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TESTIMONY OF

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ON BEHALF OF

CREDIT UNION NATIONAL ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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"The Role of Check Truncation at Credit Unions"

Chairman Shelby, Senator Sarbanes, and members of the Committee, thank you for the opportunity to provide comments on how check truncation has been working at credit unions for the past three decades. I am Lindsay Alexander, President and CEO of National Institutes of Health Federal Credit Union in Rockville, Maryland. I am testifying before you today on behalf of the Credit Union National Association (CUNA), which represents more than 90 percent of the nation's 10,000 state and federal credit unions. As you know, credit unions are cooperative non-profit financial institutions organized to provide individuals associated by a common bond with a place to save and a source of loans at reasonable rates.

I would like to provide you with information regarding:

- the frequency of check truncation at credit unions;
- how check truncation works in the credit union movement;
- the benefits to credit unions and consumers of check truncation; and
- the Federal Reserve Board proposal and other proposals to facilitate check truncation.

The Frequency of Check Truncation at Credit Unions

Credit unions have had extensive experience with check truncation for nearly three decades. When the National Credit Union Administration (NCUA) authorized all credit unions to provide share draft accounts in 1977, NCUA initially required truncation.[1] This followed a pilot program underway since 1974. As a result, most credit unions that offer checking accounts truncate. Sixty–four percent of credit unions offer checking accounts, and of those credit unions ninety-one percent truncate share drafts or checks.[2] Among the credit unions that offer checking accounts, 7.1% include images of all checks within the statements that their members receive. Although only two thirds of credit unions truncate, nearly all credit union members have access to checking accounts. In fact, 96.1% of credit unions members are in credit unions that offer checks.

How Check Truncation Works in the Credit Union Movement

Initially, the NCUA required all credit unions offering share draft accounts to truncate and NCUA defined truncation as when the original share draft was not returned to the credit union member. As a result, in the past and now, credit unions tend to truncate checks at the last step in the check collection process by not distributing share drafts to their credit union members. Under this system, there are two processes. In the first case, a credit union may receive the checks that a member writes against his or her account at the credit union, but the credit union does not pass those checks onto the member. In the second case, a credit union may have their members' checks truncated by a Federal Reserve Bank or a third-party processor, and the essential share draft information is transmitted electronically to the credit union for payment or dishonor. In this scenario, neither the credit union nor the member receives the original paper check. For all credit unions, each share draft or check is itemized on the statement that the member receives.

Credit unions do not usually truncate all the checks that they process. For example, credit unions do not usually truncate the checks drawn on other financial institutions that their members deposit or use to make loan payments at the credit union.

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[1] Share draft accounts at credit unions are equivalent to checking accounts at banks.

The Benefits to Credit Unions and Consumers of Check Truncation

Credit unions have found that check truncation, under existing check law, allows credit unions to serve credit unions members well. Check truncation has allowed credit unions to provide members with lower fees and still provide members with outstanding service. The experience of credit unions is that our members rarely request or need originals from truncated share drafts or checks. In fact, some credit unions never provide originals because they destroy the originals within 2-3 business days. In 2001, an informal survey of corporate credit unions, credit unions that provide services for other credit unions, confirmed this. In 2001, corporate credit unions processed over 1.1 billion items in total check volume. Of those 1.1 billion checks, only about 480,000 requests were made for the original check, representing .04 percent of all checks. In almost all cases, the corporate credit union could make a good-quality, clear image of the check that satisfied the member's needs.

I would like to now describe the experience of my credit union, which is a $350 million asset institution. We have 48,000 members with 26,800 checking accounts.

Like most credit unions, we truncate the share drafts drawn on our members' accounts at the end of the check process. We do not return checks to members and never have. Although we currently receive checks back from our Federal Reserve Bank, we are undergoing a process to convert to an all-electronic system. We still use the paper collection system for checks drawn on other financial institutions that are deposited by our members.

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[2] Share drafts are checks

In addition, at National Institutes of Health Federal Credit Union we image all checks that we receive (both checks drawn on our accounts and deposited checks from other institutions). After we image checks drawn on other institutions, we keep copies onsite for 30 days and retain copies offsite for seven years. Our credit union processed about 2 million of our own checks that were worth approximately $649 million and 461,532 checks drawn on other financial institutions worth approximately $340 million.

In my fourteen years at National Institutes of Health Federal Credit Union, we have never had a member that has complained about not getting an original. Members do not request originals anymore. A copy of the share draft seems to satisfy members' needs as long as the share draft or check is clear and legible. In those cases where the member does request a copy, the most common reasons are because the member needs it for proof of payment or for an audit. At my credit union, 90 percent request a copy of the check as proof of payment and 10 percent request it for Internal Revenue Service audits. Only a few members need it for court cases or other reasons.

Truncation has helped us meet our members' needs and our members are extremely complimentary of the services that we can provide along with truncation. In mid-February, we implemented a new service to complement our truncation program whereby members who are registered with our online banking service can obtain a copy of a share draft or check free by accessing the image through their online account. Since we introduced the service we have had an extraordinary response, with several members a week spontaneously sending complimentary e-mails to the credit union praising this service. This imaging service reduces the time it takes to retrieve checks from 2-3 days to making it nearly instantaneous.

The Federal Reserve Board Proposal and other Proposals to Facilitate Check Truncation

The Federal Reserve initially presented to Congress a proposal that would have permitted depository institutions to convert original checks into electronic items and send those electronic checks to other depository institutions that agree to accept electronic checks. The proposal did not mandate check truncation, however. For instance, if a depository institution did not agree to accept electronic checks, then the presenting financial institution would send that institution a substitute, paper-machine-readable copy of the check (a substitute check). During the collection and return process, checks would be converted into electronic and paper versions as necessary. This proposal represented a step forward by allowing financial institutions to voluntarily decide to present an item totally electronically without the need for previously adopted agreements.

The Federal Reserve proposal would have allowed existing truncation programs, such as those at credit unions, to coexist, without imposing new requirements from the proposal on existing credit union programs. We strongly support that provision in the Federal Reserve proposal. And we strongly oppose any expansion of the scope of the Act that would impose requirements on check truncation programs that already exist and do not use a substitute check. The Act is designed to address situations where a customer is forced to accept a substitute check and the special provisions for substitute checks in the Act should only apply to situations where the credit union member or bank customer actually receives a substitute check. In the case of credit unions, members have already agreed not to accept the check, and our experience suggests that our members are doing well with this approach. Therefore, expanding the scope of this Act is unnecessary and would interfere with credit union check truncation programs that already seem to be working. We hope the Senate, like the Federal Reserve, limits the scope of its bill.

We support changes that have been made to the Federal Reserve proposal that appear in the Check Clearing for the 21st Century Act that was recently introduced by Representative Hart and Representative Ford in the House. These changes would allow financial institutions to truncate all types of checks, including checks drawn on the Department of Treasury, without unique processing streams. Moreover, the consumer provisions found in the Act appear to reflect the experience that credit unions have had with check truncation. The Act allows an indemnifying financial institution to produce a copy to resolve a consumer's claim when a copy is sufficient for that purpose. The experience of credit unions is that at nearly all times a copy is sufficient, so being able to reproduce a good quality copy should be sufficient. The change is especially important because frequently the original will be destroyed within a few days and might not be available anyway.

We are also supportive of consumer protections in the House bill that mirror those of existing laws. Section 6 of the bill would provide a consumer who receives a substitute check with certain recredit rights. If the member suffered a loss because of the substitute check, the member's credit union under certain circumstances would be required to recredit the account of the member up to $2,500 by the end of the tenth business day following receipt of the member's notice that a substitute check was not properly charged to the account. The approach appears reasonable. The recredit procedure in Section 6 gives the member's credit union 10 business days to investigate the claim before being required to recredit the member and 45 calendar days in certain unique circumstances. The credit union's ability to investigate a consumer's claim prior to being required to recredit the consumer's account is essential for the credit union to avoid fraud losses from the new expedited recredit procedure. Similarly, the Section 6 expedited recredit procedure does not require the credit union to provide notice to the member before reversing a claim that is not substantiated. Requiring a credit union to give notice before reversal would have undermined the credit union's ability to protect itself from fraud, because it gives the person a chance to withdraw funds even when the credit union has discovered that there is a fraud in progress.

We also support Section 7 in the House bill that provides ground rules regarding when a financial institution that has suffered a loss from a substitute check must be recredited by an indemnifying bank. Under Section 7, a claimant financial institution has 120 days to make a claim that it suffered a loss as a result of a substitute check. After that, the indemnifying bank must respond by giving the appropriate recredit, or a copy of the check showing that the claim is unfounded, or information why the bank does not need to provide either of those two responses. Placing a time limit on responses to claims among financial institutions protects smaller institutions and ensures that paying financial institutions do not disproportionately bear the burden for substitute checks that may have been mishandled earlier in the collection process by an indemnifying bank.

Conclusion

In conclusion, most credit unions throughout the country in addition to National Institutes of Health Federal Credit Union truncate their share drafts or checks, and have done so for decades. The experience of these credit unions is that members like this service, and in particular, seem to find imaging helpful. Members find that in cases where they need a copy of the share draft a good copy is sufficient. We remain supportive of the current attempts to voluntarily facilitate check truncation. And we look forward to working with the Committee, the Federal Reserve and consumers in further strengthening this proposal.

Thank you for this opportunity to comment and I will be glad to answer any questions.