

Roger W Ferguson, Jr: The proposed check clearing for the 21st Century Act

Speech by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S. House of Representatives, 25 September 2002.

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I would like to thank the subcommittee for inviting me to discuss H.R. 5414, the proposed Check Clearing for the 21st Century Act. This bill, which is similar to a proposal the Board sent to Congress late last year, removes existing legal barriers to the use of new technology in check processing and holds the promise of a more efficient check collection system. The Board commends Representatives Ferguson and Ford for introducing this bill.

Technological Advances in Check Processing

Check processing is far more efficient than it once was. Less than fifty years ago, clerks hand sorted millions of checks each day. In the 1960s, the banking industry began to use mechanical high-speed check processing equipment to read and sort checks, which had been redesigned for automated processing. Today, banks, thrifts, and credit unions, which I will collectively refer to as banks, process the more than 40 billion checks that consumers, businesses, and the government write each year.

Legal impediments, however, have prevented the banking industry from fully using these new electronic technologies, such as digital imaging, to improve check processing efficiency and provide improved services to customers. This is because existing law requires that the original paper checks be presented for payment unless the banks involved agree otherwise. We can see how this requirement constrains technological adoption by following a check through the collection process. After a bank's customer deposits a check with his or her bank, the bank typically transports the check from the branch or ATM where it was deposited to a central operations center. The check is then usually sent to one or more intermediaries -- such as a Federal Reserve Bank or a correspondent bank -- or a clearinghouse for collection before it is ultimately delivered to the bank on which it is drawn for payment. During each step of this process, the check must be physically shipped to its destination by air or ground transportation. Of course, banks can agree to accept checks electronically, but the large number of banks in the United States makes it infeasible for any one bank to obtain such agreements from all other banks or even a large proportion of them. Therefore, legal changes are needed to facilitate the use of technologies that could improve check processing efficiency, which should lead to substantial reductions in transportation and other check processing costs. H.R. 5414 makes such changes.

Proposed Check Clearing for the 21st Century Act

The proposed Check Clearing for the 21st Century Act solves a longstanding dilemma -- how to foster check truncation early in the check collection or return process without mandating that banks accept checks in electronic form. The term check truncation refers to any of a number of arrangements in which the original paper checks are removed from the collection or return process. Currently, under typical check truncation arrangements, electronic information about a truncated check is presented to the bank on which it is drawn rather than the original paper check. The act facilitates check truncation by creating a new negotiable instrument called a substitute check, which would permit banks to truncate the original checks, to process the check information electronically, and to deliver substitute checks to banks that want to continue receiving paper checks.

A substitute check, which would be the legal equivalent of the original check, would include all the information contained on the original check -- that is, an image of the front and back of the original check as well as the machine-readable numbers that appear on the bottom of the check. Under this act, while a bank could no longer demand to receive the original check, it could still demand to receive a paper check. Banks would likely receive a mix of original checks and substitute checks. Because substitute checks could be processed just like original checks, a bank would not need to invest in any new technology or otherwise change its current check processing operations.

Banks could use the new authority provided in this legislation in a number of different ways. For example, a bank would no longer need to send couriers every afternoon to each of its branches and ATMs to pick up checks that customers have deposited. Instead, digital images of checks could be transmitted electronically from those locations to the bank's operations center for processing. Not only would this be quicker and more efficient, but it could permit banks to establish branches or ATMs in more remote locations and to provide later deposit cut-off hours to their customers.

Moreover, the act would give a bank the flexibility to transmit checks electronically over long distances, and create substitute checks at locations near their ultimate destination, for example to the bank on which the checks are drawn, substantially reducing the time and cost associated with physical transportation. By enabling the banking industry to reduce its reliance on physical transportation, the proposed act would also reduce the risk that checks may be lost or delayed in transit. Today, bad weather routinely delays check shipments and there have been occasions when checks have been destroyed in plane crashes. The banking industry's extensive reliance on air transportation was underscored in the aftermath of the September 11 tragedy, when air transportation came to a standstill and the flow of checks slowed dramatically. During the week of the attacks, the Federal Reserve Banks' daily check float, which is normally a few hundred million dollars, ballooned to more than \$47 billion. Had the proposed legislation been in effect at that time and had banks been using a robust electronic infrastructure for check collection, banks would have been able to collect many more checks by transmitting electronic check information across the country and presenting substitute checks to paying banks.

Finally, many banks hope to use the authority provided by this legislation to streamline the processing of checks that they must return unpaid. Today, after a bank processes its incoming checks and determines which checks to return, it has to reprocess all of the incoming checks to pull out the less than one percent of checks that are to be returned unpaid. Many banks have indicated to us that they would find it more cost effective to use their image systems to generate substitute checks for return rather than to outsort the returned checks from all the checks presented.

The act might also better position banks to provide new and improved services to their customers. For example, banks might allow some corporate customers to transmit their deposits electronically. Because the act will likely encourage greater investments in image technology, banks might also be able to expand their customers' access to enhanced account information and check images through the Internet. In addition, banks might be able to resolve customer inquiries more easily and quickly than today by accessing check images.

The act is designed to provide banks with additional flexibility in processing checks by requiring banks to accept substitute checks in place of original checks. The act does not, however, require banks to accept checks in electronic form nor does it require banks to use the new authority granted by the act to create substitute checks. This market-based approach permits each bank to decide whether to make use of this new authority. This decision will be based on the bank's internal business case analysis, which will assess the costs and benefits of using the new authority.

We believe the market changes arising from these revisions to check law will result in substantial cost savings. Clearly, because substitute checks can be processed in the same manner as original checks, recipients of substitute checks should incur little or no additional processing costs. Recipients, however, will incur some additional costs relating to the act's customer protection and disclosure requirements. It is difficult, however, to estimate the overall cost savings. Different banks will take different approaches toward using the new authority granted by the act. Each bank's use of the new authority will depend on its technology infrastructure and strategy, its physical infrastructure, and its customer and business profiles. Thus, the magnitude of the cost savings, which will depend on the rate at which banks begin using the new authority, is difficult to determine.

We recognize that the most challenging policy issue in the proposed law, and the aspect of this legislation that has generated the most spirited discussion, relates to customer protections. Current check law protects customers if there is an unauthorized debit to their accounts. A customer already has a claim against its bank for an unauthorized charge, and the bank may be liable for interest on the amount of the unauthorized charge and consequential damages for the wrongful dishonor of any subsequently presented checks.¹ The proposed legislation applies these existing protections to substitute checks. There are, however, differing views as to whether additional customer protections are necessary for substitute checks and, if so, how extensive those protections should be. We believe

¹ U.C.C. §4-401(a) and §4-402

that, in determining the form these protections should take, the associated benefits and costs will need to be carefully balanced.

Federal Reserve Board Authority to Regulate the Payments System

We understand that there is some debate regarding whether the Federal Reserve Board already has sufficient statutory authority to adopt by regulation the concepts embodied in this proposed legislation. Although Congress has given the Board authority to regulate the check system and other aspects of the payments system, we do not believe that this authority is sufficiently broad to enable us to adopt regulations that accomplish the purposes of the act.

In the 1987 Expedited Funds Availability Act (EFAA), Congress gave the Board broad authority to regulate "any aspect of the payment system, including the receipt, payment, collection, or clearing of checks; and any related function of the payment system with respect to checks" in order to carry out the EFAA.² The EFAA also provides that the Board's regulations supersede any inconsistent provision in state law, including the Uniform Commercial Code.³ In the EFAA, Congress directed the Board to consider requiring, by regulation, a number of measures to improve the check system.⁴ Many of these measures focused on improving the process by which unpaid checks are returned to the bank of first deposit. Other suggested measures related to check truncation.

The Board has used its authority under the EFAA to make several important improvements to the check system.⁵ The Board's ability to adopt some rules to improve the check system is hampered, however, by the EFAA's limitation on the Board's ability to impose or allocate the risks of loss or liability related to payment transactions.⁶ The EFAA authorizes the Board to impose on or allocate among *only depository institutions* the risks of loss or liability, and *only up to the amount of the check* giving rise to the loss or liability, except where there is bad faith. These limitations have prevented the Board from adopting by regulation some important innovations that could substantially improve the efficiency of the check system. For example, the Board cannot adopt by regulation the changes called for in the proposed Check Clearing for the 21st Century Act, because the bill affects the rights of the end users of checks (including businesses and consumers), in particular their right to receive their original checks, and allocates liability for not only the amount of the check but also interest, litigation costs, and in some cases consequential damages.

Conclusion

In conclusion, although an increasing number of payments are being made electronically, it is clear that checks will continue to play an important role in the nation's payments system for the foreseeable future. We believe that, over the long run, the concepts embodied in the proposed Check Clearing for the 21st Century Act will spur the use of new technologies to improve the efficiency of the nation's check collection system and provide better services to bank customers. Because the act should result in substantial cost savings, it would also be desirable to begin obtaining these savings in the near future, ideally before the bill's proposed 2006 effective date.

There are some technical matters in the current version of the bill that could be improved or clarified, and we look forward to working with the Committee as it further considers this legislation. Thank you for your time and I would be happy to answer your questions.

² 12 U.S.C. §4008(c)

³ 12 U.S.C. §4007(b)

⁴ 12 U.S.C. §4008(b)

⁵ The Board has adopted rules that substantially revise the process by which banks return unpaid checks, which has expedited the receipt of those checks by depository banks and ensured prompt notice of large-dollar returned checks. In addition, the Board has adopted rules that enhance the legal abilities of private-sector banks to obtain same-day final settlement for checks presented by a specified time, which has spurred competition in the provision of check clearing services, improved efficiency, and sped the collection of many checks.

⁶ Section 611(f) of the EFAA states "The Board is authorized to impose on or allocate among depository institutions the risks of loss and liability in connection with any aspect of the payment system, including the receipt, payment, collection, or clearing of checks, and any related function of the payment system with respect to checks. Liability under this subsection shall not exceed the amount of the check giving rise to the loss or liability, and, where there is bad faith, other damages, if any, suffered as a proximate consequence of any act or omission giving rise to the loss or liability." [12 U.S.C. §4010(f)]