increase in usage.

Mr. NEUGEBAUER. Does the Federal Reserve have to certify any of those vendors for compatibility? Is there a process for——

Ms. ROSEMAN. There is a testing process that the Federal Reserve Banks use before they will accept electronic files from a bank depositing checks with us with check images electronically. We do testing with them just to make sure that the way they are providing the file to us is appropriate and in a way that we can read before they start doing it live. And we have discovered that there are some banks that think they are totally ready, but when we test, we realize there may be some further work to do or some glitches in their software they need to work out. But it is something that just takes a bit of time, and then they come up and running and start using it and doing it well.

Mr. NEUGEBAUER. Thank you. Thank you, Mr. Chairman.

Chairman BACHUS. Ms. Maloney, do you want me to give you the additional 2 minutes?

Mrs. MALONEY. Thank you.

You indicated in your comments that deposit hold periods should be shortened only when two-thirds of paper checks are clearing faster, correct?

Ms. ROSEMAN. Well, I said that that was the standard that Congress suggested in the legislative history to the Expedited Funds Availability Act, so it is not something that the Federal Reserve Board made up as a standard, we are just relying on what the legislative history for the Expedited Funds Availability Act suggested.

Mrs. MALONEY. Well, I have serious questions as to whether this is good public policy in the present environment when check clearing is absolutely immediate.

And it appears that financial institutions really don't have much incentive to speed up deposit holds to match check clearing. And shouldn't we, meaning Congress and the Fed, be encouraging them to invest in new technology that would enable real-time deposit clearing to match real-time check clearing?

Ms. ROSEMAN. Actually, surveys that have been done in the past showed that in this particular instance, I think the competitive marketplace is working very well, that many, and I believe most banks provide customers availability faster than what is required by law. So this is something that is fairly pervasive in the banking industry now.

Mrs. MALONEY. Well, that is good news because deposit holds now apply to cash and electronic transfers as well, and at least for these, there is absolutely no reason not to reduce holds. And you are saying industry is doing that on their own; is that correct?

Ms. ROSEMAN. Yes. And for electronic credits and for cash, that must be made available on the next day following deposit. And the only reason that Congress had said that that was a next day availability is that when you make funds available for withdrawal, you have to make it available for withdrawal as of the start of business on that day. So if I deposit cash in my checking account at one o'clock in the afternoon there is no way that the bank can make it available from the start of business, so it must be available tomorrow morning.

Mrs. MALONEY. And with Congress saying that the Fed will only take action when banks have decided to clear two-thirds of paper checks faster, aren't we, in effect, shackling regulation to the slowest and most inefficient segment? Just mathematically, as the segment of transactions and paper checks continue to shrink, two-thirds of that number gets smaller and smaller until a tiny number of paper checks holds up the whole system.

Ms. ROSEMAN. When the expedited Expedited Funds Availability Act was working its way through Congress, and Congress was debating what theory to use for check holds, as you may remember before that time, many banks had very long holds on customer deposits, up to a month or so; and what they were doing is they were looking at how long it takes checks to get returned unpaid. And generally, it is a curve with a very long tail. And what Congress said is, we are not going to try to set the holds to ensure that every single check that may be returned is returned before you have to give the funds up, but we want to make sure that you at least have a reasonable opportunity to learn if most checks. And so they basically cut off that long tail at the end, but said that we don't want to have someone who wants to commit check fraud to have a high degree of probability that they would be able to withdraw the funds before their bank learned that the check that they deposited was bad. But if Congress——

Mrs. MALONEY. Why not shorten holds when checks are being processed more quickly these days?

Ms. ROSEMAN. One of the things—when you look at why Congress set the holds that it did, it wasn't looking at how quickly it takes to clear checks, but how quickly the bank of first deposit will learn of a check if it comes back return unpaid. And the way the check system works, it works basically on a no-news-is-good-news kind of basis, that banks don't get any affirmative notice if a check has been paid, it only learns by the ultimate return of the check if it hasn't been paid. And so it has to wait a period of time to see whether the check comes back bad in order to protect itself in some cases where they consider higher risk situations before giving the funds—making them available for withdrawal. So that was the theory behind the law that we are implementing.

Mrs. MALONEY. You keep mentioning what Congress said in Check 21, and I strongly supported that legislation. Are you saying that the Feds should not set standards in this area? I know that a number of us have written the Fed and have requested that the Fed come forward with standards, are you saying that this is an area that the Fed should not speak or have any input?

Ms. ROSEMAN. No. I think this is an important responsibility of the Fed, but what we are doing is exercising the authority that Congress gave us. And Congress gave us the authority to reduce check holds if a certain test is met. So when that test is met, we would certainly reduce the holds, but we would not have the authority to do so unless that test is met.

Mrs. MALONEY. But under that test, aren't you saying that until financial institutions or banks have decided to move that very last check faster, even while all other transactions are electronic, they won't have to do anything about deposits?

Ms. ROSEMAN. No. We are not basing the holds based on when the last check gets back, we are doing it based on when most checks are returned to the bank of first deposit.

You know, one of the things that also—that I mentioned in the testimony that is really I think acting as a newer term impetus to really improve consumer availability is redefining what is local and nonlocal, because local checks must be made available no later than two business days after deposit. Over time, as the number of Federal Reserve checks processing regions decline, the number of checks that are considered local will continue to grow.

Back in the beginning of 2003, the Fed had 45 check processing regions, by early next year, they will have 23, about half of that number, and the number is only going to decline after that. So in increasingly large area for any consumer account, that they could have checks drawn on banks in a larger area and still have them considered local subject to the shorter hold.

So I think that will probably have more dramatic near-term impact for consumers.

Mrs. MALONEY. Well, my time is up, and thank you for testimony.

Ms. ROSEMAN. Thank you.

Chairman BACHUS. Thank you.

Mr. Feeney.

Mr. FEENEY. Thank you, Mr. Chairman, and thank you for your testimony.

Could you tell us in your opinion—this is fairly new, but with respect to Check 21 and the electronic check conversion, are there some new opportunities for fraud, for criminals to take advantage of the system that didn't exist, either in the credit card system or the check cashing system, which you are familiar with?

Ms. ROSEMAN. I think on net, Check 21, over time, will reduce the opportunities for check fraud, because over the longer term what our expectation is, is that Check 21 will encourage more electronics in check clearing, and that ultimately we will have faster collection and return times so that banks will learn sooner than they do today of checks that are coming back unpaid.

Now, as an offset to that, there have been some organizations that have been somewhat concerned with moving to Check 21 because they currently have security features on the physical checks that they have, they may have microprinting on the signature line, they may have water marks on the check, those particular security features don't withstand imaging of that check. So if they rely in looking at that in order to pay or not pay a check, those security features may not be available to them in this new world.

But what the industry is doing now is they are looking at a new generation of security features that would go on checks that would withstand the image process. So it would be more electronic features that would be built into checks that you would be able to determine whether the check is genuine or not. So that is something that is currently being pursued by the industry.

Mr. FEENEY. Are there folks in the industry that are paying attention to the biometric requirements we are engaging in for new passports that are issued by the 26 visa waiver countries in terms of identifying who you are dealing with, and is that an opportunity

to reduce fraud, both in the debit card, credit card and ultimately in the electronic check cashing field?

Ms. ROSEMAN. I have not heard of using that particular technology, but that may be a question to pose to the banking industry witnesses later.

Mr. FEENEY. And I am interested, if you can predict in the future, where we are going, we know we have more electronic payments, we know we have got more debit cards, we know we have got less checks, both locally and that go through the Federal Reserve if they are nonlocal. It occurs to me that as we streamline this, one day I ought to be able to do everything I need by a home computer or a carried computer, or with one basic card, and that card—tell me if this animal exists today , a combination debit card and credit card. I sent $10,000 to whoever is the card issuer, and in addition, I have a $10,000 line of credit. Are there such things as a combination debit credit card in existence today?

Ms. ROSEMAN. Frankly, I am not sure if there is or not. I think technologically that would certainly be possible. But I don't know whether banks have issued joint cards or—you know, one way that gets a little close to that is if you have a debit card where your checking account has an overdraft line of credit, you can have debit and credit features on the same card, and once you exhaust your account balance, you would be tapping your credit line. But I think you are talking about a situation that on a transaction-by-transaction basis, you make the decision of whether to use the card as a debit card or credit card. I think typically people have two cards in their wallets, but I don't know that that is essential that they do so.

Mr. FEENEY. Well, some people have 22, but it would be nice to have one.

Does the Federal Reserve have any jurisdiction over things like gift cards, other payroll devices? I mean, we have got prepaid phone cards, department stores now are issuing these things. Do you have any—your entity deals with check clearing or credit clearing, do you have any regulatory authority over those folks?

Ms. ROSEMAN. As part of our authority to implement the Electronic Fund Transfer Act, we have been looking at the applicability of that act to certain types of prepaid cards, and for example, we currently have a proposal that had gone out for comment, the board has not yet taken final action, looking specifically at payroll cards and how Regulation E should apply to those cards.

Mr. FEENEY. Well, I ask you to do that. I hope that if you have time you can respond; but I hope you will take a look at the issue of slippage. I just recently came across a 4-year-old gift card for a hundred dollar restaurant, of course, it expires after a year. And you know, I am confident that people lose these cards, that they forget to use them. What happens—there is a huge advantage to the retailer or the merchant if they issue a hundred dollars worth of prepaid credit and then there is a big slippage in the system; and as you move to this, I hope it is something that if you have jurisdiction, you will take a look at.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. And what we are doing is going in the order that the members came.

I have Ms. McCarthy next.

Mrs. MCCARTHY. Thank you, Mr. Chairman.

I want to ask one question. With brokerage firms, now that basically offer checking accounts within the whole package, are they covered also under Check 21? Being that you would have a checking account with that particular brokerage firm?

Ms. ROSEMAN. The Check 21 authorities apply to banks; but, for example, a brokerage firm, if you have a CMA type account where you can write checks against your money market account, those checks are drawn on a bank. That bank could then truncate those checks and process them electronically. Also, brokerage firms have been interested in Check 21 authority for the checks that they accept for deposits. You think of a lot of brokerages which have offices all around the country, they have bank accounts locally because they take in check deposits at their local offices, they don't take cash, but they do take checks, so they have to manage a large number of local bank accounts.

What some of them have been talking about is putting image technology in each local office so when their customers bring in a check, it would be imaged and sent directly to whatever their central bank account is to then be collected. And they would be able to do that if the bank they deposit it in agrees to accept it from them and the bank agrees to accept the warrantees that they would be providing when they put it into the check collection system. Under Check 21, only the banks would be providing the warranties, but they could extend it to their customers by agreement and take the risk.

Mrs. MCCARTHY. So in other words—and I did support Check 21, and I still do support it—with that being said, I guess what I am trying to find out is then whose responsibility would it be to get a copy of the check from, or to have even the image of the check sent back to the consumer, me? The brokerage firm or the bank that they are dealing with?

Ms. ROSEMAN. That is something I think I would need to get back with you on in writing just to make sure I give you the right answer on that.

Mrs. MCCARTHY. Okay. Thank you.

Ms. ROSEMAN. Thank you.

Mrs. MCCARTHY. The other thing I wanted to ask, there is an awful lot of information on checks, and obviously—I know from reading the testimony on the second panel we are going to be talking a little bit more about fraud, but why do they do it? But people still apparently put their Social Security number on checks—hopefully we can get that message out that they should never do that in my opinion—or their full credit card number. Is the chance of ID theft greater with substitute checks than with cancelled payment checks in the consumer's home? And I am wondering if you have had any feedback from any of the groups that that was happening?

Ms. ROSEMAN. No, I don't think that the risk of fraud would be any greater. If anything, when you truncate the original check, to the extent that you are processing it electronically, there is fewer eyes that could look at the actual check and be able to copy off a Social Security number or a credit card.

I have not heard of instances where that has increased any risks that would already be there with a paper check, or that information is in the clear at that point.

Mrs. MCCARTHY. We start talking about identity theft all the time, I will be very honest with you, whether it is my telephone bill or anything, I won't put my account number on any of my checks anymore, and it is probably causing them a problem on the other end, but I just think it is, you know—we don't know anymore who is looking at the checks.

Mr. BACA. I have my account number on it.

Mrs. MCCARTHY. Do you carry checks with you? Thank you very much.

Chairman BACHUS. Thank you. Mr. Hensarling.

Mr. HENSARLING. Thanks, Mr. Chairman.

I am glad to hear from your testimony that apparently Congress did some good in the Check 21 Act. It is unusual that we passed it 405 to 0, because we usually can't get that unanimity of opinion to change the name of a post office on a Tuesday night. Be that as it may, actually, my colleague, Mr. Feeney, covered most of the ground I wanted to cover, but I would like to get a sense from you of kind of the scope of economies of scale that can be achieved as we move increasingly into our non-cash payment transactions.

In your testimony I think I read, let's see, today the Reserve bank's cost to process an ACH transaction is less than one-fifth of the cost of processing a check. And we have 80 billion non-cash payment transactions annually.

Can you just give me some sense of what this might mean ultimately to the consumer, this savings?

Ms. ROSEMAN. Well, first, you are right, there are a lot of economies of scale when you look at electronic payments because you are relying there on computers and telecommunications networks, and a lot of that is fixed cost. When you think about paper-based payments like checks, you need people running them through automated sorters, you need a lot more manual intervention. Even though we have reduced the number of staff within the Federal Reserve Banks that handle check transactions, I believe still one out of every 4 or 5 Federal Reserve Bank employees processes checks. But we have very few employees who need to process ACH or Fed wire transactions.

So over time, as checks continue to decline, electronic payments grow, I think it will significantly reduce the cost in the payment system. But I think there is something also very important. With Check 21, for the checks that are written and banks invest in image technology, that image technology, they are also going to be able to leverage to improve the services that they provide their customers.

So, for example, for my bank I can now go on line and see a copy of all the checks that I have written. As soon as they have cleared the bank, even before my monthly statement posts, I can look it up on line. Or if I call my bank to inquire about an issue about a particular check, they can call the image up on line and resolve my question a lot more timely than they could have a couple of years ago.

So I think that these kind of things that the banks are investing in, they are going to leverage both to improve interbank clearing, but they are also going to use it to leverage to provide better services to their customers.

I know a number of banks are talking about putting image technology in their branch networks, so to the extent that they do that, and take in check deposits at a branch, they may be able to have a later in the day cut-off hour for that deposit. So if you deposit a check at 3 or 4 in the afternoon, it will then be considered today's deposit rather than tomorrow's deposit, which speeds everything up.

Mr. HENSARLING. The very limited number of constituents I have that are even aware of the Check 21 Act would tend to have a few concerns. Number one, ultimately is this going to save me money or cost me money, and we have covered that subject to some extent. Another, does this heighten or lessen the chances for identity theft, and we have covered a fair amount of that ground. And then a number are under the impression that Congress has told their banks they can no longer give them cancelled copies of their checks.

In your testimony, you talk about some education efforts of the Fed. I would like to know what are you doing to help educate the constituents of the 5th Congressional District of Texas that I didn't vote for a law that prevents them from getting copies of cancelled checks.

Ms. ROSEMAN. Well, that is something we have always heard, and we have, as part of our education material, several frequently asked questions and answers relating specifically to the fact that because Check 21 passed, that does not mean that you wouldn't get your checks back if you otherwise would; that is something totally independent, that is part of the agreement between the bank and their customer, but is not influenced by this new law.

I have not seen any bank put that in writing, but I do suspect that some customers, when they call their banks saying why aren't I getting my checks back anymore, the customer service rep may use it as an excuse at times because we have gotten some feedback in that regard, and that is why we have added information on our Web site specifically on that issue.

Mr. HENSARLING. Thank you, Mr. Chairman, I yield back.

Chairman BACHUS. Thank you. Mr. Baca.

Mr. BACA. Thank you very much, Mr. Chairman.

I guess one of the questions that Ms. McCarthy asked—I am still very puzzled because I do have on my checking account, I do have my account number. And it is puzzling because now I start looking at, in terms of security identity theft and others, when you don't know who that person is when you transfer that particular check, if they can take your account; and hopefully it is a better process and we can look at that.

But let me ask a question in reference to Check 21. Right now it does not require banks to shorten the hold period they place on deposit even though the checks are clearing faster; is that true, yes or no?

Ms. ROSEMAN. Check 21 did not require that because there was already a law on the books that did require us to reduce check

holds, so there was no need to reiterate the same requirement in Check 21.

Mr. BACA. And the reason I state that, for example, a consumer's check may pay his power bill online, may clear immediately, but a payment check he wants to deposit may take 2 to 5 business days to show up in his account. Also, the consumer may be uneasy now that they have less time to cancel the check before it is debited for their account. And as you know, the Federal Reserve is required to study within 2 years the impact of Check 21 on the U.S. Payment system to see if there are any reductions in time periods that it takes to clear a check.

Do you believe that there will be a requirement change in hold time following the 2-year study? That is question number one.

Ms. ROSEMAN. Frankly—oh, go ahead.

Mr. BACA. And then do you believe that 2 years is necessary to gather the information needed to make that decision on hold time?

Ms. ROSEMAN. Actually, given the very limited use of Check 21 to date, I think that it would not benefit consumers to try to speed up the time in that study because the sooner we do the study, the fewer improvements would have been made due to Check 21 that we would be able to discern from the survey results. So you would want to give Check 21 enough time to play out in the marketplace so that you could see some noticeable improvements because of it. If we did the survey today, we wouldn't see those noticeable improvements.

So what we are trying to do is move the study late enough that there may be some improvements, but frankly, I am not sure if the studies that Congress required, that this initial study will see sufficient improvements because we will be doing that next year. And I suspect it may be——

Mr. BACA. What do we have to do to see significant improvements? Is there any changes that need to be done?

Ms. ROSEMAN. It needs—the way Check 21 was developed, it authorized, but did not require banks to use new authorities that the law provided. So the theory was that as banks had a business case to invest in the technologies and the equipment needed to leverage the authority, they would do so. And a lot of banks are doing so. But there is, frankly, a fairly long lead time involved in that.

So I think that we will see noticeable improvements—personally, and this is just a personal guess—I think that those improvements we will start seeing more significant improvements in the 2007, 2008 time frame. I don't know whether the improvements will be significant enough when we do our survey next year to at that time reduce the holds, but I think a couple years out from there we would see.

Mr. BACA. Okay. Thank you. The next question I have is the implementation of Check 21 has created some confusion among consumers. There is confusion among the hold time of their checks and the difference between Check 21 and account receivable conversions. It appears to me that perhaps there should be a greater, as stated before, education of consumers to know about how to adjust and shift electronic payments. Does the Federal Reserve play a role in providing such educational programs? If so, how and when and where will they be implemented?

Ms. ROSEMAN. Well, we have come up with information. We have consumer brochures talking about electronic check conversion, about Check 21. We have other information on our Web site. We have talked to—because there was lot of press coverage around the time this law became effective, and we talked to a lot of reporters and others developing stories. They did not quite get it right, even after having talked to them in many cases.

But we have been trying to disseminate information. We have been relying on, leveraging our Consumer Advisory Council and thinking about educational efforts in this regard. But there are a number of things on our Web site that we refer consumers to, media to. So that has been the primary vehicle that we have used.

Mr. BACA. Is any of your material bilingual?

Ms. ROSEMAN. There are some in Spanish as well as English, yes.

Mr. BACA. And what about Korean or Asian or any other foreign language or——

Ms. ROSEMAN. I believe, I can correct in writing if I am wrong, but I believe at this time it is just Spanish and English.

Mr. BACA. Okay, well, hopefully, we can develop other languages, too, as well as we want more consumers to participate and utilize the system. Thank you very much.

I yield back the balance of my time if there is any

Chairman BACHUS. Thank you. Ms. Roseman, let me—I have got—we have had people, other Congressmen or even one or two constituents that have called us because of a lot of publicity with Check 21, and they have given us various scenarios. And so I want to kind of ask you an extended question with fact scenarios and let you kind of clarify whether or not Check 21 is involved in this or not involved. I think I know the answer, but I just want to hear it from you. And basically, I think that there is a lot of misinformation on what Check 21 does and what it does not do, what it authorizes and causes and what it does not authorize or cause. And have you—have you all had some of the same confusion that we have had?

Ms. ROSEMAN. Yes, and a lot of it was prompted, I believe, by a lot of media reports last fall. There is confusion between Check 21 and electronic check conversion as we discussed. There is confusion regarding, if you no longer get your checks back with your account statement, is that due to Check 21? It is not. So there have been some issues along those lines, yes.

Chairman BACHUS. Yeah. Let me give you some examples of what we have found when we looked into these matters. Now, one is this—and that is, I think, a valid complaint that people have. And I—maybe you can tell me where you would fix this. People will say, they will look on their bank statements, and there will be a debit, a debit to their account where you have authorized a direct debit. And they really cannot tell from that debit much about the transaction. I have actually seen examples—they have sent me some of these. And it may actually—I saw one recently, where a cable company deducted on a direct deposit, and the only thing that appeared on that was the name of the city.

Ms. ROSEMAN. I am sorry. The name of——

Chairman BACHUS. Was the name of the city.

Ms. ROSEMAN. Well, under the—I believe, under the Electronic Fund Transfer Act and the Federal Reserve Boards' Regulation E on periodic statements, if you are—you know, if a consumer has an electronic payment, it has to include the name of the payee. So, for example, most of the bills I pay, I pay through the ACH. It just automatically debits my account, but it will say, Comcast or Verizon or the name of the mortgage company, as part of the information that appears on my statement. That is required by law.

Chairman BACHUS. Well, this one, they sent to us—it actually did not. And it was a large cable company. It had the name of the city.

We have also seen another one that someone sent to us and it just had numbers. Now, what that was, and let me just move down. This is another one. We have the direct debits, and then you have where you go into a store, you hand them a check, they run it through some process, and they give you your check back.

Ms. ROSEMAN. Right.

Chairman BACHUS. In that situation, what is required? The merchant can then immediately go and debit your account; is that correct?

Ms. ROSEMAN. What typically happens in that case is the merchant will use the information at the bottom of the check to create an ACH transaction that will——

Chairman BACHUS. An ARC transaction basically?

Ms. ROSEMAN. Well, there are two different types. ARC transactions are for payments that you send in to pay a bill.

Chairman BACHUS. Okay.

Ms. ROSEMAN. There is another transaction code but it is the same concept.

Chairman BACHUS. And what is it called when they do it in the store?

Ms. ROSEMAN. POP, point of purchase. I knew it was POP; I just could not remember what it stood for. And that is just another code for a different but similar type of ACH transaction. But in that case, on the statement, they should be getting the name of the store along with the other information, you know, date of the purchase and the amount of the purchase. That should appear there, similar to the way, if you use a debit card or credit card, that information would show up.

Chairman BACHUS. And so when you get your statement, it should have all that information.

Ms. ROSEMAN. It should. Under the law, it should.

Chairman BACHUS. And I think, maybe this is a transitionary period, but you know, we are seeing, in these, you know, cases where the information does not appear, they are getting that kind of information. The third one, as you mentioned—I think you mentioned it—is where you mail your payment in. And we are getting—with the utilities. You mail it in, and what is happening is, it goes into a lock box as I understand.

Ms. ROSEMAN. Right.

Chairman BACHUS. That check is destroyed, and it goes—they immediately have access to your account. Now, you are agreeing to that apparently.

Ms. ROSEMAN. Well, when you say, immediately, what they will do, the lock box processor will get in all the checks for your credit card or mortgage or whatever, and they will again use the information at the bottom of the check to create ACH transactions that they will put into the ACH system. It would typically be the next day that it would settle on your account.

Chairman BACHUS. Now, none of those have anything to do with Check 21 do they?

Ms. ROSEMAN. Not at all.

Chairman BACHUS. Okay.

Ms. ROSEMAN. The main thing they have in common is they both came about in the same general time frame which is, I think, why they got so confused with each other.

Chairman BACHUS. Do you see any of those cases? I think, when this happens to a member of Congress or his constituents, they turn around and call me because I am subcommittee chair, send it over to me, and we call them. But, you know, I think the main complaint that we are hearing is, when they get their account or they call their account up on the Internet, they really cannot get enough information, or, many times, it says that—I wish I had brought one of them in here because I have got four or five—that transaction is not available; electronic image of that transaction is not available. And I think mostly those are on those lock box things. But are they supposed to be available?

Ms. ROSEMAN. Generally, what happens for the lock boxes is they will take an image of your check for their records when they—before they initiate the ACH. So in the event the ACH transaction comes back bad, they have more information about who you are to be able to pursue you. And sometimes, they may end up then over time creating a substitute check from that information to collect it as a check if for some reason it did not clear as an ACH transaction.

Chairman BACHUS. But I guess my question is, are they required to—is there a requirement by the Federal Reserve that, on your statement, where you go on to the Internet and you can get—go in and electronically call up an image, is there some requirement that you will be able to do that?

Ms. ROSEMAN. Yes. There are requirements for what appears on your periodic statement, what information about an electronic payment must be there. And it would have to include the name of the person that you are paying.

Chairman BACHUS. Are you getting the same complaints that we are?

Ms. ROSEMAN. I am not aware of complaints along those lines in particular.

Chairman BACHUS. Okay. But none of those complaints would be, as you say, are Check 21. They are really more to do with either the Expedited Funds Availability Act or deposits.

Well, another example is this. This is my fourth example. And I have heard this from time to time. And I think this has been happening for years, but people, now with Check 21—they call and say this is Check 21. A person has someone working at their home, painting or, you know, cutting the grass or whatever. And they give them a check. And they go down to the bank and deposit it. I

mean—I am sorry, they give them the check, to XYZ bank. They realize, oh, you know, I do not have the money to cover that. So they go down to the bank at the same time, you know, usually 3:00 or 4:00 in the afternoon, and they deposit money to cover that check. And it could be that the person that they gave the check to walks into one branch, and they walk into the other branch about the same time, or even an hour apart. What we are hearing is the person is able to cash the check and when they do, they will overdraft because there is overdraft protection, and then they will go in and put a check in, you know, between 3:00 and 5:00 of the same day, and they do not get credit for it. Now, they complain that that is part of Check 21.

Ms. ROSEMAN. No. That is totally independent of Check 21. I think the circumstance that you raise often is the case. If you give a check to a handyman, and your check happens to be drawn on a bank that is local, he may go directly to that bank and, you know, cash that check over the counter because they want their money right away.

Chairman BACHUS. And that is what has happened in several cases. In fact, they leave the house. They go down to the book and they cash the check. You are following them in the car, and 30 minutes later, you deposit a check.

Ms. ROSEMAN. But I think it is important to have further education for consumers to make them understand that when you write a check, that check is payable on demand. So you should have the money in your account to cover the value of that check at the time you write it and give it to somebody.

Chairman BACHUS. I will not go any further with that. They do have another complaint about when they get two or three issued worthless checks they sort of think that, you know, and the bank ought to probably not take the biggest one first, biggest check and run it through first. They ought to take the little ones, which would have gone. But then, I had a constituent who called and said they bounced my mortgage payment because they took that one first. I guess it is hard to know which one they ought to take first, right?

Mrs. Maloney.

Mrs. MALONEY. No questions.

Chairman BACHUS. All right. No further questions of this panel. But—so we will dismiss our panel one, or Ms. Roseman, and call our panel two.

And Mr. Ford is going to introduce one of our witnesses to the second panel.

Mrs. Maloney, I know that you are friends with Mrs. Duke, and so I do not know if—you have introduced her in the past. I did not know if you wanted to do it today. We welcome our second panel. And at this time, I am going to recognize Mrs. Maloney to introduce one of our panelists.

Mrs. MALONEY. Okay. Thank you so much.

And it is my great honor to introduce Betsy Duke who is the Chair of the ABA. And she is the first woman in history to hold this position. So I am always supporting women when they break that glass ceiling and become trail blazers, make the road easier for other woman. But it is an extraordinary achievement, and we are very proud of this achievement. She is also a former president

of the Bank of Tidewater. And this position, likewise, was the first time that a woman held this position. And she hails from the great State of Virginia, and my hometown of Virginia Beach, Virginia. And every time I come home, everybody talks about Betsy Duke.

So your hometown is extremely proud of you.

And she also happens to be the personal banker to my family.

And they are very fond of you and send their regards and thank you for everything you do and for being—thank you. What can I say?

And she is really a vice president now of Wachovia and my good friend, Mel Watt, is very proud of that position in the bank that hails from the great State of North Carolina.

Mr. WATT. I just told her not to try to steal my constituent while she was making the introduction, Mr. Chairman.

Do not try to steal Wachovia for Wall Street, you know. We are delighted to have her here, and we were arguing about who got to introduce her, so we just split it. That is what happens when you are so popular. Everybody wants to introduce you. Thank you for being here.

Chairman BACHUS. Mr. Watt, you have from time to time talked about larger institutions gobbling up smaller institutions, and as Mrs. Maloney——

Mr. WATT. But Charlotte is bigger than Wall Street.

Chairman BACHUS. Mrs. Maloney used to be employed by South Trust Bank in Birmingham, and in fact, South Trust was gobbled up by a Charlotte bank, Wachovia, which is a very fine bank. And we are still proud to have her with us now kind of tentative——

Mr. WATT. I told you everybody wanted to introduce you. I mean, what can you say? When you are on a roll—anybody else want to get in on this introduction?

Chairman BACHUS. We believe that actually that is probably the reason for that. They were actually trying to get a chairman of the American Banking Association. They had to buy a bank to get one, so—and then Mr. Ford is going to introduce the gentleman from Tennessee.

Mr. FORD. I feel bad. Hayes is not going to get the kind of intro that Ms. Duke got. I am delighted to see you, too, Madam Chairlady and to Chairman Bachus and all the members of the committee. I feel bad for the professor and for Mr. McEntee, that they are not going to get these glorious introductions.

But welcome to you, as well, to the committee. I am delighted that a fellow Tennessean, although not from my congressional district, but someone whose organization, independent community bankers I have leaned on greatly over the last few years in my service on the committee to learn more about issues confronting not only bankers but certainly their customers throughout my state. Mr. Hayes hails from the Security Bank of Dyersburg and, as stated, is the chair of this great organization.

And today, Chairman Bachus, he will bring a perspective that I know has been shared or is shared by many on this committee. And as one who was active in the passage of this great act that we talk about today, Check 21, for many, many reasons, the fact that it reduces fraud and makes it—reduces costs for banks and customers alike—it is interesting to hear the perspective of commu-

nity bankers, really institutions that are at the forefront and on the front line of providing capital to families and farmers and small business people.

Oftentimes, as Mrs. Maloney and Mr. Watt know, we brag in this institution about the great job growth over the last 10 years. And sometimes we forget—as easy as it is to point to large operations, and we have one the largest in my district called FedEx—it was really small businesses that lead the job creation engine in this country. And it is community bankers like Mr. Hayes and many of his colleagues within his organization that have provided fuel for that wonderful fire over the last several years.

He will bring a set of recommendations today, Chairman Bachus, that I hope this committee not only listens to but heeds, in many ways, as we do our best to implement what is a positive act. And I applaud you, Chairman, for having the good sense to allow an assessment of where we are and how this bill will be implemented, how this law will be implemented. But I hope we pay close attention as we talk about the deployment of technologies and the resources needed to ensure that banks in his organization and his peers within his association are able to bring not only this law to reality but bring the good benefits to their many customers.

So with that, I welcome you, Chairman Hayes, and welcome the other members of the panel as well.

And, Ms. Duke, I look forward to getting to know you because all these folks love you. You must be doing some great things. And you have got a good man siting right behind you in Floyd so keep him on board.

And with that, I yield back the balance of my time.

Chairman BACHUS. Thank you. Our two other panelists are friendless. They are both—I will note, that I do not know if that is because you are the two Democratic witnesses, but I welcome both of you. Professor Mark Budnitz from Georgia State University College of Law. I can tell you that Georgia State is a fine institution, has a tremendous School of Business and known for its economics and now its law and other fields, and a very good school, right in the top 20 and top 30 in several fields. So I am very aware of them. And it is a fine institution.

So despite what your testimony may be, you come from a fine institution. But, no, we very much welcome you. Mr. Hayes and Ms. Duke have been here on other occasions, and so we have not mistreated them. They have come back. That may tell you something about this committee.

And Mr. Elliott McEntee, president and CEO of NACHA, which is the Electronic Payments Association. And what a fine association.

We welcome you to our panel.

So without further ado, we welcome your testimony, and we will start from my left with Ms. Duke.

STATEMENT OF ELIZABETH A. DUKE, CHAIRMAN, AMERICAN BANKERS ASSOCIATION

Ms. DUKE. Good morning, Mr. Chairman, and members of the committee. Thank you for that introduction. I am not sure anybody has ever been as warmly welcomed as I have been here today.

When it started out—it reduced my nerves. Perhaps as it went on, it maybe increased them. I will try not to disappoint anyone.

My name is Betsy Duke. I am chairman of the American Bankers Association and an executive vice president with Wachovia Bank. I am pleased to be here today to discuss Check Clearing For the 21st Century, or Check 21. Prior to Check 21, every single check that was deposited in the United States had to be physically transported to the bank on which it was drawn. And now, banks will be able to use 21st century technology to transport those checks electronically in the same way that most of us today use e-mail rather than mailing physical letters. So no longer will there be tons of paper checks having to move around on trucks and planes subject to damage, delay by weather, accident or vandalism. Customers will retain the convenience of a check but will also have the efficiency of an electronic payment. Funds will be collected faster, making them available sooner and reducing fraud. And check transport will be more predictable and more secure.

But all of this will not happen overnight. The initial cost that enables the bank to be able to send and receive electronic checks is very high, and any new process needs testing and refinement. My bank, Wachovia, is a leading-edge electronic processor, but despite these capabilities, we expect to process only 2 to 3 percent of our checks through electronic image exchange by year end.

Nationally, the Federal Reserve, as you have heard, reports that less than 1 percent of the checks that it processes are done electronically. So the adoption will be gradual, and significant volume is certainly not expected until some time in 2007.

Now, in spite of a concerted effort to educate the public about Check 21, we continue to hear predictions of dire consequences of the law, none of which has any basis in fact. For example, some consumer activists reported that 7 million checks would begin to bounce each month as a result of the new law. Nothing like this has occurred nor is it expected to occur. Moreover, the length of the float time has been declining for decades as banks and companies find more efficient ways to collect their payments. Electronic presentment is simply one other efficiency method. And those who use the float quickly adjust just as they have for many decades of innovations in check processing.

We have also seen stories claiming that banks will place extra holds on checks in order to avoid paying interest. This is simply untrue. By law, banks must begin paying interest as soon as the institution itself receives credit for the deposit. Check holds are extremely important to preventing fraud. Banks need enough time to allow the paying bank to return the check to discover insufficient funds or fraud. The Federal Reserve by law has established schedules for funds availability and is required to adjust those schedules as average clearing times change. As more checks clear electronically and as normal times speed up, the Federal Reserve is required to change the availability schedules.

However, the funds availability schedules should not be shortened until the actual time to process the checks has speeded up. It is important to note that most banks do make funds available sooner than the mandated availability schedules, especially in cases where the risk of fraud is low. An ABA survey has shown

that between 72 and 87 percent of banks provide funds for local checks before the law requires; for nonlocal checks, between 72 and 82 percent do so.

Mr. Chairman, the ABA and our member banks are committed to providing the most efficient cost-effective check processing possible for our customers. Check 21 will speed funds availability and reduce fraud for all of our customers. We are excited about the potential, and we look forward to providing the benefit, and I appreciate the opportunity to testify on the progress of Check 21 to date and to clear up some misconceptions. I will be happy to answer any questions.

[The prepared statement of Elizabeth A. Duke can be found on page 60 in the appendix.]

Chairman BACHUS. Professor Budnitz.

STATEMENT OF MARK E. BUDNITZ, PROFESSOR, GEORGIA STATE UNIVERSITY COLLEGE OF LAW

Mr. BUDNITZ. Good afternoon, Mr. Chairman, members of the subcommittee.

Congress passed the Check 21 Act with the best of intentions. It is a good act. It enables banks to process checks in a more efficient manner, reduces costs, increases the speed with which checks clear.

However, Check 21 made a really complicated situation even more complicated and more confusing for consumers than it already was. Several of you have mentioned consumer education. You asked Ms. Roseman what efforts the Fed is making to educate consumers. Well, they have a tough job to do, because the law is based on matters completely beyond the control of the consumer.

Let's just take one example. There are lots and lots, but just take one that has been mentioned this afternoon. That is why I picked it. The credit card company sends me a statement. I put a check in the mail to pay the credit card company. The credit card company gets that check—and I have two credit card companies who do it this way myself—and they can do one of two things. They can process the check the regular way, just deposit the check into their bank, their depository bank, the bank of first deposit, or they can process it electronically. Two entirely different legal regimes apply. Now, even if you have a credit card company that deals with this in the traditional way, they take my check, and they deposit the check into their bank. The banks now start processing the checks. And they can do it one of two ways. There is the usual way, or now with Check 21, they can go and use electronic check imaging, and eventually the check will be changed into a substitute check. Again, different rules, different responsibilities, different rights, different deadlines, four different sets of rules.

And I have not even mentioned the NACHA rules which also affect the electronic payments. And so, it is a very difficult situation for consumers to grasp. What I am suggesting today is that you take a look at the entire spectrum of the legal context in which these things take place and see if you can introduce some uniformity into the system, because if there is a problem, for example, if it is an electronic transfer, then there is the Electronic Fund Transfer Act and Regulation E, and the consumer is entitled to disclosures, the consumer has 60 days from after the bank sends a

bank statement to notify the bank of errors. If it is a transaction, however, that was processed through checks and Check 21 kicked in, entirely different legal regime, entirely different rules, different deadlines. The consumer, in order to submit a claim under Check 21, if the consumer thinks something went wrong, has to provide information to the bank that I can hardly even understand, and I have written law review articles, I am revising my book on this subject and so forth. Somehow the consumer has to know what a warranty claim is under Check 21 in order to—or otherwise explain why, I need to have the original check in order to understand why, when I got the substitute check, something went wrong. A very complicated regime in contrast to Regulation E. And if the check is just processed the usual way, no Check 21 kicking in, no substitute check, then the Uniform Commercial Code applies. Entirely different rules. Under the Uniform Commercial Code, the bank has no duty to investigate, has no duty if it cannot figure out what went wrong, to recredit the consumer's account. The consumer's only remedy is to go to court and file a lawsuit. But there is probably an arbitration clause in the bank agreement that does not even allow that to happen.

This is just one little tiny slice of the pie. There are all kinds of other things going on. And let me just mention one other, and that is the bank statement. We have already talked about the confusion between electronic check conversion, the ARC situation, and Check 21 with consumers being very confused about the two and not understanding the difference between them, that two entirely different rules apply. In addition, there are so many other things going into and out of the consumer's account. It is right, and it sounds just fine to say, before the consumer writes that check, the consumer better make sure there is enough money in the account. Right? Direct Deposit, pre-authorized payments, online bill payments, account aggregation, debit card payments, lots of transactions going in and out of that account at all times. So it is very hard to keep track.

Very briefly, what I recommend is that the committee take a look at the entire situation, use the Electronic Fund Transfer Act as a model. It has served well the test of time. Congress did a fantastic job with that. Also look at the NACHA rules. NACHA has some very fine rules that have been worked out in conjunction with the business community, the banking community, and incorporate some of those into the law so that we make sure that those are a definite permanent part of the law.

In terms of funds availability, one thing I would mention is that Mrs. Maloney's bill includes a lot more than making the funds available quickly. There is a lot of other stuff in there, quite apart from whether it is time now to go and reduce the waiting period. And so I would urge the committee to look at those other aspects of the bill as well and consider them seriously. Thank you.

[The prepared statement of Mark Budnitz can be found on page 53 in the appendix.]

Chairman BACHUS. Thank you. Mr. Hayes.

STATEMENT OF DAVID HAYES, CHAIRMAN, INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. HAYES. Thank you.

Congressman Ford, thank you for the kind introduction and my second day here in Washington in front of the chairman from Alabama, in both cases, so I look forward to the fall, sir.

I am honored to be here with so many former bankers. I mean, it certainly makes my life much easier. You know, it is my honor to be here today to represent the 5,000 community banks that belong to the Independent Community Banker Association of America, and to be here representing my own institution which is a $135 million asset organization and 70 employees. So I am a small business person by occupation. Check 21 became a law approximately 6 months ago, and by authorizing the creation of the substitute checks, the new law has opened the door to wide scale electronic check processing. Implementation will not happen overnight. It is very much an evolutionary process. Therefore, until the necessary technology investments are made, relatively little change will occur for community banks and our customers.

My bank began offering image statements to our customers in 1999, and today, we have invested a half a million dollars in the technology. Yet, like many community banks, in the 6 months since Check 21 became effective, we have made very few changes to our processing environment. Instead, we are waiting to move to full electronic check clearing without the need for substitute checks. Earlier this month, the ICBA surveyed its members on Check 21 implementation and its impact on our customers. Almost 400 community banks of all asset sizes responded; 86 percent are not currently using image technology to present and clear checks but are waiting for their intermediaries like software providers to develop the software and complete testing of the end-to-end image exchange. Of the banks that are using image technology for check clearing, none have engaged in full check image clearing. Image-based clearing is not yet the dominant form of check clearing, and it is important to note that the new law does not mandate that banks process or receive checks in electronic format. Analysts have predicted that it will be several years before digital images are used to clear most checks. And our survey results support this prediction. Therefore, it is premature to conclude that checks are clearing faster since the enactment of Check 21.

We also appreciate the members of this committee have acknowledged the importance of check holds in the prevention of fraud against bank and depositor losses. This is too often overlooked. I am reminded of a situation of a small community bank where a customer's check kiting scheme almost caused the bank to fail in a matter of hours. The kite depleted nearly all of the bank's capital, and the bank was close to being unable to honor the local public school payroll. Today, we have a major problem with fraudulent cashier's checks. So you see, for community banks especially, the impact of check fraud can go well beyond the institution and have real consequences for the community.

We also recognize concerns that some processing practices could increase the likelihood of overdraft fees for consumers. However, nearly 90 percent of ICBA survey respondents post deposits and

other credits before checks and debits. Therefore, contrary to the claims of consumer groups and others, most check processing practices are not yielding an illegitimate revenue stream for banks. I must also point out in the interest of good customer service, many of our member banks make funds available to customers earlier than required but still have the legal and regulatory authority to place holds where needed in specific cases: twenty-eight percent of our survey respondents provided same business day availability on items that qualify for next day availability; 91 percent provide same or next business day availability for items that qualify for two-day availability; and 86 percent provide faster availability for checks that qualify for 5 business day availability.

ICBA is concerned that with only 6 months since Check 21 became law, preemptive legislation or regulatory efforts to reduce check hold periods without a proven history of faster check clearing and settlement times will leave banks and our customers exposed to serious losses and sophisticated fraud schemes. Current law requires the Federal Reserve Board to reduce check hold periods whenever check processing times improve. The Fed must also study availability practices and existing funds availability requirements and make recommendations for legislative action. We urge Congress to give the Federal Reserve a chance to do its job. In conclusion, broad and appreciable reduction in check clearing times will only occur over time. The majority of the financial institutions must determine that there is a business case for making significant capital investments and major operational changes to support full electronic check clearing. Wide scale electronic check clearing will only be as effective and efficient as the number of banks that participate.

Mr. Chairman, thank you for the invitation to appear today, and I will be happy to answer any questions later.

[The prepared statement of David Hayes can be found on page 70 in the appendix.]

Chairman BACHUS. Thanks.

And Mr. McEntee.

STATEMENT OF ELLIOTT C. MCENTEE, PRESIDENT AND CEO, NACHA—THE ELECTRONIC PAYMENTS ASSOCIATION

Mr. MCENTEE. Mr. Chairman and distinguished members of the subcommittee, I appreciate the invitation to testify on a type of electronic processing known as check conversion.

In check conversion, a check that a consumer mails to pay a bill is processed electronically using the same payment network that is used to process Direct Deposit of payroll payments. Using an electronic payment network to process checks enables the payment to be processed more efficiently. It also provides the consumer with more protection than if the check was processed in the traditional manner.

Before I discuss check conversion in more detail I just want to give you a brief overview of the organization I work for. NACHA is a not-for-profit association that develops and maintains the operating rules that govern the processing of ACH payments. The NACHA rules spell out the rights and responsibilities of financial institutions and businesses that process ACH payments. And they

also contain several provisions dealing with consumer protection. The public and private sectors have been working since the late 1970s to use electronic payment networks to clear and settle billions of checks that are written each year in the United States.

Earlier efforts were not successful, mostly due to the lack of a clear legal framework dealing with the relationship between checks and electronic payments. Working very closely with the Federal Reserve, a legal framework was developed in 2001. That legal framework treats a check that has been converted as if it was always an electronic payment. With that legal framework, consumers have the protection of Regulation E and the NACHA rules even when they are writing a check to pay a bill. The interest in using electronic networks to collect checks increased dramatically because of the grounding of all commercial flights after 9/11. Today, check conversion is used by the Federal Government, several State and local governments and hundreds of billers.

Every biller that is going to convert checks must provide clear and conspicuous notice to consumers prior to the receipt of every check. The notice must state that receipt of the check authorizes an electronic debit to the consumer's account. Billers must have reasonable procedures for the consumer to opt out. In other words, if the consumer does not want their check converted and notifies the biller, the biller may not convert any checks received from that consumer. Billers must provide consumers with a copy of the check upon request. As with any ACH payment to a consumer's account, the NACHA rules require a consumer's financial institution to recredit the consumers account if the consumer reports within a certain time frame that a transaction was not authorized.

But what are the benefits of check conversion? For consumers, check conversion preserves the choice for consumers who want to continue to pay their bills by check. Consumers gain the protection of Regulation E and the NACHA rules, which provide more protection than when checks are processed in the traditional way. When checks are converted, consumers receive more detailed information on their monthly statements, including the name of the company that they are paying and the check number that the consumer wrote. For companies, the main benefit is gaining the efficiencies and cost-effectiveness of electronic processing while still offering consumers the choice of paying by check.

In 2004, there were about 1.25 billion checks converted by billers. The consumer opt out rate is typically less than a half a percent. A recent survey conducted for NACHA found that 69 percent of consumers surveyed responded that they are familiar with the check conversion process. The survey also found that 55 percent of the consumers, when given the open-ended opportunity to say anything, expressed no concerns about check conversion. Most of the concerns that they did express were about privacy and security issues. And as was pointed out by Ms. Roseman in her presentation, electronic check processing does offer more privacy protection and security for both consumers and the banking industry and businesses.

In the surveys that we have conducted, consumers did not express concerns about checks being cleared more quickly. And we do have statistics that I would like to share with the subcommittee on

this issue. Our data shows that the insufficient funds rate for check conversion payments is .3 percent. That is .3 percent of the ACH transactions that have been converted from paper checks are returned because of insufficient funds. And that is a lower rate than in the traditional check collection system, suggesting that check conversion is not causing more checks to bounce. The rate at which consumers claim that check conversion payments are unauthorized is much lower, .0045 percent, which means 45 out of every 1 million checks that are converted a consumer claims that the transaction was unauthorized, showing that there is no significant problem with proper authorization or with fraud.

However, we are aware, as some of the subcommittee members have pointed out, that there are some problems with check conversion, and some consumers are clearly confused with how the system works. The first problem is when the billing company does a poor job of informing its customers that the check is going to be processed electronically. To address this situation, NACHA organized an industry effort consisting of many banks and billers to develop consumer education materials that billing companies and financial institutions can use at no cost to educate customers about check conversion. The second is that there are a small number of consumers that do not want anything done differently to their checks. NACHA revised its rules to require billing companies to have reasonable procedures to allow consumers to opt out.

In conclusion, check conversion is being adopted very rapidly in the market place. Check conversion is an example of a true win-win innovation, providing consumers with more protection and more information and providing businesses and financial institutions the ability to collect checks more efficiently. That concludes my remarks, and I will be glad to try to answer any questions.

[The prepared statement of Elliott C. McEntee can be found on page 78 in the appendix.]

Chairman BACHUS. Thank you.

Mr. Tiberi.

Mr. TIBERI. Thank you, Mr. Chairman.

Thank you all for testifying today.

Ms. Duke, there has been some confusion, misperceptions, over what Check 21 does and does not do, from what I have heard over the last several months. Have you heard, either as a banker yourself or speaking on behalf of the American Bankers, some of the confusion? And can you tell us a little bit about how you all are dealing with it?

Ms. DUKE. Some of the biggest confusion just simply has to do with, are banks going to be required to convert all checks to electronic, and are customers no longer going to be able to get their checks back? And yes, we are doing everything we can to communicate what Check 21 does and does not do.

The ABA has offered news stories to media outlets. It has written columns for print outlets, all trying to explain what is happening. In addition, we have fielded thousands and thousands of calls. Wachovia Bank has sent out all of the disclosures and as well spent a lot of time training our employees. Probably training our employees is the biggest piece of Check 21.

But as far as where the confusion comes from, I am not so sure that there is not more confusion being created about things that might possibly happen as a result of Check 21, which are in fact not happening. Again, back to the example of these millions of checks bouncing. That is just simply not happening. But when you create the expectation that it will and the fear that it will, I am afraid it may be raising the anxiety on Check 21 much more than this should

Mr. TIBERI. Do you think there has been an organized effort to purposely confuse consumers in hopes of creating maybe an opportunity to have us come back and do something?

Ms. DUKE. I really could not say whether it has been purposeful or not. Like I said, we have not found that, once Check 21 came into effect, that we have had really any negative feedback about anything that actually has to do with Check 21. So, hopefully, this is a storm that will pass.

Mr. TIBERI. Okay.

Mr. Budnitz?

Mr. BUDNITZ. Yes.

Mr. TIBERI. Professor, speaking of confusion, I am very confused with something you said, a couple of things that you said, and I tried to write one of them down. You said that with debits and Direct Deposit and other things, it is hard to keep track of a checking account for a consumer. If your responsibility is to have a checking account, aren't you responsible for making sure there is enough money in that account when there is a debit or when you write a check? I am kind of confused.

Mr. BUDNITZ. Consumers are using a debit card to pay for so many items. Money comes out right away. They have to make sure that they have written it down in their check register.

Mr. TIBERI. I understand. I am a consumer.

Mr. BUDNITZ. They have to keep careful track every time they right a check, of course. Also, money is coming into the account in terms of payroll checks, and so forth, maybe child support, government benefits. Also, there are pre-authorized payments. I pre-authorize the utility company to take money out of my account.

Mr. TIBERI. I have to authorize that though.

Mr. BUDNITZ. Pardon me?

Mr. TIBERI. As a consumer, I have to authorize that. And I do that. I have—American Electric Power takes a monthly—my bill out of the checking account.

Mr. BUDNITZ. Also, consumers get calls from telemarketers, and telemarketers often will withdraw the money through a pre-authorized draft, another way of taking money out of the consumer's account.

Mr. TIBERI. But I have not authorized that.

Mr. BUDNITZ. Yes. Although there are lots of complaints and also some NACHA rules to try to ensure the integrity of telephone ACH withdrawals because of concern about problems, and the Federal Trade Commission has lots of rules about telemarketing. The point is that, sure, the consumer is responsible. The consumer has to keep track.

My point was, it is not easy to keep track of it. And then when you get your monthly statement, it is not easy to understand every-

thing that is on that monthly statement because of the way things are—there is no standardization in terms of the format and how things are identified. And so what I am suggesting is that it is not an easy task. I was not saying the consumer did not authorize it, although sometimes they did not. What happens sometimes is the consumer authorized one withdrawal, and then it keeps happening month after month. And they keep making phone calls saying, wait a minute, I only authorized one withdrawal, or too much is withdrawn and so forth. There are a lot of complaints about mistaken withdrawals. There are lots of withdrawals where no problems occur at all. All I am saying is it is not an easy matter to keep track of it all.

Mr. TIBERI. Well, I would love to continue this debate. Unfortunately, my time has expired.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Mr. Hayes, I am trying to be clear on whether you think, on balance, Check 21 increases the likelihood of fraud or decreases the likelihood of fraud?

Mr. HAYES. Check 21——

Mr. WATT. I mean, once it gets implemented out, going forward.

Mr. HAYES. Being a person that has spent a lot of time in technology over my career, I believe that Check 21 in fact will reduce fraud, and that is that we are able to ultimately clear items quicker and determine whether or not that is a valid item. Once we have those electronic clearing systems in place, then I think we put more and more fraud detection systems in place, and ultimately, that benefits the whole. So over the long term, as it evolves, I think it is in fact reducing fraud.

But still, we are dealing with a paper-based item today that someone presents to you, you being our staff, and you know, we are seeing increases in that area.

Mr. WATT. And Ms. Duke, Mr. Hayes and Mr. McEntee, what say you about the suggestion that the professor has that we should try to make all of the legal constructs around paper, Check 21, whatever mechanisms we are using, the same? I mean, I am just trying to get reactions to—that you had to the professor's bottom line suggestion. I think that was his bottom line suggestion.

Ms. DUKE. I think we all are in favor of simplicity. The difficulty is that each of the channels that checks can travel or that payments can travel have their own particular considerations, and so it is not necessarily possible to make the rules for checks exactly like the rules for electronic payments. At the end of the day, though, I am not quite sure it would even be necessary because I am not aware of any situations where consumers are being held responsible for payments that they did not authorize, regardless of the difference in the time frames and the procedures for making those objections. Typically what happens is the consumer goes to or contacts the bank and says, I did not authorize this, and that starts the process of finding out exactly what happened. And so I do not think there is really a risk there of consumers being charged for payments they did not authorize.

Mr. HAYES. I concur. I mean, I think if a consumer calls our staff and says, you know, this is not an item I have authorized, I mean, we are going to immediately respond. We operate under a sunset rule. We get a customer inquiry relative to that, and we will move on that. I think we provide consumers multiple access points for information on their accounts. You know, being able to come into our lobbies and talk to our people to being able to call into an audio response system and see what items have cleared, and today, with online banking, really the availability of that information to them online wherever they are. So you know, at this point, I think, you know, the system is working well, and I think we respond well to our consumers. That is our business, service and response.

Mr. MCENTEE. I think this concept, what the professor said, really makes a lot of sense. It would be great if you had a uniform set of rules that dealt with all types of payments, and actually, there were a group of professors and lawyers that attempted to do that quite a few years ago where they attempted to develop new provisions under the Uniform Commercial Code that all the States would agree to follow that would basically try to marry check law and electronic payments law together. It was a very, very complex task, and it ended up not succeeding.

There is quite a bit of difference between a paper check and an electronic payment. There are a lot of things that you could do with electronic payments where you can offer more protection to the consumer that you cannot do with a piece of paper that is moving through the physical check collection system. So, in theory, I would like to go down the path that the professor is suggesting. But I think, in reality, it would be very, very difficult to do.

Mr. WATT. One final question. Most of us, some of us on the committee were supporters of this Check 21 process because we thought, ultimately, it would lead to efficiency, reduce fraud, reduce errors, and speed up the processing time which, all of which would be to the benefit, ultimately, of customers.

Ms. Duke, I heard your testimony saying, do not rush to the speeding up of the processing time before you get this in place. But first of all, how long do you think it will be before we get to that ultimate objective of saving processing time so that customers have the money in their accounts quicker and we can get to that? I am not trying to rush us there, I am just trying to get a good estimate. And ultimately, what do you see as the real—the totality of cost savings? What part of you all's bankers' dollars were actually being spent on processing paper checks, and what is the potential savings, looking way out, once all of this is implemented and the equipment is in place?

Ms. DUKE. To begin with, as far as how quickly this is likely to happen, it is almost a chicken and the egg thing. When you are right at the very beginning, we have very few items being processed and so actually any item that is processed electronically today is very expensive because you have this huge investment to process a very small number of items. The second piece is a lot of items are being processed partially electronically. But then if you take a check and you convert it to an electronic image and then later on convert it back to a paper check and then process that piece of paper, you actually have a transaction that is more expen-

sive than if you had simply processed the original check. The third piece is you need to have more than one or two banks able to accept these electronic items. And so there is that process.

It seems to me that the vendors who supply the community banks are really well along on the game on this, and there is a process right now of putting everything in place to do it. I would say it is probably going to be very slow for the next year or so, but there is all of a sudden going to come some tipping point where all of a sudden a lot of volume moves very quickly to electronic processing. I am hopeful that this will happen somewhere around 2007, but there are so many pieces that have to come together at the same time, it is difficult to say.

As to the question of reducing hold times before these checks are actually moving faster, the danger you have there is not just to the banks but also to the consumers themselves. There is nobody who studies the funds availability schedules and the actual processing times that it takes checks to move better than the criminals who are out to perpetrate fraud. And the newest of the consumer scams right now is a consumer will have something for sale, say on the Internet, and are contacted by a purported buyer who says, you know, I cannot get there right now, but I have somebody who owes me some money. They will send you a cashier's check, and then, you know, we will pay for the item, and then you could wire me the difference, which is the money that they owe me. The cashier's check is required to be credited within 1 day. It turns out to be counterfeit, and so the customer has actually lost both the item they were selling and the money that they have wired out. So that is the real risk when you shorten the availability times. Customers do get confused and believe that if the deposit is available in their account that it has been finally collected from the other bank, and that is not necessarily the case. And I think—did I answer all of that question? Thank you.

Mr. WATT. Thank you. I yield back.

Chairman BACHUS. Thank you. Mr. Ford.

Mr. FORD. Thank you. Really quickly, first of all, I thank—I recognize Stoner over there. I want to also recognize you have got good people. Walter Price is good, and Joy Sheffield is pretty doggone good, too. David Hayes.

But the question that I have to all of you and that ties into what the first panel—although I was not in the committee room; I was in the back and I watched portions of it. And Professor, you raised part of this as you talked about financial education. And I am curious, three questions very quickly. And I hate—I am going to have to leave, Hayes, right when we finish the questioning, so I want to apologize in advance. One, in your testimony, you cite through specific things that as you talk about, in order to move to a check image exchange platform, we must have three critical components in place—the new software, the intermediaries must have the capability to send and receive check images, and there must be widespread acceptance of common interbank image exchange rules. What can we do specifically? It sounds like the first one, maybe, is there some resources that we need to look at providing here through the Congress? And if not, can you give me how we can help affect those three steps?

Mr. FORD. The second is financial literacy. I am as big a supporter of anyone and profess and believe that at the end of the day that is the answer to much of the problem in Congress. We do all this big talk about it, but we provide no money for it.

And I applaud this chairman, Chairman Bachus, because he has been more willing not only to talk about this, but to act on this than many people on this committee. And I can only hope that—you are not the only witness. Witness after witness, panel after panel, come before this committee urging us to do this. And we talk a good game, but we do very little.

So I guess my question is, what kind of financial education has been given to current and new account holders with regard to Check 21? And what more can we in the Congress do to help provide not only on Check 21, but really the broader enlightenment that needs to occur, even the younger level, the middle—elementary, middle and high school, I would argue as well.

So specifically, Mr. Hayes, what can we do on the first three, and what has been done to help people understand how this Check 21 will work?

Mr. HAYES. To answer the questions, Congressman, I think we are in that process. As any movement of change, especially as it relates to technology, there is a learning curve and there is an implementation curve, and as we sit here today we are so early in this process.

I have viewed Check 21 since day one as really somewhat of drawing of a line in the sand that says we can move to this new frontier, but for a period of time the transaction balance between physical items and electronic items will gradually change. We have seen that in history as it relates to ATM usage, as it relates to debit card usage. You go back, and it is almost as though the older we get, the less we are likely to change; and our young people, as we teach them the tools, they adapt that technology, and as they become our age, the movement is there

So I think we have done that. I think the leadership that this committee and the members have in setting Check 21 really will move us forward.

Now, I am a guy that goes back to the mid-1960s and we are still processing checks the way we did in the mid 1960s, and so Check 21 is the vehicle that allows us to look to the future. And I think we are there, it is just now time. And I can't particularly say anything that there needs to be, that this Congress or this committee needs to recommend, because I think we have the tools. It is now time and education.

I will be glad to answer the financial literacy because you recognize where I am from in west Tennessee, and we have a challenge of financial literacy. And I think it is the responsibility of government and the private sector and our leaders in education to start education at the very lowest level, and explaining that here is a dollar, a dollar will buy you this; you don't have 1.25, you have a dollar. So we have got to teach the basics, and it has to start early, and it has to be reinforced by, you know, the government, the teachers and the private sector.

Mr. BUDNITZ. I fully agree with everything that Mr. Hayes has just said. My problem as an educator is that, as I said in the begin-

ning, it is just so complicated now to try to even explain these things because of the present legal structure that it is a formidable task. And it is important to start early.

And what can the Congress do? Well, unfortunately, I think the answer is if there were money available to provide incentives so that materials could be developed and teachers could be trained and so forth, that is the way to go.

If I could respond to one aspect, though, that is related to consumer education and how uniformity would help. You can't have one law that is going to be exactly the same for every payment system, but if we could teach consumers that well, once you get that bank statement, you have X number of days to look at that, and then you have to tell the bank if there is something wrong. Now it is not that way. If it is certain kinds of transfers, it is 60 days; if it is a Check 21 problem it is 40 days; if it is a regular kind of a check, the traditional check processing, it is up to the bank and the customer's agreement, which often says 2 weeks.

Consumer education is so much more feasible if we just could say to consumers, you have 60 days to get back to the bank and tell them what is wrong.

Mr. HAYES. May I add something, Congressman? I think as we look at our role as bankers, our role is to be there for our customers. And when there is customer confusion, a customer question, I mean, it is our responsibility, and we take it seriously. And we do advise customers of their rights, because at the end of the day, service is what we deliver and trust.

And therefore, I think we move to that next level of always being there for that customer and trying to advise them of their rights. And at the end of the day, we are there for our customer.

Mr. MCENTEE. If I could just add a couple of points. One is, even though the time frames are different, depending on the type of transaction that is involved, I think if we can communicate to consumers that it is important to look at your financial statements as quickly as possible; if you see a problem, contact the financial institution or the company that initiated the transaction.

I think the key to the consumer is to look at the statement as quickly as they get the statement, and if there is a problem, point that problem out right away, because there is plenty of procedures and regulations in place for the consumer to have that problem addressed.

And Congressman Ford, when you mentioned about education, I have two teenage daughters, and they think money all revolves around my wallet. So I think—it would help me personally, but I think it is really important for consumers to understand what a checking account is, what a credit card is, what a debit card is, even while they are in elementary school, middle school, and high school. And I think anything that Congress can do to help out in that area would be a tremendous benefit to consumers.

Mr. FORD. Thank you, Chairman, I yield back. Thank you.

Chairman BACHUS. Ms. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman.

And I thank all of the panelists, and particularly I appreciate your kind comments, Professor, about my bill. And I invite you to

elaborate on the provisions that you think are particularly fair and appropriate.

But I would like to ask the panel about their views on two provisions of my bill which were literally raised by constituents who brought them to my attention, and they felt that they were unfair. And I invite anyone to comment on them, and I would like to start first with the professor, since he said such nice things about the bill.

Anyway, the first one, it would require banks to process credits before debits; in other words, to add deposits before deducting checks, and this would reduce the number of bounced checks. And this practice—the reverse of this practice has happened to some of my constituents, and they have complained to me about it; they thought it was unfair. So I invite anyone on the panel to comment on this provision.

And the second provision that I invite anyone to comment on, if they support it or oppose it or think it is fair, or whatever, is to count Saturdays as one of the business days towards the check-hold period if the bank takes the money out of consumer accounts on Saturdays. So, a reciprocity of treatment on Saturdays.

And I have got to tell you that even in New York, in the great city of New York that is so advanced, I get many, many concerns about the long hold on checks. I just relay that to my good friends.

Anyway, Professor.

Mr. BUDNITZ. In terms of the long holds and the problems that banks have with the risk of fraud—and there certainly is a lot of fraud. I wanted to point out that in the Federal law the availability schedules have important exceptions for new accounts. There is an exception for a customer that has frequent overdrafts, and there is an exception if the bank has reasonable cause to doubt the collectibility of the check, language to that effect.

And so Congress has already recognized the fact that there is a risk of fraud, there are certain circumstances under which that risk is greater, and allow the banks to provide accordingly. And that has been in the law for a long time in the Expedited Funds Availability Act; it is also in Check 21.

In regard to the order of posting and counting Saturday as a business day under certain circumstances, to me it just sounds like that is fair. And beyond that, as Mr. Hayes was pointing out, it is really important for a bank to have a customer that trusts the bank, that has confidence in the bank, and so responsible bankers really take that seriously.

When I talk to consumers, part of consumers' anger is that what they are doing in terms of the funds and the posting and so forth just doesn't seem fair, and that engenders a distrust in the institution, which is not good for the bankers but also not good for consumers. We don't want to be scaring consumers away from the banking system. We want to encourage them to use the traditional banking system and not be running to these marginal fringe operators.

Mrs. MALONEY. Any comments?

Mr. HAYES. I would address—well, I think that the majority of the banks post credits first, no question, and that is fair. And the consumer has—they have a decision of who to do business with.

And you know, quite honestly, if someone is not posting their credits first and the bank down the street is, then there is a decision.

Number two, on Saturdays. Having spent a lifetime in the processing side of the business, I mean, you know, if Saturday is a business day, Saturday is a business day all over the organization because you know, the bottom line is debits have to equal credits. And so posting checks and not posting credits, you know, to me is just foreign. And I think that the bankers take that seriously, and I would not see that as something that engenders trust in our customers.

Mrs. MALONEY. Thank you. Thank you for the comments.

Mr. MCENTEE. I would like to respond to the concern about hold policies. I know quite a few of the subcommittee members had expressed some concern about funds' availability practice of banks. I just want to point out that there is an alternative that consumers have for payroll payments, retirement payments, interest and dividend payments, and that is direct deposit. About 71 percent of the consumers are now being paid by direct deposit. Over 75 percent of Social Security recipients are now being paid by direct deposit. My guess is everyone in this room today is being paid by direct deposit. And one of the big benefits of direct deposit is that financial institution must make the funds available at the opening of business on pay day. That is a NACHA rule. The NACHA rule is even stronger than the Regulation E requirement. So if the consumer has the opportunity to get any income payment by direct deposit, we urge them to do that. Then they wouldn't have to worry about any hold policy that a financial institution might have.

Mrs. MALONEY. Well, thank you. My time is up, and I appreciate all of your testimony today. It is great to see you again, Betsy.

Chairman BACHUS. Thank you. I reserved my questions until the end because I knew members had other hearings to go to, so I am going to ask one or two.

But Ms. Duke, there have been a lot of recent revelations about data security breaches. ID theft is on everybody's mind, fraud prevention. Some people have talked about immediately across-the-board reductions in deposit hold times. What effect would that have—would that make it more difficult for banks to detect and prevent frauds?

Ms. DUKE. Well, across-the-board reduction in hold times without any similar improvement in the times where checks are actually collected would make things a whole lot easier for those who wanted to perpetrate bank fraud, because they are the ones that really study and test what the actual clearing systems are, and their best friend is the difference between the fund ability schedule and the actual clearing times.

Chairman BACHUS. And I think you have alluded to that earlier, or mentioned that, but if we do consider reducing those hold times, we run the risk of playing into the hands of——

Ms. DUKE. Actually, I think if you reduce them below the actual clearing times, you have the worst of both worlds because you have consumers who don't have access to their funds as early as they might like, and yet depriving them of that period of access hadn't helped anybody in terms of preventing any fraud. So I think that would be absolutely the worst thing we could do.

Chairman BACHUS. Do any of the panelists disagree with that?

All right. Professor, in your testimony you say that consumers who have agreed to have their checks truncated or exposed to the risk of new errors in fraud but do not get Check 21's protections, who were you referring to there?

Mr. BUDNITZ. Yes. Check 21 makes a major distinction. If you are among the 40 percent of customers who get your checks back every month, your canceled checks along with your statement, then you will be provided with substitute checks, if what is happening with your check includes imaging, and your right to your re-credit and indemnity rights kick in. And this is an important protection. However, if you are among the other 60 percent of customers who have already agreed not to get your canceled checks at the end of the month, then you do not get those protections unless the bank decides to provide you with substitute checks anyway out of the goodness of their heart.

But they do not have to, under the law, provide them to the customer, because the customer has already previously agreed not to get the original canceled checks and therefore does not have any right to get substitute checks. One of the things that concerned me is that I received a notice from one of my banks just a couple of months before Check 21 went into effect, urging me to sign up for check truncation, urging me not to get my canceled checks, and not alerting me to the fact that on October 28, 2004, when Check 21 goes into effect, if you do agree not to get your canceled checks, tough luck; you are going to lose the protections that Check 21 would give you—you, the customer who does get his canceled checks back at the end of the month.

So Check 21 made this very fundamental division, giving some important rights to consumers who did not agree to truncation, who still get their original checks, but depriving the others of those protections.

I do a survey——

Chairman BACHUS. Did it take the protections away or does the period, the 40-day period start to run? Or do they just take the protections away altogether?

Mr. BUDNITZ. The consumer who is not provided a substitute check has no right to claim an expedited recredit, and consumers who have agreed to truncate their checks have no right under the law.

Chairman BACHUS. Other than the underlying UCC; right?

Mr. BUDNITZ. The bank may choose to give those customers substitute checks anyway, in which case the protections would kick in, but the bank does not have to.

Chairman BACHUS. But I would think the underlying UCC provisions would still be in effect.

Mr. BUDNITZ. Yes, absolutely. The UCC, however, in article 4 of the Uniform Commercial Code, the Uniform Commercial Code does not require the bank to engage in an investigation if a consumer complains.

Now, as Mr. Hayes is saying, a responsible bank does it anyway, but they are not required to; and they are not required, as under Check 21 and the Electronic Fund Transfer Act, to recredit the consumer's account if they can't figure out in 10 days what the prob-

lem is. If it is true that banks all investigate anyway and will recredit within a reasonable time anyway, then what is the harm of just putting that into the law? It just codifies what the banks are doing anyway, if they are doing it.

Chairman BACHUS. Mr. Hayes, now the professor, he has recommended that we amend the Expedited Funds Availability Act to require banks to give consumers access to their funds more promptly. How would that affect community banks and their customers?

Mr. HAYES. Number one, as I stated earlier, a majority of our member banks, and my bank in particular, gives our customers, you know, availability, unless we have some reason as allowed under the law to question the item. If we knew the item being presented was always a valid and nonfraudulent item, we wouldn't be having this conversation. But there is nothing out there that gives us that protection, so we are in the risk management business. But at end of the day, our customers—we look at that relationship and we try and move forward.

So until we can fix the fraud side, I don't think we can expedite, you know, the clearing; because we are speeding the process up over time and I think that will pass, you know, to the consumer and those institutions. But to say that we have to do that where we sit today, I do not see that.

Chairman BACHUS. Professor, back to you. Check 21 requires the Federal Reserve Board to make recommendations to us for legislative action by April of 2007. And I think they can reduce—I don't know if you can reduce check-holding times now by regulation. Do you think other than if check holding times—if check processing speeds up, they have a right to go ahead and reduce check holding times? Do you think that is sufficient or do you think we ought to go further with additional legislation?

Mr. BUDNITZ. I think you need to gather as much data as you can so that you know what the present situation is to see if it is justified to shorten those times. And also I think you need to take a careful look at where the problem areas are.

Ms. Duke was talking about this scam using cashiers checks. I have received a lot of complaints about that recently. I get the complaints from lawyers who are representing customers, who then come to me for help in terms of what can we do under the law. And this is an area that I would urge the committee to take a very serious look at to see what it is possible to do to protect consumers who are subject to this cashier's check fraud. So it is a complicated situation. There are lots of different kinds of risks that banks take, some more than others.

But just one final point. Bankers keep saying, we are giving consumers much faster credits on almost all the checks than we are required to anyway, and so there is sort of a disconnect. If you are doing it anyway, what is the harm in shortening the time periods? At least as long as we carefully define the situations under which the bank can say, wait a minute, we need to have a special rule here, like with new accounts and overdrafts, and reasonable cause to doubt collectibility. That is in the present law.

So I am not giving a simple answer because it is not a simple situation. There may be special cases which need special kinds of rules where the bank does not have to give the money as quickly;

in other situations where there is little risk and the banks are doing it now anyway.

Chairman BACHUS. I have heard a lot of cases where people buy a car with a forged cashier's check. And we do hear that from time to time, and it turns out that it is a fraudulent check. Oftentimes, I think it is stolen from the banks. But in that situation, it seems to me that reducing the hold time, once a consumer, he goes down, and once it is credited through his account, he probably lets the car go. But he probably holds it until that check clears. So it almost seems to me in that case it might make it easier for someone that is trying to pass a cashier's check.

Mr. BUDNITZ. Well, as I indicated, I urged the committee to take a specific look at the cashier's check problem and see just what, if anything, would be a legislative solution to that particular problem. But there may be other areas where there just are not problems where the availability could be made quicker.

Chairman BACHUS. Okay. All right.

And Check 21 does have that. And what we are going to do is basically what you are saying; we are going to gather information, and by that date they are going to make recommendations to us. And they are free to make recommendations before that date. It is simply by that date.

My last question, one thing—and I do see your point about truncated checks, Professor. I am not sure that consumers do realize that if they agree to that, that they fall back into a different category. I don't know how, unless we—it does seem like we could have maybe more uniformity. I am not sure that it is possible. But——

Mr. BUDNITZ. As I suggested.——

Chairman BACHUS. Have you known of any instances where someone has come back to their bank, say, after a month and said this is a fraudulent account—other than the cashier checks maybe—and their bank—that is actually a deposit, but a case where their bank account has been charged and they have come to their bank after 3 or 4 weeks and their bank said too late?

Mr. BUDNITZ. Well, let me just suggest one other element that came up earlier, just to make your job even harder. Mr. Feeney was asking Ms. Roseman about other kinds of cards and Ms. Roseman was talking about payroll cards. The thrust of much of my remarks today has been that you can't just look at Check 21 very narrowly. It is part of a much larger picture, because as Ms. Roseman was indicating, the Federal Reserve Board has proposed to treat payroll cards under Regulation E.

Now, payroll cards come within the category of stored value cards and they have not been regulated at all by Federal statutes or by most States. And I think it is good to bring the payroll card under the regulatory umbrella as well. But this is a moving target and that is why the whole situation becomes so confusing to consumers. Lawyers, businesspeople—I try to educate businesspeople and they are very confused as well.

So I am not making your job any easier but I am saying you need to take a look at all the different things going on.

Chairman BACHUS. But even—and I realize you are pointing these problems out, but I don't think Check 21 precipitated any of these problems or made them worse; is that correct?

Mr. BUDNITZ. I believe it made it worse in the sense that it makes things even more confusing, as I think everybody this afternoon has agreed. Consumers can't figure out the difference between ARC or electronic check conversion at the lockbox and Check 21. They are confused about that. So that is an area where——

Chairman BACHUS. I guess I am saying it did not take any rights away from them.

Mr. BUDNITZ. Yes, you are right. You are correct.

Chairman BACHUS. Mr. McEntee, it seems to me there is a lot of confusion surrounding Check 21 that has come from the fact—and I said this earlier to the director of the Federal Reserve, Ms. Roseman—that there has been a sharp increase in the number of ARC or ARH?

Mr. MCENTEE. ARC.

Chairman BACHUS. ARC transactions, and little or no awareness by the consumers. You say your associations work to make them more aware of what is happening. But how would you respond to that? Do you see there is some confusion there?

Mr. MCENTEE. We definitely think there is confusion there. Actually, I think part of the confusion is that, although the rules for ARC were approved before Check 21 legislation was implemented, what happened was a number of large billers started to convert checks around the same time that Check 21 regulations went into effect, and there was a tremendous amount of media coverage around Check 21, but a lot of the coverage, I think, really conveyed a confusing story to the consumer. They got Check 21 and check conversion all mixed up together, and that led to a lot of confusion and phone calls—a lot of phone calls to billers. And I know Congress has gotten a number of letters and phone calls as well.

We hope that that confusion has been greatly reduced because we do know that the biller community and the banking community are doing a much better job now disclosing the information. I have seen quite a few brochures and pamphlets that banks have provided that really explain very carefully the difference between check conversion and Check 21. So our belief is and our hope is that the confusion that was out there 5 or 6 months ago has been greatly diminished.

Chairman BACHUS. I can tell you that in every case—and I bet there were 30 cases where we had referrals from other Members of Congress—in every case when we tracked it down, it was not Check 21. It was another existing problem.

But my final question is this. And I will say that this is not a problem that has gone away. Is really—does not have anything to do with this hearing because this hearing is on Check 21. But it does have something to do with customers having the right to know what is going on in their accounts and whether or not these checks drawn on their account are legitimate transactions or not.

In hearing all of these complaints and hearing people talk, I still believe there are situations where people's bank accounts do not contain enough information about various transactions. I think a lot of them are direct deposits. It is hard to figure out for a while

whether it is a direct deposit or what it is. You just see there is a withdrawal from an account and sometimes it takes us 2 or 3 weeks trying to figure out, talking to whoever is making the deduction.

But I think surely at least some threshold of information should be in there. And you said you require that?

Mr. MCENTEE. Yes. Our rules require that the financial institution display the name of the payee, and our rules also require the company that converts the check to list their name in the electronic record as well as the check number. So that information should be provided to the consumer.

We do know that some banks have done a great job in modernizing their statements. Others are still in the process of making changes to their statements. But our belief is that if the consumer looks at their complete statement, they will have an easier time reconciling that statement than when checks are processed in the traditional way, the name of the payee and the check number.

We also know that some of the billers, at least initially, were not doing a very good job disclosing the information about the possibility that the check could be converted to an ACH transaction. I don't want to be too critical of lawyers, but in some cases the lawyers got ahold of very carefully crafted language by the marketing and customer service people, and they turned it into absolute gobbledygook and buried the information on the back of the statement.

When that kind of problem is pointed out to us we will contact the biller, explain the problem that the biller is causing, and strongly urge the biller and their bank to come up with a better disclosure and to get the information on the statement so that the consumer can readily understand what possibly could happen to that check.

Chairman BACHUS. All right. Anybody else want to comment on anything? No? Any final comments? This is open mike time.

Mr. HAYES. I think at the end of the day, you know, you go through transitions. And I cannot recall a situation where Check 21 has been a problem, where there is an issue—problem with a consumer and the check and our image statements. Because I think at end of the day, as I said earlier, you call me or you call my staff, we are going to research it, because the customer is why we are there. And if we do not serve them properly, we are not going to have them tomorrow.

And so you got regulation and you got relationship, and we are in the relationship business. And I am proud to say if a customer calls us, we are going to be on top of it and help educate if there is a question.

Chairman BACHUS. I said this when we started considering Check 21—I think we had 14,000 airplanes in the air and over 100,000 vehicles. And most of them have not been eliminated now, but they will be; and with gas prices at $2.40 a gallon and us importing 65 percent of our energy today, this goes a long way towards making a more efficient system when we really do not have gas to burn or waste.

And the other countries that we compete with have already gone to this model. So you know, we are certainly making our financial system more competitive with our global competition. And that is

one reason why we need to make this work and not abandon it and not confuse other problems with Check 21.

But I appreciate all of your suggestions and your testimony here today. Thank you.

[Whereupon, at 4:47 p.m., the subcommittee was adjourned.]

A P P E N D I X

April 20, 2005

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

"Implementation of the Check Clearing for the 21st Century Act"

April 20, 2005

Good afternoon. I want to welcome today's witnesses and thank Subcommittee Chairman Bachus for calling this hearing today to discuss the implementation of Check 21. It is my hope that this hearing will clear up some misconceptions about the law and provide Members some insight into what is going on in the world of check processing. I am pleased to learn that banks are taking a measured approach to implementing Check 21 and that the Federal Reserve is closely monitoring the time it takes to process a check, as we directed them to do in the law.

Before Check 21, our nation's check transportation system was stuck in the age of the pony express. Billions of original checks were bundled and flown or driven around the country every year. The problems with this inefficient process came to light following the September 11, 2001 terrorist attacks when our air traffic system was grounded. This interruption in air transportation resulted in the payments system virtually grinding to a halt. If it had not been for quick action by the Federal Reserve, there could have been serious consequences. Check 21 grew out of the desire to improve the security and efficiency of check transportation.

Check 21 became effective less than six months ago. In the weeks and months leading up to the effective date we heard from some interest groups that there would be a radical change in the way consumer's checking accounts operated. This "sky is falling" scare campaign resulted in consumer confusion that reached all the way into the customer service departments of some financial institutions. The result was misinformed and anxious banking customers. What we have learned is that there is no radical change and that financial institutions are taking a prudent approach to Check 21 implementation. We have learned that many institutions actually offer shorter check hold times than is required by law. This is good as it fosters confidence and promotes a stronger understanding of how the system works.

At its essence Check 21 does only 2 things. First, it permits the creation of a substitute check which will allow financial institutions that do not have the resources to accept check images to continue to operate in the paper world as they do today. Second, the law grants consumers expanded protections beyond what exists in current check law. Check 21 does not change the way that checks are processed or presented for payment. Because Check 21 merely improves the movement of checks, all of the check law protections that have existed for over 100 years will still apply.

It is my understanding that a lot of the confusion of late has resulted from the explosion in the use of accounts receivable checks, or ARCs. There has been very little consumer education as to what ARCs are and how they work. These electronic transfers permit a biller to directly access a consumer's checking account and do not require the return of a check image to the consumer. Many consumers have received ARC entries in their bank statements and, due in large measure to the Check 21 misinformation campaign, have been led believe that it is a Check 21-related debit. Consumers have not been well informed of what ARCs are and what protections they have under this system. I would urge both the enterprises that undertake ARC transactions and organizations that set their standards to work to fully inform their customers and ensure that there is no additional confusion.

Thank you and I look forward to the testimony of our witnesses.

OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT "IMPLEMENTATION OF CHECK 21" APRIL 20, 2005

Good afternoon. The Subcommittee will come to order. Today's hearing will focus on the implementation of Check 21, which facilitates the movement of checks through the payments system by making it easier to transport check images electronically between banks. On June 5, 2003, the House of Representatives approved H.R. 1474, the "Check Clearing for the 21st Century Act," or Check 21, by a vote of 405 to 0. Check 21 was signed into law by the President on October 28, 2003, and became effective six months ago. Today's hearing was requested by Ranking Members Frank and Sanders and Congresswoman Maloney but has also been priority for Chairman Oxley and myself because of concerns that have been raised since the passage of Check 21.

Check 21 is an innovative measure which aims to modernize the nation's check transportation system by providing an interim step towards the electronic movement of checks. Although the goals of Check 21 are significant, the Act itself has a relatively narrow focus — making substitute checks legally equivalent to original checks, thereby facilitating electronic check presentment. This change in law was necessary because most banks — aside from some of the larger ones — don't have the resources to accept electronic check images. These banks will be able to request that a "substitute check" be created in lieu of electronic image which can then be processed like a traditional paper check.

Over 36 billion checks are processed through the payments system every year in the United States. The vast majority of these checks are physically transported from one bank to another for payment. This system has historically relied upon the steady flow of air and ground traffic in order to ensure that checks are presented to paying banks in a timely manner. That way of doing business has been in practice for more than 100 years and the technology that is being used today dates to the 1950's.

Perhaps the most dramatic example of the need for this legislation was demonstrated in the week after the September 11th terrorist attacks. As everyone remembers, for approximately one week, planes were not allowed to fly. This prohibition extended to flights carrying checks through the payments system. Over the course of that week, billions of dollars of float built up in the system and the Federal Reserve was forced to come up with alternative means for transporting checks. One of the primary goals of Check 21 is to ensure that if there are future problems with the nation's transportation system, the payments system would continue to function.

It is important to note that the consumer protections under current check law continue to apply under Check 21. In fact, Check 21 goes further and grants additional protections through an expedited re-credit if a consumer asserts that the electronic check or substitute check was improperly charged against their account. In addition, the legislation requires banks to provide warranties for substitute checks and to indemnify consumers for losses resulting from the receipt of a substitute check rather than an original one.

Since the enactment of Check 21 there has been some confusion as to the impact this law has had on consumer accounts. The reality is that Check 21 is still in its infancy. Of the 50 million checks processed by the Federal Reserve every day there are only 400,000 digital images or substitute checks

being handled – that is less than 1% of all checks moving through the system. What has occurred is an increase in ACH transactions appearing on consumer banking accounts at a time when the publicity surrounding Check 21's enactment was at its peak. The result is many consumers believe the ACH transaction on their statement is a Check 21 related transaction. I hope that today we can clear up some of the confusion of what Check 21 does and does not do as well as learn more about ACH transactions.

Because there has not been widespread adoption of Check 21 to date, there has not been a significant reduction in the time it takes to clear checks. The Federal Reserve expects Check 21 to become widely used by the private sector by 2008. In addition, the Federal Reserve is required under Check 21 to study the impact of the new law on the U.S. payments system to determine if there are reductions in the time periods that it takes to clear a check. If the Federal Reserve finds that the time period for clearing checks is reduced, then it must also reduce the permitted hold times that banks may place on checks.

Chairman Oxley and I have been concerned that banks would reduce check processing times without reducing hold times. Accordingly, Chairman Oxley, Congresswoman Hart, Congressman Tiberi and I sent a letter to the banking trade associations urging them to provide consumers timely access to their funds as check processing times are reduced. As the time period for the transportation of checks is reduced by greater electronic processing, simple fairness would seem to dictate that consumers should also realize the benefits of quicker access to their deposits.

Let me close by saying what we said in our letter to the trade associations:

"Holding a deposit to ensure its safety and soundness is reasonable, but holding a deposit in order to profit from the interest is completely unacceptable. The latter practice prevents consumers from realizing the benefits of their own assets, while creating an illegitimate revenue stream for financial institutions. It unfairly penalizes consumers and should be eliminated from the U.S. payment system."

The Chair now recognizes the Ranking Member of the Subcommittee, Mr. Sanders, for any opening statement that he would like to make.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
"IMPLEMENTATION OF THE CHECK CLEARING FOR THE 21ST CENTURY ACT (CHECK 21)"
APRIL 20, 2005

Chairman Bachus and Ranking Member Sanders,

I want to express my sincere appreciation for you holding this hearing today. As an original co-sponsor of the legislation that established the Check Clearing for the 21st Century Act, also known as "Check 21," I welcome this hearing and all of the witnesses that will testify today.

I intend to monitor the implementation of "Check 21" closely to ensure that the Federal Reserve and all the banks it overseas adhere to all the requirements of the Expedited Funds Availability Act (EFAA). As most of you are aware, the EFAA sets the maximum permissible time banks may hold checks deposited at their institution before crediting them to a customer's account. The timeframe in which they may hold the check(s) varies according to the risk and origin of the deposited check.

I understand that legislation has been introduced to reduce the amount of time banks may hold checks, but I am not willing to support such a tactic at this time. I believe that we here in Congress need to allow the Federal Reserve additional time to monitor whether changes to the funds availability policies set out in Regulation CC may be warranted. I was pleased to learn in Federal Reserve Board Director Roseman's testimony that the Fed will be studying the effects of "Check 21's" adoption on the banking industry next year.

According to Director Roseman's testimony, the Federal Reserve "will study how this law [Check 21] is affecting the check-collection system and the appropriateness of the current maximum permissible hold periods." However, I believe that they may need to report their findings to us sooner, and act sooner, than April 2007 if they find significant reductions in the times needed to collect and return checks.

We need to ensure that the law is implemented in such a way that it takes into consideration the best interest of our constituents as well as our financial services community. I believe that we can arrive at a nexus between the two that reduces the cost to both consumers and financial institutions that streamline their activities using "Check 21."

I hope that today's witnesses and this hearing will provide me with some answers for these constituents.

Having said that, Chairman Bachus, I yield back the remainder of my time.

Testimony of Mark E. Budnitz
Professor of Law
Georgia State University College of Law

Before the Subcommittee on Financial Institutions and Consumer Credit
House Committee on Financial Services

Hearing on Implementation of the Check Clearing for the 21st Century Act

April 20, 2005

Introduction

As a law professor specializing in the law of consumer payment systems, I am deeply concerned about the impact of the Check Clearing for the 21st Century Act (Check 21). Payments law should treat people in similar positions in the same manner, unless there are compelling reasons not to. Check 21 violates this fundamental principle; it makes arbitrary distinctions among check customers, depriving more than half of them of important rights to which the others are entitled. It establishes obligations and deadlines that are different from those imposed by other payment laws. The result is law that is confusing and unfair. As a result of this confusion, people cannot understand their rights and obligations. Unfairness undermines consumers' trust in financial services institutions and in the law itself. The good news is that Congress can greatly improve this situation by preserving the substance of the law, but modifying some of the details, using the Electronic Fund Transfers Act as its model. That statute, together with the Federal Reserve Board's Regulation E, has served the test of time, producing little litigation and no substantial controversy.

The major issues addressed in my testimony are the following:

- Check 21 treats persons who agreed to truncate their checks (that is, those who agreed not to receive their original checks with their bank statements) far less favorably than those who did not agree, even though both types of customers are exposed to the same risk of errors due to check image exchange and the creation of substitute checks.

- Tremendous confusion is engendered by the differences in the way Check 21 and other laws deal with error resolution, both in terms of the banks' duty to investigate and deadlines for consumers to report errors.

- Check 21's requirements for submitting a claim are unduly stringent.

- Because of the similarities between Check 21 transactions and electronic check conversion (known as ARC), consumers confuse the two and are unaware of the vast legal differences between them in regard to their rights and obligations.

- Consumers are exposed to increased risk and cost as a result of Check 21's faster processing times and resulting bank fees for insufficient funds.

In order to ameliorate these problems, Congress should:

★ Enact statutes that introduce greater uniformity into the law of payment systems. The Electronic Fund Transfers Act provides the best model.

★ Incorporate into the law the rules of the National Automated Clearing House Association (NACHA) that provide consumers greater protection than current law.

★ Amend the Expedited Funds Availability Act to ensure quicker access to depositors' funds.

Putting Check 21 in Context

In the last few years financial institutions have taken advantage of technological advances to develop and market a proliferation of new payment systems and devices. These have been accompanied by several new laws and regulations. Substitute checks and ARC are two new methods to process payments. My testimony focuses on these two. However, in assessing Check 21's impact on consumers, it is important to understand that consumers are being barraged with many new payment products and ways of transferring funds. These include new payment devices such as payroll cards, gift cards, and prepaid phone cards. Many types of payments are being taken out of the consumer's bank accounts through on-line bill-paying, account aggregation, pre-authorized electronic transfers, pre-authorized drafts (telechecks), electronic check conversion, including ARC, substitute checks and ordinary checks. The monthly bank statement has become as arcane as the typical cell phone statement.

Another characteristic of today's payments marketplace is the consumer's loss of control. Approximately 40% of consumers have entered into account agreements with their banks whereby the bank is obligated to return the original checks to the consumer along with the monthly statement. Those consumers have refused the inducements many banks have offered to persuade their customers to agree to truncation of their checks. Check 21, however, nullifies that contractual guarantee. That law says the consumer has no right to receive original checks if substitute checks are produced instead, regardless of what the bank's contract guarantees. While Check 21 makes substitute checks the legal equivalent of original checks, the Federal Reserve

and law enforcement have warned of new types of errors and fraud that will result from the electronic processing that creates substitute checks, still more activity over which the consumer has no control. Consumers who agreed to have their checks truncated have even less control over what may happen to them; not only are they also exposed to the risk of new errors and fraud, but they do not get Check 21's limited protections.

Consumers lose control in other ways as well. Checks are clearing faster than ever, and many different types of fund transfers are being made in and out of the consumer's account at various times, making it difficult for consumers to keep track of their account balances. Consequently, it is easy for consumers inadvertently to have insufficient funds in their accounts. This results in bounced check fees or the imposition of very expensive "courtesy overdraft" protection that the consumer never agreed to and that can be triggered, not only by writing checks, but also for ATM and point of sale transfers.

Check 21 should be viewed within the context of these many new and different types of developments. Moreover, the Check 21 Act has special characteristics that make it particularly confusing to consumers.

The Impact of Check 21

The Check 21 Act has the beneficial objective of facilitating the processing of checks by means of image exchange, increasing the speed and efficiency of getting checks from payees to the consumer's bank. However, Check 21 has a negative impact on consumers. As a result of the greater speed, consumers have less time to ensure that they have adequate funds in their accounts. If their accounts have insufficient funds, they will be subject to expensive bounced check fees or overdraft protection charges. It is easy to blame consumers, saying it is their fault for writing checks without having enough money in their account. However, it is difficult for consumers to keep track of the transfers taking money out of their account since it can happen in so many new ways. In addition, consumers have no control over some sources of funds: unanticipated medical expenses, a late child support check, the delayed direct deposit of a paycheck, etc.

Another detrimental effect of Check 21 is the confusion it produces among consumers. When I speak to consumers, the aspect of Check 21 that confuses and discourages them the most is the different treatment of consumers who agreed to truncation and those who have not. Because of Check 21, all consumers' checks may be transferred to images and reconverted into substitute checks. As the Federal Reserve Board has acknowledged, many errors may occur as a result of these transformations of the original paper check into other forms. Representatives of law enforcement have warned that new forms of theft are now possible and it will be far more difficult to investigate check fraud criminals. However, only those consumers who have not agreed to have their checks truncated get the benefit of the recredit and indemnity rights granted by the Check 21 Act.

Consumers also are confused by the different deadlines by which consumers must notify their bank of errors in their monthly statement. For electronic transfers the consumer has 60 days to notify the bank. Under Check 21, the consumer must notify the bank within 40 days in order to make a claim for a recredit where the bank provided a substitute check. But if the bank provided the consumer with the original paper check, the deadline is specified in the bank account agreement, and may be as short as two weeks.

The bank's duties when the consumer reports an error is another source of confusion. For electronic fund transfers where the consumer claims an error, the bank must recredit the entire amount in dispute if the bank cannot complete its investigation within ten days. Under Check 21, the bank is required to recredit only $2500 if the consumer is provided a substitute check. However, consumers who have agreed to have checks truncated are not entitled to a bank investigation and cannot get any recredit, even if the error was caused by a substitute check. Those consumers are treated the same as the consumer who receives an original check. The Uniform Commercial Code applies, and it does not require the bank to investigate or recredit any amount. If the bank refuses to investigate and recredit, the consumer's only remedy is to sue the bank, and usually the amount in dispute does not justify the cost of litigation. The investigation and recredit provisions of the Electronic Fund Transfers Act and Check 21 provide consumers with a reasonable non-litigation remedy. That remedy should be available whenever there is a dispute, not only for electronic fund transfers and one category of check writers.

Finally, Check 21 imposes stringent requirements upon consumers submitting a claim for a recredit. For example, the consumer is required to inform the bank of "the reason why production of the original check or a better copy of the original check is necessary to determine the validity of the charge to the consumer's account or the warranty claim." I have yet to find a consumer who has any idea what that means. In contrast, the Electronic Fund Transfers Act provides consumers with a simple procedure for notifying banks of errors. That statute should serve as the model for future legislation.

All the consumers I have tried to educate about Check 21 have been well-educated, middle class people. They seemed quite well-informed about credit cards and the basics of traditional check transactions. But they were understandably baffled by the complications introduced by Check 21. I have spoken to consumer organizations who hear from far more consumers than I, and they confirm my finding that consumers are indeed confused. For example, many consumers started registering complaints about Check 21 even before it went into effect. They had actually encountered problems with ARC, but due to the similarities between Check 21 and ARC transactions, they did not realize that different rules apply when checks are processed through that system.

ARC

When consumers mail a check to pay a bill, some businesses use the check as a source

document from which they take data in order to process the payment as an electronic fund transfer via the automated clearing house system. Those transfers are subject to NACHA's ARC rules. Consumers lack any understanding of how ARC works and what their rights are when their payments are processed in that manner. The superficial similarities between ARC and Check 21 transactions add to the confusion engendered by Check 21. Moreover, consumers have no control over how the check is processed.

Consumers reasonably assume that when they send a check in the mail to pay a bill, one set of legal rules apply. In reality, depending upon how the business deals with the check, it may be subject to the Uniform Commercial Code, Check 21, or the Electronic Fund Transfers Act and NACHA's ARC rules. If subject to either Check 21 or the ARC rules, the consumer who never agreed to have checks truncated nevertheless does not receive the original check that the consumer's agreement with the bank said he was entitled to. If the check has been processed through electronic image exchange, the consumer will receive a substitute check. If processed through ARC, all the consumer receives is a notation on the monthly statement. There is no required labeling or description. My bank calls it an "automated check," a term that does not adequately describe the transaction.

If a business wants the option of processing a check under the ARC rules, Reg. E (issued pursuant to the Electronic Fund Transfers Act) requires the business to notify consumers that their checks may be processed electronically. Two of my credit card companies provide that notice. One has it buried in a very long dense paragraph that addresses many topics having nothing to do with ARC. The other company has the notice in the portion of the statement that I return when I pay the bill. Consequently, I have no record of that notice to refer to once I mail the payment.

NACHA recently enacted an opt-out rule, enabling consumers to choose not to have their checks processed as an ARC. Unfortunately, the rule does not require businesses to notify consumers of their ability to opt out. The opt-out rule is not the only one that NACHA has adopted that provides consumers with greater protection than current law. There also are favorable rules on what businesses do with checks that will be processed electronically and rules on stop payment and recredits. The problem is that NACHA could change or withdraw them at any time. Congress should incorporate them into the law.

Expedited Funds Availability

Congress enacted Check 21 because financial institutions wanted a law that would facilitate quicker and more efficient check processing. Congress' purpose was not to create a new profit center for banks. However, because checks are cleared faster, consumers lose float and have less time to exercise their right to stop payment. As described above, they also are more likely to be subject to bounced check and overdraft protection charges, as well as the risk of double debits and other errors. A good law is one that is fair. A measure of the fairness of a law

is one that is balanced. Congress could strike a better balance by requiring that banks give consumers quicker access to funds they deposit.

Financial institutions claim no action should be taken yet. They say that it will be years before Check 21 becomes fully effective and most checks are processed by means of check image exchange. But Congress should not wait until the vast majority of checks are processed electronically. Congress should not wait because apparently banks are already clearing checks much faster than the law requires. Some industry estimates are that 95% of checks are cleared in one day. (Andrea McGlinn, "Check Clearing for the 21st Century Act: The Impact on Consumers," 9 North Carolina Banking Institute 179 (2005)). According to the Senior Policy Counsel at the American Bankers Association, "[t]he vast majority of banks already allow access to deposits earlier than the law requires; most banks generally allow consumers to withdraw funds on the day of deposit or the day after deposit for funds drawn on both local and nonlocal checks." (Letter from ABA posted on the ABA's web site, www.aba.com). Furthermore, the law includes major safeguards for banks. The deadlines for availability do not apply if a consumer opens up a new account, has repeated overdrafts, makes large deposits, has checks redeposited, or the bank has reasonable cause to doubt collectibility.

The second reason Congress should not wait is because the future is now, or pretty close to now. Major financial institutions have joined companies such as SVPCo and Endpoint in order to take advantage of Check 21. JP Morgan Chase and Key Corp. started exchanging checks electronically last August. Bank of America, Wells Fargo, and Electronic Data Systems started doing so last December. The General Manager of CheckClear stated last month, "Imaging is about to do that hockey-stick curve of growth...It's going to become very big, very fast." (Daniel Wolfe, "Endpoint Agrees to use ECCHO's Exchange Rules," American Banker, March 24, 2005). It is not only the biggest banks that are taking advantage of Check 21. For example, Independence Community Bank Corp. recently announced that starting this summer it will convert most of its customers' checks into digital images at the teller window.

Finally, I urge you to ask your constituents how they feel about a law allowing banks to hold onto their funds for many days after the check has cleared. The law permits a five day hold for nonlocal checks, but the law's terms are defined such that in addition to the five days, usually the hold will include a weekend. The consumers I talk to often mention this delay. They are quite angry about having to wait to be able to use their money.

Conclusion: Recommended Changes in the Law

Congress should improve the law by mandating uniform rules modeled after the Electronic Fund Transfers Act and Regulation E. Substantially the same rules should apply when a consumer mails a check to a business, regardless of whether a payment is processed as a check transaction or an ARC transfer. If an error occurs when checks are converted to digital images and reconverted into substitute checks, the same Check 21 protections should apply to both consumers who agreed to truncate and those who did not. If consumers believe an error

occurred, they should be able to notify the bank of the alleged error and trigger a mandated investigation, regardless of whether they paid by check or debit card. The procedure to trigger the investigation should be easy to understand and comply with, no matter what type of payment instrument consumers use. Financial institutions should be required to recredit the consumer's account after ten days if they cannot resolve the consumer's claim, with a maximum of 45 days to investigate the claim if the consumer paid with a check as well as when the consumer uses a debit card. NACHA rules providing greater protection to consumers should be enacted into law.

Finally, the Expedited Funds Availability Act should be amended to require banks to give consumers access to their funds more promptly.

The Check 21 Act and advances in technology have combined to make the world of payment devices and systems far more complex, confusing and problematic than ever before. In addition, consumers have less control than ever. Congress should not enact laws that would stifle the development of new products and systems made possible by technology. But Congress also should not, and need not, make consumers the losers when financial institutions implement these innovations. As the Electronic Fund Transfers Act demonstrates, it is possible to strike the appropriate balance.

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April 20, 2005

Testimony of

Elizabeth A. Duke

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Financial Institutions and Consumer Credit

Of the

Committee on Financial Services

United States House of Representatives

Testimony of
Elizabeth A. Duke
On behalf of the
American Bankers Association
Before the
Subcommittee on Financial Institutions and Consumer Credit
Of the
Committee on Financial Services
United States House of Representatives

April 20, 2005

Good morning, Mr. Chairman, members of the Subcommittee. My name is Betsy Duke and I am the Executive Vice President of Wachovia Bank and the American Bankers Association (ABA)'s current Chairman. I am pleased to be here this morning to discuss the Check Clearing for the 21st Century Act ("Check 21"), the statute intended to promote the efficiency of check processing by allowing depository institutions to take advantage of 21st century technology. Under Check 21, no longer must checks physically travel across the country in order to be processed. Instead, the establishment of the substitute check has provided a vehicle to facilitate electronic check processing. While the transition to electronic check processing is a gradual one, we believe that ultimately, it will be beneficial to banks and their customers.

Testifying here today presents the banking industry with the opportunity to assure the Committee that, for the most part, Check 21 has meant business as usual for the average consumer. As expected, Check 21 means gradual and orderly change, for consumers and banks. Today's hearing also gives us the opportunity to correct much of the disturbing and continuing misinformation and inaccuracies promoted by some.

The American Bankers Association, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks--makes ABA the largest banking trade association in the country.

We would like to emphasize a few points:

- As the ABA and the banking industry predicted, Check 21 was not a "flip of the switch" event, in part, because moving to electronic check processing is voluntary. Most consumers have yet to notice an impact. At

this time, it is expected that electronic check processing will not reach a significant level until late 2006 or early 2007.

- Contrary to press reports and statements by some consumer activists, federal law does indeed require that the time banks may hold deposits be shortened once the check processing system is, in fact, more efficient.

- The funds availability schedules should not be shortened until checks are actually processed more quickly. Most banks already make funds from most deposits available earlier than the law requires.

- Holds are critically necessary to help prevent check fraud, which harms both the banking system and consumers. It makes no sense to shorten holds before checks are actually processed more quickly.

As expected, Check 21 is an evolution, not a revolution.

Despite dire warnings by some consumer activists and reporters, that as of October 28, 2004, all checks would be processed "within hours," Check 21 has basically been a nonevent for consumers. The move toward electronic check processing, facilitated by Check 21, is proving to be a gradual one. In fact, it is even slower than anticipated.

At Wachovia, we are considered to be a leading edge electronic check-processing bank, as we currently possess the ability to both send and receive electronic check images and data. However, despite these capabilities, we do not anticipate that we will be processing more than 2 to 3 percent of our checks via image exchange by years end. Furthermore, given our understanding of the time and investment required to implement electronic check processes, we feel that the industry ramp-up period will most likely occur somewhat slowly over several years.

More specifically to Check 21 and our responsibilities relative to the substitute check, Wachovia has gone to great lengths to ensure that all of our check-writing and depositing customers are appropriately notified of their rights under the Act. We are also actively monitoring all Check 21 related feedback received at our branches and call centers, and though some of our customers did share some concerns prior to the implementation date, we have logged very few customer comments or concerns in the past several months. One of the primary indicators of consumer impact from Check 21 is the number of expedited recredit claims we receive. If you'll recall, the expedited recredit provision provides recourse in the event of injury sustained due to the fact the consumer received a substitute check as opposed to the original. Of the roughly 2 million substitute checks that we have processed since the inception of Check 21, we have received zero expedited recredit requests.

According to the Federal Reserve Board ("Board"), less than one percent of the checks the Reserve Banks collect on a daily basis are either deposited with the Reserve Banks as image cash letters or truncated at the Federal Reserve Banks and converted into image cash letters using its Check 21 products. It has indicated that the average amount of a converted check is between $13,000 and $15,000, far above the average check of $1,070 (includes both consumer and business checks).

ABA members also report that the migration to Check 21-type processing has been slow. Many are not yet converting their deposits into electronically transmittable images.

Some of the reasons that movement toward electronic processing is not more rapid are: 1) banks must invest in and deploy new systems; 2) some banks have adopted a wait and see approach; and 3) the current costs of creating a substitute check are often higher than the cost to process the check by the usual paper route.

It is also important to keep in mind that even in those cases where there is electronic processing of check images, at some point in the process, a substitute check is frequently created. This substitute check is then processed as any paper check, and it must physically travel. There are few transactions that are processed entirely by electronic means from the bank of first deposit to the paying bank. For example, many corporate customers are interested in converting their deposits into images to transmit to their bank electronically because they avoid expensive transportation costs. However, once the images reach the bank, they are converted into substitute checks for processing in the traditional fashion. This means that even though some checks are converted into electronic images and transmitted electronically for some portion of the check processing route, the checks are not necessarily being processed more quickly.

We expect that as systems are installed and the electronic process becomes more affordable, more banks will adopt electronic processing. At this point, it is expected that there will not be significant electronic processing of checks until late 2006 or early 2007.

Because the transition to electronic check processing has been gradual, the grim predictions that on October 28, 2004, the effective date of Check 21, consumers would be shocked that checks would be charged to their account instantaneously, generating "a barrage of bounced checks flying through the system,"[1] simply did not materialize. These erroneous reports, unfortunately, only served to alarm consumers unnecessarily.

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[1] Suze Orman, "How the New Check 21 Law Affects You." Http://biz.yahoo.com/pfg/e21check/

As the check processing system becomes more efficient, the law requires that the funds availability schedules be reduced to allow consumers quicker access to their deposits.

Another alarming and persistent Check 21 myth is that Check 21 eliminates float for banks, but no law requires banks to make funds available sooner or pay interest sooner. This assertion is simply not accurate.

First, it is important to point out that most banks today already provide funds sooner than the law requires. ABA's 2004 *Deposit Account Fraud Survey Report* shows that most banks provide funds on the *day of deposit or the day after deposit.* For local checks, depending on the region, between 72 percent and 87 percent of banks provide funds before the law requires. For nonlocal checks, between 72 percent and 82 percent do so. These statistics are consistent with ABA's previous biennial surveys, conducted since 1992 (except one year when the Board conducted its own check processing survey). It is also worth noting that survey responses are based on the institutions' *published* funds availability schedule and indicate the *latest* funds will generally be available. In many cases, funds are made available even earlier. Moreover, any theoretical concerns about holds are exaggerated because the vast majority of consumers receive their most important check -- their paycheck -- by direct deposit. In this case, funds are available on the morning of payday.

Second, even when holds are placed, customers receive interest on interest-bearing accounts from the time the bank receives the funds. Check 21 has no impact on the long-standing requirement under Section 606 of the Expedited Funds Availability Act that depository institutions pay interest to consumers no later than the time the institution receives credit for the funds.

Third, federal law does indeed require that funds availability schedules be shortened once "most" checks are returned in a shorter time,[2] a fact that some consumer activists and reporters have ignored. Some have asserted that *Check 21* does not require the funds to be available sooner, which is technically correct, but quite misleading. Check 21 does not include such a provision, because the Expedited Funds Availability Act already does.

Congress recognized the existing requirement of the Expedited Funds Availability Act and therefore did not include a redundant requirement in Check 21 that would have created confusion and unnecessary debate. Moreover, the Expedited Funds Availability Act requirement was well understood and explained in Board discussions with industry and consumer representatives.

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[2] Section 603(d)of the Expedited Funds Availability Act, 12 USC 4002(d), requires that the Board "reduce the time periods" to periods which allow banks to learn of nonpayment of "most items of each category of check."

In fact, pursuant to its responsibilities under the Expedited Funds Availability Act, the Board in December 1999 investigated whether the schedules should be shortened. After an expensive study, it concluded that checks were not being processed quickly enough to justify shortening the schedules. Since that study, until passage of Check 21, little had changed in check processing to suggest that checks are moving more quickly. We certainly believe that the Board, having previously demonstrated its commitment to comply with the statute, will continue to take its responsibility seriously.

The funds availability schedules should not be shortened until the check processing system is, in fact, more efficient.

The funds availability schedules should not be shortened until checks are, in fact, processed more quickly. Until that time, it is critical that banks have the option and flexibility to place holds pursuant to the Expedited Funds Availability Act. In brief, the system should allow time for the bank to learn that a deposit is not good before it must release funds. We realize that under the Expedited Funds Availability Act not all checks will be returned within this time frame, but at the very least, most should be.

To explain, today check processing typically requires that checks be physically transported from the bank of first deposit, by plane and truck, to the paying bank. If the check is returned because it is not payable, for example because it is fraudulent or there are insufficient funds in the account, it must make a return journey to the bank of first deposit. The journeys back and forth involve a complicated and sophisticated network of connections and transportation systems. Weather and other complications can slow delivery. The fact that it can take days for an unpayable check to travel from the bank of deposit, to the paying bank, and then back to the bank of first deposit is the reason holds are necessary.

Criminals attempt to take advantage of these check processing limitations and funds availability schedules by depositing fraudulent items and withdrawing the funds before uncollectible items are returned. They rely on the fact that banks, by law, must release funds before they can learn that the check is not payable.

Indeed, one particular scam in recent years that has fleeced thousands of consumers and banks relies on the requirement that banks release funds before the check can be returned. Under these scams, instigators of the fraud persuade consumers to accept a check, often a cashiers' check, as payment, and then ask the consumers to wire funds back to them (fraudsters) as soon as the funds from the check are available. While details vary and continue to evolve, in a common scam, the consumer is selling an item on the internet. The "buyers" (fraudsters) explain that because they are not in the United States, payment is difficult. They offer to have a "friend" in the United States, who owes them money, send the

seller a cashier's check in an amount greater than the purchase amount. The fraudsters then instruct the seller to wire the excess funds as soon as the bank makes the funds available.

Under the Expedited Funds Availability Act, the bank must make the funds available on the day after deposit and inform the consumer of this fact if asked. Accordingly, the consumer wires the funds as soon as funds are available, only to learn a few days later that the check is counterfeit. Consumers are then liable for those wired funds, as they authorized the transactions, but banks often suffer the loss because the consumer simply does not have the money.[3]

Fraudulent cashiers' checks are growing in frequency. Hardly a day goes by without the FDIC sending out a notice of fraudulent or stolen cashiers' checks.

As demonstrated, holds are important protections against fraud. In 2003, banks lost nearly $700 million to check fraud.[4] Consumer activists' calls to shorten the funds availability schedule before the system is actually more efficient are putting the cart before the horse. It would be irresponsible to remove these important fraud protection tools unless the system has otherwise addressed the threat.

To determine whether the system is more efficient, the Board is currently developing a study to determine how quickly checks are being processed. However, it is important to keep in mind that if a study were conducted today, the check processing times would probably not justify shortening the schedules. ABA's 2004 *Deposit Account Fraud Survey Report* found that most checks are not returned before the bank must release funds. The vast majority of *local* uncollectible checks are not returned to the bank of deposit until some time after the second day after deposit, when the funds must generally be available. Depending on bank size, less than half of uncollectible *nonlocal* checks are returned before funds must be available, generally the fifth day after deposit. Check 21 has yet to make a significant impact on these return times. Thus, if a study were conducted today, the funds availability schedules would probably remain unchanged.

It is also important to understand that studies to measure the speed of check processing are difficult and expensive. They should be done periodically, but not continuously, as has been suggested. Such in-depth studies require special efforts by bankers to carefully analyze, measure, and track check processing

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[3] ABA has partnered with the National Consumer League in efforts to warn consumers of these schemes. We jointly developed a pamphlet explaining the scams, available at the teller window or with statements. In addition, we participated in a radio tour of 18 stations, with an estimated 7.9 million listeners. A "matte piece" article was distributed to 10,000 outlets. Information is also available on our aba.com website.

[4] *The ABA Deposit Account Fraud Survey Report 2004.*

times for items that have thousands of possible routes and endpoints. Asking banks to repeatedly divert resources to measure what has changed marginally provides little incentive to continue responding to multiple surveys. The result will be fewer and less robust responses that will diminish the value of any subsequent surveys. Accordingly, we strongly recommend that Congress give both the Expedited Funds Availability Act and Check 21 time to work.

ABA, as in the past, will encourage banks to respond to the Board's survey. When the Board conducted its last study, ABA refrained from conducting our own Check Fraud Survey so that banks could focus on and respond to the Board study. ABA will similarly encourage bankers to respond to the next study.

Concerns related to float are grossly exaggerated.

Adding to the concern and confusion about the impact of Check 21 were repeated assertions that consumers would lose float as of October 28, 2004 and suddenly and inadvertently be bouncing millions of checks. Some consumer activists asserted that consumers would bounce more than 7 million checks each month. Mellody Hobson, a guest of Diane Sawyer on ABA's *Good Morning America*, echoed those predictions. Obviously, nothing like that has happened, nor do we expect it to. Nevertheless, those grim warnings continue to sound.

As discussed earlier, Check 21 will bring about gradual change. Consumers will not be caught unaware. As checks gradually are processed more quickly, those who use float will adjust their behavior as they have in the past. For example, before the introduction of magnetic ink character recognition (MICR), in the 1950s, checks were processed manually, creating a fairly lengthy float. As banks moved to processing checks in an automated fashion using machines that read the numbers found on the bottom of the check, float was drastically reduced. Consumers modified their behavior accordingly. We believe that consumers will again respond just as rationally and calmly as checks are over time processed more quickly because of Check 21.

Moreover, even if a consumer is caught off guard when the first check is processed more quickly than expected, most banks already waive overdraft fees for customers who occasionally overdraw their accounts if requested. Once consumers realize that checks may be processed more quickly, they will not continue to rely on the float and incur multiple fees, as some consumer activists have suggested. Consumers are smarter than that. They will adjust their behavior, much as people do not continue to park in illegal parking spaces day after day after receiving multiple parking tickets.

We should also point out that banks too will lose float; the money drawn on their customers' accounts will be withdrawn more quickly. Moreover, any float banks may derive from holds is wildly exaggerated. As noted, most banks allow customers to withdraw funds by the day after deposit, they pay interest from the

date they receive credit, and the permissible holds eventually will be shortened as the process becomes more efficient.

Images have been accepted as proof of payment for decades: a substitute check is unnecessary.

In addition to misperceptions about float and bounced checks, consumer activists have asserted that consumers need a "substitute check" for proof of payment, that an image of a check is insufficient for these purposes. Yet, for decades, the IRS, landlords, merchants, and others have accepted copies and images of checks as proof of payment. Virtually all credit union members and over 60 percent of consumers receive check images or copies and rely on them to prove payment. To assert that these images, which consumers have used for years, can no longer show proof of payment, is irresponsible and causes unnecessary concern and angst among consumers.[5]

Consumers are protected against unauthorized transactions even if they do not receive back a substitute check.

Concerns were also raised about consumer protections from unauthorized transactions when consumers receive back the original check or an image, rather than a "substitute check" with their statement. Check 21 kept existing state consumer protection laws intact and they need not be altered. State check laws (such as those based on the Uniform Commercial Code), which remain in effect, work. While the technical, legal details may vary, consumers, by law, generally are not responsible for unauthorized transactions, whether they receive back an original check, a substitute check, or a copy of either. Different laws use different terms, but whether it is called a recredit, a refund, or stated in some other fashion, the results are the same: generally, the consumer gets back the money in a timely fashion. Assertions to the contrary do a disservice to consumers who might be led to believe that they lack rights and, consequently, do not know to exercise them.

Moreover, in addition to legal considerations, customer service pressures ensure that banks resolve check disputes expeditiously. Banks have a good track record for investigating and resolving complaints in a timely fashion.

ABA has gone to great lengths to educate its members and the public about what to expect under Check 21.

Soon after passage of Check 21, we provided complimentary "Check 21 Toolboxes" to all our members. These toolboxes explain the new law and how to educate customers and the media about what to expect under Check 21. In

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[5] Even the Federal Trade Commission issued the misleading statement, since corrected, "You can use a substitute check as proof of payment, but only if it includes this statement: 'This is a legal copy of your check. You can use it the same way you would use the original check.'"

addition, we provided to depository institutions an educational brochure, "Checks Are Changing," which many depository institutions have voluntarily provided to customers in addition to the statutorily required notice. ABA also participated in a Check 21 radio tour and distributed a video news release to all the television news departments in the country. We sent a sample personal finance column explaining Check 21 to 20,000 print publications. ABA responded to hundreds of inquiries from reporters and agreed to appear in numerous television news programs. ABA also provided a Check 21 media kit to all Congressional press secretaries. ABA staff even talked to and wrote letters to individual concerned consumers.

In addition to the industry's efforts, Congress ensured that consumers would be informed about Check 21 and its potential implications. It included in Check 21 a provision requiring that banks send out to affected customers explanations about Check 21 and its potential impact. ABA will continue these education efforts as Check 21 continues to be implemented.

Conclusion

Mr. Chairman, members of the Committee, I am pleased to have had the opportunity to report on the progress of Check 21 to date and to clear up some misconceptions about certain aspects of this law. I am happy to answer any questions.

Testimony of

Independent Community Bankers of America

on
"Implementing the Check Clearing for the 21st Century Act"

before
the Subcommittee on Financial Institutions
and Consumer Credit

of the

House Financial Services Committee

April 20, 2005

David Hayes
President & CEO
Security Bank
Dyersburg, Tennessee

and

Chairman
Independent Community Bankers of America
Washington, DC

Mr. Chairman, Ranking member Sanders, and members of the Committee, my name is David Hayes. I am Chairman of the Independent Community Bankers of America ("ICBA"),[1] and President and CEO of Security Bank, a $135 million community bank located in Dyersburg, TN. My bank is one of six community banks commonly owned in west Tennessee communities. Our collective assets total approximately $525 million. I am pleased to appear today on behalf of ICBA and its nearly 5,000 members.

We strongly support the Check Clearing for the 21st Century Act ("Check 21") and the increased efficiencies to the nation's payments system, and cost savings that will be realized because of its enactment. By authorizing the creation of substitute checks, Check 21 has opened the door to bank-to-bank electronic check processing. Prior to the passage of Check 21, the original paper check had to physically move through the entire clearing process from the bank of first deposit to the paying bank – a labor-intensive process. Banks were required by law to obtain customer consent in order to truncate their checks and process them electronically. Check 21 has removed such legal impediments, and is facilitating the industry's progression towards more efficient check processing to the benefit of both the consumer and the bank.

Check 21 Technological Implementation is an Evolutionary Process

Check 21 became law on October 28, 2004, approximately six months ago, and while the new law has established the legal framework to speed up check processing, the technological infrastructure is still developing. This is very much an evolutionary process, not an overnight process, and has been appropriately referred to as a marathon, not a sprint. Therefore, relatively speaking, little has changed in the past six months for community banks.

I would like to share my bank's experience with check imaging technology to illustrate the technological infrastructure required for banks to take advantage of the Check 21 processing model. Our ownership structure allows us to centralize many functions, including check processing, for the six banks. We started offering image statements in 1999. Today, only 8% percent of our collective checking account customers do not receive image statements. We are extremely pleased with our implementation of image statements and the overwhelmingly positive customer response. The benefits have been enormous. For the

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[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.

With nearly 5,000 members, representing more than 17,000 locations nationwide and employing over 260,000 Americans, ICBA members hold more than $631 billion in insured deposits, $778 billion in assets and more than $493 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

customer, we are able to expedite statement delivery along with improving the quality of the statements. Account reconciliation has been simplified, and we can respond to inquiries in minutes instead of hours. For the bank, imaging has led to significant cost reduction, particularly in postage expenses. Additionally, we have experienced improved production in the check processing areas, simplified statement preparation, and streamlined document storage. We have invested approximately a half million dollars in this technology so far.

We have made few changes to our processing environment in the six months since Check 21 became effective. Given the cost of substitute check production and the associated warranties, we do not want to create substitute checks. Instead, we are waiting to move to a full electronic clearing platform. However, in order to move to a check image exchange platform, we must have three critical components in place:

First, we need new software that will allow us to send and receive check images. Our software provider's current product does not meet our needs.

Second, intermediaries – correspondent banks, check processors, and the Federal Reserve – must have the capability to send and receive check images. Intermediary efforts range from the design to limited implementation stages.

Third, there must be widespread acceptance of common interbank image exchange rules. ICBA recognizes and supports the Electronic Check Clearing House Organization (ECCHO) rules for electronic check presentment and check image exchange; however, acceptance of these rules among community banks is in its infancy. ICBA is working closely with ECCHO on this issue.

A small number of banks have invested in the needed technology. The cost of implementation is high, and those banks that have purchased the technology are implementing it slowly in order to fully understand the impact it will have on both their operations and their customers. The industry must be given time to adopt the technology, rules and standards, procedures, and products to take advantage of the processing efficiencies envisioned under Check 21.

Check 21 Today

Check 21 allows collecting banks to truncate paper checks, process them electronically, and create paper substitute checks for those paying banks desiring to continue receiving paper.

It is important to note that the new law does not mandate that banks process or receive checks in electronic form, rather it provides the flexibility, on a bank-by-bank basis, to adapt to electronic check clearing over time without interfering with the existing paper check process. Nevertheless, many community banks have begun streamlining their check operations through the use of imaging technology to provide customers with monthly account statements containing images of canceled checks in lieu of bundles of original canceled checks.

Over time, reducing the dependency on the physical presentment of original items will result in expedited check collection, expedited funds availability and statement delivery, better quality statements and less fraud. These benefits go beyond simple consumer

conveniences. The ability to access check images online allows consumers to quickly and conveniently verify their transactions, identify potential errors, and detect fraudulent transactions sooner. This, in turn, allows banks to minimize customer inconvenience, control potential losses, and gives law enforcement an advantage in tracking down perpetrators.

However, image based clearing is not yet the dominant form of check clearing, and analysts have predicted that it will be several years before digital images are used to clear most checks. Therefore, it is premature to conclude that checks are clearing faster since the enactment of Check 21.

ICBA Survey. Earlier this month, ICBA surveyed its members to learn more about community banks' implementation of Check 21 and its impact on customers. Almost 400 community banks throughout the country, and of all charter types and various asset sizes, responded to this survey. Eighty six percent of the banks responding are not currently using image technology to present checks for clearing and settlement. They are waiting for intermediaries such as the Federal Reserve or third-party processors to develop the software and complete the testing of end-to-end image clearing platforms, or have opted not to pursue imaging at this time as they do not want to incur the cost of substitute check production and warrant substitute checks.

Of the respondents that indicated that they are using image technology for check clearing and settlement, none are engaged in a full image-clearing environment. Some are using the application to exchange check images with a single financial institution. Others are using the application to exchange check images with financial institutions using the same software. Still others are relying on intermediaries to determine which large dollar checks are appropriate for conversion to images and subsequent substitute checks.

Substitute checks currently account for a minuscule percentage of the checks processed. More than two-thirds of the survey respondents estimate that they receive fewer than 50 substitute checks per month. Ninety-two percent of the respondents are not creating substitute checks. In my own case, our six banks receive fewer than 50 substitute checks per month, representing less than one fourth of one percent of our total monthly check volume.

Survey responses reveal few Check 21 implementation issues for community banks and most importantly, their depositors. Virtually all respondents (99%+) reported no losses to depositors or the bank due to receipt of a substitute check. Ninety-one percent indicated that they have not received any expedited recredit claims. Additionally, 90% reported no consumer complaints since Check 21 became effective. The examples provided by the respondents reporting consumer complaints showed that consumer questions were due largely to unfamiliarity with substitute checks, the media's distortion of the potential loss of float, or confusion regarding ACH check conversion. Our six banks have had a similar experience.

ICBA believes that the industry's migratory implementation of Check 21 is appropriate and is in the best interest of both financial institutions and their customers.

Check Holds Play An Important Role in Reducing Check Fraud

While the technological infrastructure of Check 21 will, over time, minimize the incidences of check fraud, the potential for risk will remain. As banks implement check imaging technology, we must remain aware of the potential for the perpetration of fraud against automated check clearing processes that will be detrimental to both the consumer and the bank. We strongly believe that is premature for any legislative or regulatory changes that would reduce check hold periods until a technological infrastructure is more developed and checks are indeed clearing faster.

Under your leadership, Check 21 was drafted to include very effective consumer protections in light of the creation of a new instrument, the substitute check. Similarly there are effective protections for financial institutions as well. For example, Regulation CC and the Expedited Funds Availability Act were designed to balance the depositor's need to have access to deposited funds with the need of financial institutions to protect against and prevent fraud and losses to depositors and financial institutions.

Members of the Committee have acknowledged the importance of check holds in the prevention of fraud against banks and depositor losses; however, this is too often overlooked. There are losses due to fraud that are prevented by check holds, such as kiting, washed checks, and counterfeit checks. However, many more fraud schemes result in significant losses to financial institutions because next-day availability is generally required for certain checks. For example, fraudulent U.S. Postal Service money orders, fraudulent U.S. Treasury checks, fraudulent cashier's checks, and fraudulent official bank checks have become a chronic problem for community banks.

I am reminded of a situation at a small community bank where a check-kiting scheme, carried out by a customer, almost caused the bank to fail in a matter of hours. The kite depleted almost all of the bank's capital, and the bank was close to being unable to honor the local public school payroll. So you can see, for community banks especially, the impact of check fraud can go well beyond the institution and have real consequences for the community. This further supports our position that it would be premature to alter existing check hold policies before the technological infrastructure is more developed and checks are indeed clearing faster.

Banks Already Make Funds Available to Customers Sooner Than Required By Law

Many of our member banks already make funds available to customers earlier than required by the Expedited Funds Availability Act and Regulation CC in the interest of good customer service **and** with the knowledge that the flexibility exists to apply longer holds if warranted. For example, 28% of the survey respondents provide same business day availability on items that qualify for next business day availability. Ninety-one percent provide same or next business day availability for items that qualify for two-business day availability. Additionally, 86% provide faster availability, more than half by the next day, for checks that qualify for five-business day availability. But, while banks offer this customer service, they still have legal and regulatory authority to place holds where needed.

The following are survey responses with examples of how the bank's existing check-hold policies have helped to prevent check fraud.

- On new accounts, we hold for 10 days. If we had not held these, we would have had new account fraud losses. We place case by case and exception holds. In many cases, we have avoided losses due to holds we have placed.
- The length of time allowed for both local and non-local checks helps to prevent the withdrawal of funds on items that will be returned to us. If these times were shortened, we would definitely experience additional losses.
- Holds are placed on checks that are deposited to accounts that are kiting suspect accounts. New accounts with non-local checks might have holds placed on them until the account is established.
- We are a small community bank and know virtually all of our customers. Implementation of our check hold policy is very uncommon. In the rare instances that we do place a hold, it is because we have some reason to believe that the item poses some risk to either the bank or the customer.
- Holds don't work when the Fed won't enforce timely returns and large item notifications. We properly held funds on a $60M check for ten days before releasing funds to the depositor. Then on the eleventh day received the item back in our returns. We received no large item return notice. Fed would not enforce the rules, so we had to charge off the item.
- Our hold policies on Cashier's Checks have been strengthened to prevent check fraud. We push the limits of Reg CC to protect us and the customer from fraudulent items. Regulation CC as written for Cashier's Checks needs to be changed to treat Cashier's Checks no differently than other items. With the rash of FDIC Financial Institution Letters on this matter, it should be obvious to the regulatory bodies that the regulation has caused the counterfeiters to focus on using Cashier's Checks to take advantage of the shorter hold periods on these items.
- We accepted a $48,000 check that turned out to be counterfeit. Had we not placed a hold, we would have been out that amount.
- We have made a habit of placing holds on most large items if they are not the normal habits of our customers. This has saved us thousands of dollars in losses.
- Following Reg CC guidelines during the initial stages of the account have helped us avoid split deposit fraud that is common. Once the accounts are open fro 90 days, most of the bad ones have been washed out, as we are diligent in our efforts to screen out the risky accounts. Annually, we have very little check fraud loss. Current Reg CC rules are needed, especially in the first three months of the account. Until every single bank in the country is exchanging images, reducing Reg CC hold times will be impractical, and will increases losses for all banks.
- Especially with large items, our hold policies allow us the cushion needed to ensure the deposit will be covered. As so many checks are being reproduced by unlawful individuals and/or stolen and passed as valid signatures, we are open to losses daily.

Bank Check Processing Practices Are Fair

We recognize that some Committee members have concerns that banks' processing practices are designed to increase the likelihood of overdraft fees. Ninety percent of our members responding to the survey post deposits and other credits before checks and other debits; 93% do not post deposits and other credits to consumer checking accounts on Saturdays, and 95% do not post checks and other debits to consumer checking accounts on Saturdays. Therefore, contrary to the claims of consumer groups and others, check-

processing practices are not designed to yield an illegitimate revenue stream for banks.

Moreover, the Federal Reserve, FDIC, OCC and NCUA recently issued final guidelines on courtesy overdraft protection programs, often called "bounce protection." The guidelines, similar to those issued separately by the OTS, outline steps banks should take to address safety and soundness concerns, legal risks, and best practices to consider when offering the service.

The best practices include recommendations for marketing the programs and customer disclosures. For example, banks should avoid promoting poor account management by advertising the service in a way that appears to encourage customers to overdraw their accounts. Staff should be properly trained to explain the operation of the program, and disclosures should clearly explain that a bank's decision to honor an overdraft is discretionary. Since courtesy overdrafts incur fees, banks should clearly distinguish the service from "free" account features. Moreover, fees should be clearly disclosed and the bank should explain how checks are cleared and the types of transactions that are covered.

ICBA initially raised concerns with the draft guidelines about many burdensome provisions that would cause banks to discontinue offering this popular customer service. The final guidelines are more flexible and are designed to help ensure banks make responsible disclosures and properly administer the programs. The guidelines generally apply to automated programs, but the agencies suggest that banks consider the guidelines whenever honoring a customer's overdraft. Additionally, the guidelines remind banks that courtesy overdraft protection is subject to a variety of legal requirements, including the FTC Act's ban on deceptive acts and practices.

Under the guidelines, banks should offer customers the opportunity to opt out of the protection, and the amount of overdraft protection availability should be clearly distinguished from account balances so that customers can avoid overdraft fees, and customers should be promptly notified whenever the services are used.

It is important to remember that this is a service most consumers welcome. Unfortunately, many consumers fail to regularly balance or reconcile their accounts. Bounce protection is often a guard against embarrassment and additional fees. When properly used and administered, bounce protection is a consumer service. Burdensome restrictions would cause banks to discontinue this service -- to the detriment of consumers.

In light of the numerous customer protection measures included in the regulatory guidance to the industry for this customer service, ICBA believes additional legislative measures in this area are not warranted.

Additional Legislative or Regulatory Efforts Would Be Premature

ICBA is also concerned that with only six months since Check 21 became law, preemptive legislative or regulatory efforts to reduce check hold periods without the proven history of faster check clearing and settlement will leave financial institutions and their customers exposed to serious losses and sophisticated fraud schemes. As new technology is implemented we must be aware of the potential risk of fraud to midsize and community banks as fraudsters may avoid those larger banks with greater resources to invest in more

rigorous fraud detection systems.

Current federal law already requires the Federal Reserve Board to reduce check hold periods whenever check-processing times improve. Moreover, Check 21 requires the Federal Reserve Board to study the impact of the law, the funds availability practices of financial institutions, and the appropriateness of existing funds availability requirements, and to make recommendations for legislative action, if necessary, by April 28, 2007. We understand that the Federal Reserve Board plans to conduct a survey of financial institutions to collect information for its study.

We urge Congress to give the Federal Reserve a chance to do its job. Broad reduction in check clearing times will only occur when the majority of financial institutions determine there is a business case for making significant capital investments and major operational changes to support full electronic check clearing. Bank-to-bank electronic check clearing is only as effective and efficient as the number of banks that participate.

Conclusion

ICBA strongly supports Check 21 facilitating check truncation and fostering innovation in the payments system without mandating electronic processing of checks. Removing the legal impediments to the expanded use of electronics for check clearing and settlement will improve the efficiency of our nation's payment system to the benefit of both banks and consumers.

Check 21 implementation is in its infancy and little has changed in the past six months since Check 21 became effective. For many community banks, there is not a business case for creating substitute checks. Instead, they are waiting for the software, intermediaries, and widespread acceptance needed to support a full electronic clearing platform.

To date, Check 21 and the new payment instrument it created – the substitute check – have created few implementation issues for community banks and most importantly, their depositors.

The current body of law, including Check 21, and the regulations that have developed around the existing check clearing processes are both effective at protecting consumers and minimizing the banking industry's exposure to fraud. Additional legislative or regulatory efforts to reduce check hold periods in the absence of a proven history of faster check collection would be premature and unnecessarily expose banks and their customers to increased losses. The banking industry and consumer experience with existing law, and processes demonstrate that existing law and regulations work.

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

Implementation of the *Check Clearing for the 21st Century Act*

April 20, 2005

Statement by:
Elliott C. McEntee
President & CEO
NACHA – The Electronic Payments Association

Introduction

Mr. Chairman and distinguished members of the Subcommittee, my name is Elliott McEntee and I am the President and CEO of NACHA – The Electronic Payments Association. In this testimony, I will report on the adoption in the marketplace of a type of electronic check processing known as check conversion. In check conversion a check that a consumer mails to pay a bill is processed electronically using the same payment network that is used to process Direct Deposit payments. Using an electronic payment network to process a check enables the payment to be processed more efficiently. It also provides the consumer with more protection than if the check was processed in a traditional manner. For this reason consumer acceptance of check conversion has been widespread.

In the testimony I will provide a brief history on the development of check conversion through the ACH Network, explain how it works, compare it with the *Check Clearing for the 21st Century Act* ("Check 21") enacted by Congress in 2003, and summarize the consumer protection rules.

Background

Before I begin with the first issue, I want to provide you with a brief explanation of NACHA and the ACH Network. NACHA is a not-for-profit association that develops and maintains the operating rules (the "NACHA Rules") that govern the processing of ACH payments. ACH payments include the Direct Deposit of payroll and Social Security payments, automated consumer and business bill payments, and check conversion transactions. The NACHA Rules list the rights and responsibilities of financial institutions and businesses that process ACH payments, and contain provisions that provide consumer protection. Because the Federal Government follows the NACHA Rules, representatives from the Treasury Department and Federal Reserve participate in developing the rules.

Description of the ACH Network

Last year there were over 12 billion ACH payments made valued at over $28 trillion. The Federal Government is one of the largest users of the Network. Over 99% of financial institutions in the United States participate in the ACH Network. There are about 5 million

businesses and 145 million consumers involved in ACH payments. There are two Network operators, the Federal Reserve and a private sector clearinghouse, that process payments between financial institutions.

Description of the NACHA Rules

The NACHA Rules work in tandem with Regulation E, the Federal Reserve's regulation that implemented the Electronic Funds Transfer Act of 1978. Regulation E provides certain rights and protections to consumers centered on financial institution disclosure, authorization, and error resolution requirements. The NACHA Rules, which bind together all financial institutions and businesses that use the ACH Network, detail very specific requirements in these areas. For example, under Regulation E a financial institution is only required to conduct a limited investigation when the consumer alleges an error. In contrast, the NACHA Rules require the financial institution to immediately re-credit the consumer's account for the amount of the error and return the incorrect transaction back to the party that made the mistake. NACHA has the authority to impose financial penalties on financial institutions that violate the Rules.

Check Conversion Timeline

The public and private sectors have been working since the early 1970s to promote the use of electronic payments – Direct Deposit being an excellent example. The public and private sectors have also been working since the late 1970s to use existing electronic payment networks to clear and settle the billions of paper checks that were still being written.

These efforts were not successful, mostly due to the lack of a clear legal framework dealing the relationship between checks and electronic payments. Working closely with the Federal Reserve, a legal framework was developed in 2001. That legal framework treats a check that has been converted as if it was always an electronic payment. With that legal framework, consumers have the protection of Regulation E and the NACHA Rules, even when they are writing a check to pay a bill.

In 2000, while testifying before this Subcommittee I discussed a project that was being prepared to test this concept. After the test was completed, NACHA shared the results with Congressional staff and consumer groups.

The interest in using electronic networks to collect checks increased dramatically because of the grounding of all commercial flights after 9/11. The collection of checks relies heavily on air transportation. Today, check conversion is used by the Federal Government, several state and local governments and hundreds of billers. Over 1.2 billion checks were converted last year and we expect this number to increase to over 2 billion this year.

Check Conversion – How it Works

Check conversion begins when a billing company notifies the consumer that it will process checks electronically. In practice, virtually all companies notify the consumer through the monthly account statement. The consumer mails the check to the biller. The biller or its agent (usually a financial institution processor known as a "lockbox") captures the routing and account numbers from the bottom of the check (known as the MICR line for "Magnetic Ink

Character Recognition"), and enters the payment amount. The biller uses this data to create an ACH debit, which is then processed just like any other ACH payment, and usually posts to the consumer's account the next business day. The biller creates a copy of the check, and then destroys the original to prevent it from being processed a second time. The payment shows up on the consumer's monthly account statement with the date, amount, and name of the billing company, which is more information than if the check was processed in the traditional manner.

Rules for Check Conversion

Every biller that is going to convert checks must provide clear and conspicuous notice to consumers prior to the receipt of every check. The notice must state that receipt of the check authorizes an electronic/ACH debit to the consumer's account. Billers must have reasonable procedures for a consumer to opt-out. In other words, if the consumer does not want their check converted and notifies the biller, then the biller may not convert any checks received from that consumer. This is an option that is not provided under Check 21. It would not be feasible under Check 21 to provide such an option as several different parties have the ability to create a substitute check, whereas with conversion only the biller or its financial institution can do the conversion. This creates the possibility that a consumer may opt out of check conversion through the ACH Network, but nonetheless have their check converted under Check 21.

Billers must provide consumers with a copy of a check, upon request. As with any ACH payment to a consumer's account, the NACHA Rules require a consumer's financial institution to re-credit the consumer's account if the consumer reports within a certain timeframe that a transaction was not authorized.

Benefits of Check Conversion

Consumers: Check conversion preserves the choice for consumers who want to continue to pay their bills by check. Check conversion does not require consumers to do anything differently.

Consumers gain the protection of Regulation E and the NACHA Rules, which provide superior protection than when checks are processed in the traditional way. As I just noted, the NACHA Rules give consumers the right to have their account re-credited in the event of an unauthorized transaction. In recent comment letters to the Federal Reserve, four leading consumer groups have endorsed the Regulation E and NACHA protections as superior to those to exist when checks are processed traditionally.[1]

When checks are converted, consumers receive more detailed information on their monthly account statements, including the name of the company being paid. With more and more electronic payments replacing checks, such as Direct Deposit, debit cards, and various forms of electronic and online bill payment, consumers' monthly account statements are coming more and more to resemble credit card statements, where every transaction is easier to identify.

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[1] Consumers Union et al to Federal Reserve Board on Regulation J, July 7, 2004:
http://www.consumersunion.org/pub/core_financial_services/001264.html
Consumers Union to Federal Reserve Board on Regulation E, November 1, 2004:
http://www.federalreserve.gov/SECRS/2004/November/20041109/R-1210/R-1210_21_1.pdf

Companies: The main benefit to companies is gaining the efficiencies and cost effectiveness of electronic processing while still offering customers the choice of paying by check. Electronic payments generally cost companies less to process than checks. Maybe the most important, but least understood, benefit is that electronic payments greatly speed up the process of returning payments if there is a problem, such as insufficient funds. When checks are processed traditionally, it can take 1 or even 2 weeks to get the check returned if there is a problem. With check conversion, these returns are often done in just 2 or 3 business days. Not only is this good for the company, but it is also better for the consumer to have these problems resolved more quickly.

The Consumer Experience

In 2004 there were about 1.25 billion checks converted. The consumer opt-out rate is typically 0.1 – 0.25 percent. In October and November 2004, a survey conducted for NACHA found that 69 percent of consumers surveyed responded that they are familiar with the check conversion process. The survey also found that 55 percent of consumers, when given an open-ended opportunity to say anything, had no concerns about check conversion. In the survey, no consumer expressed that they were concerned about checks clearing more quickly.

NACHA's data shows that the insufficient funds rate for check conversion payments is 0.3 percent – lower than that for checks – suggesting the check conversion is not causing more checks to bounce.

The rate at which consumers claim that check conversion payments are unauthorized is 0.0045 percent, which is 45 out of every 1 million, showing that there is no significant problem with proper authorizations or with fraud.

A recent survey of financial institutions conducted for NACHA found that only 1 out of 31 institutions surveyed responded that customer service issues as a result of check conversion were significant.

Taken as a whole, this data is evidence that the implementation of check conversion in the marketplace has been smooth, that the application is high-quality, and that consumers generally accept it.

We are aware, however, of three problem situations that cause confusion or concern among consumers, and can lead to complaints to companies, financial institutions, NACHA, consumer organizations, the media, and to Congress.

The first is when the billing company does a poor job of informing its customers that it is going to process checks electronically, and this can paradoxically cause consumers to call their financial institutions with questions. To address this situation, NACHA organized an industry effort to develop consumer educational materials that billing companies can use at no cost to educate their customers about check conversion. Financial institutions can also use these materials at no cost, in case consumers call them.

The second is that there are a small number of consumers who are very insistent that they don't want anything done differently to their checks, that the checks are their property, and that

no one has the right to do anything with them. No matter how beneficial check conversion is, no matter the better protections available under Federal law and the NACHA Rules, no matter the additional information available on their account statements, a small number of people simply do not want their checks converted. In recognition of this, NACHA revised the rules to require billing companies to have reasonable procedures to allow consumers to opt-out.

The third problem area is manual data entry of the dollar amount of the transaction, which can be a source of errors. The transmission of an incorrect dollar amount is often blamed on check conversion, but the manual data entry has to occur no matter how the check is processed. There is no evidence that data entry errors occur more or less frequently depending on how the check is ultimately processed. In fact, because a consumer has better protection and avenues for redress in the event of errors, it is in their interest that payments are processed electronically.

The Future of Check Conversion and Electronic Check Processing

With check conversion continuing to be adopted in the marketplace, NACHA expects the number of checks converted to reach or exceed 2 billion this year, and to continue to grow for the next several years. Some industry estimates are that consumers still mail 6-8 billion checks a year to pay bills.

It is much more difficult to predict what may happen with Check 21-enabled processing, because it is newer. The early adoption of Check 21 seems to be oriented toward large-dollar corporate checks.

In the long term, we expect that check conversion and other types of electronic check processing will be transitional, as consumers continue to write fewer and fewer checks and switch to various forms of electronic payments. This has already been happening for years at retail with credit and debit cards, and with various forms of electronic and online bill payment (which, incidentally, all have greater protections than checks).

Conclusion

Check conversion is being rapidly adopted in the marketplace. Check conversion is an example of a true "win, win" innovation by providing consumers more protection, and providing businesses and financial institutions the ability to collect checks more efficiently.

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Elliott McEntee

Elliott C. McEntee is currently the President and Chief Executive Officer of NACHA – The Electronic Payments Association. NACHA is a nonprofit banking trade association that promulgates the rules and operating guidelines for electronic payments including the ACH Network. NACHA's mission includes the development, promotion and use of electronic solutions to improve the payments system through activities including financial EDI, Electronic Benefits Transfer (EBT), cross-border transactions, bill payments, electronic checks and Internet Council. NACHA also produces marketing collateral and technical publications and provides education services such as conferences, seminars, The Payments Institute, and the Accredited ACH Professional (AAP) program. NACHA is closely affiliated with the National Council for Uniform Interest Compensation (N.C.U.I.C.) which addresses primarily check processing and wire transfer issues. The ACH Network reaches more than 20,000 financial institutions, and about 5 million businesses and 145 million consumers in the U.S.

Prior to joining NACHA in November 1988, Mr. McEntee was an Associate Director on the staff of the Board of Governors of the Federal Reserve System. He was responsible for managing a function that oversees the nation's payments mechanism and financial services the Federal Reserve provides to banks, thrift institutions and the United States Government.

Mr. McEntee is a 1968 graduate of San Jose State University and earned a Bachelor of Science degree in Industrial Relations.

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Statement of

Louise L. Roseman

Director, Division of Reserve Bank Operations and Payment Systems

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

U.S. House of Representatives

April 20, 2005

Mr. Chairman, Ranking Minority Member, and Members of the Subcommittee, I appreciate the opportunity to discuss with you the initial implementation of the Check Clearing for the 21st Century Act (Check 21) and, more broadly, implications of the greater use of electronics in the nation's payments system. The backdrop for this discussion is the declining use of checks in the United States. I will focus my remarks on the implementation of Check 21 and how it relates to the maximum permissible hold periods banks may place on check deposits before making those funds available for withdrawal. Then I will discuss electronic check conversion and related consumer protection and education efforts that the Federal Reserve has undertaken. Finally, I will look at the responses of the Federal Reserve Banks and the industry to declining check volumes.

The U.S. Payments System is Becoming Increasingly Electronic

The United States is in the midst of a significant shift away from the use of paper checks and toward the much greater use of electronic payments. This change is clearly evident in the Federal Reserve's recent payments research, which shows that in 2003, for the first time ever, businesses and consumers made more payments electronically than by check. By contrast, only twenty-five years ago the vast majority of consumer and business noncash payments were made by check.

We estimate that the number of checks used in the United States peaked during the mid-1990s at around 50 billion per year. By 2003, the number of checks had fallen by one-quarter, to around 37 billion. This decline is continuing. In contrast, electronic payments, such as payments made by credit and debit cards or through the automated clearinghouse (ACH), have tripled, from 15 billion in the mid-1990s to 45 billion in 2003 (see attached chart).

As technology improves and scale economies are realized, the cost of electronic payment processing decreases relative to the cost of paper processing. For example, the Federal Reserve Banks realized significant operational-cost savings as a result of centralizing their electronic payment services. Today, the Reserve Banks' cost to process an ACH transaction is less than one-fifth that of processing a check.

Because the number of noncash payment transactions in the U.S. economy exceeds 80 billion per year and is growing, even small savings in processing costs per payment may have large effects on overall payments system efficiency. Over the past decade, the reductions in the processing costs for ACH have allowed the Reserve Banks to cut approximately in half the fees they charge depository institutions for providing ACH services. Over the same period, the Reserve Banks have increased the price of their more labor-intensive paper check service approximately 50 percent. So we can expect that this shift to the use of electronic technology for making payments and away from the physical handling, processing, and transportation of paper checks will translate, over time, into a reduction in the overall costs of making payments.

Check 21 will Eventually Change the Way Checks are Collected

The declining use of checks is only a part of the ongoing change within the payments system. How checks are collected also will evolve as a result of Check 21. This is very important legislation, which will ultimately foster fundamental changes to the check collection system that will improve the efficiency of the nation's payments system.

You will recall that one of the purposes of the law was to reduce legal barriers to the use of electronic imaging and networking technologies to collect checks and to return those that are not paid. Specifically, state laws governing check collection allow banks to demand that the original checks be physically presented for payment. Although state laws typically allow banks

to agree to alternative presentment arrangements, the large number of banks in the United States has made the widespread adoption of electronic check collection through industry agreements extremely difficult.

While Check 21 does not mandate that checks be presented electronically or change a bank's right to demand paper, it does facilitate the adoption of check truncation and electronic collection of checks through the action of market forces.[1] When the paying bank does not agree to receive checks electronically and demands that presentment be made by paper checks, Check 21 allows the other banks to create and present paper substitute checks that are legally equivalent to the original checks. As banks increasingly send and receive checks electronically, this new authority will reduce the handling of paper checks and enable banks to reduce their paper-check infrastructure more easily. It also will reduce the number of checks that must be flown or driven around the country to be collected or returned, which reduces transportation and other operating expenses. Of course, each bank will determine for itself which makes good business sense: adopting new technologies for sending and receiving checks electronically or continuing to demand paper.

In addition, we will be monitoring the banking industry's experience with the Board's regulations implementing Check 21. We believe it is important to ensure that these fairly detailed regulations are producing the desired improvements in our national check-collection system. As we gain greater experience with substitute checks and other elements of the law, we will revisit these rules over the next few years and determine whether any refinements are necessary.

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[1] Check truncation is the removal of an original check from the forward-collection or return process by the bank of first deposit or an intermediary, such as a Federal Reserve Bank. In lieu of the original check, a substitute check or, by agreement, information relating to the original check, such as an electronic image of the original check, is then sent on for collection or return.

Adoption of Check 21 is an Evolutionary, not a Revolutionary, Process

Like any significant operational and technological change, the adoption of electronics within the check-collection system will be gradual. This is an evolutionary, not a revolutionary, process. The check-collection system did not change materially last October 28, when Check 21 took effect. To date, relatively few banks have taken advantage of the opportunities provided by Check 21. The rate of adoption of Check 21 is not at all surprising; we did not anticipate that there would be an immediate, large shift in the way checks are collected. Still, there have been some important first steps that help enable banks to leverage the new Check 21 authority, such as agreement on technical standards for creating substitute checks. It is important to recognize, however, that while a critical impetus for change, banks will no longer need substitute checks for processing once they both collect and receive checks electronically.

For the banking industry to realize the vision for the nation's check-collection system laid out in Check 21, additional steps must be taken. For example, software vendors and third-party check processors need to adapt their systems to support the creation of substitute checks and the exchange of digital check images. As these systems become more prevalent, additional banks will invest in them. Once banks make these investments, however, they will have to adjust their operations to make the best use of the new technologies. They also will need to verify that their updated systems are compatible with those of other banks and will permit them to exchange checks electronically.

As banks improve their technological capabilities, they can reduce their reliance on air and ground transportation, especially shared transportation arrangements. The banks that remain tied to paper checks will continue to bear the costs of those arrangements. As a result, I believe

pressures to reduce check transportation costs will be an important determinant of the pace at which banks make the transition to electronic check collection.

The Federal Reserve Banks have long been at the forefront of encouraging the electronic collection of checks. As a result, even before Check 21 became law, one out of every five checks collected through the Federal Reserve Banks was being presented electronically. The Reserve Banks also have been leaders within the payments industry in making use of the authority granted by Check 21. They began offering Check 21 services as soon as the law became effective. These services allow for the acceptance of digital check images for deposit and the truncation of some large-dollar paper-check deposits, which are then transmitted to the Reserve Bank closest to the paying bank, thereby eliminating the need to transport physically paper checks between the Reserve Banks. The receiving Reserve Bank then prints substitute checks from the check images to present them to the paying bank, or provides electronic check information to paying banks that already accept the presentment of checks electronically.

Although all types of depository institutions are among the initial Reserve Bank customers for these services, the volumes are still relatively small. The operational and technical preparations and testing requirements necessary to use these new payments services naturally limit the pace at which banks can take advantage of them. Out of the approximately 50 million checks that the Reserve Banks collect each business day, only 400,000, or less than 1 percent, involve the deposit of digital check images with the Reserve Banks or the printing of substitute checks to present to the paying bank.

Looking across the entire banking industry, some banks, both large and small, have begun to take advantage of the opportunities created by Check 21. For the most part, they have done so within the context of cooperative agreements, through third-party processors, or, as I just

mentioned, by sending check images to the Federal Reserve Banks. The banking industry's efforts are generally less extensive, at this time, than those of the Federal Reserve Banks.

So six months after Check 21 went into effect, it is clear that much remains to be done before electronic check collection becomes widespread. I do believe, however, that we are laying the groundwork for widespread changes in the check-collection system. While the pace of change is not clear, I believe that a decade from now our check-collection system will look much different. Though we may still be writing checks, I would expect that their number will be substantially lower and that most will be collected electronically.

The Federal Reserve is Monitoring the Need to Reduce Hold Periods

In light of the potential for improvements that could speed check collection and return times, the Federal Reserve has been monitoring whether changes to the funds availability policies set out in Regulation CC may be warranted.

As you know, Congress established the current funds availability rules for check deposits in 1987 through the Expedited Funds Availability Act, or EFAA, which the Federal Reserve Board implements through Regulation CC. EFAA sets the maximum permissible hold periods on funds deposited by check at levels that are intended to balance the desirability of providing consumers with timely access to their funds with banks' need to manage the risk of check fraud.

Congress also recognized that when it comes to checks they accept for deposit, banks operate under the dictum of "no news is good news." A bank of first deposit does not receive any affirmative notice that another bank has paid a check. It only learns that a check will be returned unpaid when it receives the returned check or a notice that the check is being returned. Thus, under EFAA, the time needed to not only present a check to the paying bank but also

return the unpaid check to the bank of first deposit is the statutory standard for determining whether reductions in the maximum permissible hold periods are warranted.

Under the current funds availability schedule, next-business-day availability is required for checks considered low risk, such as Treasury checks, postal money orders, and cashier's checks. For local checks (that is, checks for which the paying bank and the bank of first deposit are located in the same Federal Reserve check-processing region), funds must be available for withdrawal no later than the second business day following deposit. For nonlocal checks (checks for which the paying bank and the bank of first deposit are located in different Federal Reserve check-processing regions), funds must be available for withdrawal no later than the fifth business day following deposit. Congress also provided safeguard exceptions to these maximum hold periods for certain types of accounts or deposits, such as new accounts or large-dollar check deposits, which may carry a greater risk of check fraud.

The Federal Reserve's Responsibilities under EFAA

Congress expected that as the check-collection system became more efficient, the amount of time it would take to return an unpaid check to the bank of first deposit would decrease. With that in mind, Congress specifically required the Federal Reserve Board to reduce, by regulation, the maximum hold periods to levels that are "equal to the period of time achievable under the improved check-clearing system for a receiving depository institution to reasonably expect to learn of the nonpayment of most items for each category of checks" (12 USC 4002(d)(1)). The EFAA's legislative history indicates that the term "most items" should be interpreted as at least two-thirds of unpaid checks in a given category, such as nonlocal checks.[2]

[2] Conference Report on H.R. 27 (H. Rept. 100-261), 100th Congress, 1st session, 179 (1987), pp. H6906-7.

The Federal Reserve Board takes its responsibilities under EFAA very seriously. We monitor developments in the check-collection system on an ongoing basis to determine if the maximum permissible hold periods should be shortened.[3] If we find sufficient improvement in check-collection and return times, we will reduce the Regulation CC availability schedule accordingly.

Although developments have yet to show that changes to the Regulation CC availability schedules are warranted, that does not mean that banks routinely impose the maximum allowable hold periods before making funds available to their customers. Many banks regularly provide faster availability of funds to their customers. Some consumers also have been gaining faster access to funds from some of their deposited checks as a result of the Federal Reserve Banks' initiative to reduce their check-processing infrastructure in the face of declining check volumes. When Reserve Bank check-processing regions are combined--for example, the Pittsburgh and Cleveland check-processing regions--checks that were considered nonlocal in Cleveland because they were drawn on banks located in the Pittsburgh region became local and subject to the two-day rather than five-day maximum hold period. This means that consumers in Cleveland are receiving faster funds availability on deposited checks drawn on Pittsburgh banks.

With the passage of Check 21, the Federal Reserve also is paying particularly close attention to how rapidly the banking industry embraces the use of electronics in collecting and returning checks. We monitor these developments in a number of ways. Because the Reserve Banks collect more than half of all checks that are drawn on a different bank than the one into which they are deposited (interbank checks), we closely monitor how quickly depository

[3] In the mid-1990s, we surveyed depository institutions to estimate the level of check fraud prevalent at that time and to quantify the average time it would take a bank of first deposit to receive or be provided notice of a returned check (see http//www.federalreserve.gov/boarddocs/rptcongress/chkfraud.pdf). We found that a reduction in the maximum permissible check-hold periods was not warranted at that time.

institutions are adopting the Reserve Banks' Check 21 services. We also monitor broader industry trends in the use of electronics to collect checks. As I noted earlier, change to date has been limited.

Although we have yet to see material improvements in the speed with which banks learn that checks they had accepted for deposit have been returned unpaid as a direct result of Check 21, next year we will be studying the effects of Check 21's adoption on the banking industry. In particular, we will study how this law is affecting the check-collection system and the appropriateness of the current maximum permissible hold periods. We will report our findings to Congress no later than April 2007. If we discern significant improvements in the times needed to collect and return checks, we will accelerate the study.

Given how little time will have elapsed since Check 21 came into force, this upcoming study may indicate that there has not been sufficient improvement to check-collection and return times to trigger reductions in the maximum permissible hold periods. But, as required by EFAA, the Board will continue to monitor check-return times and reduce the funds availability schedules in Regulation CC as changes in banking industry practices warrant.

Check Conversion is not Check 21, but is a Means to Collect Funds Electronically

Another important catalyst for change in the payments system is electronic check conversion--a rapidly growing means of collecting funds electronically from consumers' bank accounts using information that appears on their checks. Electronic check conversion does not involve the collection of checks or the use of the authority granted by Check 21. In 2004, approximately 1.5 billion checks were replaced by electronic check conversion. We expect these types of payments will continue to increase.

Because electronic check conversion is sometimes mistakenly associated with Check 21, I think it may be helpful to explain what electronic check conversion is and how it works. Electronic check conversion involves using the routing, account, and serial numbers printed in magnetic ink on the bottom of a consumer's check as the source of information to create an electronic payment that is made using the ACH or a debit card network. Sometimes the conversion occurs at the cash register. More commonly, it occurs at so-called lock-box processing centers to which consumers mail checks to pay, for example, their credit card, mortgage, or utility bills.

Check conversion and Check 21 are complementary and provide businesses and banks with choices regarding how to collect their customers' payments most efficiently. Check conversion allows merchants and so-called lock-box processing centers to collect funds electronically without ever using the check-collection system. The National Automated Clearing House Association's (NACHA) rules limit the use of check conversion, however, to checks written by consumers; checks drawn on business accounts are not now eligible to be converted, in part because many businesses arrange with their banks to block any ACH debits to their account. By contrast, Check 21 allows banks to collect any check electronically once it has entered the check-collection system.

Whether the checks are converted in stores at the time of purchase or remotely at processing centers, the notice that is provided should enable consumers to understand that proceeding with payment authorizes the merchant or biller to electronically debit their accounts. For in-store transactions, consumers receive notice that a check will be converted to an electronic payment and authorize that conversion by signing an authorization slip and proceeding with the transaction. In the case of payments that are mailed, consumers receive notice with their bill that

a check will be converted to an electronic payment and authorize the conversion by sending a check to the biller. NACHA rules permit consumers to opt out of electronic check conversion by their billers, that is, choose not to have their billers convert their checks to electronic payments.

The Federal Reserve is Protecting Consumers and Educating the Public about Check Conversion and Check 21

The conversion of checks to electronic fund transfers initially raised questions about whether those transactions were covered by check law or electronic fund transfer law for the purposes of consumer rights and protections. In 2001, the Federal Reserve Board clarified that the Electronic Fund Transfer Act, as implemented by Regulation E, protects consumers for electronic payments made via check conversion (66 FR 15187, March 16, 2001).

I would note, however, that the substantive rights of consumers are very similar whether they are derived from check or electronic fund transfer law. For example, as a general matter, in either case consumers have recourse for unauthorized transactions. The particular procedures for asserting a consumer's rights vary slightly depending on how the payment was made.

The Board is now considering how to address concerns that have been raised about the notices consumers receive when their checks are converted to electronic payments. We have found that the quality of these notices varies widely and that consumers may be confused about what they are authorizing. The Board has requested comment on revisions to the Regulation E commentary to include specific language to be used in these consumer notices. The Board expects to take action on this proposal later this year. We are also considering whether to require by regulation, along the lines of current NACHA rules, a written, signed authorization by the consumer when a check is converted at a merchant location.

The Federal Reserve also is actively working with consumer groups (particularly through the Board's Consumer Advisory Council), the banking industry, and the media to help inform the public about check conversion and Check 21. We are educating consumers about their rights in the event of an unauthorized transaction involving check conversion or a substitute check. Among our initiatives in this area was the publication of several brochures that help explain what check conversion, Check 21, and substitute checks are all about. These brochures are available on our web site (http://www.federalreserve.gov/consumers). We also have made available on our web site (http://www.federalreserve.gov/check21) answers to frequently asked questions and other important information about Check 21.

Transition to a More-Electronic Payments System Affects the Federal Reserve Banks and the Banking Industry

Since 1999, the number of checks collected through the Reserve Banks has fallen nearly 20 percent, to less than 14 billion in 2004. We expect Reserve Bank check volumes to continue to fall as the total number of checks being written declines and as check conversion further reduces the number of checks collected.

The Monetary Control Act of 1980 requires the Federal Reserve to set fees for providing certain payment services to depository institutions that, over the long run, recover all the direct and indirect costs of providing the services, as well as the imputed costs such as the income taxes that would have been paid and the profit that would have been earned had the services been provided by a private firm. As a result of the accelerating decline in the number of checks they collect, the Reserve Banks have not achieved their targeted level of profitability since 2001; but

they have recovered, in aggregate, all their direct, indirect, and imputed costs of providing payment services.[4]

In response, the Reserve Banks have undertaken major initiatives to reduce check costs by standardizing their check systems and operations and by reducing the resources devoted to this service. The Reserve Banks have announced a reduction in the number of offices at which checks are processed, from the forty-five that existed at the beginning of 2003 to twenty-three by early 2006. I emphasize, however, that the reduction in the number of check-processing sites has not changed the Reserve Banks' commitment to making their check collection and other payment services available to depository institutions nationwide.

As a result of the restructuring and other cost-reduction initiatives, the Reserve Banks expect that in 2005 they will recover fully all of their costs of providing check collection and other payments services, including the targeted return on equity or profit. As check volumes continue to decline, however, the Reserve Banks will need to take additional steps to reduce costs, including further restructuring of their processing operations.

The challenges of a changing payments system are not unique to the Federal Reserve Banks. The entire banking industry faces similar cost and revenue pressures as check volumes decline. This is a particularly challenging environment for large banks that have made significant investments in physical check infrastructure. Over the coming years, many banks will need to decide how much longer to continue their paper-check-processing operations. At the same time, they must decide what investments to make in the technologies underlying Check 21 and check conversion and in technologies for making fully electronic payments.

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[4] Because the check service represents more than 80 percent of all priced services costs, its performance is the primary determinant of the Reserve Banks' overall profitability for payment services. The Reserve Banks have recovered fully the total costs, including imputed costs, and profits of each payment service other than check during this four-year period.

Conclusion

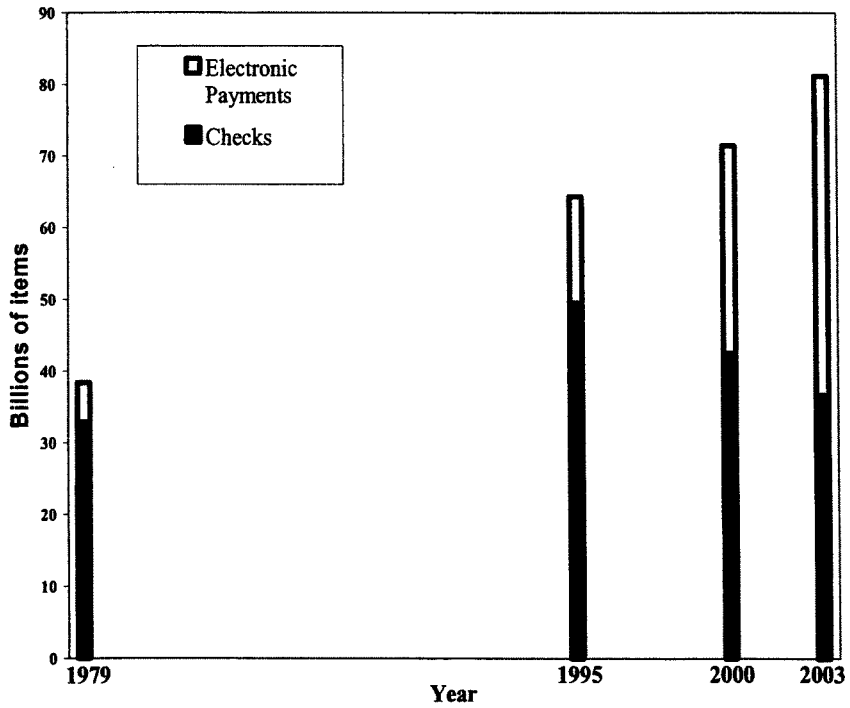
In summary, the payments system in the United States is continuing to change and become increasingly efficient. However, the shift away from the use of paper checks does create challenges for the banking industry and the Federal Reserve Banks. To address these challenges, over the coming years the industry will be making important decisions about how best to incorporate the greater use of electronics into their payments operations while reducing their paper check-processing infrastructures.

Although the implementation of Check 21 is expected to lead to a much more electronic and efficient check-collection system over the longer term, change will be evolutionary, not revolutionary. Banks will embrace the use of digital check images to present and return checks as the business case to make the necessary investments and improvements to their operations and systems becomes more compelling. This market-based approach to change was a fundamental principle underlying Check 21.

Ongoing improvements in the check-collection system have not yet been extensive enough to warrant a reduction in the maximum permissible check-hold periods, but we will continue to monitor developments closely. Many banks, however, routinely provide customers with faster availability than required by Regulation CC; moreover, as the Reserve Banks adjust their check-processing regions, the maximum hold periods for some checks are effectively being reduced. But again, I want to emphasize the Board's commitment to reducing check-hold periods as developments warrant.

I would be pleased to answer any questions that you may have.

Annual Number of Noncash Payments in the United States



April 20, 2005

The Honorable Spencer Bachus
United States House of Representatives Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit (Room: 2129)
Washington, DC 20515

Dear Chairman Bachus:

America's Community Bankers[1] (ACB) applauds the Subcommittee on Financial Institutions and Consumer Credit for holding today's hearing regarding Implementation of the Check Clearing f or the 21st Century Act (Check 21). ACB is pleased to provide this statement for the record in conjunction with today's hearing.

Check 21 will help modernize the check clearing process and facilitate a more efficient flow of payments needed to move checks through the U.S. payments system. This not only helps lower costs for consumers and banks, but it also strengthens the infrastructure of the financial system. Following the September 11, 2001 tragedy, the check payments system was paralyzed when airlines were shut down. Check 21 will help to relieve the effects of any future physical disruption by allowing the electronic transmission and clearing of checks.

Despite its benefits, some consumers and consumer advocates are concerned that Check 21 could potentially lead to the abuse of consumers by financial institutions. Concerns have been expressed about the potential for banks to quickly clear checks written by consumers while taking longer to process deposits in order to collect more fees for bounced checks. Additional concerns have been expressed that consumers may not be aware that the one or two days float they had sometimes previously enjoyed may no longer exist, leading to a greater number of bounced checks. Finally, there are concerns that consumers may not be able to gain access to copies of cleared checks that are needed in order to resolve disputes. ACB and its member institutions understand all of these concerns and are working to ensure that such issues do not arise.

ACB commends the Financial Services Committee and its members for being at the forefront of consumer protection during Check 21's implementation. Your leadership has made it clear that industry's top priority should be protecting its customers.. As your letter to the financial services

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[1] America's Community Bankers is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit *www.AmericasCommunityBankers.org.*

trade associations made clear: "Holding a deposit to ensure its safety and soundness is reasonable, but holding a deposit in order to profit from the interest is completely unacceptable."

We commit to working with the committee to protect consumers as implementation of Check 21 continues. ACB members believe that Check 21 is good for consumers, but that the key to avoiding confusion or misperceptions is a vigorous educational program. As part of a broader consumer education campaign on Check 21, ACB members have distributed over 3 million educational brochures to their customers to help educate them about the benefits and the pitfalls of faster clearing times, as well as their rights under the new bill. A copy of the brochure is attached with this statement. Copies of this brochure were also sent to every Congressional office earlier this year so that members of Congress would be able to work with concerned constituents to help avoid confusion or misunderstandings.

In addition, ACB's chairman Harry Doherty recently sent a letter to all of ACB's members reminding them of their obligations to their customers. The letter, which is also attached with this statement, makes it clear that Congress did not intend for Check 21 to be used for quick profits from holding customer deposits. It made clear that though ACB's members have historically been at the forefront of consumer protection, they must continue in that tradition and hold deposits only long enough to ensure the safety and soundness of the institution.

Before any conclusions are drawn about the success or failure of the Check 21, ACB believes that it is important to note that electronic check clearing programs are being implemented slowly throughout the industry. Few institutions have adopted a fully electronic check clearing system and the number of Check 21 items currently being processed represents a very small percentage of the total number of items processed. Many institutions still clear paper checks. Until electronic check processing is fully adopted it will be difficult to tell whether the Federal Reserve should consider revising the regulations governing check clearing times issued pursuant to the Expedited Funds Availability Act. In addition to setting maximum check hold times, the law requires the Federal Reserve to monitor changes in the technology for clearing checks and adjust the maximum hold times appropriately. ACB and its members support the Federal Reserve proactively monitoring the affects of Check 21 and when appropriate adjusting its regulations under the Expedited Funds Availability Act.

In closing Mr. Chairman, ACB wants to thank you again for your continued work to ensure that Check 21 is implemented in a fair and responsible manner, and we stand ready to work with you to ensure that a few bad actors in the banking industry do not take advantage of consumers and diminish the respectability and credibility ACB's members have worked so hard to establish. We believe that Check 21, once fully implemented, will benefit both consumers and the financial services industry.

Sincerely,

Robert Davis
Executive Vice President and Managing Director

April 14, 2005

Dear ACB Member:

Enactment and implementation of Check 21 (the Check Clearing for the 21st Century Act) and advances in technology have provided a number of opportunities for community banks to speed check processing, lower costs, and offer new services to customers. The price for these benefits is fresh scrutiny on the way the industry provides customers access to their funds.

Legislation has been proposed that would mandate shorter hold periods and increase pressure on the Federal Reserve to consider changes in check availability schedules. Also, the media continues to run stories that claim banks are profiting from slow processing. As a result, a hearing is scheduled before the House Finance Services Committee to discuss perceived consumer abuses stemming from purportedly untimely processing.

In addition to the hearing, Chairman Mike Oxley and Ranking Member Barney Frank of the House Financial Services Committee have asked each of the financial services trade associations to urge their members to make every effort to clear checks in a timely manner. While I believe that ACB's members have been at the forefront of consumer protection and best practices, the increased attention to check hold times following implementation of Check 21 makes it important to once again stress banks' responsibilities to their customers. Holding a deposit to ensure safety and soundness is both reasonable and a necessity, but holding deposits unnecessarily long to make a profit does nothing but give a bad name to an industry for which we have worked so hard to bring respectability and integrity.

We are happy to be on record in complying with the Oxley-Frank request. We will submit testimony at the hearing highlighting the work ACB and its members have done to educate consumers on the benefits and pitfalls of Check 21. More importantly, we know that ACB's members are at the forefront of consumer protection. Our members have distributed over 3 million brochures provided by ACB, which describe Check 21, its benefits, and the changes it may bring to their customers. In addition, our members have engaged in innumerable efforts to address customer questions and concerns. We must continue to educate our customers about the changing financial services landscape and what it means for them.

ACB will continue to monitor legislative and regulatory developments and the media, and we will keep you informed on issues that could affect your institution. Thank you for your efforts in making ACB's members among the most progressive and responsive in the financial services industry. If you have any questions or need additional information on what you can do, please contact Rob Drozdowski at 202-857-3148 or rdrozdowski@acbankers.org.

Sincerely,

Harry P. Doherty
Chairman, America's Community Bankers
Vice Chairman, Independence Community Bank, Brooklyn, New York
and Chairman, America's Community Bankers

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

LOUISE L. ROSEMAN
DIRECTOR
DIVISION OF
RESERVE BANK OPERATIONS
AND PAYMENT SYSTEMS

May 16, 2005

The Honorable Carolyn McCarthy
House of Representatives
Washington, D.C. 20515

Dear Representative McCarthy:

I am pleased to enclose my written response to the questions you asked during the April 20, 2005, hearing before the Subcommittee on Financial Institutions and Consumer Credit on "Implementation of the Check Clearing for the 21st Century Act." You asked whether checking accounts offered to consumers by brokerage firms are covered by the Check 21 law and who would be responsible for responding to a consumer's request for a copy of a paid check drawn on such an account.

A copy of this response has been submitted to the Committee on Financial Services for inclusion in the hearing record. Please let me know if I can be of further assistance.

Sincerely,

Louise L. Roseman

Enclosure

Email: Louise.Roseman@frb.gov
Phone: (202) 452-2789 • Fax: (202) 452-2746

Insert page 34, after line 803:

Louise Roseman subsequently submitted the following for the record in response to a question raised by Congresswoman McCarthy:

A brokerage firm that offers a service through which its consumer customers can write checks typically holds an account at a bank and uses the funds in that account to pay checks written by its consumer customers. Generally in this situation, the bank's account relationship is with the brokerage firm, not the consumer. Because the consumer's relationship is with the brokerage firm, usually the consumer would obtain copies of paid checks through the brokerage firm and would resolve any check-related problems through that firm.

With regard to the consumer's rights under Check 21, the consumer would have some, but not all, of the rights that he or she would have if the account had been held directly with a bank. The Check 21 Act's expedited recredit procedure would not apply to a consumer customer of a brokerage firm. In certain situations, a consumer customer of a bank may use the Check 21 Act's expedited recredit procedure when the consumer receives a substitute check that was improperly charged to the consumer's account. As noted above, the deposit account at the bank is generally held by the brokerage firm and would not be a consumer account, even if that account is used to clear checks drawn by its consumer customers.

Nevertheless, the Check 21 Act's warranties and indemnity would be available to a consumer customer of a brokerage firm. These protections are not restricted to particular types of accountholders but instead flow to all substitute check recipients. A brokerage customer who is charged for a substitute check therefore could have a warranty or indemnity claim, provided that all the requirements for making such a claim were met.

CUNA & Affiliates

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WRITTEN STATEMENT OF THE
CREDIT UNION NATIONAL ASSOCIATION (CUNA)
ON
IMPLEMENTATION OF THE CHECK CLEARING FOR THE 21ST CENTURY ACT
TO THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

APRIL 20, 2005

**WRITTEN STATEMENT OF THE CREDIT UNION NATIONAL ASSOCIATION (CUNA)
ON
IMPLEMENTATION OF THE CHECK CLEARING FOR THE 21ST CENTURY ACT
TO THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT**

APRIL 20, 2005

The Credit Union National Association (CUNA) would like to submit this statement regarding issues surrounding the implementation of the Check Clearing for the 21st Century Act (Check 21). By way of background, CUNA is the largest trade association serving credit unions in this country. CUNA represents over 90% of our nation's 9,300 state and federal credit unions. Approximately 86 million consumers are credit union members.

Credit unions are dedicated to providing their members with excellent financial benefits and quality service. This is evidenced by many credit unions' liberal hold policies that were in place before the enactment of Check 21. We understand that checks or share drafts, including non-local items, that are deposited into credit unions are generally available sooner than the Expedited Funds Availability Act (EFAA) requires.

CUNA believes that the benefits of Check 21 should be shared with consumers and supports current statutory consumer protections regarding check collections. In fact, most credit union members realize benefits at the time their deposits are made and not when the credit union receives credit for the deposited funds. This is because credit unions typically pay dividends (interest) to their members when a deposit is made to an interest-bearing account and not at a later date, when they receive credit for the check. This is another example of credit unions placing a priority on members' interest, as Regulation CC, which implements the EFAA, does not require dividends to accrue on funds deposited until the day a financial institution receives credit for the funds.

Check 21 became effective approximately six months ago, on October 28, 2004. It was designed to enhance efficiency in the payments system by facilitating the electronic exchange of checks and allowing financial institutions to handle more checks electronically. Since the implementation of Check 21, there has been little change to the check clearing system, and credit unions, in particular, have rarely seen checks converted to substitute checks. We believe efficiency to the check clearing system will occur, but will do so gradually over the coming years and support the Federal Reserve Board's efforts to expedite the full implementation of Check 21.

Section 16 of Check 21 requires the Federal Reserve Board to study the appropriateness of check hold time periods and amount limits by April 28, 2007. This provides sufficient time for more financial institutions to participate in electronic imaging and for the Federal Reserve to study its impact on consumers on an informed basis. Additionally, the EFAA requires the Federal Reserve Board to monitor check collection times and to reduce hold times to as short a time as possible when check clearing times improve.

CUNA looks forward to working with Congress and the Federal Reserve Board and will welcome the opportunity to provide feedback as needed on credit union check hold policies, check collection times, and the check payment system and its impact on credit union members.

In the meantime, we will continue to monitor the implementation of Check 21 and ensure that credit union members benefit further from any image exchange advances. We are committed to working with the Federal Reserve Board and others in the financial institutions industry to ensure a fair and efficient check processing and payments system.