

Testimony of
America's Community Bankers
American Bankers Association
Consumer Bankers Association
The Financial Services Roundtable
Independent Community Bankers of America

on

Check Clearing for the 21st Century Act

before the

Subcommittee on Financial Institutions
and Consumer Credit

of the

Financial Services Committee

of the

United States House of Representatives

on

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Curtis L. Hage
Chairman and CEO
Home Federal Bank
Sioux Falls, South Dakota

and

Chairman
America's Community Bankers
Washington, DC

I am Curtis L. Hage, chairman and CEO of Home Federal Bank in Sioux Falls, South Dakota. Home Federal is a \$720 million institution headquartered in South Dakota with 32 branches in South Dakota and an additional branch in Minnesota. I also currently serve as Chairman of America's Community Bankers. I am here today representing the five major banking and financial services trade associations — America's Community Bankers, the American Bankers Association, the Consumer Bankers Association, the Financial Services Roundtable, and the Independent Community Bankers of America (the “banking and financial services trade associations”).

I am pleased to present the banking and financial services trade associations’ views on the proposed Check Clearing for the 21st Century Act (“the Check Clearing Act”). It is somewhat exceptional when all the banking and financial trade associations are in agreement on any topic. However, on this issue the associations are united in supporting efforts to increase the efficiency of the nation’s payments system. We believe that by providing financial institutions with clear authority to use substitute checks to reach banks and customers not currently participating in check image programs, Congress can help drive significant cost savings and efficiencies that will benefit both consumers and financial institutions.

On behalf of the banking and financial trade associations, I would like to extend our appreciation to both Chairman Bachus for holding this hearing, as well as to Congressman Ferguson and Congressman Ford for introducing this legislation. Our appreciation also extends to the outstanding efforts of the staff of the House Financial Services Committee and the Federal Reserve Board (“Board”) who worked tirelessly to address the concerns of the banking industry, consumer groups, and others in moving this proposal forward.

Consumer Payment Alternatives and the Check Clearing Process

Typical consumers have a variety of alternatives at their disposal to make non-cash retail payments including debit cards, credit cards, ACH debit as well as traditional checks. According to the Board, American consumers make more than 70 billion of these non-cash retail payments each year. And while the number of electronic payments represents an increasing number of these non-cash payments, traditional paper checks remain the dominant form of non-cash payment in the U.S. today. Despite repeated prediction of their demise, checks play a significant role in the U.S. payments system, and will continue to do so for years to come.

The processing of checks is an enormously expensive and labor-intensive process that requires the handling, sorting, and physical transportation of checks to payor banks. Current law generally requires physical checks to move through the entire clearing process from the bank of first deposit to the payor bank. To clear checks electronically, banks must negotiate an agreement that permits the processing of checks without the original paper check. Since the benefits of electronic processing are not shared equally among the participants, these agreements are most often found between very large institutions with massive check processing volume.

While physical checks continue to move through the clearing process, an increasing number of consumers do not have their original checks returned to them. Informal industry assessments estimate that more than 30 percent of all checks drawn by bank customers, and nearly all checks drawn by credit union customers are not returned to the check writer. Through a variety of safekeeping strategies, many consumers, rather than receive their original check, receive detailed information about

their check transactions in their monthly account statement. Some customers also receive images of canceled checks, or have the ability to access check images online. Those who do not automatically receive check images can request a copy from their bank. Detailed check transaction information and check images satisfy virtually all customer needs (e.g., proof of payment, tax records, etc.) and original items are rarely requested or needed.

The removal, or truncation, of paper checks from clearing, processing, and settlement activities is growing and will continue to grow regardless of whether the Act is passed. However, passage of the Check Clearing Act will facilitate and advance the orderly movement toward electronic processing which provides benefits to all participants.

Improving the Efficiency of the Check System

Responding to the massive costs and inefficiencies associated with check processing, the Board's Payments System Development Committee actively sought input from the banking industry, consumer groups, check clearinghouses, processors, and others in developing a proposed legal framework intended to remove the barriers to the wide scale use of electronic truncation. The Fed's efforts served as the foundation for the Check Clearing Act proposed by Congressmen Ferguson Ford.

The Proposed Check Clearing Act for the 21st Century

The Check Clearing Act would allow a collecting bank to remove, or truncate, the original paper check from the check collection or return process. The proposal would enable the entire banking industry to use electronic images to process and clear checks. For those banks that choose to process paper checks, the proposal allows for the creation of a "substitute check" that would retain the legal equivalence of the original check. It is important to note that under the Check Clearing Act, substitute checks must adhere to rigorous standards that ensure the document accurately represents the original check and can be processed in the same manner as the original check.

Under the Check Clearing Act, no longer would a California bank have to ship a check drawn on a New York bank across the country for clearing, processing and settlement. Substitute checks could be processed and transmitted electronically in lieu of the original paper check. Most importantly, the proposal does not require the banking industry to adopt a fully electronic check clearing system; rather it provides the industry with the flexibility to adapt to electronic check clearing over time without interfering with the existing paper check process.

The banking and financial services trade associations believe that removing the legal impediments to the expanded use of electronics for check clearing and settlement will improve the efficiency of our nation's payments system and provide benefits to consumers as well as banks. Expanding the use of electronics in check processing will help streamline the collection and return of checks, reduce processing costs, and minimize the effect of unexpected disruptions to air and ground transportation systems. Moreover, reducing the dependency on the physical presentment of original items will result in faster check collection, provide information about transactions to consumers more rapidly, make funds available sooner, and help combat fraud.

Improving the check clearing process may also allow banks to develop new and more flexible banking services. For example, new image-capable ATMs may make it possible for banks to offer extended deposit cutoff at remote locations since the need for physical same-day pick up could be eliminated.

This technology could also make it possible for banks to deploy more ATMs in remote locations as the cost of retrieving deposits and servicing ATMs could be reduced.

Benefits of Check Truncation and Imaging

In addition to the direct impact on costs, the Act would serve to promote imaging technology that can help speed processing and improve service to customers. Many consumers are already enjoying the benefits and conveniences associated with check imaging. Rather than dealing with bundles of canceled checks, consumers are able to receive concise and convenient summaries of their transactions in order to reconcile their accounts. These benefits go beyond simple consumer conveniences. The ability to access check images on the Internet helps consumers to quickly and conveniently verify their transactions, identify potential errors, and detect fraudulent transactions sooner by reviewing check images on-line. Identifying errors and potential fraud as soon as possible helps banks minimize customer inconvenience, control potential losses, and gives law enforcement an advantage in tracking down perpetrators.

Imaging also benefits those less tech-savvy consumers by empowering customer service representatives with immediate access to check images in order to respond to customer inquiries, or to provide copies checks instantaneously. Accessing images of checks takes a fraction of the time required in microfilm or physical archives. No longer will customers have to wait for a copy of their check to be obtained from a central processing facility or microfiche library. Today, institutions that have implemented check imaging offer customers a wide variety of ways to access these images, including in person at branches, through the mail, over the Internet, in image-statements and at advanced ATMs.

Finally, it's important to note that the Check Clearing Act could provide real benefits to rural community banks and their customers. In South Dakota we are constantly challenged to meet our federally mandated funds availability deadlines due to adverse weather conditions and limited access to air courier services. For example, one Home Federal branch provides financial services for a remote part of the state that is nearly five hours away via ground transportation to a central processing facility. No air courier is available, and every banking day we courier items from this branch to our central processing facility in Sioux Falls. Customers of this branch are subject to the earliest possible deposit deadline allowed under regulations, and we frequently end up having barely enough time to process items within federal funds availability time limits. Additionally, the limited competition for courier services in remote areas means that Home Federal customers pay a premium for moving checks across the state. The Check Clearing Act would allow Home Federal and other rural community banks to transmit electronic images of checks that can be used for clearing and settlement with our existing systems.

One Community Bank's Experience

Some critics of this legislation have expressed concern over relying too heavily on check images. The experiences of my institution and of many others who have been offering check safekeeping services for a number of years demonstrate that these concerns are unfounded.

Home Federal began offering checking accounts around 1980, and from the beginning we provided customers with the convenience of check safekeeping. Home Federal customers receive detailed information about checks drawn on their accounts, while the original physical check is microfilmed

and stored for a period of time at our check processing facility. Safekeeping programs benefit both consumers and banks. Consumers receive a convenient summary of transactions in order to reconcile their account, and avoid the burden of receiving and storing reams of canceled checks. Banks in turn reduce mailing and handling costs. These savings can be passed on to consumers in the form of more competitively priced products and services.

About seven years ago in response to the demands of customers from an acquired institution and other competitive pressures, Home Federal began offering the option of having checks returned with statements for a very nominal fee. Today, Home Federal processes more than a half million check items every month for our 25,000 checking account customers, with more than 90 percent of our customers choosing not to have checks returned. Later this fall, Home Federal will begin providing full image statements of processed checks to customers and online access to images as part of our Internet banking services. We expect that once these image products are available, that almost all of our customers will choose not to have their original checks returned.

Existing Consumer Protections for Checks are Adequate

The banking and financial services trade associations support the concepts outlined in the proposed Check Clearing Act. The legislation effectively removes the dependency on the physical presentment of original checks without mandating receipt of checks in electronic form. We believe that the protections provided to consumers under existing check law provide adequate protection for the substitute checks authorized under the proposed legislation.

The banking industry and consumers have an established history of dealing with truncated checks and image documents. The millions of consumers who agree to receive their return checks in the form of images or other electronic representations demonstrate that existing law provides adequate protections. There is no evidence to suggest any significant consumer issues relating to the receipt of images or electronic representations of return check items.

Under the Uniform Commercial Code, a bank is liable to its customer if it charges its customer's account for a check that is not "properly payable." This includes checks that are not authorized by the consumer, checks containing a fraudulent endorsement or signature, and other erroneously posted checks. A bank that improperly debits a customer's account is liable to the customer not only for the amount of the improper debit, but also for the amount of any damages that are caused by any checks that are returned due to insufficient funds resulting from the improper debit. Additional protections and funds availability schedules are provided under Federal Reserve Board Regulation CC. For example, under Regulation CC returning banks warrant to the bank customer to whom the check is being returned that they have returned the check in accordance with the requirements of applicable law, that they are authorized to return the check, and that the check has not been materially altered.

Proposed Expedited Recredit Provisions Unnecessary and Could Cause Problems

The proposed Check Clearing Act establishes a complicated expedited recredit and reversal of recredit structure for consumers and banks. Under the proposal, a consumer who suffers a loss because a substitute check was charged to their account is entitled under certain circumstances to receive recredit of up to \$2,500 within 10 days of the claim. The banking and financial services trade associations believe this provision is unnecessary and may result in unintended consequences. Today, banks respond to customer claims of check fraud or processing errors in a timely and effective manner.

Complaints are rare. In fact, Board staff has indicated that an informal review of the consumer complaints filed with all the banking regulatory agencies reveal no significant consumer issues relating to existing check protections or checks generally, whether truncated or not. Complicated new recredit procedures would only serve to confuse customers, create compliance headaches for banks, and expose banks to potential new sophisticated fraud schemes.

In addition to the banking and financial trade associations' concern over the proposed expedited recredit provisions, we also believe the proposed effective date of January 1, 2006 may be too lengthy. The original Board proposal suggested a one-year effective date from time of enactment. We respectfully request that the committee carefully consider whether a shorter effective date may be more appropriate.

Conclusion

The banking and financial services trade associations support the general principles outlined in the Check Clearing Act to facilitate innovation in the check collection system without mandating receipt of checks in electronic form. We believe, however, that the body of law and regulation developed around existing check clearing processes is both effective at protecting consumers and minimizing the banking industry's exposure to fraud. The banking industry and consumer experience with existing check safekeeping and truncation programs demonstrate that existing law and regulations work. We urge members of the committee to consider changes to the legislation that will preserve existing law with respect to substitute checks authorized under this proposal. We urge members of Congress to take this opportunity to help improve the efficiency of the U.S. payments system universally supported by the banking industry and the Federal Reserve Board.

Represented Organizations

America's Community Bankers:

America's Community Bankers represents the nation's community banks of all charter types and sizes. ACB members, whose aggregate assets exceed \$1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

American Bankers Association:

The American Bankers Association brings together all categories of banking institutions, including mutually-chartered savings banks and savings associations, to best represent the interests of the 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.

Consumer Bankers Association:

The Consumer Bankers Association is the recognized voice on retail banking issues in the nation's capital. Member institutions are the leaders in consumer financial services, including auto finance, home equity lending, card products, education loans, small business services, community development, investments, deposits and delivery.

CBA was founded in 1919 and provides leadership, education, research and federal representation on retail banking issues such as privacy, fair lending, and consumer protection legislation/regulation. CBA members include most of the nation's largest bank holding companies as well as regional and super community banks that collectively hold two-thirds of the industry's total assets.

The Financial Services Roundtable:

The mission of The Financial Services Roundtable is to unify the leadership of large integrated financial services companies in pursuit of three primary objectives: to be the premier forum in which leaders of the United States financial services industry determine and influence the most critical public policy issues that shape a vibrant, competitive marketplace and a growing national economy; to promote the interests of member companies in federal legislative, regulatory, and judicial forums; and to effectively communicate the benefits of competitive and integrated financial services to the American public.

Independent Community Bankers of America

ICBA is the nation's leading voice for community banks and the only national trade association dedicated exclusively to protecting the interests of the community banking industry. We aggregate the power of our 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.

ICBA has 5,000 members with branches in 17,000 locations nationwide. Our members hold nearly \$511 billion in insured deposits, \$624 billion in assets and more than \$391 billion in loans for consumers, small businesses, and farms in the communities they serve. ICBA members employ more than 231,000 people.