Testimony of

Independent Community Bankers of America

on
"Implementing the Check Clearing for the 21st Century Act"

before
the Subcommittee on Financial Institutions
and Consumer Credit

of the

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and

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Washington, DC

Mr. Chairman, Ranking member Sanders, and members of the Committee, my name is David Hayes. I am Chairman of the Independent Community Bankers of America ("ICBA"),[1] and President and CEO of Security Bank, a $135 million community bank located in Dyersburg, TN. My bank is one of six community banks commonly owned in west Tennessee communities. Our collective assets total approximately $525 million. I am pleased to appear today on behalf of ICBA and its nearly 5,000 members.

We strongly support the Check Clearing for the 21st Century Act ("Check 21") and the increased efficiencies to the nation's payments system, and cost savings that will be realized because of its enactment. By authorizing the creation of substitute checks, Check 21 has opened the door to bank-to-bank electronic check processing. Prior to the passage of Check 21, the original paper check had to physically move through the entire clearing process from the bank of first deposit to the paying bank – a labor-intensive process. Banks were required by law to obtain customer consent in order to truncate their checks and process them electronically. Check 21 has removed such legal impediments, and is facilitating the industry's progression towards more efficient check processing to the benefit of both the consumer and the bank.

Check 21 Technological Implementation is an Evolutionary Process

Check 21 became law on October 28, 2004, approximately six months ago, and while the new law has established the legal framework to speed up check processing, the technological infrastructure is still developing. This is very much an evolutionary process, not an overnight process, and has been appropriately referred to as a marathon, not a sprint. Therefore, relatively speaking, little has changed in the past six months for community banks.

I would like to share my bank's experience with check imaging technology to illustrate the technological infrastructure required for banks to take advantage of the Check 21 processing model. Our ownership structure allows us to centralize many functions, including check processing, for the six banks. We started offering image statements in 1999. Today, only 8% percent of our collective checking account customers do not receive image statements. We are extremely pleased with our implementation of image statements and the

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[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.

With nearly 5,000 members, representing more than 17,000 locations nationwide and employing over 260,000 Americans, ICBA members hold more than $631 billion in insured deposits, $778 billion in assets and more than $493 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

overwhelmingly positive customer response. The benefits have been enormous. For the customer, we are able to expedite statement delivery along with improving the quality of the statements. Account reconciliation has been simplified, and we can respond to inquiries in minutes instead of hours. For the bank, imaging has led to significant cost reduction, particularly in postage expenses. Additionally, we have experienced improved production in the check processing areas, simplified statement preparation, and streamlined document storage. We have invested approximately a half million dollars in this technology so far.

We have made few changes to our processing environment in the six months since Check 21 became effective. Given the cost of substitute check production and the associated warranties, we do not want to create substitute checks. Instead, we are waiting to move to a full electronic clearing platform. However, in order to move to a check image exchange platform, we must have three critical components in place:

First, we need new software that will allow us to send and receive check images. Our software provider's current product does not meet our needs.

Second, intermediaries – correspondent banks, check processors, and the Federal Reserve – must have the capability to send and receive check images. Intermediary efforts range from the design to limited implementation stages.

Third, there must be widespread acceptance of common interbank image exchange rules. ICBA recognizes and supports the Electronic Check Clearing House Organization (ECCHO) rules for electronic check presentment and check image exchange; however, acceptance of these rules among community banks is in its infancy. ICBA is working closely with ECCHO on this issue.

A small number of banks have invested in the needed technology. The cost of implementation is high, and those banks that have purchased the technology are implementing it slowly in order to fully understand the impact it will have on both their operations and their customers. The industry must be given time to adopt the technology, rules and standards, procedures, and products to take advantage of the processing efficiencies envisioned under Check 21.

Check 21 Today

Check 21 allows collecting banks to truncate paper checks, process them electronically, and create paper substitute checks for those paying banks desiring to continue receiving paper.

It is important to note that the new law does not mandate that banks process or receive checks in electronic form, rather it provides the flexibility, on a bank-by-bank basis, to adapt to electronic check clearing over time without interfering with the existing paper check process. Nevertheless, many community banks have begun streamlining their check operations through the use of imaging technology to provide customers with monthly account statements containing images of canceled checks in lieu of bundles of original canceled checks.

Over time, reducing the dependency on the physical presentment of original items will result in expedited check collection, expedited funds availability and statement delivery, better quality statements and less fraud. These benefits go beyond simple consumer conveniences. The ability to access check images online allows consumers to quickly and conveniently verify their transactions, identify potential errors, and detect fraudulent transactions sooner. This, in turn, allows banks to minimize customer inconvenience, control potential losses, and gives law enforcement an advantage in tracking down perpetrators.

However, image based clearing is not yet the dominant form of check clearing, and analysts have predicted that it will be several years before digital images are used to clear most checks. Therefore, it is premature to conclude that checks are clearing faster since the enactment of Check 21.

ICBA Survey. Earlier this month, ICBA surveyed its members to learn more about community banks' implementation of Check 21 and its impact on customers. Almost 400 community banks throughout the country, and of all charter types and various asset sizes, responded to this survey. Eighty six percent of the banks responding are not currently using image technology to present checks for clearing and settlement. They are waiting for intermediaries such as the Federal Reserve or third-party processors to develop the software and complete the testing of end-to-end image clearing platforms, or have opted not to pursue imaging at this time as they do not want to incur the cost of substitute check production and warrant substitute checks.

Of the respondents that indicated that they are using image technology for check clearing and settlement, none are engaged in a full image-clearing environment. Some are using the application to exchange check images with a single financial institution. Others are using the application to exchange check images with financial institutions using the same software. Still others are relying on intermediaries to determine which large dollar checks are appropriate for conversion to images and subsequent substitute checks.

Substitute checks currently account for a minuscule percentage of the checks processed. More than two-thirds of the survey respondents estimate that they receive fewer than 50 substitute checks per month. Ninety-two percent of the respondents are not creating substitute checks. In my own case, our six banks receive fewer than 50 substitute checks per month, representing less than one fourth of one percent of our total monthly check volume.

Survey responses reveal few Check 21 implementation issues for community banks and most importantly, their depositors. Virtually all respondents (99%+) reported no losses to depositors or the bank due to receipt of a substitute check. Ninety-one percent indicated that they have not received any expedited recredit claims. Additionally, 90% reported no consumer complaints since Check 21 became effective. The examples provided by the respondents reporting consumer complaints showed that consumer questions were due largely to unfamiliarity with substitute checks, the media's distortion of the potential loss of float, or confusion regarding ACH check conversion. Our six banks have had a similar experience.

ICBA believes that the industry's migratory implementation of Check 21 is appropriate and is in the best interest of both financial institutions and their customers.

Check Holds Play An Important Role in Reducing Check Fraud

While the technological infrastructure of Check 21 will, over time, minimize the incidences of check fraud, the potential for risk will remain. As banks implement check imaging technology, we must remain aware of the potential for the perpetration of fraud against automated check clearing processes that will be detrimental to both the consumer and the bank. We strongly believe that is premature for any legislative or regulatory changes that would reduce check hold periods until a technological infrastructure is more developed and checks are indeed clearing faster.

Under your leadership, Check 21 was drafted to include very effective consumer protections in light of the creation of a new instrument, the substitute check. Similarly there are effective protections for financial institutions as well. For example, Regulation CC and the Expedited Funds Availability Act were designed to balance the depositor's need to have access to deposited funds with the need of financial institutions to protect against and prevent fraud and losses to depositors and financial institutions.

Members of the Committee have acknowledged the importance of check holds in the prevention of fraud against banks and depositor losses; however, this is too often overlooked. There are losses due to fraud that are prevented by check holds, such as kiting, washed checks, and counterfeit checks. However, many more fraud schemes result in significant losses to financial institutions because next-day availability is generally required for certain checks. For example, fraudulent U.S. Postal Service money orders, fraudulent U.S. Treasury checks, fraudulent cashier's checks, and fraudulent official bank checks have become a chronic problem for community banks.

I am reminded of a situation at a small community bank where a check-kiting scheme, carried out by a customer, almost caused the bank to fail in a matter of hours. The kite depleted almost all of the bank's capital, and the bank was close to being unable to honor the local public school payroll. So you can see, for community banks especially, the impact of check fraud can go well beyond the institution and have real consequences for the community. This further supports our position that it would be premature to alter existing check hold policies before the technological infrastructure is more developed and checks are indeed clearing faster.

Banks Already Make Funds Available to Customers Sooner Than Required By Law

Many of our member banks already make funds available to customers earlier than required by the Expedited Funds Availability Act and Regulation CC in the interest of good customer service **and** with the knowledge that the flexibility exists to apply longer holds if warranted. For example, 28% of the survey respondents provide same business day availability on items that qualify for next business day availability. Ninety-one percent provide same or next business day availability for items that qualify for two-business day availability. Additionally, 86% provide faster availability, more than half by the next day, for checks that qualify for five-business day availability. But, while banks offer this customer service, they still have legal and regulatory authority to place holds where needed.

The following are survey responses with examples of how the bank's existing check-hold policies have helped to prevent check fraud.

- On new accounts, we hold for 10 days. If we had not held these, we would have had new account fraud losses. We place case by case and exception holds. In many cases, we have avoided losses due to holds we have placed.

- The length of time allowed for both local and non-local checks helps to prevent the withdrawal of funds on items that will be returned to us. If these times were shortened, we would definitely experience additional losses.

- Holds are placed on checks that are deposited to accounts that are kiting suspect accounts. New accounts with non-local checks might have holds placed on them until the account is established.

- We are a small community bank and know virtually all of our customers. Implementation of our check hold policy is very uncommon. In the rare instances that we do place a hold, it is because we have some reason to believe that the item poses some risk to either the bank or the customer.

- Holds don't work when the Fed won't enforce timely returns and large item notifications. We properly held funds on a $60M check for ten days before releasing funds to the depositor. Then on the eleventh day received the item back in our returns. We received no large item return notice. Fed would not enforce the rules, so we had to charge off the item.

- Our hold policies on Cashier's Checks have been strengthened to prevent check fraud. We push the limits of Reg CC to protect us and the customer from fraudulent items. Regulation CC as written for Cashier's Checks needs to be changed to treat Cashier's Checks no differently than other items. With the rash of FDIC Financial Institution Letters on this matter, it should be obvious to the regulatory bodies that the regulation has caused the counterfeiters to focus on using Cashier's Checks to take advantage of the shorter hold periods on these items.

- We accepted a $48,000 check that turned out to be counterfeit. Had we not placed a hold, we would have been out that amount.

- We have made a habit of placing holds on most large items if they are not the normal habits of our customers. This has saved us thousands of dollars in losses.

- Following Reg CC guidelines during the initial stages of the account have helped us avoid split deposit fraud that is common. Once the accounts are open fro 90 days, most of the bad ones have been washed out, as we are diligent in our efforts to screen out the risky accounts. Annually, we have very little check fraud loss. Current Reg CC rules are needed, especially in the first three months of the account. Until every single bank in the country is exchanging images, reducing Reg CC hold times will be impractical, and will increases losses for all banks.

- Especially with large items, our hold policies allow us the cushion needed to ensure the deposit will be covered. As so many checks are being reproduced by unlawful individuals and/or stolen and passed as valid signatures, we are open to losses daily.

Bank Check Processing Practices Are Fair

We recognize that some Committee members have concerns that banks' processing practices are designed to increase the likelihood of overdraft fees. Ninety percent of our members responding to the survey post deposits and other credits before checks and other debits; 93% do not post deposits and other credits to consumer checking accounts on

Saturdays, and 95% do not post checks and other debits to consumer checking accounts on Saturdays. Therefore, contrary to the claims of consumer groups and others, check-processing practices are not designed to yield an illegitimate revenue stream for banks.

Moreover, the Federal Reserve, FDIC, OCC and NCUA recently issued final guidelines on courtesy overdraft protection programs, often called “bounce protection.” The guidelines, similar to those issued separately by the OTS, outline steps banks should take to address safety and soundness concerns, legal risks, and best practices to consider when offering the service.

The best practices include recommendations for marketing the programs and customer disclosures. For example, banks should avoid promoting poor account management by advertising the service in a way that appears to encourage customers to overdraw their accounts. Staff should be properly trained to explain the operation of the program, and disclosures should clearly explain that a bank’s decision to honor an overdraft is discretionary. Since courtesy overdrafts incur fees, banks should clearly distinguish the service from “free” account features. Moreover, fees should be clearly disclosed and the bank should explain how checks are cleared and the types of transactions that are covered.

ICBA initially raised concerns with the draft guidelines about many burdensome provisions that would cause banks to discontinue offering this popular customer service. The final guidelines are more flexible and are designed to help ensure banks make responsible disclosures and properly administer the programs. The guidelines generally apply to automated programs, but the agencies suggest that banks consider the guidelines whenever honoring a customer’s overdraft. Additionally, the guidelines remind banks that courtesy overdraft protection is subject to a variety of legal requirements, including the FTC Act’s ban on deceptive acts and practices.

Under the guidelines, banks should offer customers the opportunity to opt out of the protection, and the amount of overdraft protection availability should be clearly distinguished from account balances so that customers can avoid overdraft fees, and customers should be promptly notified whenever the services are used.

It is important to remember that this is a service most consumers welcome. Unfortunately, many consumers fail to regularly balance or reconcile their accounts. Bounce protection is often a guard against embarrassment and additional fees. When properly used and administered, bounce protection is a consumer service. Burdensome restrictions would cause banks to discontinue this service -- to the detriment of consumers.

In light of the numerous customer protection measures included in the regulatory guidance to the industry for this customer service, ICBA believes additional legislative measures in this area are not warranted.

Additional Legislative or Regulatory Efforts Would Be Premature

ICBA is also concerned that with only six months since Check 21 became law, preemptive legislative or regulatory efforts to reduce check hold periods without the proven history of faster check clearing and settlement will leave financial institutions and their customers exposed to serious losses and sophisticated fraud schemes. As new technology is implemented we must be aware of the potential risk of fraud to midsize and community banks as fraudsters may avoid those larger banks with greater resources to invest in more rigorous fraud detection systems.

Current federal law already requires the Federal Reserve Board to reduce check hold periods whenever check-processing times improve. Moreover, Check 21 requires the Federal Reserve Board to study the impact of the law, the funds availability practices of financial institutions, and the appropriateness of existing funds availability requirements, and to make recommendations for legislative action, if necessary, by April 28, 2007. We understand that the Federal Reserve Board plans to conduct a survey of financial institutions to collect information for its study.

We urge Congress to give the Federal Reserve a chance to do its job. Broad reduction in check clearing times will only occur when the majority of financial institutions determine there is a business case for making significant capital investments and major operational changes to support full electronic check clearing. Bank-to-bank electronic check clearing is only as effective and efficient as the number of banks that participate.

Conclusion

ICBA strongly supports Check 21 facilitating check truncation and fostering innovation in the payments system without mandating electronic processing of checks. Removing the legal impediments to the expanded use of electronics for check clearing and settlement will improve the efficiency of our nation's payment system to the benefit of both banks and consumers.

Check 21 implementation is in its infancy and little has changed in the past six months since Check 21 became effective. For many community banks, there is not a business case for creating substitute checks. Instead, they are waiting for the software, intermediaries, and widespread acceptance needed to support a full electronic clearing platform.

To date, Check 21 and the new payment instrument it created – the substitute check – have created few implementation issues for community banks and most importantly, their depositors.

The current body of law, including Check 21, and the regulations that have developed around the existing check clearing processes are both effective at protecting consumers and minimizing the banking industry's exposure to fraud. Additional legislative or regulatory efforts to reduce check hold periods in the absence of a proven history of faster check collection would be premature and unnecessarily expose banks and their customers to increased losses. The banking industry and consumer experience with existing law, and processes demonstrate that existing law and regulations work.