

Testimony of

American Bankers Association

America's Community Bankers

Consumer Bankers Association

The Financial Services Roundtable

Independent Community Bankers of America

On

The Federal Reserve Board's

Proposed Check Truncation Legislation

before the

Senate Banking Committee

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Salt Lake City, Utah

Good morning. My name is Danne Buchanan. I am the Executive Vice President of the E-Business Solutions Group at Zions Bankcorporation, Salt Lake City, Utah. I also serve as CEO of NetDeposit, a subsidiary of Zions Bankcorporation that provides processing and clearing technology which allows organizations to move to electronic presentment of paper checks.

I am here today representing the five major banking and financial services trade associations — the American Bankers Association, America's Community Bankers, the Consumer Bankers Association, the Financial Services Roundtable, and the Independent Community Bankers of America (“the associations”). I am pleased to present the banking and financial services trade associations views on the concept of check truncation as envisioned in the Federal Reserve Board’s (“Board”) proposal (“proposal”).

Although the associations sometimes have divergent views on issues, on this issue, we are unequivocally united in supporting efforts to increase the efficiency of the nation’s payments system. We believe that legislation to sanction “substitute checks” will facilitate electronic check processing that will produce significant cost savings, efficiencies, and new consumer conveniences, to the great benefit of both consumers and financial institutions.

On behalf of the associations, I would like to extend our appreciation to Senator

Shelby for holding this hearing. We also commend the staffs of the Senate Banking Committee and the Board who have worked tirelessly to address the concerns of the banking industry, consumer groups, and others in moving this concept forward.

Consumer Payment Alternatives and the Check Clearing Process.

Consumers today have a variety of alternatives at their disposal to make non-cash retail payments. These include debit cards, credit cards, automated clearing house (“ACH”) debit payments in addition to traditional checks. According to the Board, American consumers make more than 70 billion of these non-cash retail payments each year. While electronic payments represent an increasing number of these non-cash payments, paper checks remain the dominant form of non-cash payment in the U.S. today. Despite repeated predictions of their demise, checks play a significant role in the U.S. payments system and will continue to do so for years to come.

Check processing is an enormously expensive and labor-intensive process that requires checks to be handled, sorted, and physically transported to the paying bank. Because of current law, paper checks generally must physically move, by train, plane, and automobile, from the bank of first deposit to the paying bank. The primary impediment to elimination of this paper check travel route and adoption of electronic check processing is the fact that customers have the right to receive their original paper checks back. Of course, checks today can be truncated at the paying bank site because

paying banks and their customers can agree to the arrangement. However, the bank of first deposit usually does not have a relationship with the paying bank's customer and cannot know whether the check writer will insist on receipt of the paper check.

Therefore, checks generally cannot be truncated at the point of deposit, necessitating the long trip to the paying bank. The only exceptions are unusual cases where very largest banks with large check volumes have reached private agreements.

At our bank we have over the last 2 years been truncating original items for payments and creating Image Replacement Documents that have been processed by every major financial institution in the United States for thousands of customers. We have accomplished this with two-party agreements between Zion's Bank and its customers even though the customer's deposit account may be held with another financial institution. I am pleased to let you know that the process works. After we disclosed the process, we had few customer inquiries and have successfully dealt with every issue or question posed by a paying bank. We have also proven the value propositions by streamlining our internal operations and reducing costs in float, clearing fees, and transportation.

We also have a pilot program for our imaging product with a large New York bank and one of its customers and their results are equally positive. The benefits have gone beyond banking as we are finding our commercial customers anxious to begin truncating their payments utilizing this same technology. We have several in production now, with a large number awaiting implementation. The benefits for these customers

are improved availability, integration to back office systems, and elimination of the daily bank delivery, along with the extension of operating timeframes. We are currently processing approximately a million dollars per day with this process and expect it to ramp significantly in the coming months.

Keep in mind that many customers today do not receive their checks back with their statements. Informal industry assessments indicate 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. Depending on the bank's check safekeeping strategy, many consumers receive convenient images of cancelled checks or detailed information about their check transactions on their monthly account statement. Those who receive notations on their check statements may obtain copies of checks upon request. In addition, some customers also have the ability to review check images online.

It is important to note that the detailed check transaction information and check images satisfy virtually all customer needs today. For example, images are routinely used and accepted as proof of payment, for tax records, etc. Original items are rarely requested or needed. ***This fact is critical because many of the objections raised by consumer advocates about the broader check imaging envisioned under the Board's proposal exist today, but in fact present few, if any, problems.***

The removal, or truncation, of paper checks from clearing, processing, and

settlement activities is growing and will continue to proceed regardless of whether legislation is enacted. However, passage of legislation will facilitate electronic processing so that it progresses in a more orderly, efficient fashion, to the benefit of all participants.

The Board's Proposal Will Improve the Efficiency of the Check System.

Responding to the massive costs and inefficiencies associated with check processing, the Board's Payments System Development Committee over three years ago began actively seeking input from the banking industry, consumer groups, check clearinghouses, processors, and others in developing a proposed legal framework that would remove the barriers to the wide scale use of electronic check processing. The Board's diligent review of comments, resolution of issues, and creative thinking produced its draft legislation. We applaud those efforts and the ultimate product.

The Board's proposal would allow a collecting bank to remove, or truncate, the original paper check from the check collection and return process. Checks could then be processed as images that are transmitted electronically. Any bank in the process as well as the check writer could demand that items be reconverted from electronic form into a "substitute check," complete with back and front images and the magnetic ink character recognition ("MICR"). The proposal would establish that substitute checks are the legal equivalent of the original check. The proposal provides that 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. As noted earlier in my testimony, we have proven that the concept works in the real world without adverse impact to banks or customers.

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. Checks could be processed and transmitted electronically without the original paper check. Moreover, the proposal does not require the banking industry to adopt wholesale electronic check clearing; rather it provides 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 electronic check processing will improve the efficiency of our nation's payment system and provide benefits to both consumers and depository institutions. Electronic check processing has the potential to streamline the collection and return of checks, reduce processing costs, and minimize the effect of unexpected disruptions to air and ground transportation systems. Reducing the dependency on the physical presentment of original items will result in faster check collection, which will allow consumers sooner access to their funds. Consumers will also have faster, more convenient access to information about check transactions.

Improving the check clearing process may also allow banks to develop new and

more flexible banking services. For example, image-capable ATMs that can forward deposits electronically will allow banks to deploy more ATMs in remote locations as the cost and frequency of physically retrieving deposits and servicing ATMs could be reduced. Consumers may be able to use these ATMs to cash payroll checks at their place of employment, which may be particularly attractive for those without bank accounts. It will also be possible for banks to offer extended deposit cutoff at remote locations since the need for physical same-day pick up could be eliminated.

Check Truncation and Imaging Will Benefit Banks and Their Customers.

In addition to the direct impact on costs, the proposal would serve to promote check imaging technology by adding another positive weight to the business case for adopting check imaging generally. This broader adoption of check imaging will help provide benefits beyond those attributable to the electronic processing facilitated by the proposal. New applications, services, and benefits will emerge and existing ones expand if check imaging is boosted by the electronic processing aspect envisioned under the proposal.

For example, today many consumers receive compendious and convenient image statements of checks rather than disorganized, loose checks. In addition, a more recent application of check imaging allows customers to view check images on-line. This helps consumers to quickly and conveniently review transactions, identify potential

errors, and detect fraudulent transactions sooner. Customers who do not bank online also benefit from imaging because customer service representatives can quickly bring up for view images to verify transactions for the customer. This requires a fraction of the time typically required to research microfilm or physical archives and transmit copies. 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. Such current imaging applications will expand with the additional application of check truncation.

Finally, the proposal could provide real benefits to rural community banks and their customers. In remote areas, banks are constantly challenged to meet the federally mandated funds availability deadlines due to adverse weather conditions and limited access to air courier services. In some places, it can take hours via ground transportation to reach a processing facility. Air couriers are often not available. With the Board reducing check processing services and closing facilities, such physical challenges and complications will only increase. Banks in these situations struggle to process checks before they must make funds available pursuant to the schedules mandated under the Expedited Funds Availability Act. The proposal would allow rural community banks to transmit electronic images of checks that can be used for clearing and settlement with their existing systems, regardless of weather, transportation constraints, or distances to processing centers.

Existing Consumer Protections for Checks are Adequate.

The associations support the concepts outlined in the Board's proposal. The legislation removes the need to transport and present original checks. However, we strongly believe that the provisions of Section 6 of the proposal related to expedited recrediting for consumers are unnecessary and will not only facilitate, but indeed encourage fraud. We believe that existing check law provides appropriate and adequate protection to consumers with respect to substitute checks as envisioned under the proposal.

The banking industry and consumers have an established history with truncated checks and image documents. Indeed, millions of consumers have been receiving either images or a notation in their statements for years, without complaint that disputes are not addressed satisfactorily. The current check law works in the truncated and image environment. There simply is no evidence to justify deviation from existing check law.

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. Banks report the same dearth of complaints on these matters. Complicated new recredit procedures would only serve to confuse customers, create compliance headaches for banks, and expose banks to potential new sophisticated fraud schemes.

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 the Board's 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. These laws ensure check-related disputes are handled appropriately. And they work, whether the original check, an image, or a statement notation is involved.

Proposed Expedited Recredit Provisions Are Unnecessary and Will Promote Fraud.

The proposal establishes a complicated expedited recredit and reversal of recredit structure for consumers and banks that will promote fraud. Section 6 of the proposal provides that consumers may make claims for expedited recrediting if they

assert that the bank charged the account for a substitute check that was not properly charged and that production of the check is necessary to determine the validity of the charge. The bank then must either produce the original check and show that the account was properly charged or recredit the consumer account for the amount of the check up to \$2,500 no later than the business day following the banking day of the claim. The remainder must be available not later than 20 business days following the banking day of the claim. Funds must be available the day after recrediting. Banks may delay recrediting under certain circumstances: the account is “new;” the account has been repeatedly overdrawn; the bank has reasonable cause to believe that the claim is fraudulent; and emergencies.

Even with the exceptions, the expedited recrediting period is far too short and will not only facilitate fraud, but indeed encourage it. To illustrate:

1. A fraudster sets up a bank account and writes a check drawn on the account for \$2,400 that is deposited into another account belonging to the same individual at another institution.
2. After the original item is truncated and a substitute check sent to the paying bank, the fraudster disputes the item, claiming the original has been altered from \$240 to \$2,400 and that the original is required to resolve the problem.
3. Because in most cases, it will not be possible to obtain the original check within two days, the bank will be obliged to release the funds. The fraudster walks away with \$2160 of the bank’s money.

Under the proposal, the paying bank must make funds available two days after the claim, risking that the funds will be withdrawn before --- and if -- it can produce the original check. In addition, the bank risks liability for wrongful dishonor of additional checks drawn on the account.

As a practical matter, under the proposal, the bank has no time to obtain the check or investigate before it must release \$2,500 *per claim*. (The Proposal does not limit the number of claims an individual may make in a single day.) Multiply the claims by multiple checks and multiple accounts and the sum can be significant reward for such little effort and time.

This is attractive not only for “true fraudsters,” but also for customers who may be tempted to abuse the law on an occasional basis. Certainly, this is banks’ experience and complaint under Regulation E which governs electronic fund transfers related to consumer accounts and generally permits a more generous 10 days to recredit the account. Banks complain that this current 10-day recrediting requirement means that they must absorb losses due to fraudulent claims that cannot be resolved within the 10-day time frame. Accordingly, we strongly recommend retaining current check law.

Consumer Groups’ Concerns Are Unfounded Because Consumers’ Situation Will Be Unchanged.

Consumer representatives complain that consumers need protections above and beyond what is required today because they will be at a disadvantage if they receive substitute checks rather than originals. However, the situations they cite have existed for years in the truncated environment without adverse consequence to consumers. As noted earlier, millions of bank customers receive check images with their statements. Generally, banks providing the images destroy the checks within 30 to 60 days. In many cases, by the time the consumer requests the check, it has already been destroyed and only a copy is available. Thus, the environment under the proposal will differ little from the environment of today.

Testimony presented by Gail Hillebrand on behalf of Consumer Union and others on 25 September 2002 before the House Financial Services Committee, asserted that the substitute check would not be able to “show things that cannot be copied such as the pressure applied to the pen by a forger.” This is true today with the ubiquitous image statements.

First, by the time consumers determine they want the original, it has usually already been destroyed. Second, examining pen pressure, which is expensive, would typically only arise in rare cases, i.e. high dollar checks. In such cases today, the check may not have been destroyed. Similarly, if the proposal is adopted, the bank may choose not to truncate large checks or retain the original if they are truncated, given the risk of loss in the event the item is disputed. Thus, in rare cases when pen pressure

might be examined, the check would probably be available for examination as it is today.

In addition, consumer groups expressed concern that “It will be up to the consumer to persuade a landlord or another person to accept the substitute check as proof of payment.”) Again, today, by the time consumers determine that they want the check, it is likely to have already been destroyed. Moreover, under the proposal, substitute checks will bear the legend, “This is a legal copy of your check. You can use it the same way you would use the original check.” We believe that this will be sufficient to quickly convince landlords and others of the legal equivalence of the check.

Finally, consumer groups also demand that the expedited recrediting provisions of the proposal extend to all truncated checks, including those provided today with the customers’ consent. They argue that consumers will be confused because the rules for dispute resolution for those who receive images voluntarily, as they do today, will be different from those who insist on substitute checks. The need for consistency argues for retaining current check law. Since existing check law has a long, proven record of success in the truncated environment, if a single consistent rule is adopted, it should be based on current proven law, not a new law that arguably will promote fraud.

Conclusion

The banking and financial services trade associations support the general principle outlined in the Board's proposal 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 regulations that has developed around existing check clearing processes is both effective in 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. The worries of consumer groups demanding additional consumer protections are unfounded: the examples they raise exist today without complaints of the harms or inconveniences they predict will accompany the legislation.

We urge members of the committee to consider changes to the Board's proposal that will preserve existing law with respect to substitute checks. We hope members will also take this opportunity to improve the efficiency of the U.S. payments system by quick passage of the proposal, which has the broad support of the banking industry and the Federal Reserve Board.

Represented Organizations

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 finance (auto, home equity and education), electronic retail delivery systems, bank sales of investment products, small business services, and community development. CBA was founded in 1919 and provides leadership and representation on retail banking issues such as privacy, fair lending, and consumer protection legislation/regulation. CBA members include 85% of the nation's largest 50 bank holding companies and hold two-thirds of the industry's total assets.

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.

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, "The Nation's Leading Voice for Community Banks," represents nearly 5,000 institutions at more than 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business agricultural and consumer lending. ICBA's

members hold more than \$526 billion in insured deposits, \$643 billion in assets and more than \$405 billion in loans for consumers, small businesses and farms. They employ more than 231,000 citizens in the communities they serve.