

**THE FEDERAL RESERVE BOARD'S PROPOSAL
ON CHECK TRUNCATION**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

LEGISLATION TO INCREASE THE EFFICIENCY OF CHECK COLLECTION
AND TO ELIMINATE UNNECESSARY STEPS THAT WILL HELP IMPROVE
OUR FINANCIAL SYSTEM

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THURSDAY, APRIL 3, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m. in room SD-538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

We have some pending nominations and if we get a quorum, Governor Ferguson, we will probably interrupt the proceedings and move to the nominations and then go back to where we are, so if you will be patient with us. We appreciate that you are here today.

This morning the Committee meets to consider the Federal Reserve Board's proposal on check truncation. We are very pleased to have as our first witness Vice Chairman Roger W. Ferguson of the Federal Reserve System, who will discuss their proposal and its benefits in some detail.

For our second panel today, we will welcome three witnesses: Ms. Lindsay Alexander, President and Chief Executive Officer of the NIH Federal Credit Union, representing the Credit Union National Association; Ms. Janell Mayo Duncan, Legislative and Regulatory Counsel from Consumers Union; and Mr. Danne L. Buchanan, Executive Vice President from the Zions Bancorporation, testifying on behalf of several banking trade associations.

Long before credit cards and debit cards came along, the paper check served as a convenient and a safe means for consumers to make purchases and pay bills. Despite the growing popularity of these newer payment instruments, checks remain a significant part of the American payment system. The Federal Reserve System estimates that over 40 billion checks are written annually, accounting for \$39.3 trillion in payments.

I doubt that many of us have given any great thought to what happens when we write a check to a merchant or put one in the mail to pay a bill. Today's hearing provides us an opportunity to highlight how the existing check clearing process works and how little that process has changed to fully incorporate advances in technology. I truly believe that most Americans would be surprised at how dependent our system remains on the physical transportation of paper checks.

Under current law, banks must physically present and return original checks to receive payment unless the bank has an agreement with another bank to do so by electronic means. Some banks have such agreements and have been able to take advantage of electronic processing using advanced imaging technology. However, since there are over 15,000 banks, thrifts, and credit unions, negotiating such agreements with each individual institution would be impossible. As a result, we continue to have billions of checks, literally tons of checks, either trucked or flown across the country every night. Given the availability of inexpensive electronic transmissions media, this enormous dependence on ground and air transportation systems makes very little sense. Truncation could be used to make the process less expensive over the long-term.

The Fed's proposal would end the requirement to move paper by allowing banks to transfer electronic images of checks rather than the originals. In cases where a hard copy of a check was needed, a legally equivalent substitute could be downloaded from the electronic image and delivered to the bank. The end result is considerable savings in time and money through the elimination of an outdated law. We can learn from the experience of the credit union industry, which has used the truncation process for many years. We will hear more about that later this morning.

I look forward to hearing the testimony of the witnesses today. Governor Ferguson, we are pleased to have you with us this morning. Modernizing the check clearing process would provide benefits to consumers and financial institutions and I believe to our economy as a whole. I intend to work with my colleagues on both sides of the aisle to develop legislation that accomplishes this task.

Senator Bennett, do you have a statement?

COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Yes, thank you, Mr. Chairman. I very much appreciate your holding this hearing. I will get into it more when we get into the second panel, but I have seen this process at work. I have seen the software. I have seen the product. And once you have seen it actually happen, you wonder, why in the world would anybody want to continue the present system?

We should remind ourselves that on September 11, the entire airline system was shut down for security purposes. It was the prudent thing to do. It was the essential thing to do. We did not know where the attacks were coming from, and the only way that we could find out was to get all of the airplanes out of the sky and then any that were still flying, we knew were under control by someone other than by the FAA.

That was the homeland security requirement. No one questioned it at the time and no one would question it if it were to be required again. But it completely brought to a halt all transfer of funds in the United States because there was no physical transfer of checks outside of individual communities. And the economic cost of that physical transfer was highlighted in that situation.

So in the new world in which we live, where terrorists can interrupt economic activity with physical acts, we should have an electronic work-around that can resolve that and keep the economy going smoothly in the face of such an attack. And that is why, in

addition to all of the economic reasons, this makes sense, there are security reasons why it makes sense as well.

I thank you again for holding the hearing.
Chairman SHELBY. Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Chairman Shelby, for holding today's hearing on check truncation. While we may not spend a lot of time thinking about how our checks get processed, it is clear that electronic presentment of checks is an important step forward in modernizing our Nation's payment system.

In the days, as Senator Bennett has noted, following September 11, when planes across the country remain grounded, banks were forced to take drastic steps to ensure the shipment of checks from bank to bank. Check payments across the country were delayed, which opened up possibilities for processing errors and fraud.

Electronic payments, on the other hand, continued to be processed in a safe and timely fashion during that crisis. But even absent a crisis, processing challenges confront banks in my State of South Dakota every winter. Deep snowfalls and vast distances between small town banks and processing centers add significant costs to physical transportation of checks. These costs trickle down to consumers and everyone ends up paying the price of our out-dated system.

Last year, I introduced a Check Truncation Act, together with my colleagues, Senator Carper and Senator Miller. Our bill would improve America's check payment system by allowing banks to exchange checks electronically. Current law requires banks to physically present and return original checks, a tedious, antiquated, and expensive process. Our bill would also reduce infrastructure costs for banks, allowing for more flexibility and great cost savings for the consumer.

Our bill would not, however, prevent banks from returning checks to consumers who still like getting their physical checks returned. Banks would continue to have the discretion to provide returned check services. The only difference would be that some of those checks might be legal substitutes rather than the original payment instrument, and this is an example of that legal substitute [indicating].

The Federal Reserve Board has spent a greater deal of time analyzing the potential benefits of check truncation. I want to commend Mr. Ferguson and the Fed for their exhaustive efforts in this area. They have put together a comprehensive working group that included a diversity of viewpoints, ranging from members of the industry to consumer representatives. Our bill closely mirrors their proposal. Some of the Fed's recommendations have evolved over time and I would urge the Committee to pay attention to some of these changes as we proceed with any legislation.

I also wanted to note that Senator Bennett, who is now Chairman of our Financial Institutions Subcommittee, has spent a great deal of time on this issue and our staff has been working closely together with his on check truncation.

I look forward to working with Senator Bennett on this and a number of issues that affect America's financial institutions and

Mr. Chairman, I am pleased that you are working so quickly to focus the Committee's attention on the potential for check truncation to increase the stability and efficiency of our financial system.

It is the right time to give electronic versions of checks the same legal validity as paper checks, so America's financial institutions can provide customers with faster check clearing and better access to liquid funds in both good times and times of crisis.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman. I want to thank you for holding this hearing, and I would like to thank all of our witnesses for appearing today.

I am very familiar with check truncation. My bank in Kentucky has been truncating checks for a number of years. There have been no problems, and I think it has added a good service I receive by being able to have my checks cleared faster. At my bank, we have seen none of the problems that at least one of our witnesses will speak to today. Of course, not every bank is as well run as the bank I have in Kentucky.

[Laughter.]

I certainly understand the concerns of opponents of the Federal Reserve proposal. They are valid. But I believe that they are being addressed. Nobody wants consumers to be charged twice for a check-cashing service. We have to do what we can in this legislation to make sure that it does not happen. We also must make sure that criminals are not able to get their hands on the original or truncated checks and do everything we can to prevent fraud. I think the banks understand this. If one of their customers is a victim of a double charge or fraud. It is very likely that the consumer will vote with their feet and probably take their family and friends with them. In this highly competitive financial service environment, not very many banks can afford that.

I would especially like to welcome Governor Ferguson today. I am probably one of the Fed's strongest critics when I think they have done something outside of their mandate, and I make no apologies for that. But if I am going to criticize the Fed when I believe they are wrongfully exceeding their mandate, it is only fair that I compliment them when I think they are doing a job well done. I believe the Fed should be commended for moving this issue forward and trying to promote the use of technology to clear checks faster. Clearing checks faster is pro-consumer.

Once again, Mr. Chairman, I thank you for holding this hearing and I look forward to hearing from our witnesses.

Chairman SHELBY. Thank you.

Senator Miller.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. Thank you, Mr. Chairman, for holding today's hearing, and I thank all of the witnesses for being here.

I have no opening statement.

Chairman SHELBY. Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. No, I do not have an opening statement, Mr. Chairman. Thank you.

Chairman SHELBY. Senator Chafee.

COMMENTS OF SENATOR LINCOLN CHAFEE

Senator CHAFEE. I have no opening statement. Thank you.

Chairman SHELBY. Thank you.

Governor Ferguson, you proceed as you wish.

**STATEMENT OF ROGER W. FERGUSON, JR.
VICE CHAIRMAN, BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM**

Governor FERGUSON. Thank you very much, Mr. Chairman. I would also like to thank the Committee for inviting me to discuss the proposed Check Truncation Act and for holding hearings on this very important legislative initiative.

The proposal that the Board forwarded to Congress in December 2001, is designed to remove the legal barriers to the use of new technology in check processing. It accomplishes this essentially by allowing banks to replace one piece of paper during the check collection or return process, the original check, with another piece of paper that contains exactly the same payment information, a substitute check. This simple change holds the promise of a more efficient check collection system.

Today, consumers, businesses, and the Government write about 40 billion checks annually. And over the years, banks, thrifts, and credit unions, which going forward I will refer to collectively as banks, have applied a variety of electronic technologies to automate check processing, which involves handling and sorting checks so that they can be physically shipped to their destinations.

A typical check is processed several times before it is eventually paid. First, it is processed by the bank in which it is deposited. Then it may be shipped for processing to one or more intermediaries. And finally, it is shipped for processing and payment to the bank on which it is drawn.

While most checks are currently processed in this fashion, some checks are removed from the collection process and the payment information on the checks is captured and delivered electronically to the banks on which they are drawn. This process, which is commonly referred to as check truncation, as Senator Bunning has indicated, reduces the number of times that each check must be physically processed and shipped. As a result, check truncation is generally more efficient, more cost-effective, and less prone to processing errors.

The check system's legal framework, however, has not kept pace with technological advances and is now constraining the efforts of many banks to use new electronic technologies, such as digital check imaging, to improve check processing efficiency and to provide improved services to customers.

Today, check truncation can only occur by agreement of the banks involved because existing law requires the original paper checks to be physically presented or returned in the absence of an agreement to the contrary. Given the thousands of banks in the

United States, it is not feasible for any one bank to obtain check truncation agreements from all other banks, or even a large proportion of them. Therefore, legal changes are needed to foster the use of new electronic technologies to improve check processing and to reduce the need for physical transportation in the check collection process.

The proposed legislation facilitates check truncation early in the check collection or return process, without mandating that banks accept checks in electronic form. The proposed legislation accomplishes this by creating a new negotiable instrument called a "substitute check," and this, as you have already seen, is an example of a substitute check. That is a check that banks could use in place of an original check.

Under the proposed legislation, banks would be able to truncate original checks, process check information electronically, and deliver substitute checks to other banks and bank customers that want to continue receiving paper checks. As a result, banks could handle much of their check processing electronically without needing to obtain legal agreements from thousands of other banks to truncate checks.

A substitute check would be the legal equivalent of the original check, and could be used by both banks and their customers just as if it were the original check. It would look like a regular check, as you have seen, would carry an image of the original check on the front and the back, as you can tell, and could be processed on existing check processing equipment.

Under the proposed legislation, a bank could still demand to receive paper checks, although it would be likely to receive a mix of both original checks and substitute checks. Because substitute checks could be processed just like original checks, the bank would not need to invest in any new technology or otherwise change its current check processing operations.

Further, bank customers that receive cancelled checks with their monthly statements would continue to receive cancelled checks. Only some would be the original checks and some would be substitute checks. Bank customers would be able to use the substitute checks in exactly the same way that they would use the originals.

While allowing banks to replace one piece of paper with another might seem like a small change, eliminating the need to deliver original checks would allow banks to speed up a process of technological transformation in check clearing that is already under way. By adopting a market-based approach that permits each bank to decide when and how to use substitute checks, the proposed legislation should result in the use of technology to provide a more efficient and flexible check collection system.

The proposed legislation would also help address the risks to the check collection system from its extensive reliance on air transportation that was highlighted immediately after the September 11 tragedy. One effect of air transportation being grounded was that the flow of checks slowed dramatically. During the week of the attacks, the Federal Reserve Bank's daily check float ballooned to over \$47 billion, which is more than one hundred times its normal level.

Had the proposed legislation been in effect at that time, and had the banks been using a more 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 the substitute checks to paying banks that desired them.

The proposed legislation might also enable banks to provide new and improved services to their customers. For example, banks might allow some corporate customers to transmit their deposits electronically.

Further, if banks begin to transmit check images from the point of deposit to their operation centers for processing, they might be able to establish branches or ATM's in more remote locations and provide later deposit cut-off hours for their customers. Later deposit cut-off times could result in some checks being credited one day earlier and interest accruing one day earlier for some checks deposited in interest-bearing accounts.

Because the proposed legislation 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.

Further, as the banks reduce their operating costs, the savings will be passed on through a combination of lower fees to their customers and higher returns to their shareholders. After all, the banking industry, as Senator Bunning has already noted, is quite competitive. And banks have indicated that they expect cost savings to be substantial.

While there is a fairly broad consensus on the desirability of the underlying concepts of the proposed legislation to permit the use of substitute checks, the issue of customer protections has been the subject of much debate. Since we forwarded the proposed legislation to Congress in late 2001, the Board has had an opportunity to further reflect on the views that have been expressed by both consumer advocates and the banking industry.

The Board originally included the expedited recredit provisions in an attempt to balance the interests of consumers and banks. Given that existing check law already protects customers from check processing problems, and there does not appear to be a pattern of problems suggesting these protections are inadequate, the Board has now concluded that these provisions are not necessary for the successful implementation of the proposed legislation.

Congress, however, may arrive at a different conclusion as it considers the need for customer protections, and I would like to briefly discuss why we believe the expedited recredit provisions are not necessary.

The Board's proposed legislation extended the protections of the existing check law, including the Uniform Commercial Code, or UCC, and the Federal Reserve Board's Regulation CC, to substitute checks as though they were original checks.

Long-established check law protects bank customers if checks are improperly charged to their accounts. If a bank charges a customer's account for a check that is not properly payable, the bank

could be liable to its customer not only for the amount of the unauthorized charge, but also for interest on that amount and consequential damages for the wrongful dishonor of any subsequently presented checks.

While it is true that the UCC does not provide a specific time frame within which a bank must act, the UCC's provisions give the bank a significant financial incentive to resolve problems on a timely basis.

Specifically, the longer a bank takes to research and resolve a customer's claim, the longer the bank is exposed to the liability for consequential damages arising from the wrongful dishonor of subsequently presented checks.

These existing protections appear to have worked well for many decades.

In addition to the protections provided in current check law, the proposed legislation requires banks to provide new warranties for substitute checks and to indemnify customers for losses resulting from the receipt of a substitute check instead of the original check. Specifically, banks must warrant that substitute checks that they handle are legally equivalent to the original checks and that the check will not be paid more than once from a customer's account.

Banks must also indemnify customers for losses they incur due to the receipt of substitute checks rather than the original checks. And taken together, these warranties and the indemnity provisions provide customers with, I think, additional protections against losses related to the use of substitute checks.

The use of substitute checks is not expected to result in problems different from those that are routinely addressed in today's environment. And existing law already encourages the prompt redress of consumer complaints.

Therefore, the Board believes that the significant compliance burdens imposed by the expedited recredit provisions on banks that receive substitute checks would outweigh the small incremental benefits that the provisions would provide to consumers.

Nonetheless, Congress may conclude that the expedited recredit provisions for consumers should be included in the legislation. In that case, we believe any expedited recredit provisions should be consistent with the proposed legislation's basic purposes and should not go beyond the provisions proposed by the Board. In the unlikely event that additional consumer protections are needed for substitute checks, the proposed legislation grants the Board the authority to adopt such protections by regulation.

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 payment systems for the foreseeable future.

The Board believes that over the long run, the concepts embodied in the Check Truncation Act will spur the use of new technologies to improve the efficiency and the flexibility of the Nation's check collection system, and provide better services to bank customers.

The proposed legislation accomplishes this by simply permitting banks to replace one piece of paper, the original check, with another piece of paper, the substitute check, and both of which contain the same payment information. Because the proposed legisla-

tion should result in substantial cost savings, it would also be desirable to begin obtaining these savings as quickly as possible.

We look forward to working with the Committee as it further considers this legislation. I thank you gentlemen for your time and I would be happy to answer your questions.

Thank you.

Chairman SHELBY. Governor Ferguson, I believe this is a copy of a check that the Fed has given us.

Governor FERGUSON. Yes. This is what a substitute check would look like. As you can see, it is very much the same size as a regular check and it includes notification.

Chairman SHELBY. It is very clear, the imaging on it.

Governor FERGUSON. Yes, it is quite clear. The technology for imaging is good.

Chairman SHELBY. I think most of the Members have seen that up here. I do not know about the press.

The use of imaging technology is an additional cost to banks and may be a larger consideration for smaller community banks. Is there any reason, Governor Ferguson, to believe that up-front costs could impede the small banks from moving toward more electronic processing?

Governor FERGUSON. No, I have no reason to believe that the up-front costs will impede the small banks from moving. The cost of the imaging equipment has come down quite dramatically. And there also are a number of service providers that are willing to provide that kind of service to small banks. So, I think there is no competitive disadvantage that could emerge from this legislation.

Chairman SHELBY. Wouldn't electronic processing be particularly attractive to banks which are more remotely located and are thus, sensitive to transportation disruptions or paper checks?

Governor FERGUSON. Absolutely. It would be both beneficial to the banks and as Senator Johnson has indicated, potentially beneficial to those customers, as well as time speeds up.

Chairman SHELBY. Rural areas?

Governor FERGUSON. Rural areas, mountainous areas, areas with bad weather that impedes transportation. There are a number of parts of the country where this is clearly a net plus.

Chairman SHELBY. The Fed is required, as I understand it, to monitor funds available under the Expedited Funds Availability Act. Greater use of electronic images will likely mean that checks will clear through the system faster, as you have indicated. Assuming that truncation legislation is passed, would it be appropriate to phase in truncation prior to making decisions regarding expedited funds availability? In other words, how long a trial period of observation would be appropriate here?

Governor FERGUSON. Well, I think, as I have tried to suggest, that since there are some savings and benefits here, it is appropriate to move expeditiously, as you intend, and to make sure that the effective date is as near to passage as you think reasonable.

I do not see a reason to phase in truncation per se. I do think it is appropriate to let truncation and this Act develop over some time and give us plenty of opportunity to see what does, in fact, happen with respect to presentment times and when that funds availability becomes sooner.

We will be monitoring that extremely closely and will be prepared to act under the Expedited Funds Availability Act as soon as the facts do become clear.

So, I think that there would be nothing that we would do that would slow down the benefits at all. We would be quite aware of the question that you just raised and our need under the Act to track very closely when funds become available to make sure that the regulations reflect reality.

Chairman SHELBY. You went into this earlier, the truncation at the point of sale.

Some merchants have implemented programs to truncate checks at the point of sale in stores already. In some of these cases, the consumer actually gets to keep a copy of the cancelled check. This type of system also has some appeal as it permits customers to continue to use checks that they are familiar with while also eliminating transportation of paper checks. Has the Fed been involved in these types of initiatives?

Governor FERGUSON. We have been watching them and monitoring them closely. We spend a great deal of time—I personally, and the staff even more so—talking to the institutions that have been doing this, including some of the larger retailers.

Many of the benefits that you observed have come forward. And what we have seen, particularly in grocery stores and others that have a heavy dependence on cash and checks, is that for many of them, this has been a real plus. It has been important, obviously, to explain to customers that they will get their check back and what that implies. But there seem to be no major problems that have emerged as we have watched this closely.

Chairman SHELBY. As I understand it, these transactions are handled through an automated clearinghouse and are not governed by check law. Can you confirm that?

Governor FERGUSON. That is true. In those cases, the check is being used as the initiating document for electronic funds transfer and it is not governed by the usual check law.

Chairman SHELBY. What about the customer acceptance of that?

Governor FERGUSON. There appears to be no problem with customer acceptance. Many customers already are familiar with electronic deposits, electronic debits, et cetera, and they understand in many cases what is happening. The only thing that needs to be explained is that they will be getting their check back and that it is just being used in some cases to start an electronic funds transfer.

Chairman SHELBY. As we move toward greater use of electronic images, there will have to be some type of standard format or data requirements for the substitute checks. Could you elaborate as to what set of standards there would be and how detailed those standards are likely to be?

Governor FERGUSON. There is a private-sector group called ANSI, I believe, that is already working with respect to the question of standards. The standards would have to do with things such as the placement and size of the image on the substitute check. There would also have to be standards in the image archives themselves to make them work together, to make them more interconnected.

But the good news is that there is already progress underway there and that there are many standards that the private sector is

developing that are responding to the questions that I have just identified, such as what the contrast should be, for example.

Chairman SHELBY. Governor, the privacy of electronic checks, that has been raised. What protections govern how financial institutions and other processors use these images and the information on them?

Governor FERGUSON. Well, the check activity would be governed by the usual rules that cover privacy and financial privacy, and you are obviously well aware of what those rules are. There is nothing here that would in any sense change that one way or the other.

I would also hasten to add that there is nothing in the ability to use images that creates new incentives for banks to change or violate privacy of their customers. So the preexisting privacy laws would obviously continue to apply for the substitute checks in images, as well as the existing approaches to paper checks.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Governor Ferguson, are you familiar with the 1996 study published by the Michigan Federal Reserve Bank's quarterly review?

Governor FERGUSON. I think I am, yes. You may have to remind me of some of the details. But go ahead.

Senator BENNETT. In that study, they said that the social cost of clearing a check is currently \$3, and it would be \$1.25 for an electronic transfer. Do those numbers sound about right to you?

Governor FERGUSON. Those numbers sound about right, but let me be cautious.

It has always been hard for us to get a very good fix on the social cost. I have seen numbers that size. I have seen numbers somewhat smaller, to be fair. I have seen numbers on the scale of \$20 billion, for example. But there is a significant cost in the check clearing process. And as I have said, I believe, and based on talking to bankers, that there would be significant cost savings.

I would encourage you, Senator, to talk to the second panel where there are some bankers to talk about their experience and what the cost savings may look like. It has been very hard for us to really get the kind of Fed quality numbers on cost savings, but I am quite convinced that there would be significant cost savings that would occur.

Senator BENNETT. I picked on that one because it is connected to the Fed. It is the Minneapolis Federal Reserve Bank.

Governor FERGUSON. Right. I realize that. And as I said, that study is certainly a valid one. We have had many other studies as well and the numbers do change somewhat.

The reason I suggest that you talk to the banks in particular is that the Act deals with permission to do something. Part of the question of how much cost savings comes depends on how fully the banks use it. That is the linkage there.

Senator BENNETT. My own assumption—my own experience, I should say—says that as it becomes more widespread, the cost savings would become even greater.

Governor FERGUSON. I agree.

Senator BENNETT. So, you do not know the assumptions that are built into this as to what level of use it has. But simply doing the math, that is \$73 billion a year, if you take the 42 billion checks.

Governor FERGUSON. There are significant savings, potentially significant savings. The question of how much of those savings we capture and how quickly depends on business decisions and how quickly banks continue to go down this path.

Senator BENNETT. Now can you address or do you know of any studies that address the issue of the increased profits to the banks that come as a result of the reduced float time?

Governor FERGUSON. I have not seen any studies that address that specifically. I would again encourage you to talk to some of the bankers that are on your second panel.

But one of the things that one has to recognize is, as I have indicated as an economist, and others here know, the banking industry is extremely competitive. And one of the things that I have seen in a number of advances in payment systems, including creation of ATM's and other things, is that because of the competitive nature of the industry, the cost savings that occur to banks are quickly transmitted in terms of better products and services for customers, because, indeed, customers get a number of mailings as you know with respect to bank services almost on a daily basis.

It is also the case that we have found many of these advances with respect to payment systems, if they have led to greater profitability, have obviously then been returned to bank shareholders.

So, I am not in any sense concerned about how our financial system works from a competitive standpoint, and insofar as there are cost savings. I think they will accrue to consumers in one form or another over time because we have a very competitive banking system. And that has been borne out with almost every advance with respect to payment systems, that, ultimately, the banks make the investments and the consumers reap the rewards in one form or the other—lower costs, better services.

Senator BENNETT. That is the point I was hoping the question would make, and I thank you for that explanation because it is very clear that if we can bring the costs of doing business down in the economy wherever, the net result is more economic efficiency. More economic efficiency means lower prices, and it ultimately means better economic activity.

One of the challenges that we have in the Congress right now is that we are in a sluggish economy and we are trying to find ways to make it revive. And if we could do something that puts \$73 billion a year, plus whatever additional economic advantage would come from the improvement of the float, into the economy, at least during the budget debate, we would say that was a good day's work, if we could find \$73 billion of stimulus one way or the other.

[Laughter.]

The only other comment I would make, echoing what Senator Johnson has said, is there are plenty of rural people in Utah. And to do something that would improve services to the customers who live in those rural towns is something that clearly we need to do.

However, we should be careful not to get carried away with concerns that apply theoretically that cause us to deny benefits that are there in reality for a lot of people who do not happen to live in big cities.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Johnson.

Senator JOHNSON. I will waive questioning, Mr. Chairman.
Thank you.

Chairman SHELBY. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I don't know whether you read Ms. Duncan's testimony or not.

Governor FERGUSON. I am aware of some of it. I have been told some of it.

Senator BUNNING. Would you like to respond or comment on some of her concerns? Particularly the recommendations that she has made on the final page.

Governor FERGUSON. I do not have the recommendations per se.

Senator BUNNING. Because all consumers are equally susceptible to harm from processing errors, the recredit loophole in the proposed ETA should be closed—

Chairman SHELBY. Senator Bunning, could you suspend? We have a quorum now where we can move—

Senator BUNNING. Absolutely.

[Laughter.]

Chairman SHELBY. Thank you. We will now move into Executive Session and deal with some nominations.

We have: Alfred Plamman, to be a Member of the National Consumer Cooperative Bank; Thomas Waters Grant, Noe Hinojosa, and William Robert Timken, all of whom were nominated to be Directors of the Securities Investor Protection Corporation.

All of these nominees appeared before this Committee at a hearing held on March 25. So, I would ask now, is there any comment or debate on the nominations?

[No response.]

Hearing no objection, it is so ordered.

All in favor of the nominations, say aye.

[A chorus of ayes.]

Chairman SHELBY. Those opposed, no?

[No response.]

Chairman SHELBY. The ayes appear to have it. And the four nominations will be favorably reported to the Full Senate.

Thank you, Senator Bunning.

Senator BUNNING. Thank you.

Chairman SHELBY. Senator Bunning is recognized again.

Senator BUNNING. Mr. Ferguson, would you like to comment?

Governor FERGUSON. Yes, I would like to comment on them. I would also observe that, having been a nominee before this Committee, I am pleased to see the Committee move so expeditiously with nominations.

[Laughter.]

To a more serious point, because I take it very seriously, the concerns that have been raised in this testimony, particularly the recommendations, are ones that, frankly, I do not share. And it is not from any lack of concern about consumers whatsoever on my part. It is rather based on analysis of the current situation and what the likely new situation would be under the Check Truncation Act.

The current situation is one in which we have a number of laws that emerged out of common law because people have been drawing drafts on banks for hundreds of years. It has been codified in the UCC and also in some Federal Reserve regulations, in which the

banks, if they do, inadvertently do a double debit, have the legal responsibility to fix that problem so that the consumers are not at risk there and there are a number of incentives that are built in to encourage the banks, incent the banks, to fix any of those problems early on.

I would also observe, as others have, that we have a system that has 40 billion checks or so every year. And as we have looked at our databases, we see very, very few problems across all of the regulatory agencies that deal with consumer complaints, that deal with the kinds of concerns that are raised here in terms of double debits or a calculation error or an error in simply transmitting the correct information. So, we have a system that works very well.

All we are doing here under this proposal is creating a new form of paper in lieu of the old form of paper. But the same protections would be there and we have proposed some new protections in terms of a warranty and an indemnity.

Now to the specifics. That is the background, of a system that works well, common law that is codified that has worked well, plus some new protections here to really give the right kind of teeth to this legislation.

Now to go to these two comments.

First, on the question of processing errors and the right of re-credit to be expanded, I have said to you, while we would have no objection if you wanted to put in a right to recredit, we do not think it is necessary. We do believe that if you choose to put in, the right to recredit, it should not be expanded beyond the case in which consumers get back a substitute check. The reason is that if we expand it more broadly than that, you are going to find that we have two different types of legal regimes that could potentially, as you were indicating, come into conflict with each other.

We would be building a system in which we are trying to protect against potential risks that I think are really fairly remote. And so, if one were to have a recredit, I would encourage it to be a fairly narrow and focused recredit because otherwise, you are opening up a case in which consumers do not know which rights they really have and you are creating, I think, more confusion than you are clarity.

With respect to the second point here regarding the comparative negligence standard as an inappropriate way to resolve harm suffered by consumers due to processing errors, again, we have very, very few processing errors as far as we can tell. But this question of comparative negligence already exists in many of the common law standards for tort and particularly as embodied in a variety of different ways, sometimes using the words, comparative negligence, sometimes not, in the UCC. And it has withstood the test of time.

I would argue that comparative negligence is a standard that is well understood in common law, well understood in business tort, well understood in check law, and I think that is appropriately maintained by the Check Truncation Act as we have proposed it.

So in both cases, while I am always sympathetic to consumer interests as part of what I am asked to do, I think that these two recommendations really do not find a useful place in the kind of proposal that is being put forward here, and they are indeed presuming a greater degree of risk than we think is likely to occur,

and are creating, if you will, a set of check law that is in some sense, in the case of recredit, not a necessary addition to a check law that we have had for many years that works very well and that would not be undercut—in fact, would be reinforced—by what we have in the proposed Act.

Therefore, I am not supportive of these two recommendations.

Senator BUNNING. Thank you very much.

Chairman SHELBY. Senator Miller.

Senator MILLER. I guess following up a little bit more on that, Governor Ferguson, you do not have a great concern, then, of the possibility of the customer getting debited twice, once for the original check and once for the substitute check?

Governor FERGUSON. No, I do not because there are a number of incentives already built in that stop that from happening.

We have, as I said, 40 billion checks a year that are written now and we have very little evidence of this as a major problem whatsoever. And partially, I think it has to do with the incentives that Senator Bunning talked about in the competitive environment.

Banks have created a number of systems to minimize the risk of a double debit, and I do not think that creating an opportunity to use more electronics is going to increase that risk or change those incentives.

Senator MILLER. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sununu.

COMMENTS OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

Governor Ferguson, could you be more specific? Very little evidence, 40 billion checks. For what percentage does the double debit problem exist?

Governor FERGUSON. We have gone back and looked at the databases of all the consumer complaints that we have had. I believe that we have absolutely none where I have heard anything of a double debit.

[Pause.]

And the staffers are shaking their heads in agreement. There may be the rare case out there, but it has not emerged through the complaint process.

Senator, I am not going to be facetious at all. I get a large number of letters with a variety of complaints about things that banks do. I have gone back and looked at my files and the things that I have responded to. And over the 7 years that I have been on the Board, the 6-plus years that I have been on the Board, I haven't received one complaint of this nature.

So, I would have thought since there is something at stake here, that either the formal complaint process or others would suggest an issue here.

Senator SUNUNU. And other than the interpretation based on correspondence or complaints that you are receiving through formal channels, there is no statistical database of the 40 billion checks and what kind of problems—

Governor FERGUSON. No. We have a statistical database for all complaints. There is not a statistical database of what happens to the 40 billion checks.

Senator SUNUNU. Okay.

Governor FERGUSON. But since we are responsible for consumer complaints in part, we have looked across all the FFIEC agencies and we see nothing there.

Senator SUNUNU. No evidence that consumers are reluctant to call you and complain?

[Laughter.]

Governor FERGUSON. I am not encouraging more of that.

[Laughter.]

But, no, there is no evidence of reluctance of their part to let me know if things are not going well.

Senator SUNUNU. You say that you do not recommend or advocate necessarily for a credit provision. Correct?

Governor FERGUSON. That is correct.

Senator SUNUNU. Why not? And I apologize, it may have been at least touched on in your testimony, which I missed. But could you elaborate on the reason that recredit, you do not see it as being necessary?

Governor FERGUSON. We do not see it as being necessary because current check law gives the right set of incentives to fix any problems that might emerge. Banks have effective problem-solving resolution processes already for these kinds of problems insofar as they emerge. And we have proposed in this Act an additional warranty and an indemnity that gives even a little more strength there.

We do not see that there is a hole in current existing law that needs to be filled because of this new proposed approach to dealing with paper checks. And so, it is just simply an analysis based on reflection, the passage of time, and a better understanding.

Senator SUNUNU. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I have a couple of questions concerning the point of sale of the merchandise.

Will it be possible at some point to eliminate the paper check at the point of sale or purchase instead of at the point of first deposit, further reducing the paper requirements?

Governor FERGUSON. It is quite possible that other institutions may decide that they want to truncate the checks and pass that information on electronically and use that to start an EFT, an electronic funds transfer.

Some of that already does occur. And obviously, we have a large number of nonpaper-driven retail payments through the form of debit cards and credit cards already.

So, indeed, we are getting assistance and becoming gradually more electronic and less paper-based. But when you start with a system that has 40 billion checks, we still have a very large critical mass of checks. Even though they are not increasing, other things are, and we will I think over time see fewer checks being written.

But, still, when you are counting things in the billions, it is important to deal with that problem as well.

Senator ALLARD. Well, when a consumer gets used to a certain format, they tend to like to stick with it, particularly as they get older. They do not like to change.

Governor FERGUSON. Right.

Senator ALLARD. My understanding is the retailers generally support your effort on check truncation. There has been some that have expressed concerns with the logistics of the warranty provisions in the draft legislation from the standpoint that a retailer would like to process a check electronically from the point of sale.

If the warranty to process a check electronically with legal protections came from individual banks, a clerk would have to examine each check to determine whether it was written on the bank providing the retailer with a warranty. Do you see the need for revisions or expansions in that area?

Governor FERGUSON. No, I do not. I think it is not as onerous a problem as perhaps some believe—we thought through this balance issue and are pretty comfortable with where we came out in the proposed legislation. I do not see any reason for changes there.

Senator ALLARD. Thank you, Mr. Chairman. I ask unanimous consent that my opening remarks be made a part of the record.

Chairman SHELBY. Without objection, your statement will be made part of the record.

Governor Ferguson, we appreciate your appearance here today. We might have some other questions for the record and we will expedite them to you.

Governor FERGUSON. Sure.

Chairman SHELBY. Our second panel will consist of: Ms. Lindsay Alexander. She is President and Chief Executive Officer of the NIH Federal Credit Union in Rockville, Maryland. She will be representing the Credit Union National Association. Ms. Janell Mayo Duncan, Legislative and Regulatory Counsel, Consumers Union. And Mr. Danne Buchanan, Executive Vice President, Zions Bancorporation, on behalf of the American Bankers Association, the Financial Services Roundtable, America's Community Bankers, Independent Community Bankers of America, and the Consumer Bankers Association.

We welcome all of you here today. Your written statements will be made part of the record in their entirety and if you would sum up the points of what you want to touch on, it would be appreciated and it would give us some time to ask questions.

Ms. Alexander, we will start with you.

**STATEMENT OF LINDSAY A. ALEXANDER
PRESIDENT & CHIEF EXECUTIVE OFFICER
NATIONAL INSTITUTES OF HEALTH FEDERAL CREDIT UNION
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION**

Ms. ALEXANDER. Chairman Shelby 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 the 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.

I would like to provide you with information regarding how check truncation works at credit unions and insight into our views on proposals to facilitate check truncation.

Most credit unions that offer checking accounts truncate. Sixty-four percent of credit unions offer checking accounts, and of those credit unions, 91 percent truncate share drafts or checks.

Credit unions tends to truncate checks at the last step in the check collection process by not distributing share drafts to their credit union members by not giving the checks back.

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.

Credit unions have found that check truncation, under existing check law, allows credit unions to serve their members very well. The experience of credit unions is that our members rarely request or need originals from truncated share drafts or checks.

We found in an informal survey in 2001, that of 1.1 billion checks, only about 480,000 requests, or 0.04 percent, were made for the original check. In almost all cases, a good quality, clear image of the check satisfied the member's needs.

I would like to now describe the experience of my credit union.

Like most credit unions, we do not return checks to members and never have. We image all the checks that we receive, both the checks drawn on our members' accounts and the deposited checks from other institutions. This imaging service reduces the time it takes to retrieve checks from approximately 2 to 3 days to almost instantaneous.

In my 14 years at NIH Federal Credit Union, we have never had a member that has complained about not getting an original check. 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, about 90 percent of those that request a copy need it as proof of payment and about 10 percent request it for audits such as IRS audits. In a very few, isolated cases, members need it for a court case or some other reason.

The Federal Reserve initially presented to Congress a proposal 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 in credit unions, to co-exist, 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. Expanding the scope of this Act is unnecessary and would interfere with credit union check truncation programs that already seem to be working very well.

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 Representatives Hart and

Ford in the House. These changes would allow the financial institutions to truncate all types of checks. Moreover, the House bill allows an indemnifying financial institution to produce a copy to resolve a consumer's complaint or claim when a copy is sufficient for that purpose.

The experience of credit unions is that at nearly all times a copy is indeed sufficient, so there should not be a requirement to reproduce anything more than a good quality copy.

We are also supportive of consumer protections in the House bill that mirror those of existing laws and give credit unions more time to investigate complaints. The recredit procedure in Section 6 gives the member's credit unions 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.

In conclusion, most credit unions truncate their share drafts or checks and have done so for decades. 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.

I thank you for this opportunity to comment and I would be happy to answer any questions.

Chairman SHELBY. Ms. Duncan.

**STATEMENT OF JANELL MAYO DUNCAN
LEGISLATIVE AND REGULATORY COUNSEL
CONSUMERS UNION**

Ms. DUNCAN. Good morning, Chairman Shelby and Members of the Committee. Thank you for providing me the opportunity to come before you today. I am Janell Mayo Duncan, Legislative and Regulatory Counsel at Consumers Union. And my testimony today on the proposed CTA is supported by the Consumer Federation of America, the U.S. Public Interest Research Group, and the National Consumer Law Center.

We believe that in its current form the proposed CTA would be bad for consumers for three important reasons. First, the proposed legislation would eliminate the ability of an estimated 45 million consumers to receive their original cancelled paper checks each month. Second, the recredit provisions in the proposed CTA would not protect all consumers whose check information is processed electronically. Third, if enacted into law, the proposed comparative negligence provisions would give banks an unfair ability to deter, delay, or reduce claims for damages resulting from processes errors by alleging that a consumer was somehow at fault.

Although we recognize the value of the advances in technology, and we recognize what they could provide to consumers, we are concerned that the proposed CTA would take a system that works relatively well and change it in a way that imposes new risks on consumers.

Those risks include: The inability to get original checks back in order to prove payment or forgery. Potential improper account deb-

its resulting from the double processing of a single check. Errors in reading the amount of, or account number on, a check.

This proposal contains a loophole. Recredit is limited to consumers who receive substitute checks back from their banks. However, issuance of substitute checks is at the discretion of each bank.

Although Section 6 of the proposed legislation requires a bank to put \$2,500 in disputed funds back into a consumer's account if the matter is not settled in one business day, it would allow consumers to seek recredit of disputed funds only if they receive a substitute check from their banks.

Banks could prevent consumers from having the right to recredit simply by not issuing them a substitute check. We believe that the recredit provision should be mandatory and extend to all consumers, regardless of whether or not he or she receives a substitute check.

Consumers unable to seek recredit would not be similarly and adequately protected. They would have to seek redress under the UCC provisions and State law that do not require a bank to re-deposit disputed funds in consumer accounts and would require a consumer to sue his or her bank over disputes. This is too expensive and time-consuming for consumers for most amounts likely to be in dispute.

Although the proposed CTA has added warranty and indemnity provisions, they also require a lawsuit to enforce. Because all consumers are equally susceptible to harm from processing errors, the recredit loophole in the CTA should be closed and the right expanded to apply in every case.

The recredit provision is critical. Until a recent reversal, the importance of the recredit provision has been recognized by the Federal Reserve Board. The initial summary documents that were included in the transmittal letter sent in December 2001, by Chairman Greenspan to then-Banking Committee Chairman Sarbanes with the proposed CTA stated: "The expedited recredit procedure is intended to mitigate the effects on consumers of any potential problems associated with the receipt of substitute checks." It also states: "These expedited recredit provisions of the proposed Act are limited to consumers who are generally not in a position to negotiate with their banks the terms of their deposit accounts that affect the consumer's rights and liabilities, such as how payments are processed and charged to their accounts."

We, therefore, would strongly oppose any CTA without recredit for consumers.

The proposed CTA contains comparative negligence provisions that would allow banks to reduce the amount of damages a consumer can recover by asserting the consumer was somehow at fault. It is unlikely that a consumer could contribute to improper check processing, but this provision could unfairly allow a bank to deter or delay a consumer's claim by asserting that a consumer was partly responsible. The comparative negligence standard is inappropriate to resolve harm suffered by consumers and should be removed from the proposed CTA.

I thank the Chairman and the Members of the Committee and I look forward to any questions that you may have.

Chairman SHELBY. Mr. Buchanan.

**STATEMENT OF DANNE L. BUCHANAN
EXECUTIVE VICE PRESIDENT
ZIONS BANCORPORATION
ON BEHALF OF THE
AMERICAN BANKERS ASSOCIATION
AMERICA'S COMMUNITY BANKERS
CONSUMER BANKERS ASSOCIATION
FINANCIAL SERVICES ROUNDTABLE AND THE
INDEPENDENT COMMUNITY BANKERS OF AMERICA**

Mr. BUCHANAN. Good morning. My name is Danne Buchanan. I am the Executive Vice President of E-Business Solutions at Zions Bancorporation in Salt Lake City, Utah.

I am here today representing the six major banking and financial services trade associations—the American Bankers Association, the America's Community Bankers, the Consumer Bankers Association, the Electronic Funds Transfer Association, the Financial Services Roundtable, and the Independent Community Bankers of America. I am pleased to present the associations views on the concept of check truncation as envisioned by the Federal Reserve Board's proposal.

The associations 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 the consumers and the 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 important concept forward.

Check processing is a very 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 from the bank of first deposit to the paying bank. The primary impediment to elimination of this route is the fact that customers have the right to receive back their original paper checks. The only exceptions when checks do not have to be returned are unusual cases where the very largest banks with the largest check volumes have reached private agreements. Such arrangements and check truncation are out of reach for small institutions, rendering the technology largely unusable for them.

At our bank, over the last 2 years, we have been truncating original items for payments and creating substitute checks. We have accomplished this with two-party agreements between Zion's Bank and its customers. I am pleased to let you know that this process works. We have had few customer inquiries and have successfully dealt with every issue or question posed by a paying bank.

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.

It is important to note that these are sufficient for consumers. For example, images are routinely used and accepted as proof of payment for tax records. 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 exists today, but in fact present few, if any, problems.

Electronic check processing has the potential to streamline the collection of checks, reducing processing costs, and minimize the effect of unexpected disruptions to air and ground transportation systems. No longer would a bank in California have to ship a check drawn on a New York bank across the country.

Improving the check clearing process may also allow banks to develop new banking services. For example, image-capable ATM's that can forward deposits electronically will allow banks to deploy more ATM's in remote locations as the cost and frequency of physically retrieving deposits and servicing ATM's could be reduced. Consumers may be able to use these ATM's to cash payroll checks at their place of employment, which may be particularly attractive for those without bank accounts.

The proposal would also serve to promote check imaging technology by adding another positive weight to the business case for adopting check imaging generally.

For example, a more recent application of check imaging allows their customers to view check images online. 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.

Finally, the proposal could provide real benefits to rural community banks and their customers. This 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.

The associations support the concepts outlined in the Board's proposal. However, we strongly believe that the provisions related to expedited recrediting for consumers are unnecessary and will not only facilitate, but also, indeed, encourage fraud. We believe that existing check law provides appropriate and adequate protection to consumers with respect to substitute checks.

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

Consumer representatives complain that consumers need protections above and beyond what is provided today because they will be at a disadvantage if they receive substitute checks rather than originals. However, the situations they cite have existed for many years in the truncated environment without adverse consequence to

consumers. For example, consumer groups express concern that it will be up to the consumer to persuade a landlord or another person to accept a substitute check as proof of payment.

Again, today, by the time consumers request a check, it is likely to have already been destroyed in a truncated environment, as was mentioned earlier by the credit unions. 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 the original check." We believe that this will convince landlords and others of the legal equivalence of the check.

In addition, consumer groups also demand that the expedited re-crediting provisions of the proposal extend to all truncated checks, including those provided today. 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 proven check law, not a new law that, arguably, will promote fraud.

The trade associations support the general principle outlined in the Board's proposal to facilitate innovation in the check collection system. We believe, however, that existing law and regulations are both effective in protecting consumers and minimizing the banking industry's exposure to fraud.

We hope that Members will also take this opportunity to improve the efficiency of the U.S. payments system by quick passage of this proposal.

Thank you.

Chairman SHELBY. Ms. Alexander, you have indicated that most customers who do request copies need them as proof of payment.

Ms. ALEXANDER. That is correct.

Chairman SHELBY. Have your customers ever run into any problems using the copies for this purpose?

Ms. ALEXANDER. No, Mr. Chairman, not that I am aware of. Although I do not get the volume of complaints that Mr. Ferguson does, I get a lot of complaints that reach me. I have never had a complaint from a member that they could not get an original. Courts accept good images. The IRS accepts good images. We have never had a problem with that.

Chairman SHELBY. You have answered my question. The next one was the IRS audits and other reasons.

Ms. ALEXANDER. Yes, they do.

Chairman SHELBY. They accept the images?

Ms. ALEXANDER. Yes, they do.

Chairman SHELBY. Mr. Buchanan, today, among other things, we have discussed how some banks, which have agreements with other banks, already use electronic transmissions to clear checks. What happens to the original checks in these cases?

Mr. BUCHANAN. In the current environment, the physical documents still follow in these environments. But then the checks, if the checks are not returned to the consumer, they are truncated and destroyed after a period of time.

Chairman SHELBY. What can you tell us about consumers' desires to get copies of these checks? You alluded to it earlier.

Mr. BUCHANAN. Well, within our own bank, we still receive requests for copies of checks, some that the consumer may have even lost, for record of payment. We think that the banking industry has always responded efficiently to those requests and rarely receive problems around those issues.

Chairman SHELBY. Are you aware of any problems associated with consumers having to use copies of the checks rather than the original checks?

Mr. BUCHANAN. No, sir. I am unaware of any problems with that.

Chairman SHELBY. Ms. Alexander, how many customer complaints does your credit union receive regarding their checks? Just your judgment.

Ms. ALEXANDER. Regarding copies or just checks in general?

Chairman SHELBY. Yes.

Ms. ALEXANDER. I have not seen one in 14 years. I have not had a specific—

Chairman SHELBY. In 14 years?

Ms. ALEXANDER. Yes. Not a specific complaint about receiving a check copy.

Chairman SHELBY. So, you do not have any complaints at all about them that you know of?

Ms. ALEXANDER. I may, that have not reached me. I think that earlier on, when we did not image, it took longer to get a copy of a check and I did have some complaints about that. Now it is immediate.

Chairman SHELBY. Do you have any other complaints about checks other than just trying to get a copy?

Ms. ALEXANDER. I would say that, on the whole, the complaints about our checking-account services are very low.

Chairman SHELBY. Okay.

Ms. ALEXANDER. We have very good services.

Chairman SHELBY. Does the use of imaging enable you to resolve just basic complaints more quickly than a paper-based system?

Ms. ALEXANDER. Absolutely.

Chairman SHELBY. It is quicker, is it not?

Ms. ALEXANDER. Absolutely. Very quick.

Chairman SHELBY. Ms. Duncan, you have testified that the right of recredit should be expanded to apply in every case where the original check is not returned to the customer. This would affect even those customers who have already agreed with their bank to not receive paper checks back. What information, what data can you provide us here at the Committee regarding consumer complaints involving their checks?

For the record. In other words, I will ask it again. What information can you provide to the Banking Committee here regarding consumer complaints involving their checks?

Ms. DUNCAN. Well, I think quite a bit of your focus already has been on image quality. And certainly, consumers do not have problems when they receive checks, as long as the image quality is good. If they need proof of payment, if the image quality is good, oftentimes—

Chairman SHELBY. Have you seen this, that the Fed gave us just awhile ago [indicating]?

Ms. DUNCAN. I have not yet seen that.

Chairman SHELBY. I do not know what the other image is. This is real clear, and I guess it depends on—

Ms. DUNCAN. What we are concerned about is those case where a check image is not clear. Actually, I have a copy of a letter here that I was cc:ed on, that was sent to the Chairman and to Senator Sarbanes yesterday. It is from a lawyer in San Francisco who represents low-income clients who experienced a great deal of harm and stress based on the fact that the best copy they could get of a mortgage payment they claimed to have made was a microfiche and was unreadable.

Basically, just in summary, they paid their mortgage. Their bank destroyed the original check, as was the practice. They told the mortgage company that they had paid it, got a copy of the microfiche, presented it to the mortgage company. The mortgage company said that this was not acceptable because it was not legible. Then the mortgage company turned the case over to a collection company and foreclosure proceedings were initiated.

We are concerned that this may be the tip of the iceberg. This is just a microfiche copy and the way that it is done now. The system that we are talking about would have images converted in and out of electronic form. So, yes, that is one of our concerns.

Chairman SHELBY. I would agree with you that the imaging should be legible. You should be able to read it. But there has been tremendous breakthroughs in imagery technology. The digitization of images would replace what you are talking about, the microfiche, and would be much better, I believe.

I am just looking at what the Fed gave us up here.

Ms. DUNCAN. We welcome improvements in technology.

Chairman SHELBY. You are right in this regard. The technology, the imaging has to be clear.

Ms. DUNCAN. Yes.

Chairman SHELBY. You have to be able to read it. Otherwise, I do not guess you can have proof of anything.

Ms. DUNCAN. Right.

Chairman SHELBY. But if you have some other information regarding, other than this one instance, furnish it to the Committee. Will you do that?

Ms. DUNCAN. We will furnish any additional information that we receive.

Chairman SHELBY. Do you know how common these complaints are? I guess that is what—

Ms. DUNCAN. Our main concern here is there is a consumer protection provision within the proposed legislation, and it anticipates certain events.

We just think that if you were going to anticipate consumers having a double processing—and it is more likely when you have an electronic image and a substitute check going through the system, it is more likely than you would have today with just a paper check going through the system. We would just like to see it applied to all.

Chairman SHELBY. But you cannot hold back technology.

Ms. DUNCAN. And that is not what we are suggesting.

Chairman SHELBY. I know. Okay.

Ms. DUNCAN. We are just suggesting that consumers receive adequate protection.

Chairman SHELBY. Sure.

Ms. DUNCAN. Somewhat similar to the Regulation E that governs debit card transactions and electronic transactions today.

Chairman SHELBY. Sure.

Mr. Buchanan, are you aware of consumers having difficulty getting access to their checks, digital images of checks?

Mr. BUCHANAN. No. In fact, if I could comment about the earlier message around microfilm.

I think that what we are talking about here is looking at an old medium and we can actually improve upon that. I think things like microfilm and microfiche potentially have more problems than what the imaging technology is.

Chairman SHELBY. But these are dated technologies.

Mr. BUCHANAN. Exactly. We think that this is a dramatic improvement and that the quality of those images in terms of storage and retrieval would be far better. We are unaware of any issues or problems around that.

Chairman SHELBY. How do we get the banks to get up to the digital world on imaging? That is important, too, for uniformity.

Mr. BUCHANAN. Well, I think that there are a couple of beneficial things with this Act.

One is that if a bank chooses not to have to adopt image technology, the process still works with a substitute check. I would say, though, that the way our system works, those who do not adopt would be forced to through the competitive environment because people will clear checks against those banks quicker, which we think the marketplace will force adoption.

Chairman SHELBY. Ms. Alexander, your written testimony indicates that your credit union currently receives checks back from the Federal Reserve Bank, but that you are undergoing a process to convert to an all-electronic system. What made you decide to make that conversion? What will that conversion cost your institution? And do you expect to save money over the long run?

Ms. ALEXANDER. We are constantly looking for ways to expedite the process and to also reduce our costs. I do not have an actual figure on what it will cost us. We know that doing transactions electronically is less expensive than actually handling the paper.

Chairman SHELBY. But do you know how much less expensive? Can you furnish that to the Committee?

Ms. ALEXANDER. I can furnish that later, yes.

Chairman SHELBY. Just give us a benchmark.

Ms. ALEXANDER. I could. I am sorry I do not have those figures with me.

Chairman SHELBY. Okay.

Ms. ALEXANDER. We know it will be less expensive and we are looking for ways to not have to handle the paper checks.

Right now, we do actually, once we receive the checks back from the Fed, we have to process them through our equipment. We are trying not to do that and looking to the Fed for ways to facilitate

not doing that. And we know that it will be faster and it will also be less expensive for us in terms of staff.

Chairman SHELBY. Mr. Buchanan, one last question. How many smaller or community banks pursue the alternative of savings from the electronic process? And what are the potential savings from moving away from the paper system?

Mr. BUCHANAN. We think that the savings are substantial, and let me give you some examples within our banking system in Utah.

As Senator Bennett mentioned, we have many rural communities. Many of those communities we cut off at 1:00 in the afternoon to be able to make deliveries to get them to our item processing centers to clear checks.

Chairman SHELBY. And you wouldn't have to do that.

Mr. BUCHANAN. We wouldn't have to do that any longer. We would be able to provide our customers longer time frames to be able to conduct their banking, make their deposits, make their payments, and at the same time improve the process dramatically by not having to physically transport these items around the Nation and deal with them on a manual basis. So, we think the savings will be substantial.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman.

Ms. Duncan, I would get a hold of the lawyer and say, microfiche technology is 30 to 40 years old. And I do not anticipate any bank or credit union utilizing that under this legislation. Any bank that would try to use microfiche to take advantage of check truncation is living in the Dark Ages. It is just incredible to me that anybody would even bring it up as a possible way of handling this right now. I mean, I am sure the incident occurred.

Ms. DUNCAN. It is old technology. And our concerns really are making sure that consumers have adequate protections. Speaking of actually things that have been around for a while, the UCC was created quite a while ago. There are protections that were created today with the types of issues that we are concerned about in mind.

And as I mentioned, Regulation E has a 10-day right of recredit, and it has an unlimited amount. It is unlimited in a dollar amount. So, we would like to move forward. We would like to look at things considering the technology of today. We would like consumers to have protections, taking current technology into account.

Senator BENNETT. Let me just state a general thought that has occurred to me.

Mr. Buchanan, of course, the hometown excitement is here. You come from Utah, so, automatically, we are very proud of you.

[Laughter.]

But I do not recall any time in the history of this Committee that the ABA, the ACB, the CBA, the Roundtable, and the ICBA—those alphabets do not mean anything to most of you—but this is virtually every banking organization in the world, have been satisfied by a single witness.

They always insist on coming in, each with a slightly different take on things. I think this is the first time in the history of this Committee that we have had that kind of unanimity. And then to have the credit unions sitting at the same table with the same view, maybe we should declare peace in our time.

[Laughter.]

And to move forward on this. I think it is extraordinary that we have had this kind of unity here.

So, we come back to you, Ms. Duncan. You have heard the testimony here this morning from Governor Ferguson and then from Ms. Alexander that says that there is virtually no double charging going on and that this problem simply does not exist.

It would seem to me that the burden would fall upon your organization to tell us, A, their figures are wrong and give us surveys that demonstrate that there is a fairly high level of problem here. Or B, how the adoption of the kind of technology that Mr. Buchanan's bank is using would suddenly create problems that aren't there.

Now is that an unfair question on my part? I want to be as fair to you as I possibly can. But it seems to me, listening to this, that the burden falls on you to say either, A, they are wrong and there are a lot of problems, or, B, okay, there aren't any problems, but there will be if we go in this direction.

Ms. DUNCAN. Well, it is my understanding that the organization that Ms. Alexander is here to represent also supports the recredit provisions as they stand.

I think what we are talking about here is the fact that this will be a new system. The way credit unions do what they do today, a check is truncated at your bank. At the credit union, you can walk right into your credit union and say, I would like to see a copy of my check, the best copy you have.

What we are talking about here is, a consumer's original check will be stopped somewhere back in the process where, with a bank or an institution, the consumer may not have a relationship with. And so the recredit provisions that we would like to have to apply to everyone will just incentivize their own bank to do whatever investigation is necessary to find out what happened if there has been some error.

We are talking about just incentives. We are talking about consumers and the real-life obstacles that they face. Bureaucracy in a financial institution may well be one of them.

So this is what we are talking about. It is just an incentive to balance this legislation so that consumers will have more of an ease to resolve any disputes.

Senator BENNETT. My only problem with what you are saying is that the testimony we have heard says that those problems now do not exist, that there are—Governor Ferguson said zero. He did not say a small percentage. He said zero. And Ms. Alexander said, at the beginning, she remembered a few instances where the image wasn't good, which would recall microfiche; but that in the last 14 years, it is zero.

Mr. Buchanan, as I understand the technology, a customer could do exactly what Ms. Duncan just said, could walk into your bank, even if the truncation occurred some place else, and your bank would have electronically the ability to generate the image and say to the customer, here is a substitute copy of your check. Isn't that correct?

Mr. BUCHANAN. That is correct, Senator.

Senator BENNETT. So it doesn't matter where in the system the truncation occurs. The fact that the information is being shared electronically means that the customer has more control than they do now because if you depend entirely on the printed check now, the chances of that printed check getting lost somewhere in the system are much higher than the chances of the electronic check getting lost.

We have had hearings in this Committee about identity theft. And one of the main ways people get a hold of your identity is by simply stealing your mail. And there is a check, there is a credit card application, and so on, and they just go out and steal mail without regard to what is in it, hoping as they go through it that they will find a financial document which they can then use.

This says, you cannot steal it. You can steal all the mail you want, but the image of your check, wherever it got truncated, is available at your bank.

It would seem to me that consumers would like that because it would reduce the chances of fraud. It would increase their opportunity to control their accounts, for the circumstances you are appropriately concerned about, rather than going the other direction.

I am having a hard time understanding why Consumers Union is against this because everything that I see in the real world says, this is going to make security of consumer information substantially higher than it is today, and it is going to lower costs, which can only benefit consumers in the long run as well.

Now help me understand where I am off base here because I am trying to do the right thing for the consumer.

Ms. DUNCAN. Right. Our concern is to ensure that consumers are adequately protected, and we would like to have the protections available to all consumers. That is our concern. This will be a new system. And the system as it stands right now poses different problems and has different risks and benefits for consumers.

As I said earlier, you walk into your bank. You can get a copy. In the truncated system, in this new system, the copy at your bank may not be the best copy available. They might have to trace back up through the system to find the best copy available, which may be—

Senator BENNETT. There is no evidence that that is the case. Isn't that true, Mr. Buchanan, that the copy that you get from the bank in many ways might be better because it hasn't been handled and crinkled?

Mr. BUCHANAN. Again, I think I would go back and say in the current environment, you would be relying on microfilm or microfiche instead of an image document. In any case, an image is going to be better than those alternatives.

Senator BENNETT. Thank you.

My time is up. However, I really have a problem understanding why there is a problem because, as I see it, the consumer would have access at more places to the information. The information would be protected from intrusion. It would be protected from physical deterioration.

I have 6 kids and 17 grandkids and the checks can disappear. My 2-year-old grandson can go through the house and all kinds of things disappear.

[Laughter.]

And I have a sense of comfort knowing that it is preserved electronically in the bank and that I can go there at any time and get whatever I need.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

Senator ALLARD. I have a question for Mr. Buchanan.

Obviously, the proposal would involve new systems and equipment. I have some bankers in my State of Colorado that provide services in communities that are pretty small. They operate more on the lower margin. Will this pose a burden for small independent community banks? And how can we assure a smooth transition?

Mr. BUCHANAN. Yes. Let me address that a couple of ways.

One of the great things about this bill is it does not force banks to adopt imaging technology. As I have mentioned, I think the marketplace will force that, for them to remain competitive.

But let me go to your question about—

Senator ALLARD. Before you move on, I would like to pursue that question a little further.

Mr. BUCHANAN. Sure.

Senator ALLARD. We may not have a mandate in the bill, but where these gets centrally cleared, they may say, well, you have to bring your system up to standards. We are not going to take these unless they are electronically checked. So, we are not going to accept it. Do you see what I am saying? In effect, it becomes a mandate because somebody at the central clearing point may refuse to accept it unless the individual banks adopt that technology.

Mr. BUCHANAN. The item would look exactly as an original.

Senator ALLARD. Yes.

Mr. BUCHANAN. So there is no way to really force that without stopping any original check from coming through the system, which I think is unlikely.

But with that being said, let me move to your other question about the cost for small banks.

One of the great things with technology right now is that it is very affordable. We have scanning devices that we can implement for branches that start at \$700, moving to the low couple of thousand dollars, and then on up. And so, there is no evidence that we can see that only large banks can participate in this. In fact, I would say that small banks have a competitive advantage in being able to move quicker than a large bank will be able to move. And cost will not be an issue for them.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

Ms. Duncan, I am interested, first of all, in whether, under the proposed legislation, consumers would lose protections they now have under the UCC?

Ms. DUNCAN. The proposed legislation does not necessarily—well, yes, it would. And the concern actually is—the proposed legislation has a comparative negligence provision which is actually broader

than what the UCC is. It would establish—somehow, if the consumer is at fault, that their damages could be reduced.

Under the UCC, as it stands for checks, the comparative negligence provisions really apply to areas that a consumer has control over, such as paying attention and making sure that there are not a series of fraudulent or forged signatures on their checks. So it would expand comparative negligence in a way that is not in current law.

Senator SARBANES. So the proposal, as I understand it, would in fact diminish consumer protections on the comparative negligence issue. Is that correct?

Ms. DUNCAN. That is correct.

Senator SARBANES. Does anyone at the panel disagree with that?

Mr. BUCHANAN. I am not sure that I have a comment about that, knowing it well enough to comment.

Senator SARBANES. All right. Now, of course, it is not necessarily the case that the existing protections for consumers are adequate. So, I do not know that that is necessarily the baseline that one should operate from. That leads me to my next question. And that is the question of expedited recredit for consumers. What is your view of the provision in the legislation on that issue?

Ms. DUNCAN. We believe that the recredit provision is inadequate because it does not apply to all consumers whose check information is processed electronically. And we also believe that consumers are not adequately protected. Those consumers that do not have the ability to benefit from recredit are not adequately protected because recredit is a simple nonlitigation remedy, and consumers who are not protected would be required to sue their banks, which would be a very big burden on consumers for the amounts we are talking about.

Senator SARBANES. Ms. Alexander, Mr. Buchanan, do you want to comment on that issue?

Mr. BUCHANAN. Our belief, from an industry standpoint, is that it is unnecessary. It does create fraud risk in that if you have an immediate recredit provision, that what it does is promotes the ability for fraudsters to take advantage of the system. It also creates a regulatory burden for the banks that we believe is unnecessary and is covered very well and handles all the consumer issues with current UCC law.

Ms. DUNCAN. May I respond?

Senator SARBANES. Certainly.

Ms. DUNCAN. Our concern is that the UCC—I am sorry. I lost my train of thought.

Senator SARBANES. Well, let me go to Ms. Alexander and see if she wants to add anything to Mr. Buchanan's comments?

Ms. ALEXANDER. Actually, I would echo Mr. Buchanan's comments. We believe that the recredit provisions are sufficient as they now stand.

In our own credit union, we have experienced a 256 percent incident increase of check fraud in the last 5 years. Two days, which was the original proposal, is simply not enough time to be able to determine whether or not that check is legitimate. We believe, as it stands now, is what we would support.

Ms. DUNCAN. I have regained my thought, if I may.

Senator SARBANES. All right. I thought you might.
[Laughter.]

Ms. DUNCAN. Thank you. We believe that banks are adequately protected, if not overly protected, in the legislation. Banks are not required to recredit in instances where they believe that fraud is an issue. They are not required to recredit in areas where there is a new account, where there has been a negative balance. And a bank is also able to reverse a recredit where they believe that there is a problem.

So, we do think that that particular issue is well-addressed in the legislation and it balances the consumer's need for recredit. And to remove recredit would just be a negative impact on consumers and that provision should apply to all.

Senator SARBANES. Now to what extent has the privacy question been addressed in terms of this new technology? We are seeing new technology being developed all the time. And every time it happens, we seem to have another potential serious incursion into people's privacy.

Of course, electronic documents have the advantage of being easily transmitted. I understand some of the benefits of that. But, presumably, this is going to result in the creation of a large electronic database, which will have a lot of information in it about the consumer and his check writing habits. That is a valuable store of information. How is that privacy going to be protected?

Mr. Buchanan.

Mr. BUCHANAN. I would say that the current process has all of the information you are talking about anyway, and I am not aware of problems around that. And I would also suggest that the new process would eliminate manual steps and handling that, in fact, would enhance privacy, not diminish it.

Senator SARBANES. How in the current system do you create a database which can be either sold or exploited for other purposes which fully identifies the consumer's spending practices?

Mr. BUCHANAN. Well, banks today currently are able to retain images. And so many banks already retain those images, as we have discussed. For instance, there is a company by the name of U-Point that stores images for banks like Bank of America, Chase, Zions, First Tennessee, and others. The data is currently available. I am not aware of any consumer privacy issues around that, or banks using that inappropriately.

Senator SARBANES. So what do the banks do with this stored information?

Mr. BUCHANAN. Primarily, it is used for a couple of things.

One is for customer service aspects. If a customer calls up and says, I would like to see what this check was from 3 months ago, it can be easily retrieved. Going back to the comment about being able to go into a branch and request a copy of a check, those images are retrieved from those types of devices.

Senator SARBANES. And what other purposes?

Mr. BUCHANAN. The other purpose would be for Internet usage. So if I am a consumer at home, I may want to be able to look at my last 30 days' checks and retrieve those images online.

Senator SARBANES. Are the banks currently using these checks to identify consumer spending patterns and then to use that infor-

mation either themselves or—to either sell or convey it to others to be used for various marketing purposes?

Mr. BUCHANAN. I could not speak for all banks. I can tell you that at our bank, we do not use it that way.

Senator SARBANES. But you do not know if other banks do so?

Mr. BUCHANAN. No, sir, I do not.

Senator SARBANES. Would it be easier to engage in that activity if this material was being stored electronically?

Mr. BUCHANAN. I would suggest again that if a bank wanted to do that, they could currently do it, and have had that ability for quite some time.

Senator SARBANES. But they would have to add another step. Whereas, you are now going to substitute or introduce this technology, so it will be done not for that purpose, but for the purpose of the truncation, to gain the advantages that are sought in this legislation, which we recognize.

Then, having done it for that purpose, they will have this database then available for other purposes. They do not have to go through the extra step. Isn't that correct?

Mr. BUCHANAN. Let me try and address it. I think there is—

Senator SARBANES. Let me first just make sure I am correct. Then they would not have to go through the extra step. Correct?

Mr. BUCHANAN. I think that there is confusion between storage and clearing. And what this Act primarily relates to is creating efficiencies in the clearing system not relating to storage of data.

Banks currently store vast amounts of data that could be used in that way. This Act really is related to making efficiencies in our clearing system with the use of substitute checks so that those physical items never need to flow through to the paying banks.

So, I do not believe that it changes the dynamics from a privacy standpoint, and I do not think that it even requires additional steps from a privacy standpoint. This is really related to clearing and not storage.

Senator SARBANES. Would the industry support check truncation if there was a very strong rule that check images could not be used for any purpose other than check processing, dispute resolution, and consumer requests?

Mr. BUCHANAN. I would like to address that with the industry and not speak for them off the cuff. So, I would like to get back to you on that question.

Senator SARBANES. I take it that that means that giving a simple yes to its limitation for those purposes, that would create problems. You are not comfortable with that. Is that correct?

Mr. BUCHANAN. I am not saying it would create problems. I am just saying that if I were to speak for my institution, I would answer one way. I do not know if I would feel comfortable answering for the entire institution.

Senator SARBANES. Presumably, for your institution, the answer would be yes. Am I correct?

Mr. BUCHANAN. I think that from our institution's standpoint, we would like to use the data in the same ways that we currently do, which falls within—

Senator SARBANES. Which goes beyond these objectives that I discussed, that I mentioned?

Mr. BUCHANAN. No, no.

Senator SARBANES. It stays within them?

Mr. BUCHANAN. It stays within them.

Senator SARBANES. Okay. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Good morning. Thanks for joining us this morning. I apologize for missing your testimony, but I will have a chance to read it later, and I actually will. I know that some people find this subject boring, I am told; but I really find it actually pretty interesting.

When I was a pup of a Congressman back in the House of Representatives serving with then-Congressman Shelby, I think the first bill I ever introduced was legislation dealing with the availability of funds. When we deposit checks into our accounts, how quickly can we have access to those monies.

I have a question. Mr. Buchanan, I will start with you, but I want to ask the others to respond as well.

I am pleased that today, people have quicker access, quicker availability of funds when they deposit checks than used to be the case, say 20 years ago. I want to make sure that if this legislation were enacted, that we do not somehow set the clock back and, if anything, that we could actually make availability of funds maybe expedited even further for people who deposit checks into their accounts. Can you tell me how this legislation relates to the availability of funds and our ability to make use of the funds when we have deposited a check?

Mr. BUCHANAN. Yes, I can. I think if you go back to my earlier example about rural communities within Utah and Nevada, for instance, as I mentioned earlier, the way that the process works is that a branch needs to be cut off at a certain time to be able to make the physical transportation deadlines. That can be, say, 1:00 in the afternoon for some of our branches.

With this technology, we believe, and we would implement within our environments the ability for consumers to make deposits up until the branch closure, which could be 8:00 at night for some of our banking centers, which would then provide them the ability to earn interest on those funds a day earlier, to have their payments posted sooner and their deposits made the same day, instead of being held over for the following banking day.

Senator CARPER. Let me say to Ms. Duncan and Ms. Alexander, in considering this legislation, I am interested in how this legislation is not just going to help financial institutions. I think it is pretty clear how it would help or be advantageous to the industry. But I am looking for ways that this legislation could actually be of benefit to consumers. And this would appear to me, at least at first blush, to be a plus for consumers. Am I missing something there, or do you see it that way, too, at least this aspect of it?

Ms. DUNCAN. The faster the availability of funds would certainly be a potential benefit of the legislation. It certainly is not included as a requirement for part of this legislation. So, we would definitely want to make sure that if this does become a possibility, that it becomes a reality.

Senator CARPER. How might that happen?

Ms. DUNCAN. Well, there are two possibilities.

The banks would—it is within their purview whether to make the funds available faster. We would want to see that happen. In addition, if it becomes possible for funds to become available faster, then the Fed can take a look at this. And we want them to take a hard look at it if the legislation were to become law, to see if there is an ability to make the funds available faster and possibly change the regulations governing funds' availability to make sure that consumers are benefiting from this.

Senator CARPER. Thank you.

Ms. Alexander, any comments?

Ms. ALEXANDER. Well, I would agree certainly that the funds' availability to consumers is certainly going to be a benefit, a side benefit of this legislation and other legislation that may follow.

We would be able to make funds available to our members much more quickly. I also think in the longer term, that overall expense of offering checking accounts may come down as well. It is less expensive to offer electronic transactions than over-the-counter teller transactions and other types of transactions that require human beings.

Senator CARPER. Can you quantify that at all in terms of the order of magnitude?

Ms. ALEXANDER. We offer online banking to our members and they are able to transfer funds, create a check, access check images, do any number of things in the online banking environment.

It costs us approximately a little over \$3 to serve a member at a teller counter. It costs us about 45 cents for a member to actually access his account and do a transaction with online banking. So as a not-for-profit institution, credit unions look for ways to reduce costs and ultimately return those back to the members. We see this as being able to ultimately offer something along those lines because we will be able to restructure pricing.

Senator CARPER. Let me just ask the others, are there other examples in this legislative proposal that would also inure to the benefit of consumers, or at least have the potential of inuring to the benefit of consumers?

Mr. BUCHANAN. Yes, I could give a couple more.

Another example would be ATM usage, which I mentioned in my testimony, where consumers would be able to make deposits in ATM's, which have again the same type of cut-off time frames in making a deposit. And we believe that those capabilities would be far expanded again over the current availability for consumers.

Another example would be where, again, rural commercial customers that need to drive to the bank every day to make their check deposits would no longer be required to do so. They could actually truncate those checks at those commercial enterprises and move the images through the clearing system.

Senator CARPER. How would that work?

Mr. BUCHANAN. We actually have a system that Senator Bennett has seen that provides for the scanning of the image and the voiding and making the image, the actual original item, nonnegotiable, and then moving the image through the clearing system and providing significant benefits to commercial customers.

Senator CARPER. Ms. Alexander, as I understand it, the credit unions have had for some time the ability to truncate checks. What have you learned from that experience with your industry that we should put to use in this instance?

Ms. ALEXANDER. Well, credit unions truncate the checks at the very end of the process. We do not return checks to members as most banks do. In fact, when we were permitted in 1977 to offer checking accounts, we weren't allowed to return them. That has since changed.

But we have done a very good job of educating our members that in most cases, they do not really need the paper checks back. If they do, we are able to provide them a very clear and legible copy.

In the early days, we actually did provide them back with the original if they needed it. Now, we provide them an imaged copy. My members, they do need to request copies once in a while. It is not frequent. When they do, we can provide it immediately, which is faster than we could have if we gave them the paper check.

We feel that the service has actually improved. Our members do not see the need to have the checks returned and we have not been returning them. We never returned them. And we have been offering checking accounts at my credit union since about 1978.

Chairman SHELBY. Senator Bennett, any other questions?

Senator BENNETT. Yes. But just a comment to Senator Carper.

I made reference to a study that was done by the Minneapolis Federal Reserve Bank that indicated that this would save \$1.75 per transaction. I did the math and that is \$73 billion a year. And given the conversations that we are having around here, if you multiply that by ten, that is \$730 billion, which, by coincidence, just happens to be the size of the President's proposed tax cut to stimulate the economy.

[Laughter.]

So if we could have the same kick on the economy by passing this legislation that we could have by passing the President's tax bill and not have to worry about the deficit, I think it is a legitimate thing that we should do.

Senator CARPER. I thought you were going to say, we wouldn't need the President's tax cut.

Senator BENNETT. No.

[Laughter.]

Close, but no cigar.

[Laughter.]

I want to come back to what I was doing in the previous round, and I do not want to beat this to death, but Senator Sarbanes' questions raised it once again: The issue of privacy.

Hearings before this Committee have indicated that identity theft and concern about privacy comes from the present situation, where there is access to a physical financial institution, that people steal mail in order to get a financial instrument.

And just to nail this down, is it not true, and my understanding of it, is it not true that exposure to identity theft from those who would move into the area of privacy would be eliminated by the kind of system that Mr. Buchanan has indicated. I have seen it operate. I have seen it work. My understanding of it is that consumer

privacy would go up very substantially as a result of application of this system.

Now that is as soft a ball as I can give you, Mr. Buchanan, but I think it is an important one for everybody to understand. Could you expand on that?

Mr. BUCHANAN. Yes, I would agree. Again, I think that by eliminating the need to move these items around in the system, and being able to truncate checks, we would enhance privacy, not diminish it. And so, I would echo your views.

Senator BENNETT. Ms. Alexander.

Ms. ALEXANDER. I would just like to comment. I would tend to agree. In fact, at my credit union, it is much harder for my staff to get an image of a check. It is a two-password system on a separate server and much more secure than the paper checks that are put in with the daily work and locked in a drawer. And to me, it seems that the overall privacy issue is strengthened by this kind of a system. It is just harder to get those images than it is anything on paper.

Senator BENNETT. Ms. Duncan, do you have a reaction to that?

Ms. DUNCAN. I would just be concerned that we take a close look at the storage of this information. To the extent that the information might be aggregated, might be potentially mined for information, that would be available for somebody who had a nefarious intent. The identify theft type—

Senator BENNETT. In what way would it be available that it is not available now?

Ms. DUNCAN. Actually, you make a good point. There is a lot of electronically stored data as it stands right now. This would just increase the amount and possibly increase the risk for consumers.

Senator BENNETT. I do not want to be argumentative, but I do not understand how it would increase the available data. Let me walk through what I have seen because maybe we are talking past each other here.

A merchant in a Delaware town—

Senator CARPER. Where we have no sales tax.

[Laughter.]

Senator BENNETT. Yes. Okay.

[Laughter.]

A merchant in a Delaware town at the end of the day has a series of checks. And under the present situation, he adds all those checks up, makes a handwritten deposit slip, puts them in a bag, and carries it to the bank and deposits it in an overnight depository and it gets opened the next day.

Under this system, the merchant sits there, he has a little black box. He runs the check through the black box and then he locks the check up.

It is transmitted instantly and electronically to the bank, which means it is in the merchant's account that night. It doesn't get there the next morning. The availability of funds is there. The bank then has that electronic information, which then goes back to the various customers and is taken out of their banks electronically and instantly.

How is that creating a database that can be mined for nefarious purposes that is any different from the present situation where the

bank makes a microfiche or an electronic whatever, or the credit union keeps track of it?

How is the transmission efficiency created by this system creating a new database that doesn't exist, that is more vulnerable than what we have now?

Ms. DUNCAN. If we are talking about the increased opportunities for ID theft or underneath this proposed legislation, then we would want to wait to have more information on how the banks would intend to use this information because increased storage, collection, and dissemination of information does lend to ID theft. We would just continue to pay close attention as this moves along to how the data may be used for other purposes.

Senator BENNETT. Ms. Alexander and Mr. Buchanan, just very quickly, does the system increase the database that could be used for ID theft?

Mr. BUCHANAN. No. Maybe just a final comment around this.

The data is already stored. I think what you described, Senator, is very good in that the way the new process will work is that it will eliminate a number of manual steps that I think could create more problems around privacy and the vulnerability of dealing with physical items moving through the various points versus just moving it electronically, storing it as it currently is stored—I do not think, and I think it is important to understand that we are not talking about storing anything differently than it is already being stored, and then being able to clear these items. We see this system improving significantly, not diminishing.

Senator BENNETT. Ms. Alexander.

Ms. ALEXANDER. I agree that the database exists now. If someone wishes to use it for nefarious reasons, they could do it this day. I do not see that this process exacerbates that. It simply uses it much more efficiently and for the benefit of the consumer.

Senator BENNETT. If I understand your previous testimony, actually, this system could make the current database more secure. Is that—am I—

Ms. ALEXANDER. That has been my experience, yes, it does.

Senator BENNETT. I see.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Any other questions?

Senator CARPER. Just one, if I could.

Margaret Simmons, my staff member here, was good enough to share with me a copy of—this is a legal copy of your check. You can use it the same way you would use the original check.

I am one of those people who actually balances his checkbook. I still reconcile my checking account every month.

My kids—my boys are now 13 and 14. And as they get older, they actually watch what I am doing and they say, what are you doing? Why do you do that every month? I tell them, I just want to make sure that I know how much money is in our checking account. Well, don't you get those statements? And I say, yes, but I sometimes make mistakes and I just like to check the math and make sure that I know exactly what is in the account.

And I save, religiously save my checks, and I have them like stacked up in our basement and they are in their boxes in the right

order and everything. My wife says, it is a disease. I am not sure if it is or not.

[Laughter.]

But I have been into this for a long time. I think I am beyond redemption. So, I face the prospect of not having my checks coming in my statement every month. But if I actually need a copy of my check, I guess I can get something like this. And my question is, how quickly can I get it? Do you have to go through a lot of hoops? Do you have to submit something in writing? How does it work? Ms. Alexander, I guess you all have been doing this for a while.

Ms. ALEXANDER. We have. In fact, members can give us a call on the telephone. They can walk into a branch. If they are an online branching user, they can access it themselves and print it out. It is absolutely instantaneous. It takes very little effort to produce. It is right there. It is as good as that copy you have.

Senator CARPER. So online, I can get it right away?

Ms. ALEXANDER. Yes.

Senator CARPER. If I telephone, what are we talking about?

Ms. ALEXANDER. Well, we will mail it to you, or you could stop in and pick it up. I can fax it, but, of course, faxing denigrates the printing a little bit. But there are a number of ways that you can get that. We encourage our online banking users to obtain their checks themselves, which they do, in large numbers.

Senator CARPER. The complaints from consumers that you hear most about the kind of check truncation that you have at your credit unions, what are the complaints that you hear?

Ms. ALEXANDER. We really do not hear complaints now about truncation. In the early days, members did complain. They wanted their checks back. It did take a while to get a copy. You had to go retrieve the physical check. You had to make a copy of it or give them the original and keep a copy yourself if they needed it for an audit or for a court case. But that was 20-some years ago.

The credit union where I am at now and where I was previously have offered checking accounts from the beginning. And after the first couple of years, members accepted it, we became better at retrieving copies for them, and we tried to do our best to give them excellent service.

Now, they consider it to be a very normal part of their checking account process. I have had no complaints about truncation.

Senator CARPER. Ms. Duncan, a closing word from you on this?

Ms. DUNCAN. Our main concern is just to make sure that consumers are well-protected. In this situation, what we are talking about is taking a consumer's check and turning it virtually into an electronic transmission of information.

There is a scheme out there, Regulation E, which gives consumers protection, which is taking into account electronic processing of information and potential errors that can occur. And that regulation includes a 10-day write of recredit and an unlimited amount. So that is the thing that we would like to see on a broad application.

When we look at the CTA, we would like to take the current recredit system and apply it broadly to protect consumers.

Senator CARPER. One last one. Mr. Buchanan and Ms. Duncan and Ms. Alexander, do you see some way to resolve some of the dif-

ferences that we have heard here today? You talk about issues about which reasonable people can disagree. Is this an issue that we can resolve if we give it our best?

Mr. BUCHANAN. Well, my impression is that anything can be resolved. I think that change is difficult, although I would say that our position is that we are not taking anything away. In fact, going back to your example about wanting to retain your checks, I think it is important to know that you would not necessarily not get those checks back. You would receive a substitute document instead of the original check.

But from a consumer's standpoint, they would still receive the items. You would still be able to take comfort in storing those for as long as you would like. We do not see take-aways here. We see value-adds. And therefore, we believe it is unnecessary to add any additional regulation around that.

Senator CARPER. That wasn't my question.

Mr. BUCHANAN. I understand.

Senator CARPER. Are these differences resolvable?

Mr. BUCHANAN. Excuse me?

Senator CARPER. In your view, are the differences that you have heard here today resolvable?

Mr. BUCHANAN. I believe they are.

Senator CARPER. Ms. Duncan.

Ms. DUNCAN. I believe they are resolvable, yes.

Senator CARPER. Ms. Alexander.

Ms. ALEXANDER. I would believe so.

Senator CARPER. Good. All right. Well, let's try to do that.

Thank you.

Chairman SHELBY. I want to thank all of you—Ms. Alexander, Ms. Duncan, Mr. Buchanan—for your appearance here today. I think it has been a good hearing.

The hearing is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I want to thank Chairman Shelby for holding this hearing to discuss legislation that will ultimately improve the check collection system and eliminate unnecessary steps in the process. I look forward to the discussion today and am hopeful that we can work together to develop legislation that will contribute to the overall improvement of our financial system.

The Federal Reserve Board first sent its proposed Check Truncation Act to the Congress in December 2001, with the goal of increasing the efficiency of the check collection system. Their proposal recognizes the existing legal barriers preventing the possibilities new technology could bring to enhance the current system, and improvements that would save time, money, energy, and resources.

Thank you to all of our witnesses for agreeing to appear before the Committee today to discuss an important procedure that could change the way our banks, thrifts, and credit unions handle check processing, a major component of the money-handling system. I look forward to your testimony.

PREPARED STATEMENT OF SENATOR ELIZABETH DOLE

Thank you, Mr. Chairman, I would like to express my appreciation to you and to Ranking Member Sarbanes for agreeing to hold this hearing on the Federal Reserve's proposed Check Truncation Act. Checks have long served a critical function in the U.S. payments system. In 2001, consumers made approximately 41 billion payments by check. However, most checks continue to process as they did 50 years ago, requiring physical presentation of the check at the bank at which the account is held.

This requirement necessitates the physical transportation of millions of checks across the country on a daily basis. According to the Federal Reserve, an estimated 37 million checks were transported every day in 2001. In order to accomplish this tremendous task, the Fed contracts with independent air freight services to fly these checks around the country. After the tragic events of September 11, 2001 halted all air traffic, this critical function of our system of payments ground to a halt and further compounded the crisis which ensued after the attacks.

Because of this weakness in the payment system, and as an effort to improve its efficiency, the Fed has presented Congress with a legislative proposal to transform our check processing system from a physical to an electronic system. These improvements to the system would result in considerable savings throughout the financial system and would also reduce check clearing time for consumers and businesses.

As with any such fundamental change to our system of payments, however, some questions will need to be answered as we move ahead with reform of the process. In particular, the anticipated changes in the system may open the door to fraud unless all necessary precautions are taken. It is my understanding that this proposal would require the destruction of the physical check at the bank the check is deposited. Currently, checks contain security devices such as microprinting and watermarks which would be lost in a digital image. I would be very interested in gaining a better understanding of the new security features which would replace the traditional ones.

I look forward to discussing this issue and others with our distinguished panel of witnesses today. I want to thank you all for taking the time out of your busy schedules to join us here today to share your considerable knowledge on this issue.

Thank you.

PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER

Thank you, Mr. Chairman. I want to commend both you and Senator Sarbanes for putting together such a distinguished panel. I also want to thank our panelists for taking the time to meet with us.

Several days ago, I had the pleasure of meeting with a small group of community bankers from New York, and we discussed this check truncation proposal. These individuals represented community banks who, as we all know, have a strong dependence on the support and patronage of the individuals and businesses in their area. Efficiency is important, but doing the right thing to maintain the customer relationship is critical.

These bankers support the Fed's proposal on check truncation. Many have already moved to electronic statements in their operations. They told me that not a single customer had objected to the modernization of the banking processes.

I have long been an advocate of consumer protection in our banking systems. To me, the consumers can be the real beneficiaries if we decide to make this change. While there are no guarantees in this proposed legislation, experience tells us that lower operating costs enable businesses to offer lower costs or better services to their customers. Things like broader deposit options, later deposit cut-off hours, more timely access to account information, and faster deposit clearance. If one bank doesn't do it, another will. That is the nature of our market system. And in the end the consumer wins.

"The check is in the mail," is an old expression. Today, despite the tremendous advances in data systems, networks, and technology, the check is still in the mail. It is time we updated our banking processes so that the check doesn't have to be in the mail for banks.

The Federal Reserve has provided a thoughtful proposal. There is some work to be done to ensure that the interests of consumers and bankers are safeguarded and balanced. And much progress has already been made. But it is time we moved forward with this legislation.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF ROGER W. FERGUSON, JR.

VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

APRIL 3, 2003

I would like to thank the Committee for inviting me to discuss the proposed Check Truncation Act (CTA) that the Board sent to Congress for its consideration in December 2001. The proposed CTA 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 the Committee for holding hearings on this very important legislative initiative.

Technological Advances in Check Processing

Check processing is far more efficient than it once was. Less than 50 years ago, clerks hand-sorted millions of checks each day. In the 1960's, 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 about 40 billion checks that consumers, businesses, and the Government write each year.

Typically, after a check has been deposited at a bank's branch or ATM, the bank transports the check 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 for payment to the bank on which it is drawn. At each step, the check must be physically processed and then shipped to its destination by air or ground transportation. Some of the checks, however, are removed from the collection or return process, and the payment information on the checks is captured and delivered electronically. This process, which is commonly referred to as check truncation, reduces the number of times that the checks must be physically processed and shipped. As a result, check truncation is generally more efficient, more cost-effective, and less prone to processing errors.

Today, however, check truncation can only occur by agreement of the banks involved because existing law requires that, in the absence of an agreement, the original paper checks be presented or returned. Further, given the thousands of banks in the United States, it is infeasible for any one bank to obtain check truncation agreements from all other banks or even a large proportion of them. As a result, the check system's legal framework, which has not kept up with technological advances, has constrained the efforts of many banks to use new electronic technologies, such as digital check imaging, to improve check processing efficiency and to provide improved services to customers. Therefore, legal changes are needed to facilitate the use of technologies that could improve check processing efficiency and lead to substantial reductions in transportation and other check processing costs. The proposed CTA makes such changes.

Proposed Check Truncation Act

The proposed Check Truncation Act solves a long-standing dilemma—how to foster check truncation early in the check collection or return process without mandating that banks accept checks in electronic form. Currently, under typical check truncation arrangements, electronic information about a truncated check, rather than the original paper check, is presented to the bank on which the check is drawn. The proposed legislation 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 print and deliver substitute checks to banks and bank customers 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 proposed legislation, 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 ATM's 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, where substitute checks could be created and forwarded for collection. Not only would this be quicker and more efficient, but it could also permit banks to establish branches or ATM's in remote locations more cost effectively and to provide their customers with later deposit cut-off hours.

Moreover, the proposed legislation 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, near 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 legislation would also reduce the risk that checks may be lost or delayed in transit. Today, bad weather routinely delays check shipments and check shipments 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 over \$47 billion, or more than a hundred times its normal level. 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 1 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 having to reprocess all of their physical checks.

Both individual and corporate bank customers would also benefit from the proposed legislation. As I noted earlier, as banks restructure their branch and ATM networks, they could offer customers broader deposit options or extended deposit cut-off hours. Such changes could result in some checks being credited one day earlier and interest accruing one day earlier for some checks deposited in interest-bearing accounts. In addition, banks might allow some corporate customers to transmit their deposits electronically. Because the proposed legislation will likely encourage greater investments in image technology, banks might also be able offer their customers new and improved services. For example, banks might be able to provide customers with access to online images of deposits and payments before the delivery of paper statements or provide printed copies of checks deposited at ATM's on ATM receipts. The same investment in image technology might also enable banks to provide better customer service by using check images to resolve customer inquiries more easily and quickly than today. Further, as banks reduce their operating costs, the savings will be passed on through a combination of lower fees to their customers

and higher returns to their shareholders. Banks have indicated that they expect cost savings to be substantial.

The proposed legislation is designed to provide banks with additional flexibility in processing checks by requiring banks to accept substitute checks in place of original checks. The proposed legislation does not, however, require banks to accept checks in electronic form nor does it require banks to use the new authority granted by the proposed legislation to create substitute checks. This market-based approach permits each bank to decide whether to make use of this new authority based on its business judgment about the costs and benefits of doing so.

We believe the market changes arising from these revisions to the 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.¹ It is difficult, however, to estimate the overall cost savings. Different banks will take different approaches toward using the new authority granted by the proposed legislation. 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.

Customer Protection Provisions

While there is a fairly broad consensus on the desirability of the underlying concepts of the proposed legislation to permit the use of substitute checks, the issue of customer protections has been the subject of much debate. We recognize that this issue is the most challenging policy issue in the proposed law, and Congress will have a number of alternative approaches to consider as it contemplates the need for additional customer protections. We would not object to any approach that does not go beyond the protections included in our original proposal.

Modified Position On Customer Protections

The Board's proposed legislation extended the protections of existing check law to substitute checks and included new warranty and indemnity provisions that were designed to address losses resulting from the receipt of a substitute check instead of the original check. In addition, the proposed legislation included consumer and interbank expedited recredit provisions. Since we forwarded the proposed legislation to the Congress in late 2001, the Board has had an opportunity to further reflect on the views that have been expressed by both consumer advocates and the banking industry and has concluded that the expedited recredit provisions originally suggested by the Board are not necessary for the successful implementation of the proposed legislation. I would like to discuss briefly why we believe that expedited recredit provisions are not necessary.

Existing Customer Protections

Long-established check law protects bank customers if checks are improperly charged to their accounts. The proposed legislation would apply existing check law, including the Uniform Commercial Code (UCC) and the Federal Reserve Board's Regulation CC, to substitute checks as though they were the original checks, to the extent such law is not inconsistent with the proposed legislation.

Specifically, a bank may only charge a check that is properly payable to a customer's account.² A check is properly payable if it has been authorized by the bank's customer and complies with any agreement between the customer and the bank. Thus, if a bank charges a customer's account for a check that is not properly payable, such as when a check has been forged, altered, or duplicated, the customer has a claim against the bank for an unauthorized charge to the customer's account. For example, if a bank pays a counterfeit check, the bank could be liable to its customer for the amount of the unauthorized charge, interest on that amount, and consequential damages for the wrongful dishonor of any subsequently presented checks. This potentially large liability provides a strong incentive for the bank to resolve a claim for an unauthorized charge as expeditiously as possible.

Over the years, no pattern of problems has emerged to suggest that existing check law is inadequate in protecting bank customers against unauthorized charges. As part of its analysis, Board staff has reviewed the consumer complaint databases of the five agencies of the Federal Financial Institution Examination Council and had found no pattern of problems associated with the timely resolution of check

¹ The extent to which banks that receive substitute checks incur additional administrative and compliance costs will depend largely on whether the legislation, as enacted, includes expedited recredit and disclosure requirements and, if so, the form of these requirements.

² U.C.C. § 4-401(a).

problems, including problems related to accounts where the checks are not returned with the monthly statements.

Additional Customer Protections Under The Proposed Legislation

In addition to the protections provided in current check law, the proposed legislation requires banks to provide new warranties for substitute checks and to indemnify customers for losses resulting from the receipt of a substitute check instead of the original check. Specifically, banks must warrant that the substitute checks they provide to their customers are legally equivalent to the original checks and that a check will not be paid more than once from a customer's account. Banks must also indemnify their customers for losses they incur due to the receipt of substitute checks rather than the original checks. Taken together, these warranty and indemnity provisions provide customers with additional protections against losses related to the use of substitute checks.

Are Expedited Recredit Provisions Needed?

The Board's original proposal to Congress also included expedited recredit provisions for consumers. (A companion section of the proposal included interbank expedited recredit rules.) The expedited recredit provisions required a bank to recredit a consumer's account, within a specified time frame, if a substitute check was not properly charged to the consumer's account. Upon further reflection, the Board has now concluded that the significant compliance burdens imposed by these provisions on banks that receive substitute checks outweigh the small incremental benefits that the provisions would provide to consumers. These compliance burdens would run counter to one of the Board's guiding principles when drafting the proposed legislation: Minimization of the operational and the administrative costs that would be borne by banks receiving substitute checks, because these banks would have no choice but to accept the substitute checks.

Further, the Board believes the expedited recredit provisions are unnecessary given the protections provided by existing check law and by the proposed legislation's new warranties and indemnity, which provide additional customer protections. As discussed above, existing check law provides substantive protections against unauthorized charges to customer accounts. Further, while it is true that the UCC does not provide a specified time frame within which a bank must act, its provisions give the bank a significant financial incentive to resolve problems on a timely basis. Specifically, the longer a bank takes to research and resolve a customer's claim, the longer the bank is exposed to liability for consequential damages arising from the wrongful dishonor of subsequently presented checks. These protections, in existing check law, appear to have worked well for many decades.³

In summary, substitute checks are not expected to result in problems different from those that are routinely addressed in today's environment. Therefore, we believe that the costs associated with the expedited recredit provisions will substantially outweigh the small incremental benefit of these requirements to consumers. To address the possibility that additional consumer protections may become necessary in the future, the proposed legislation grants the Board authority to adopt such protections by regulation, if needed. Nonetheless, Congress may conclude that expedited recredit provisions for consumers should be included in the legislation. In that case, we believe any expedited recredit provisions should be consistent with the proposed legislation's basic purposes and should not go beyond the provisions proposed by the Board.

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. The Board believes that, over the long run, the concepts embodied in the proposed Check Truncation Act will spur the use of new technologies to improve the efficiency and reduce the cost of the Nation's check collection system and provide better services to bank customers. The proposed legislation accomplishes this by simply permitting banks to replace one piece of paper, the original check, with another piece of paper, the substitute check, both of which contain the same payment information. Because the proposed legislation should result in substantial cost savings, it would also be desirable to begin obtaining these savings as quickly as possible.

³In contrast, there was no established body of law governing the rights and liability of consumers regarding unauthorized electronic funds transfers when Congress was considering the Electronic Fund Transfer Act in 1978. Therefore, Congress decided to address consumer rights and liability in that Act.

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.

PREPARED STATEMENT OF LINDSAY A. ALEXANDER
PRESIDENT & CEO, NATIONAL INSTITUTES OF HEALTH FEDERAL CREDIT UNION
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION
APRIL 3, 2003

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, nonprofit 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.
- 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 91 percent truncate share drafts or checks.² Among the credit unions that offer checking accounts, 7.1 percent 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 percent 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 of 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.

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

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

²Share drafts are checks.

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.

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 7 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 14 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 the 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 the 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.

We thank the Committee for this opportunity to comment and I will be glad to answer any questions.

PREPARED STATEMENT OF JANELL MAYO DUNCAN
LEGISLATIVE AND REGULATORY COUNSEL, CONSUMERS UNION

APRIL 3, 2003

Good morning, Chairman Shelby, Senator Sarbanes, and Members of the Committee. Thank you for providing me the opportunity to come before you today. I am

Janell Mayo Duncan, Legislative and Regulatory Counsel for Consumers Union.¹ Consumers Union is the nonprofit publisher of *Consumer Reports* magazine. Our mission at Consumers Union is to test products, inform the public, and protect the consumers. Today, I offer this testimony on the proposed Check Truncation Act as part of our consumer protection function. My testimony today is supported by the Consumer Federation of America, U.S. Public Interest Research Group, and the National Consumer Law Center.²

If the proposed Check Truncation Act (CTA) is enacted into law, it would have a significant impact on an estimated 45 million consumers who receive their original paper checks in the mail every month.³ The proposed CTA would enable banks, thrifts, and credit unions (collectively referred to in this testimony as banks) to convert original paper checks written by consumers into electronic form so they can be sent by banks to other banks that agree to accept them. Consequently, original paper checks would be “truncated,” or stopped by one of the first banks in the system to process a consumer’s check. Banks refusing or unable to accept electronic check information would receive a paper “substitute check.” During the check return process under the proposed CTA, a consumer’s check could be transferred in and out of electronic and paper substitute form. Thus, the consumer’s bank would receive either an electronic image or a “substitute check,” but would not receive back the consumer’s original paper check. Likewise, the consumer could only get back a “substitute check” but not the original.⁴

We believe the proposed CTA would be a bad deal for consumers for three main reasons. First, the proposed legislation would eliminate the choice preferred by millions of consumers who receive their original paper checks each month. Second, the provisions in the proposed CTA meant to protect consumers from processing errors will not be available to all consumers whose check information is processed electronically. Third, if enacted into law, the proposed CTA would give banks an unfair ability to deter, delay, or reduce consumers’ claims for damages resulting from processing errors by alleging that a consumer was somehow at fault.

Potential Impact of Federal Reserve Board Proposal

We recognize the value that advances in technology can provide to consumers in terms of enhanced banking and customer services. However, our concern is not with the technology—but the resulting removal of consumer choice. The proposed CTA would take a system that works relatively well and change it in a way that imposes new risks and inconveniences on consumers. Today, some consumers prefer online banking, some receive no checks with their monthly statement, and some receive checks back every month, like clockwork. The proposed CTA would tell millions of consumers that they can no longer get their original paper checks back with their

¹ Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education, and counsel about goods, services, health, and personal finance. Consumers Union’s income is solely derived from the sale of *Consumer Reports*, its other publications, and from noncommercial contributions, grants, and fees. In addition to reports on Consumers Union’s own product testing, *Consumer Reports* with approximately 4.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics and legislative, judicial, and regulatory actions that affect consumer welfare. Consumers Union’s publications carry no advertising and receive no commercial support.

² Consumer Federation of America is a nonprofit association of almost 300 pro-consumer organizations, founded in 1967 to advance the consumer interest.

U.S. Public Interest Research Group (U.S. PIRG) serves as the national lobbying office for State PIRG’s, which are nonprofit, nonpartisan public interest advocacy groups with 400,000 members in States around the country.

The National Consumer Law Center is a nonprofit organization specializing in consumer issues on behalf of low-income people. The Center’s experienced attorneys work with thousands of legal services, Government and private attorneys, as well as community groups and organizations, from all States who represent low-income and elderly individuals on consumer issues.

³At an August 2002 meeting, bank representatives stated that approximately 60 percent of consumers east of the Mississippi River, and 30 percent of consumers in the West receive their original checks back. Since approximately 90 percent of the 105 million U.S. households have a bank account, usually a checking account, this means that approximately 45.8 million U.S. households get back their paper checks.

⁴Today many bank and credit union customers do not receive their checks back in the mail monthly; however, a credit union creates an image of the customer’s check at the end of the process, after the check has made its way through the check clearing process. In contrast, a “substitute check” is a reconstituted version of the consumer’s check. Because not all financial institutions will transmit the check in electronic form, the substitute check may contain errors arising during the transmission process. In addition, if the consumer needs the original check due to a claim of improper amount, forgery, or alteration (which may require handwriting evidence) the original check will now be in the custody of someone other than the consumer’s own bank, and so it would take longer to find and retrieve.

statements to double-check what a bank has done with their funds, to make sure a payee has not changed the amount, or to prove payment where this is an issue. In addition to eliminating this consumer option, the proposed legislation creates a system of electronic transmission of checks that could expose consumers to new risks including double processing of a single check, or errors in reading the amount of or account number on a check—resulting in losses to consumers.

It is virtually certain that the largest banks will save money from the efficiencies achieved from increased electronic processing of checks. In contrast, there is no guarantee that consumers will benefit from mandatory check truncation. In return for changing their banking practices and being subjected to potential errors related to electronic processing, the consumer is offered vague and unenforceable promises that they will be sufficiently protected, promises of increased flexibility to view account information, and promises that in the future funds from checks they deposit into their account may be available sooner. None of these promises are certainties under the proposed CTA.

Loophole in Legislation Relating to “Recredit” of Disputed Funds

If the proposed CTA were enacted into law, consumers would need additional protections to address any errors or disputes that occur when their check information is processed electronically. In an effort to provide protections, Section 6 of the proposed legislation, among other duties, would require a bank to put up to \$2,500 in disputed funds back into a consumer’s account if the matter is not settled in one business day—called “recredit.”⁵ However, the proposed language would allow consumers to seek recredit of disputed funds only if they receive a “substitute check” from their bank.

This is a significant loophole because a bank could avoid giving account-holders these rights simply by refusing to return substitute checks to them. If a bank does not give a substitute check to its account-holder, the customer loses the right to recredit, and is left with weaker UCC remedies found under State law. Consumers unable to seek recredit would have to seek redress under State law—UCC Articles 3 and 4—which governs negotiable instruments, including checks. UCC liability provisions are not comparable to recredit because, although they provide rules for liability, they lack a nonlitigation remedy. In addition, UCC provisions do not set a specific time period to resolve disputes, and do not require a bank to redeposit disputed funds. If a bank delays or declines to solve the problem, the only way for the consumer to get his or her money back under the UCC is to sue, which is too expensive and time consuming for most disputes relating to modest amounts.

Although consumers would benefit from additional warranty and indemnity provisions under the proposed CTA, in order to obtain damages for losses due to an improperly paid check under either the UCC or the proposed CTA’s warranty and indemnity provisions, a consumer would be forced to sue his or her bank. And as discussed earlier, this is an expensive and cost-prohibitive prospect for most amounts likely to be in dispute. We, therefore, believe that the recredit provision should be extended to all consumers, regardless of whether or not he or she receives a “substitute check.”

Although Inadequate in Current Form—The Recredit Provision is Critical to Ensure Consumer Protections

Currently, consumers engaging in other electronic funds transfers (for example, using debit or ATM cards or allowing funds to be debited directly from their accounts) are protected by Regulation E,⁶ which includes a 10-day right of recredit, and has no dollar limit. Because the proposed CTA would allow banks to turn consumer paper check processing into electronic transmissions of check information, the recredit section essentially gives consumers protections that are similar to those governing other types of electronic funds transfers.

In the absence of *any* recredit provision in the CTA, banks would lack an incentive to expedite their investigations of possible errors. During the delay, consumers could be denied access to rightful and necessary funds. The recredit provision properly places the burden of delay on the bank rather than the consumer. As described above, in the absence of recredit, for unresolved disputes, consumers would be required to sue their banks in order to pursue claims for improperly debited funds.

The importance of a recredit provision cannot be over-emphasized, and has been recognized by its authors. In a letter dated December 17, 2001, Federal Reserve Board Chairman Alan Greenspan presented the proposed CTA to then-Senate Bank-

⁵We believe that this amount should not be limited to \$2,500. Recredit amounts are not limited for consumers who conduct electronic transfers.

⁶12 CFR Part 205.

ing Committee Chairman Sarbanes, along with an overview of the proposed legislation, and a section-by-section analysis. The “Highlights” section of the overview of the proposed legislation states that: “The expedited recredit procedure is intended to mitigate the effects on consumers of any potential problems associated with the receipt of substitute checks.” In addition, the section-by-section analysis of proposed CTA Section 6 states: “These expedited recredit provisions of the proposed Act are limited to consumers, who are generally not in a position to negotiate with their banks the terms of their deposit accounts that affect the consumers’ rights and liabilities, such as how payments are processed and charged to their accounts.”

As recognized by the Federal Reserve Board, recredit is an essential consumer protection element of the proposed CTA. The alternative—requiring consumers to seek redress by suing their bank over a disputed check processing error—is an unacceptably unfair, time consuming, and potentially expensive alternative. We would, therefore, oppose any CTA legislation that allows banks to treat checks like an electronic funds transfer, without giving consumers the right to recredit—a legal protection they need and deserve.

Comparative Negligence Provisions

The proposed CTA contains provisions that would make it harder for consumers to seek damages from banks for improperly paid checks.⁷ These comparative negligence standards in Sections 5(b) and 8(c) of the proposed legislation would allow banks to reduce the amount of damages a consumer can recover by asserting that the consumer was somehow at fault (that is, comparatively negligent). Despite the creation of this defense, it is highly unlikely that a consumer could contribute in any way to the double processing of his or her checks, or to a processing error. This provision would unfairly enable a bank to deter a consumer’s claim, or make any litigation longer and more expensive by asserting that the consumer was somehow partly responsible for check processing errors.

The proposed CTA’s comparative negligence provisions are much broader than those currently governing consumer check transactions under the UCC. Although the UCC imposes a comparative negligence standard, it does so only relating to fraud.⁸ The proposed CTA, therefore, gives banks greater protections than exist under current law by *extending* a bank’s ability to claim a defense of comparative negligence beyond situations where there has been a loss to the consumer due to fraud or forgery. This expansion would make it harder for consumers to collect judgments against banks responsible for processing errors. We, therefore, believe that the comparative negligence standards in Sections 5(b) and 8(c) of the proposed CTA are inappropriate to resolve harms suffered by consumers due to processing errors, and should be removed.

Recommendations

We recommend the following changes to the proposed CTA to more properly balance the benefit of increased check processing efficiencies with necessary consumer protections:

- Because all consumers are equally susceptible to harm from processing errors, the recredit loophole in the proposed CTA should be closed. The right of recredit should be expanded to apply in every case where the original check is not returned to the consumer and a check may have been improperly charged to the consumer’s account.
- A comparative negligence standard is inappropriate to resolve harms suffered by consumers due to processing errors. Banks should not be able to use this standard to avoid liability, or to delay a consumer’s action for improperly paid checks that result from processing errors. Therefore, as it relates to consumers, the language relating to a comparative negligence standard should be removed from the proposed CTA.

⁷ Under Section 8(b) of the CTA, a bank could raise a comparative negligence defense with respect to *every* claim by a consumer that his or her account had been improperly debited (that is, a “warranty claim”). See CTA Section 8(b). Similarly, the CTA also would allow banks to raise a comparative negligence defense if a consumer seeks indemnity for harm caused by the unavailability of the original check. See CTA Section 5(c).

⁸ The first instance relates to fictitious payees or imposters [3–404(d)], the second involves where a consumer’s negligence contributes to a loss due to a forged signature or alteration [3–406(c)]. Finally, under the UCC, an account-holder has a duty to be diligent in reviewing his or her monthly statement, and report any item paid that was improperly altered or contains an unauthorized signature. If the consumer fails to examine his or her statement and discover and report such indications of fraud, then he or she may lose the ability to assert a claim against the bank for wrongful payment [4–406].

We also have other concerns about the proposal, but we believe that these two elements are among the most important.

I thank the Chairman, Senator Sarbanes, and the Committee for the opportunity to testify, and I look forward to any questions you may have.

PREPARED STATEMENT OF DANNE L. BUCHANAN

EXECUTIVE VICE PRESIDENT, ZIONS BANCORPORATION

ON BEHALF OF THE

AMERICAN BANKERS ASSOCIATION, AMERICA'S COMMUNITY BANKERS
CONSUMER BANKERS ASSOCIATION, FINANCIAL SERVICES ROUNDTABLE
AND INDEPENDENT COMMUNITY BANKERS OF AMERICA

APRIL 3, 2003

Good morning. My name is Danne Buchanan. I am the Executive Vice President of the E-Business Solutions Group at Zions Bancorporation, Salt Lake City, Utah. I also serve as the CEO of NetDeposit, a subsidiary of Zions Bancorporation 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 noncash retail payments. These include debit cards, credit cards, automated clearinghouse (ACH) debit payments in addition to traditional checks. According to the Board, American consumers make more than 70 million of these noncash retail payments each year. While electronic payments represent an increasing number of these noncash payments, paper checks remain the dominant form of noncash payment in the United States 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 time frames. 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 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 3 years ago began actively seeking input from the banking industry, consumer groups, check clearing-houses, 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 ATM's that can forward deposits electronically will allow banks to deploy more ATM's in remote locations as the cost and frequency of physically retrieving deposits and servicing ATM's could be reduced. Consumers may be able to use these ATM's 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 cut-off 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 online. This helps consumers to quickly and to 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 to physical archives and transmit copies. Identifying errors and potential fraud as soon as possible also helps banks minimize customer inconvenience, control potential losses, and gives law enforcement an advantage in tracking down the 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 also 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, the Board's 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. 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 also indeed encourage it. To illustrate:

- 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.
- 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.
- Because in most cases, it will not be possible to obtain the original check within 2 days, the bank will be obliged to release the funds. The fraudster walks away with \$2,160 of the bank's money.

Under the proposal, the paying bank must make funds available 2 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 September 25, 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, that is, 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 the 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 percent 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 U.S. 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.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES
FROM ROGER W. FERGUSON, JR.**

1. In your written testimony you stated that, "Check truncation is generally more efficient, more cost effective, and less prone to processing errors." Based in part on this assessment, you concluded that, "The proposed legislation should result in substantial cost savings." In defining how these benefits would be distributed, you stated that, "As banks reduce their operating costs, the savings will be passed on through a combination of lower fees to their customers and higher returns to their shareholders. Banks have indicated that they expect cost savings to be substantial." Based on these statements, I have two related questions.

Q.1.a. What is the Fed's estimate of the size of these savings for banks?

A.1.a. While we believe that the proposed legislation will result in substantial cost savings, the magnitude of those savings is difficult to estimate. The magnitude of the savings will depend on the rate at which banks begin using the proposed legislation's new authority. Each of the bank's approach toward using the new authority will depend on its technology infrastructure, physical infrastructure, business strategy, and customer profile. On the other hand, banks receiving substitute checks will be able to process substitute checks in the same manner as original checks, thereby incurring little or no additional processing costs. Banks that receive substitute checks, however, will incur additional administrative and compliance costs that will depend largely on whether the proposed legislation, as enacted, includes expedited recredit and disclosure requirements and, if so, the form of those requirements. Therefore, while banks have indicated that they expect cost savings to be substantial, the actual magnitude of the cost savings is difficult to determine.

Q.1.b. What portion of these substantial savings do you expect to go to customers as opposed to shareholders?

A.1.b. We are not able to forecast the relative amount of the cost savings that might accrue to banks' customers and shareholders under the proposed CTA. Banks implement changes for a variety of reasons. Banks might implement changes to improve profitability or to increase market share by attracting and retaining customers through improved services or fee reductions. Historically, both banks and their customers have benefited from banks' investment in technology. We expect that the proposed CTA will benefit both banks' customers and shareholders.

2. It is my understanding that the CTA reduces the amount of damages that a consumer can recover under an indemnity loss claim, breach of warranty, or failure of the bank to meet any requirement of the CTA, in proportion to the amount of negligence or bad faith attributable to the customer. In your April 3 testimony, you stated that, "The question of comparative negligence already exists in any of the common law standards for tort and . . . in the UCC. And it has withstood the test of time." Consumer groups agree. However, they allege that the comparative negligence standards in subsection 5(c) and 8(b) of the CTA are much broader

than the Uniform Commercial Code (UCC) standards governing consumer check transactions and will make it more difficult for consumers to recover damages from banks.

Q.2.a. Are consumer protections under the CTA weaker than under the UCC as the consumer groups allege?

A.2.a. The CTA consumer protection provisions are generally consistent with, and would not weaken, consumers' rights under the UCC. The comparative negligence standard is included to ensure that the doctrine of comparative negligence adheres to the newly created rights under the warranties and indemnity that would apply to substitute checks. The comparative negligence language is also intended to negate any concern that the CTA preempts well-established State check law protections. Consumer protections under the CTA are additional protections over and above current UCC provisions. The CTA warranties and indemnity, as well as the comparative negligence provisions, would overlay existing check law and apply in cases where substitute checks are used.

Comparative negligence is a common law concept under which courts apportion tort liability according to how much the actions of each party contributed toward the loss. This concept has been incorporated into check law through the UCC, as well as the Board's Regulation CC (*See* 12 CFR § 229.38(c)). The UCC contains several provisions that allocate liability based on fault. For example, the UCC sets out a comparative negligence standard in cases of imposters and fictitious payees (Section 3-404(d)) and alterations and forged signatures (Section 3-406). These cases often, but need not always, involve fraud. Other UCC provisions reduce a person's ability to recover losses based on that person's negligent actions and generally do not involve fraud. For example, Section 4-406(d) reduces a consumer's ability to recover for unauthorized items if the consumer does not make a timely examination of his or her statement. Also, under Section 3-407(c), a consumer could be held liable for a check that was completed in an unauthorized manner if the check was signed yet incomplete when it left the consumer's hands.

The CTA comparative negligence provision would operate in a manner similar to these UCC provisions: When a party to a check (which could be a consumer, a nonconsumer, or a bank) acts negligently or in bad faith, that party's ability to recover under the CTA warranties or indemnity will be proportionally reduced.

Q.2.b. Please explain why there are comparative negligence provisions in the CTA when current law governing check processing remedies already provides a comparative negligence standard?

A.2.b. Although State law already encompasses a concept of comparative negligence in the provisions of the UCC and as a common law principle, a new Federal law that did not explicitly incorporate such a concept may be deemed to preempt the State law. Therefore, the proposed CTA includes a comparative negligence provision to make it clear that the new liabilities created by the CTA warranties and indemnity could be reduced where the complaining party acts negligently or in bad faith.

Q.2.c. What types of actions are anticipated that would make a consumer somehow at fault for a bank's processing error? Does the

Board believe that a consumer could contribute in any way to the double processing of a check or to a processing error such that the amount they recover is reduced?

A.2.c. There are relatively few processing errors today, given the 40 billion checks written annually, and it is highly unlikely that the CTA would change that very positive experience for those who use checks for their payment needs. It is possible, although unlikely, that a consumer's actions would result in a bank processing error. A bank processing error could take many forms, including misencoding and the creation of illegible or duplicate substitute checks. Misencoding of checks seldom occurs today and there are encoding warranties in the UCC and the Board's Regulation CC that address this issue. Consumer actions rarely contribute to such errors. Similarly, we believe it would be a rare circumstance when a consumer's actions contributed to the creation of an illegible or duplicate substitute check. For example, a consumer may have taken some action with respect to the original check with the intent that the substitute check created from that original check would be illegible. A bank that can prove such consumer intent may be partially or fully absolved from liability.

Generally, a bank that is liable for damages because it has created an illegible or duplicate substitute check would not be able to assert a comparative negligence defense against a consumer absent unusual circumstances, such as those described above. It is our expectation that the comparative negligence provisions will apply in most cases to disputes between banks.

Q.2.d. Consumer groups allege that under the UCC, a bank may only raise a comparative negligence defense with respect to fraud or forgery. Is this correct?

A.2.d. As indicated in more detail under the first question, there are instances under the UCC where a consumer's ability to recover losses or to avoid liability is limited due to the consumer's own negligence or bad faith (*see* UCC 3-407(c) and 4-406(d)). Fraud or forgery is not necessarily involved.

Q.2.e. Is it true that under the current law a bank could not defend against processing errors on the grounds of comparative negligence?

A.2.e. The legal defenses available to a bank depend on the nature of the processing error and whether the consumer's actions contributed to that error. As indicated above, we believe that a consumer's actions rarely contribute to errors such as misencoding. However, in the event that a consumer intended to defraud a bank and took actions intended to result in misencoding or misdirection of a check, it appears that the bank could recover against that consumer under the UCC and common law. We note, however, that the case law involving misencoded checks generally is between banks and does not involve consumers.

3. In your written summary testimony you note that check imaging under the CTA could "provide their customers with later deposit cut-off hours. Such changes could result in some checks being credited one day earlier and interest accruing one day earlier for

some checks deposited in interest-bearing accounts.” Based on this statement, I have three questions.

Q.3.a. It is my understanding that while the adoption of CTA will likely allow banks to benefit from faster check clearing, the CTA does not make changes in the Expedited Funds Availability Act (EFAA) that would ensure that banks make customers’ funds available to them more quickly. Is this true?

A.3.a. The EFAA already requires that the Federal Reserve Board shorten the maximum permissible hold periods that banks may place on a category of checks if improvements in the check collection and return system enable banks to learn of the nonpayment of most of those checks more quickly (*see* EFAA Section 603(d)(1)). The Board will monitor improvements to the check system and reduce permissible holds as warranted. Because the Board complies with current law and will continue to do so, there is no need to either repeat existing mandates or create new ones. It is important to note that most institutions already make funds available to their customers more promptly than required by law. In a 1996 report to Congress on Funds Availability Schedules and Check Fraud at Depository Institutions, the Federal Reserve Board reported that over 70 percent of banks provide customers faster funds availability to customers than required by Regulation CC.

Q.3.b. In the absence of a change in the EFAA and its regulations, how can we be certain that consumers will be able to access their funds more quickly?

A.3.b. The EFAA already requires that the Federal Reserve Board shorten the maximum hold that banks may place on a category of checks if improvements in the check collection and return system enable banks to learn of the nonpayment of most of those checks more quickly. If the proposed CTA results in such improvements, the Board will shorten maximum permissible holds as required by the EFAA.

In addition to the general improvements that might result in the shortening of the maximum permissible hold schedules, the proposed CTA might result in some consumers being able to access their funds more quickly through the possible extension of deposit cut-off hours at some banks. Every bank has a cut-off hour after which check deposits are considered made on the next banking day. Banks could use the proposed CTA to transmit check deposits to central processing centers for collection faster than the deposits could be physically shipped to the centers. Banks could use this additional time to extend deposit cut-off hours, which could result in some consumer checks being credited one day earlier and consumers potentially obtaining access to funds on those deposits one day earlier.

Further, as was noted above, a large percentage of banks already provide customers with faster funds availability than required under regulation. This suggests that market forces provide banks with incentives to improve funds availability where possible. It seems likely that if technology and business processes change such that banks are able to collect checks more quickly than they do today, market forces may well lead banks to provide customers access to their funds more quickly.

Q.3.c. What steps will the Board take under EFAA to ensure that consumers receive most of the benefit from faster check clearing under the CTA?

A.3.c. As required by the EFAA, the Board plans to monitor improvements to the check system and reduce the maximum permissible hold schedules as warranted.

Q.4. A recent *American Banker* article on check truncation reported that Mr. John Hodas, Chief Financial Officer for Florida Gulf Bank, which uses check imaging, is concerned about the quality of these images. The story states that: "Mr. Hodas said the images are sometimes too faint to read, especially when checks are written in light-colored ink." Does the Fed proposal include any standards for the quality of an electronic or substitute check? Why or why not?

A.4. The proposed CTA requires that a substitute check conform to generally applicable industry standards. There are two American National Standards specifications that would be used in a future CTA environment. The first is ANS X9.90—Specifications for Image Replacement Documents. This standard outlines the design or layout of a substitute check and incorporates other existing standards, including standards that deal with paper dimensions and quality, MICR line location and printing, check background design, and check endorsements. The second is ANS X9.37—Specifications for Electronic Exchange of Check and Image Data. This standard has been revised to support the inclusion of images and electronic endorsement records, which is critical to the implementation of the proposed CTA. These two standards have already been released as Draft Standards for Trial Use (DSTU's).

The proposed CTA also requires that a substitute check include an image of the front and back of the original check. Further, to be the legal equivalent of the original check, the proposed CTA requires that a substitute check accurately represent all the information on the front and back of the original check at the time the original check was truncated. If the writing on a check is clear on the original but not on the substitute, then the substitute check would not be legally equivalent to the original check and the reconverting bank would be in breach of its legal equivalence warranty.

Q.5. It is my understanding that under the Fed proposal banks will still be able to return substitute checks to customers if both the bank and the consumer agree to that service. To do such would require that at some point the image of the check be translated into a substitute check and that that substitute check either be sent to or printed at the customer's bank. David Walker, Executive Director of the Electronic Check Clearing House Organization (ECCHO) is quoted in a recent *American Banker* article as estimating the cost of creating and processing substitute checks in the range of 2 to 2.5 cents apiece, versus about 1 cent for regular checks. As a result of this higher cost the article concludes that, "The industry's hope, of course, is that substitute checks will not be a concern for long." Mr. Ferguson, should one be concerned that the potential high costs involved in creating and handling substitute checks will make it increasingly less likely that banks will even offer customers the ability to receive substitute checks?

A.5. Under the proposed CTA, banks would have to weigh the costs associated with creating substitute checks against the savings from being able to handle more of the check collection process electronically. Mr. Walker's statement simply suggests that using the substitute checks may not be the most cost-effective approach for processing all checks. A collecting bank will collect checks using the most cost-effective approach for each type and category of check. Therefore, some checks may be collected as original checks, some as substitute checks, and some electronically under electronic exchange agreements. Regardless of how checks are collected, banks will have the ability to provide their customers with accounts that return cancelled checks with bank statements. Assuming there is demand for accounts that return cancelled checks to customers, competition in the banking industry should drive banks to offer such accounts. Further, some States have laws that require banks to offer accounts that return cancelled checks to customers.

Q.6. It is my understanding that banks are required by law to maintain a copy of all checks for 7 years. As I have been informed, the majority of these copies are kept using nonelectronic means (generally microfiche), while some smaller percentage is stored electronically. If check truncation were implemented under this proposal would you expect this to change such that the vast majority of checks would be stored electronically?

A.6. Microfiche or microfilm technology is a relatively old technology. As the cost of digital imaging technology declines, banks are increasingly using this technology to maintain copies of checks that they handle. The proposed CTA would likely accelerate this trend because there would be more business applications for the technology, thereby making investments in the technology more attractive.

7. One general advantage of electronic documents is that they are easily transmitted and that large numbers of documents can be sorted according to a wide variety of information. Thus, it is possible, perhaps likely, that this legislation could lead to the creation of a large, electronic database containing the information of many consumers' check writing habits.

Q.7.a. Is it your opinion that the CTA would create new and expanded opportunities for banks to mine personal consumer information for commercial purposes?

A.7.a. A check is typically imaged several times in today's environment. The check is imaged by the bank at which it is deposited, it may be imaged by any intermediary handling the check, and it is imaged by the paying bank. Therefore, there are already significant databases containing check images. Check images, however, are simply pictures of checks. To mine information, extra steps are required to extract information from check images and to enter that information into a database. Given the 40 billion checks that are written each year, mining information from check images would likely be relatively expensive and labor intensive.

Q.7.b. Is there any provision in the proposed Act that would limit a bank's ability to search its database of electronic check informa-

tion and use it to create and to share a detailed profile of the customer's buying and spending habits?

A.7.b. There are no provisions in the proposed CTA that address the privacy of financial information. The Congress has already addressed the protection, disclosure, and use of consumer financial information in Title 5 of the Gramm-Leach-Bliley Act. There are many ways by which banks obtain financial information about their customers other than through checks that they handle. If Congress wishes to expand the privacy provisions of the Gramm-Leach-Bliley Act, it would be more effective to consider such expansions in separate, broadly applicable, legislation rather than in a narrowly targeted bill such as the CTA.

Q.8. The Board's section-by-section analysis of the CTA, accompanying Chairman Greenspan's transmittal letter to the Committee on December 17, 2001, includes the following sentences:

"The Federal Reserve Board believes that a next day re-credit limit of \$2,500 is a reasonable compromise between banks and consumer interests" and "the expedited recredit procedure is intended to mitigate the effects on consumers of any potential problems associated with the receipt of substitute checks."

You failed to endorse this provision in your April 3 testimony. Instead, your written testimony notes that, "Upon further reflection, the Board has now concluded that the significant compliance burdens imposed by these provisions on banks that receive substitute checks outweigh the small incremental benefits that the provisions would provide consumers." There may be some practical problems with the expedited recredit provision contained in the Board's CTA proposal, but I am most interested in understanding what has changed since December 17, 2001? What are some of the new compliance burdens? Was the Board staff unaware of the Uniform Commercial Code's protections when the proposal was sent to Congress? If so, why was the provision included?

A.8. The Board submitted a draft of the CTA to the Congress in December 2001, with the understanding that it would serve as a starting point for discussions among the Congress, banks, consumer groups, and other interested parties. The Board expected that further revisions could and would likely take place as the interested parties, including the Board itself, continued to consider the pros and cons of various provisions of the legislation. In particular, the Board expected further debate on the expedited recredit provisions, which had been the subject of spirited discussions between banks and consumer groups well before December 2001.

Two of the Board's guiding principles in developing the CTA were that: (1) the burdens associated with the proposed law did not outweigh the associated benefits for either banks in the aggregate or their customers in the aggregate; and (2) banks that choose to convert a check to, or receive a check in, electronic form should internalize, to the extent practicable, the costs and risks related to the creation of the substitute check, because they receive most of the associated benefits. The Board believed at that time (and continues to believe) that the risks of any serious consumer problems under the proposed CTA would be low and was well aware in De-

ember 2001, that the UCC provided strong check-related protections to consumers. Nevertheless, our discussions with the banking industry and consumer groups on this issue focused largely on how to craft expedited recredit provisions rather than on the need for such provisions.

Since that time, however, the Board has had further opportunity to carefully consider the arguments on both sides of this debate. The Board has also had the opportunity to consider the results of ongoing experiments in the marketplace involving substitute checks, which have raised virtually no consumer problems. In addition, as the draft CTA has evolved, additional burdens in the form of notice requirements have been placed on banks that are passive recipients of substitute checks. After further reflection, the Board now believes that the compliance burdens imposed by the expedited recredit provisions on banks that receive substitute checks would outweigh the small incremental benefits that the provisions would provide to consumers. Therefore, the Board does not believe that the expedited recredit provisions are necessary to successfully implement the CTA. Nevertheless, if Congress concludes that expedited recredit provisions for consumers should be included in the legislation, we believe that any expedited recredit provisions should be consistent with the proposed legislation's basic purposes and should not go beyond the provisions proposed by the Board.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED
FROM ROGER W. FERGUSON, JR.**

Q.1. Under the Fed proposal, if a hacker interferes with a check's electronic transmission (for example, the creation of electronic counterfeit checks), who would ostensibly bear the sole liability for lost assets? Does the indemnity provision of this proposal cover incidences of electronic fraud?

A.1. Under existing law, a bank can only charge a customer's account for transactions authorized by the customer. In the example you cite, the bank's customer has not authorized the fraudulent transaction and is not responsible for the loss. The customer, of course, has a duty to examine his or her bank statement and must notify the bank of any unauthorized charges. Where the ultimate liability falls depends on the facts of the particular case. Generally, banks that have agreed to exchange checks electronically would include in their agreement provisions governing the responsibility for data integrity at various points in the check collection process.

The proposed CTA's indemnity provision only covers situations in which the receipt of a substitute check results in a loss to a bank customer or other party to the check. As I noted, existing law protects bank customers from electronic fraud.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER
FROM ROGER W. FERGUSON, JR.**

Q.1.a. Please comment on the implications of this proposal on the security of checks. My understanding is that today checks, like the U.S. dollar, are actually quite sophisticated pieces of paper "technology" with various safeguards against fraud "wired" into the check. Will the Fed proposal preserve that high degree of security?

A.1.a. Today, some checks incorporate a variety of physical security features including microprinting, chemical sensitivity, security fibers, watermarks, high-resolution border text, and latent images. Many of these security features are lost when checks are imaged. A number of vendors, however, have developed a variety of image-survivable security features to address check security issues in an image environment. These features include two-dimensional bar coding, seal encoding, and digital watermarking. Banks could use these new features to protect against fraud. Also, we expect that, as the use of substitute checks becomes more prevalent, other new security features will be developed to help prevent fraud.

Q.1.b. Who will be responsible for authenticating a check?

A.1.b. Ultimately, the bank paying a check is responsible for “authenticating” a check that is written by its customer. The paying bank has knowledge of the drawer’s signature and generally has knowledge of check stock type, check serial number range, and so forth. This knowledge is useful in identifying many fraudulent checks. We also expect that over time the security features in checks would evolve to accommodate the technological developments in check processing.

Q.1.c. And if the physical check does not end up back at the bank that is on the hook for the funds—and presumably most motivated to do a thorough security verification—how will you ensure a high level of attention to security?

A.1.c. Today, most security verification is done at the paying bank. This process will likely continue, albeit through the use of new security features. Banks at which checks are deposited will have access to the original checks and will be able to perform the same verification they do today.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY
FROM LINDSAY A. ALEXANDER**

Q.1. What is the difference in cost for clearing a check electronically versus paper?

A.1. Based on the volume of checks cleared at NIHFCU (a total of 2.5 million checks are cleared annually), our costs for clearing checks electronically versus paper are \$6,250 compared to \$37,500. The following figures showing the cost of each service are from the Federal Reserve’s website, at *www.frbservices.org*. ACH origination—.25 cents per item (\$0.0025). ACH receipt—.25 cents per item (\$0.0025). Check Truncation @ Fed—1.5 cents per item (\$0.0150). Even without our labor and fixed costs factored in, it costs one-sixth as much to move transactions electronically.

Q.2. Your testimony states NIHFCU will be undergoing a conversion to an entirely electronic system. What are the costs associated with such a conversion?

A.2. The exact figures to convert to an entirely electronic system are not available. However, we expect the costs to be minimal, since NIHFCU already truncates its checks and offers imaging and online services to its members. The fees associated with such a conversion would mostly stem from internal conversions needed as a

credit union to use the new technologies, in addition to a one-time fee from the Federal Reserve.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED
FROM LINDSAY A. ALEXANDER**

Q.1. Under the Fed proposal, if a hacker interferes with a check's electronic transmission (for example, the creation of electronic counterfeit checks), who would ostensibly bear the sole liability for lost assets? Does the indemnity provision of this proposal cover incidences of electronic fraud?

A.1. Under the Federal Reserve proposal, the liability for the lost assets would not be covered by the proposal itself. According to the section-by-section analysis of the Check Truncation Act, the indemnity section provides an indemnity for a loss incurred by the recipient of a substitute, if the loss is due to the receipt of the substitute check, rather than the original check. Moreover, under this section, if the loss would have occurred even if the original check had been transferred or presented instead of the substitute check, the party incurring the loss would not have an indemnity claim, because that party is no worse off as a result of having received the substitute check. In this case, the loss is not caused by the receipt of the substitute check. In fact, in your case, there is no mention of the substitute check. The consumer would be able to recover under the Uniform Commercial Code Article 4.

What financial institution bears sole liability for this loss under Article 4 of the Uniform Commercial Code would depend on how the electronic check was altered to commit the fraud. For instance, if the electronic counterfeit alters the check writer's signature to obtain the payment then the paying bank would cover the loss pursuant to Uniform Commercial Code 4-208(3). On the other hand, if the payee's endorsement is altered, then the presenting financial institution would be in breach of its warranty and the presenting bank would bear liability for the claim under Uniform Commercial Code 4-208(a)(1). Under different scenarios, different parties would be liable.

The indemnity provision would not cover incidences of electronic fraud. As described above, the scope of this Act and the indemnities and warranties are limited to substitute checks. For instance, the indemnity only begins when a financial institution converts an electronic check into a substitute check. From that point forward, the indemnity runs with the substitute check or any subsequent electronic version of the check. However, the loss must be suffered because of receipt of the substitute check instead of the original check. In order for that requirement to be fulfilled there would have to be a loss caused by receiving the substitute check when it was not good enough (for example, for forgeries where the original was necessary to make a determination) or for having two substitute checks presented or other similar circumstances.

Q.2. If we move forward with this legislation, what assurances can you give consumers that they will see lower costs or better services in their banking experiences: I believe consumers will benefit from this change, but perhaps you can outline some specifics for us?

A.2. Consumers would see lower costs and better services because the technology allows us to provide both. NIHFCU already truncates its checks and also offers imaging and online services to its members. By combining truncation with imaging, NIHFCU offers members greater access to their checks online. Members have used these enhanced services to access their checks much more frequently than was possible before imaging. Also as stated in the answers above, at any point in the process check truncation is much cheaper to NIHFCU than full manual processing of checks. Thus, since NIHFCU as a credit union is a member-owned institution these savings will be passed along to its members.

Q.3. In a dispute over check fraud, how will your policies change—if they change at all—in investigating fraud and making the consumer whole in the event of fraud?

A.3. NIHFCU does not believe that there would be increased fraud from electronic transactions. As a result, NIHFCU does not plan to change its policies regarding check fraud if check truncation legislation passes because its current policies and procedures to handle fraudulent items are more than sufficient to handle the fraud that may arise. If a member alleges that they have been the victim of check fraud, NIHFCU investigates the allegation and within time frames prescribed by applicable laws, NIHFCU makes consumers whole in cases of fraud.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED
FROM JANELL MAYO DUNCAN**

Q.1. Under the Fed proposal, if a hacker interferes with a check's electronic transmission (for example, the creation of electronic counterfeit checks), who would ostensibly bear the sole liability for lost assets? Does the indemnity provision of this proposal cover incidences of electronic fraud?

A.1. The Federal Reserve proposal doesn't appear to assign liability for losses due to unauthorized access or fraudulent alteration of a check during electronic transmission. In addition, the proposal does not create any new protections for electronically transmitted checks. Under the Fed proposal, the check must be transformed into a substitute check to trigger any additional protections, such as indemnity.

The indemnity provision of the Fed proposal does not clearly address the issue of a fraudulently created substitute check. The indemnity provision relates to damages resulting from the creation of a substitute check, instead of the original check. However, it is not clear that the indemnity provision would assign liability to a bank, thrift, or credit union (hereinafter collectively referred to as banks) where a substitute check is fraudulently created or altered by a hacker.

Even if the indemnity section applies to fraudulently altered or created checks, it would require a lawsuit to enforce, which would be very time consuming and potentially expensive for a consumer to pursue. Additionally, the indemnity section of the Fed proposal contains a comparative negligence section that would not assign "sole liability," and instead would require a fact intensive exploration of comparative fault between the bank and the consumer.

Presumably, common law negligence principles also would apply to a bank that negligently failed to safeguard consumer check information, leading to a loss. However, if a court were to look to the Uniform Commercial Code (UCC) to define negligence, a bank may be able to avoid responsibility if it maintained a low standard of care, but acted in compliance with industry standards. Under UCC 3-103(a)(7), “ordinary care” is defined only as “observance of reasonable commercial standards, prevailing in the area in which the person is located. . . .” In addition, UCC 4-103(c) further provides that, “Action or nonaction consistent with . . . a general banking usage not disapproved by this Article, is prima facie the exercise of ordinary care.” *See also* UCC 4-103, Comment 4. This standard of ordinary care raises the concern that if no other banks have taken sufficient security measures, it will provide prima facie evidence that a bank that has had its electronic check processing system breached is not negligent. This concern is heightened by the fact that the Fed proposal fails to create any new obligations on banks electronically transmitting consumer check information to safeguard the information from security breaches.

Finally, under existing law, Section 4-401(a) of the UCC, a bank may only charge against a customer’s account, “An item that is properly payable from the account even though the charge creates an overdraft.” The Section continues, “An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and the bank.” Under this Section of the UCC a bank may be liable for improperly paying a fraudulently created, or improperly altered consumer check because it is not a “properly payable” item. However, seeking a remedy places a tremendous burden on the consumer because in order to recover losses under the UCC, he or she must litigate the claim.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES
FROM DANNE L. BUCHANAN**

1. As the representative of the American Bankers Association, the Financial Services Roundtable, America’s Community Bankers, Independent Community Bankers of America, and the Consumer Bankers Association, please answer the following questions.

Q.1.a. Are banks, subsidiaries, or affiliates of banks or other entities that process bank checks, currently using information from checks, such as payee or amount, to identify consumer spending patterns? If so, do firms use this information themselves or do they share it with or sell it to other firms or financial institutions?

A.1.a. Banks have always had the ability to extract information from paper checks or check images to detect potential fraud and to analyze customer spending habits and there are some depository institutions which extract information on an ad hoc, sporadic basis for internal purposes or for sharing with affiliates. However, this practice of extracting information from checks is not prevalent. First, extracting information from images is relatively difficult, time-consuming, and labor intensive for both paper checks and check images. We are aware that products may emerge that may extract information more efficiently that rely on character recognition, but to our knowledge, such techniques are currently unreli-

able. Second, public sensitivities inhibit use and sharing of such information. Finally, the privacy provisions of the Gramm-Leach-Bliley Act significantly restrict how such information can be shared outside of the bank.

Q.1.b. Would the industry support check truncation legislation if it contained a provision that check images, or any data contained on the check, could not be used for any purpose other than check processing, dispute resolution, or responding to customer requests?

A.1.b. Any privacy issues related to the use of check information should be addressed in the broader context of financial information privacy and should not be included as part of any check truncation legislation. The check truncation process as envisioned by the Federal Reserve Board's proposal will have no impact one way or the other on the type of check information collected by banks, how that check information is or is not used for purposes outside of check processing, dispute resolution, or responding to customer requests.

2. As you know, on March 26, the *American Banker* reported that Viewpointe Archive Services shut down the JP Morgan and Bank of America image exchange pilot at the end of February. Viewpointe's Chairman and CEO, John Lettko, noted that the pilot was discontinued because the banks had reached, "A point of diminishing returns." According to Mr. Lettko, the banks concluded that, to get further economic value from the exchanges, they needed to install more image capability in their back-office processing shops. The article further noted that only a small number of banks can process images "from the front end of the office to the back."

Q.2.a. As we explore legislation facilitating widespread check imaging, what lessons can be learned from the Viewpointe experience with image exchange?

A.2.a. To respond to the Committee's question regarding Viewpointe and check image exchanges, I consulted with Grant Cole, Senior Vice President at Bank of America, who has more direct information on the Viewpointe project. The response below is based in part on information obtained from Bank of America.

In November 2001, JP Morgan Chase and Bank of America embarked on a research and development project to test assumptions about check image exchange using a shared central archive. Both banks are owners of Viewpointe Archive Services. The banks set out to develop processes, rules, agreements, and logistics related to the exchange of check images in a shared archive to facilitate the collection and settlement of checks that traditionally had been exchanged between the banks in paper form. The Federal Reserve was invited to participate in the design of the process, but not to exchange checks in this phase of the project. The Electronic Check Clearing House Organization (ECCHO) was asked to join the project as well, in the capacity of rules rationalization.

Through this exchange project, the banks developed the design for exchanging images of checks within a central archive, the indices required, privacy requirements, and access capabilities. This design was then tested by exchanging through the Viewpointe archive a small sample of check images from each bank. During this test, the paper checks were still exchanged by the banks. The

banks still needed the paper checks because they have not completely extended image technology to all aspects of the banks' check operations and so were needed to perform exceptions processing such as return item processing. It is anticipated that prior to a full rollout image exchange between two or more banks, the participating banks would extend the necessary technology throughout the check processing systems at such banks.

The project to test image exchange through Viewpointe was a complete success as the banks involved in the test were able to prove an operational design that fulfilled all the objectives.

The article that was published in the *American Banker* regarding the check image exchange through Viewpointe is misleading, as the comments out of context left the wrong impression. The quote by Mr. Lettko of "diminishing returns" is accurate, but only because the objective of testing the image exchange process was met, and as long as the original paper checks have to follow the exchanged check images, there would not be much of an additive economic benefit. Also, the banks recognized during the test that there is a need for more automation to handle images efficiently in "the back office" which will be accomplished prior to the full implementation of check image exchange.

The comment in the *American Banker* article about a "small number of banks being able to process images from the front end of the process to the back" is also misleading. There are check image projects underway today in almost all large banks, and many smaller financial institutions are generally ahead of large banks in deploying image technology. The 2002 ICBA and InFinet Resources Community Bank survey results indicate that community banks' use of check imaging technology outpaces that of larger banks by a margin of 2 to 1, with 47 percent of the respondents currently using the technology and another 41 percent planning to evaluate the technology within the next 12-18 months. This corresponds to 88 percent of the respondents currently using or planning to evaluate imaging technology. Many small institutions have responded that they are waiting for check truncation legislation before investing in imaging. While not all banks are today implementing front-to-back exchange of images, the image programs established by these banks are the first and necessary step toward the day when banks can exchange images with any other bank in the Nation.

We believe the Boards proposed check truncation legislation will provide the impetus for the expansion of image exchange programs.

Lessons to be learned from the Viewpointe experience are that the image exchange using a common shared archive can be accomplished efficiently and securely. It also illuminated that in order for the real benefits of image exchange to be realized for the Nation's payment system, check images must be exchanged without the need for the original paper checks to be transported. For the reasons discussed above, we believe that the substitute check process contemplated in the Board's proposal will provide the impetus required for the furtherance of the business case for check image exchange.

Q.2.b. As the President of NetDeposit, a company that provides processing and clearing technology that facilitates the electronic

presentation of paper checks, what are some of the problems you have experienced with imaging?

A.2.b. We have experienced very few problems with the technology or customer complaints. One reason is that paying banks are not required to have image capability since they are provided substitute checks. Some banks and merchants have expressed concerns about the lack of clarity with regard to the legal validity of substitute checks. The Board's proposal would provide that clarity by stating substitute checks are the legal equivalent of the original.

Q.2.c. Do the check images (substitute checks) contain securities features? If not, what are some of the obstacles currently preventing banks from imaging security features onto substitute checks?

A.2.c. New image-survivable security features have been developed, and are under development, that should provide all check issuers with superior security features for checks that are imaged or converted to substitute checks. For example, we are aware of one technology company that offers a security feature for checks that are image-survivable, but also machine-readable, allowing for automatic processing. These image-based security features/processes are superior to the paper-based security features currently in use because check issuers can verify the security procedures carried on each image on an automated basis, rather than upon physical inspection of the paper check.

Industry standards groups are also working on standards and other operational issues for check image systems and substitute checks. The standard defines a structure to properly identify security features. The standard enables the incorporation of standardized and proprietary security features into the original check by providing a trigger and identification structure. The standards do not specify requirements for the type of security features.

At the time the check is issued or printed a one- or two-dimensional bar code is printed on the check with information about the check. For example, the dollar amount or check number could be encoded. One of the benefits of this encoding process is that the image of the check with the encoding can be authenticated anywhere in the check collection process. The validating encoded information is carried on both the paper check, the image of the paper check, and a subsequent printed copy of the check image (such as a substitute check).

See example below with a one-dimensional bar code.

NAME	23-1439/2398	9012
ADDRESS	0432342113	
PAY TO THE ORDER OF _____	\$	<input type="text"/>
		DOLLARS
BANK NAME	◆ ◆ □ □ □ □ □ □ □ □ □ □ ◆ ◆	
BANK ADDRESS	_____	
MEMO	_____	
8T123456789T 0123456780 9012		

Q.3. In your written testimony, you note that, “Reducing the dependency on the physical presentation of original items will result in faster check collection, which will allow consumers sooner access to their funds.” Moreover, the Federal Reserve has noted that due to check imaging under the CTA banks could, “Provide their customers with later deposit cut-off hours.” It is my understanding that while the adoption of CTA will likely allow banks to benefit from faster check clearing, the CTA does not make changes in the Expedited Funds Availability Act (EFAA) that would ensure that banks make customers’ funds available to them more quickly. In the absence of a change in the EFAA, how can we be certain that consumers will be able to access their funds more quickly? Would the industry support a change in the EFAA requiring that funds become available to customers more quickly?

A.3. No change is necessary as the Expedited Funds Availability Act already anticipates a reduction in the funds availability schedules in the event checks are processed and returned more quickly. Specifically, under Section 603(d) of that Act, the Board must, by regulation, “Reduce the time periods . . . to as short a time as possible and 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.”

Q.4. Is it my understanding that banks are required by law to maintain a copy of all checks for 7 years. I have been informed that the majority of these copies are kept using nonelectronic means (generally microfiche), while some smaller percentage is stored electronically. If check truncation were implemented under this proposal, would you expect this to change such that the vast majority of checks would be stored electronically?

A.4. Over time, we would expect that most checks would be stored electronically regardless of whether the proposal is enacted.

5. A general advantage of electronic documents is that they are easily transmitted and many documents can be sorted according to a wide variety of criteria. Thus, it is possible, perhaps likely, that this legislation could lead to the creation of a large, electronic database containing the information of many consumers’ check writing habits. In your written testimony, you stated that you are CEO of

NetDeposit, "A subsidiary of Zions Bancorporation that provides processing and clearing technology which allows organizations to move to electronic presentment of paper checks." The *American Banker* has reported that, "Zions is selling the system [NetDeposit] to other institutions and has one money-center bank testing it." As CEO of NetDeposit, please answer the following questions.

Q.5.a. Does NetDeposit currently, or plan in the future, to handle electronic check processing for multiple banks?

A.5.a. NetDeposit will handle electronic check processing for multiple banks.

Q.5.b. What information is, or could be, kept electronically from an imaged check as it goes through the NetDeposit system?

A.5.b. The only information held by the NetDeposit system will be images that are stored for several days to ensure that if items are not received or lost, we can recreate the cash letter. At the end of 5 days, these images are backed up to tape for record retention only and stored offsite for 7 years.

Q.5.c. What restrictions regarding privacy exist for imaged checks?

A.5.c. The Gramm-Leach-Bliley Act (GLB Act) imposes significant restrictions on the sharing and use of information from paper checks or check images. Banks also could only use or disclose customer information from checks in compliance with their privacy policies adopted pursuant to the GLB Act. In addition, the GLB Act requires the banking agencies to establish appropriate standards for financial institutions relating to administrative, technical, and physical safeguards to protect: (1) the security and confidentiality of customer information, (2) against unauthorized access, and (3) against anticipated threats or hazards.

Q.5.d. Does the legislation proposed by the Federal Reserve provide any additional privacy protections?

A.5.d. No. The Federal Reserve Board proposal does not include additional privacy provisions. For the reasons stated above, we believe additional privacy legal provisions are not needed for check truncation programs. As a practical matter, customer privacy will be enhanced by the proposal as access to checks and their information will be far more restricted when controlled in an electronic check collection process. For instance, the current paper check route offers opportunity to acquire information more easily than if the check image were transmitted electronically. Today, paper checks sit in airports, etc. awaiting transport and delivery. They must also be physically handled along the various stops where the information can be compromised. Electronic delivery eliminates these physical stops and the opportunity to acquire the checks and information.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED
FROM DANNE L. BUCHANAN**

Q.1. Under the Fed proposal, if a hacker interferes with a check's electronic transmission (for example, the creation of electronic counterfeit checks), who would ostensibly bear the sole liability for lost assets? Does the indemnity provision of this proposal cover incidences of electronic fraud?

A.1. Both the Federal Reserve proposal and the Uniform Commercial Code protect consumers from liability for any check, electronic or not, that is charged against their account and is not properly payable. Thus, under no circumstances would the consumer be liable in this case. Depending on how and where the hacker intercepted the information and how the hacker used it, one of the banks in the check process would bear the loss, based on warranties of the Uniform Commercial Code, the Federal Reserve proposal, and interbank agreements. If a hacker used the account numbers in the electronic check image database to create an electronic funds transfer from the customer's account, the consumer would be protected from liability under the Electronic Fund Transfer Act and its implementing regulation, Regulation E. That law protects consumers from liability for unauthorized electronic fund transfers.

In addition, hacking would seem unlikely in this case. As currently envisioned and configured, banks use only secure data lines to transmit the check image data to the database, and the databases themselves are protected with data encryption and other security techniques.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER
FROM DANNE L. BUCHANAN**

Q.1. A question for the bankers on the panel: If we move forward with this legislation, what assurances can you give consumers that they will see lower costs or better services in their banking experiences? I believe the consumers will benefit from this change, but perhaps you can outline some specifics for us.

A.1. Generally, the potential benefits of the proposal derive from the expected cost savings and quicker access to funds and account information associated with the elimination of the need for paper checks to physically travel from the bank of first deposit, through various check processing participants, to reach the paying bank. Consumers benefit from the potential cost savings in the form of lower costs and better services. In a market as competitive as the banking industry, competitive pressures will compel depository institutions to pass on to consumers savings from a more efficient check collection system. In addition to the potential costs savings, consumers will benefit from better service:

- 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 ATM's that can forward deposits electronically will allow banks to deploy more ATM's in remote locations as the cost and frequency of physically retrieving deposits and servicing ATM's could be reduced. Consumers may be able to use these ATM's to cash their payroll checks at their place of employments, which may be particularly attractive for those without bank accounts.

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 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 online. This helps consumers to quickly and conveniently review transactions, identify potential errors, and detect fraudulent transactions sooner. In addition to the timely receipt of information, the customer might also be able to print a copy of the check or send a copy of the check to a party questioning payment.

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 the errors and potential fraud as soon as possible helps banks minimize customer inconvenience and control potential losses, and gives law enforcement an advantage in tracking down perpetrators. Such current imaging applications will expand with the additional applications contemplated in the Board's proposal.

Q.2. A question for the bankers on the panel: In a dispute over check fraud, how will your policies change—if they change at all—in investigating fraud and making the consumer whole in the event of fraud?

A.2. Generally, bank policies will remain unchanged with regard to investigating fraud and making the consumer whole.

Today, depository institutions investigate and resolve claims as soon as possible because of the potential liability under the Uniform Commercial Code (UCC) for consequential damages for failure to properly pay items. The proposal preserves these UCC rights.

In addition, though the industry believes it unnecessary and dangerous from a fraud perspective, the proposal adds new "expedited recrediting" provisions that basically guarantee consumers that funds for unauthorized substitute check transactions will be available on the second day after the depository institution is notified of a claim. We believe that this provision is unnecessary as 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 the 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.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BENNETT
FROM DANNE L. BUCHANAN**

Q.1. What is the effect of the provisions of Sections 5 and 8 in the Federal Reserve's proposed Check Truncation Act that provide a comparative negligence standard for indemnification and other claims under the Act? Would this comparative negligence standard alter the current customer protections under check law?

A.1. The comparative negligence provision of Sections 5 and 8 of the Federal Reserve proposal provides that the potential liability of a bank to another person under the proposal's indemnity relating to a substitute check or for other failures to comply with the proposal is limited to the extent that the resulting losses are caused in part by the negligence of the person making the claim. As an initial matter, it should be pointed out that the person making the claim against a bank could be a consumer, a business customer, or even another bank. The comparative negligence provision would apply the same way in all cases.

This comparative negligence provision was included in the proposal to provide a similar defense to full liability that is available under common law in most States, as well as under the Federal Reserve's Regulation CC and the State law Uniform Commercial Code (UCC) provisions that currently regulate check operations. This comparative negligence standard does not change check law liabilities as they work today, but rather makes the application of the new warranties provided under the proposal similar to the liability structure established under the UCC, and Regulation CC for checks today.

Under the Federal Reserve Board Regulation CC, the damages a person is entitled to as a result of a failure to comply with that Regulation are diminished in proportion to the amount of the negligence or bad faith attributable to that person. (See Regulation CC, Section 229.38(c).)

The UCC similarly includes the concept of comparative negligence. For example, Section 4-406 of the UCC requires that a customer must exercise reasonable promptness to examine a statement of checks to determine if any unauthorized checks have been paid. If the customer fails to comply with this duty, the customer may be precluded from recovering the amount of the unauthorized checks. Furthermore, if the customer can establish that the bank's negligence contributed to the customer's loss under this UCC section, the loss is allocated between the bank and the customer on the basis of the relative comparative negligence of the parties.

This comparative negligence approach in the proposal (as well as the UCC and Regulation CC) reflects the policy of fundamental fairness—if both parties acted wrongly and each contributed to the loss, they should share the loss accordingly.

The comparative negligence provision of Sections 5 and 8 of the proposal only applies in the event of a claim made under the Section 5 indemnity or for a failure to comply with the Act. The comparative negligence provisions of the proposal do not alter or preempt any other State or Federal law rights or claims the customer may already have under existing law relating to a check payments.

Finally, as a related matter, whenever one is discussing claims between a bank and its customer, it should be highlighted that the vast majority of customer complaints or disputes regarding a check transaction are resolved by the bank to the customer's satisfaction through the normal customer service process. Very few disputes between customers and banks actually go to arbitration or litigation. Accordingly, while this comparative negligence standard is very important for a large dollar dispute that results in litigation, in the typical consumer allegation of error in a check transaction, this comparative negligence standard would likely not be relevant or applied.