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Statement of

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Mr. Chairman, Ranking Minority Member, and Members of the Subcommittee, I appreciate the opportunity to discuss with you the initial implementation of the Check Clearing for the 21st Century Act (Check 21) and, more broadly, implications of the greater use of electronics in the nation's payments system. The backdrop for this discussion is the declining use of checks in the United States. I will focus my remarks on the implementation of Check 21 and how it relates to the maximum permissible hold periods banks may place on check deposits before making those funds available for withdrawal. Then I will discuss electronic check conversion and related consumer protection and education efforts that the Federal Reserve has undertaken. Finally, I will look at the responses of the Federal Reserve Banks and the industry to declining check volumes.

The U.S. Payments System is Becoming Increasingly Electronic

The United States is in the midst of a significant shift away from the use of paper checks and toward the much greater use of electronic payments. This change is clearly evident in the Federal Reserve's recent payments research, which shows that in 2003, for the first time ever, businesses and consumers made more payments electronically than by check. By contrast, only twenty-five years ago the vast majority of consumer and business noncash payments were made by check.

We estimate that the number of checks used in the United States peaked during the mid-1990s at around 50 billion per year. By 2003, the number of checks had fallen by one-quarter, to around 37 billion. This decline is continuing. In contrast, electronic payments, such as payments made by credit and debit cards or through the automated clearinghouse (ACH), have tripled, from 15 billion in the mid-1990s to 45 billion in 2003 (see attached chart).

As technology improves and scale economies are realized, the cost of electronic payment processing decreases relative to the cost of paper processing. For example, the Federal Reserve Banks realized significant operational-cost savings as a result of centralizing their electronic payment services. Today, the Reserve Banks' cost to process an ACH transaction is less than one-fifth that of processing a check.

Because the number of noncash payment transactions in the U.S. economy exceeds 80 billion per year and is growing, even small savings in processing costs per payment may have large effects on overall payments system efficiency. Over the past decade, the reductions in the processing costs for ACH have allowed the Reserve Banks to cut approximately in half the fees they charge depository institutions for providing ACH services. Over the same period, the Reserve Banks have increased the price of their more labor-intensive paper check service approximately 50 percent. So we can expect that this shift to the use of electronic technology for making payments and away from the physical handling, processing, and transportation of paper checks will translate, over time, into a reduction in the overall costs of making payments.

Check 21 will Eventually Change the Way Checks are Collected

The declining use of checks is only a part of the ongoing change within the payments system. How checks are collected also will evolve as a result of Check 21. This is very important legislation, which will ultimately foster fundamental changes to the check collection system that will improve the efficiency of the nation's payments system.

You will recall that one of the purposes of the law was to reduce legal barriers to the use of electronic imaging and networking technologies to collect checks and to return those that are not paid. Specifically, state laws governing check collection allow banks to demand that the original checks be physically presented for payment. Although state laws typically allow banks to agree to alternative presentment arrangements, the large number of banks in the United States has made the widespread adoption of electronic check collection through industry agreements extremely difficult.

While Check 21 does not mandate that checks be presented electronically or change a bank's right to demand paper, it does facilitate the adoption of check truncation and electronic collection of checks through the action of market forces.[1] When the paying bank does not agree to receive checks electronically and demands that presentment be made by paper checks, Check 21 allows the other banks to create and present paper substitute checks that are legally equivalent to the original checks. As banks increasingly send and receive checks electronically, this new authority will reduce the handling of paper checks and enable banks to reduce their paper-check infrastructure more easily. It also will reduce the number of checks that must be flown or driven around the country to be collected or returned, which reduces transportation and other operating expenses. Of course, each bank will determine for itself which makes good business sense: adopting new technologies for sending and receiving checks electronically or continuing to demand paper.

In addition, we will be monitoring the banking industry's experience with the Board's regulations implementing Check 21. We believe it is important to ensure that these fairly detailed regulations are producing the desired improvements in our national check-collection system. As we gain greater experience with substitute checks and other elements of the law, we will revisit these rules over the next few years and determine whether any refinements are necessary.

[1] Check truncation is the removal of an original check from the forward-collection or return process by the bank of first deposit or an intermediary, such as a Federal Reserve Bank. In lieu of the original check, a substitute check or, by agreement, information relating to the original check, such as an electronic image of the original check, is then sent on for collection or return.

Adoption of Check 21 is an Evolutionary, not a Revolutionary, Process

Like any significant operational and technological change, the adoption of electronics within the check-collection system will be gradual. This is an evolutionary, not a revolutionary, process. The check-collection system did not change materially last October 28, when Check 21 took effect. To date, relatively few banks have taken advantage of the opportunities provided by Check 21. The rate of adoption of Check 21 is not at all surprising; we did not anticipate that there would be an immediate, large shift in the way checks are collected. Still, there have been some important first steps that help enable banks to leverage the new Check 21 authority, such as agreement on technical standards for creating substitute checks. It is important to recognize, however, that while a critical impetus for change, banks will no longer need substitute checks for processing once they both collect and receive checks electronically.

For the banking industry to realize the vision for the nation's check-collection system laid out in Check 21, additional steps must be taken. For example, software vendors and third-party check processors need to adapt their systems to support the creation of substitute checks and the exchange of digital check images. As these systems become more prevalent, additional banks will invest in them. Once banks make these investments, however, they will have to adjust their operations to make the best use of the new technologies. They also will need to verify that their updated systems are compatible with those of other banks and will permit them to exchange checks electronically.

As banks improve their technological capabilities, they can reduce their reliance on air and ground transportation, especially shared transportation arrangements. The banks that remain tied to paper checks will continue to bear the costs of those arrangements. As a result, I believe pressures to reduce check transportation costs will be an important determinant of the pace at which banks make the transition to electronic check collection.

The Federal Reserve Banks have long been at the forefront of encouraging the electronic collection of checks. As a result, even before Check 21 became law, one out of every five checks collected through the Federal Reserve Banks was being presented electronically. The Reserve Banks also have been leaders within the payments industry in making use of the authority granted by Check 21. They began offering Check 21 services as soon as the law became effective. These services allow for the acceptance of digital check images for deposit and the truncation of some large-dollar paper-check deposits, which are then transmitted to the Reserve Bank closest to the paying bank, thereby eliminating the need to transport physically paper checks between the Reserve Banks. The receiving Reserve Bank then prints substitute checks from the check images to present them to the paying bank, or provides electronic check information to paying banks that already accept the presentment of checks electronically.

Although all types of depository institutions are among the initial Reserve Bank customers for these services, the volumes are still relatively small. The operational and technical preparations and testing requirements necessary to use these new payments services naturally limit the pace at which banks can take advantage of them. Out of the approximately 50 million checks that the Reserve Banks collect each business day, only 400,000, or less than 1 percent, involve the deposit of digital check images with the Reserve Banks or the printing of substitute checks to present to the paying bank.

Looking across the entire banking industry, some banks, both large and small, have begun to take advantage of the opportunities created by Check 21. For the most part, they have done so within the context of cooperative agreements, through third-party processors, or, as I just mentioned, by sending check images to the Federal Reserve Banks. The banking industry's efforts are generally less extensive, at this time, than those of the Federal Reserve Banks.

So six months after Check 21 went into effect, it is clear that much remains to be done before electronic check collection becomes widespread. I do believe, however, that we are laying the groundwork for widespread changes in the check-collection system. While the pace of change is not clear, I believe that a decade from now our check-collection system will look much different. Though we may still be writing checks, I would expect that their number will be substantially lower and that most will be collected electronically.

The Federal Reserve is Monitoring the Need to Reduce Hold Periods

In light of the potential for improvements that could speed check collection and return times, the Federal Reserve has been monitoring whether changes to the funds availability policies set out in Regulation CC may be warranted.

As you know, Congress established the current funds availability rules for check deposits in 1987 through the Expedited Funds Availability Act, or EFAA, which the Federal Reserve Board implements through Regulation CC. EFAA sets the maximum permissible hold periods on funds deposited by check at levels that are intended to balance the desirability of providing consumers with timely access to their funds with banks' need to manage the risk of check fraud.

Congress also recognized that when it comes to checks they accept for deposit, banks operate under the dictum of "no news is good news." A bank of first deposit does not receive any affirmative notice that another bank has paid a check. It only learns that a check will be returned unpaid when it receives the returned check or a notice that the check is being returned. Thus, under EFAA, the time needed to not only present a check to the paying bank but also return the unpaid check to the bank of first deposit is the statutory standard for determining whether reductions in the maximum permissible hold periods are warranted.

Under the current funds availability schedule, next-business-day availability is required for checks considered low risk, such as Treasury checks, postal money orders, and cashier's checks. For local checks (that is, checks for which the paying bank and the bank of first deposit are located in the same Federal Reserve check-processing region), funds must be available for withdrawal no later than the second business day following deposit. For nonlocal checks (checks for which the paying bank and the bank of first deposit are located in different Federal Reserve check-processing regions), funds must be available for withdrawal no later than the fifth business day following deposit. Congress also provided safeguard exceptions to these maximum hold periods for certain types of accounts or deposits, such as new accounts or large-dollar check deposits, which may carry a greater risk of check fraud.

The Federal Reserve's Responsibilities under EFAA

Congress expected that as the check-collection system became more efficient, the amount of time it would take to return an unpaid check to the bank of first deposit would decrease. With that in mind, Congress specifically required the Federal Reserve Board to reduce, by regulation, the maximum hold periods to levels that are "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" (12 USC 4002(d)(1)). The EFAA's legislative history indicates that the term "most items" should be interpreted as at least two-thirds of unpaid checks in a given category, such as nonlocal checks.[2]

[2] Conference Report on H.R. 27 (H. Rept. 100-261), 100th Congress, 1st session, 179 (1987), pp. H6906-7.

The Federal Reserve Board takes its responsibilities under EFAA very seriously. We monitor developments in the check-collection system on an ongoing basis to determine if the maximum permissible hold periods should be shortened.[3] If we find sufficient improvement in check-collection and return times, we will reduce the Regulation CC availability schedule accordingly.

Although developments have yet to show that changes to the Regulation CC availability schedules are warranted, that does not mean that banks routinely impose the maximum allowable hold periods before making funds available to their customers. Many banks regularly provide faster availability of funds to their customers. Some consumers also have been gaining faster access to funds from some of their deposited checks as a result of the Federal Reserve Banks' initiative to reduce their check-processing infrastructure in the face of declining check volumes. When Reserve Bank check-processing regions are combined--for example, the Pittsburgh and Cleveland check-processing regions--checks that were considered nonlocal in Cleveland because they were drawn on banks located in the Pittsburgh region became local and subject to the two-day rather than five-day maximum hold period. This means that consumers in Cleveland are receiving faster funds availability on deposited checks drawn on Pittsburgh banks.

With the passage of Check 21, the Federal Reserve also is paying particularly close attention to how rapidly the banking industry embraces the use of electronics in collecting and returning checks. We monitor these developments in a number of ways. Because the Reserve Banks collect more than half of all checks that are drawn on a different bank than the one into which they are deposited (interbank checks), we closely monitor how quickly depository

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[3] In the mid-1990s, we surveyed depository institutions to estimate the level of check fraud prevalent at that time and to quantify the average time it would take a bank of first deposit to receive or be provided notice of a returned check (see http//www.federalreserve.gov/boarddocs/rptcongress/chkfraud.pdf). We found that a reduction in the maximum permissible check-hold periods was not warranted at that time.

institutions are adopting the Reserve Banks' Check 21 services. We also monitor broader industry trends in the use of electronics to collect checks. As I noted earlier, change to date has been limited.

Although we have yet to see material improvements in the speed with which banks learn that checks they had accepted for deposit have been returned unpaid as a direct result of Check 21, next year we will be studying the effects of Check 21's adoption on the banking industry. In particular, we will study how this law is affecting the check-collection system and the appropriateness of the current maximum permissible hold periods. We will report our findings to Congress no later than April 2007. If we discern significant improvements in the times needed to collect and return checks, we will accelerate the study.

Given how little time will have elapsed since Check 21 came into force, this upcoming study may indicate that there has not been sufficient improvement to check-collection and return times to trigger reductions in the maximum permissible hold periods. But, as required by EFAA, the Board will continue to monitor check-return times and reduce the funds availability schedules in Regulation CC as changes in banking industry practices warrant.

Check Conversion is not Check 21, but is a Means to Collect Funds Electronically

Another important catalyst for change in the payments system is electronic check conversion--a rapidly growing means of collecting funds electronically from consumers' bank accounts using information that appears on their checks. Electronic check conversion does not involve the collection of checks or the use of the authority granted by Check 21. In 2004, approximately 1.5 billion checks were replaced by electronic check conversion. We expect these types of payments will continue to increase.

Because electronic check conversion is sometimes mistakenly associated with Check 21, I think it may be helpful to explain what electronic check conversion is and how it works. Electronic check conversion involves using the routing, account, and serial numbers printed in magnetic ink on the bottom of a consumer's check as the source of information to create an electronic payment that is made using the ACH or a debit card network. Sometimes the conversion occurs at the cash register. More commonly, it occurs at so-called lock-box processing centers to which consumers mail checks to pay, for example, their credit card, mortgage, or utility bills.

Check conversion and Check 21 are complementary and provide businesses and banks with choices regarding how to collect their customers' payments most efficiently. Check conversion allows merchants and so-called lock-box processing centers to collect funds electronically without ever using the check-collection system. The National Automated Clearing House Association's (NACHA) rules limit the use of check conversion, however, to checks written by consumers; checks drawn on business accounts are not now eligible to be converted, in part because many businesses arrange with their banks to block any ACH debits to their account. By contrast, Check 21 allows banks to collect any check electronically once it has entered the check-collection system.

Whether the checks are converted in stores at the time of purchase or remotely at processing centers, the notice that is provided should enable consumers to understand that proceeding with payment authorizes the merchant or biller to electronically debit their accounts. For in-store transactions, consumers receive notice that a check will be converted to an electronic payment and authorize that conversion by signing an authorization slip and proceeding with the transaction. In the case of payments that are mailed, consumers receive notice with their bill that a check will be converted to an electronic payment and authorize the conversion by sending a check to the biller. NACHA rules permit consumers to opt out of electronic check conversion by their billers, that is, choose not to have their billers convert their checks to electronic payments.

The Federal Reserve is Protecting Consumers and Educating the Public about Check Conversion and Check 21

The conversion of checks to electronic fund transfers initially raised questions about whether those transactions were covered by check law or electronic fund transfer law for the purposes of consumer rights and protections. In 2001, the Federal Reserve Board clarified that the Electronic Fund Transfer Act, as implemented by Regulation E, protects consumers for electronic payments made via check conversion (66 FR 15187, March 16, 2001).

I would note, however, that the substantive rights of consumers are very similar whether they are derived from check or electronic fund transfer law. For example, as a general matter, in either case consumers have recourse for unauthorized transactions. The particular procedures for asserting a consumer's rights vary slightly depending on how the payment was made.

The Board is now considering how to address concerns that have been raised about the notices consumers receive when their checks are converted to electronic payments. We have found that the quality of these notices varies widely and that consumers may be confused about what they are authorizing. The Board has requested comment on revisions to the Regulation E commentary to include specific language to be used in these consumer notices. The Board expects to take action on this proposal later this year. We are also considering whether to require by regulation, along the lines of current NACHA rules, a written, signed authorization by the consumer when a check is converted at a merchant location.

The Federal Reserve also is actively working with consumer groups (particularly through the Board's Consumer Advisory Council), the banking industry, and the media to help inform the public about check conversion and Check 21. We are educating consumers about their rights in the event of an unauthorized transaction involving check conversion or a substitute check. Among our initiatives in this area was the publication of several brochures that help explain what check conversion, Check 21, and substitute checks are all about. These brochures are available on our web site (http://www.federalreserve.gov/consumers). We also have made available on our web site (http://www.federalreserve.gov/check21) answers to frequently asked questions and other important information about Check 21.

Transition to a More-Electronic Payments System Affects the Federal Reserve Banks and the Banking Industry

Since 1999, the number of checks collected through the Reserve Banks has fallen nearly 20 percent, to less than 14 billion in 2004. We expect Reserve Bank check volumes to continue to fall as the total number of checks being written declines and as check conversion further reduces the number of checks collected.

The Monetary Control Act of 1980 requires the Federal Reserve to set fees for providing certain payment services to depository institutions that, over the long run, recover all the direct and indirect costs of providing the services, as well as the imputed costs such as the income taxes that would have been paid and the profit that would have been earned had the services been provided by a private firm. As a result of the accelerating decline in the number of checks they collect, the Reserve Banks have not achieved their targeted level of profitability since 2001; but they have recovered, in aggregate, all their direct, indirect, and imputed costs of providing payment services.[4]

In response, the Reserve Banks have undertaken major initiatives to reduce check costs by standardizing their check systems and operations and by reducing the resources devoted to this service. The Reserve Banks have announced a reduction in the number of offices at which checks are processed, from the forty-five that existed at the beginning of 2003 to twenty-three by early 2006. I emphasize, however, that the reduction in the number of check-processing sites has not changed the Reserve Banks' commitment to making their check collection and other payment services available to depository institutions nationwide.

As a result of the restructuring and other cost-reduction initiatives, the Reserve Banks expect that in 2005 they will recover fully all of their costs of providing check collection and other payments services, including the targeted return on equity or profit. As check volumes continue to decline, however, the Reserve Banks will need to take additional steps to reduce costs, including further restructuring of their processing operations.

The challenges of a changing payments system are not unique to the Federal Reserve Banks. The entire banking industry faces similar cost and revenue pressures as check volumes decline. This is a particularly challenging environment for large banks that have made significant investments in physical check infrastructure. Over the coming years, many banks will need to decide how much longer to continue their paper-check-processing operations. At the same time, they must decide what investments to make in the technologies underlying Check 21 and check conversion and in technologies for making fully electronic payments.

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[4] Because the check service represents more than 80 percent of all priced services costs, its performance is the primary determinant of the Reserve Banks' overall profitability for payment services. The Reserve Banks have recovered fully the total costs, including imputed costs, and profits of each payment service other than check during this four-year period.

Conclusion

In summary, the payments system in the United States is continuing to change and become increasingly efficient. However, the shift away from the use of paper checks does create challenges for the banking industry and the Federal Reserve Banks. To address these challenges, over the coming years the industry will be making important decisions about how best to incorporate the greater use of electronics into their payments operations while reducing their paper check-processing infrastructures.

Although the implementation of Check 21 is expected to lead to a much more electronic and efficient check-collection system over the longer term, change will be evolutionary, not revolutionary. Banks will embrace the use of digital check images to present and return checks as the business case to make the necessary investments and improvements to their operations and systems becomes more compelling. This market-based approach to change was a fundamental principle underlying Check 21.

Ongoing improvements in the check-collection system have not yet been extensive enough to warrant a reduction in the maximum permissible check-hold periods, but we will continue to monitor developments closely. Many banks, however, routinely provide customers with faster availability than required by Regulation CC; moreover, as the Reserve Banks adjust their check-processing regions, the maximum hold periods for some checks are effectively being reduced. But again, I want to emphasize the Board’s commitment to reducing check-hold periods as developments warrant.

I would be pleased to answer any questions that you may have.

Annual Number of Noncash Payments in the United States