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Testimony of Gail Hillebrand, Senior Attorney,
West Coast Regional Office, Consumers
Union of U.S. before the House Financial
Services Committee, September 25, 2002
Hearing on the Check Clearing for the 21st
Century Act

Other organizations joining in this testimony:

Consumer Federation of America

U.S. PIRG

National Consumer Law Center



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This testimony is presented by Gail Hillebrand, a Senior Attorney at the West Coast Regional Office of Consumers Union. Consumers Union is the nonprofit publisher of *Consumer Reports*. Consumers Union's mission is to Test, Inform, and Protect, and it offers this testimony as part of the consumer protection function. Joining in this testimony is the Consumer Federation of America, the U.S. Public Interest Research Group, and the National Consumer Law Center.¹

These national consumer organizations oppose both the Federal Reserve's proposed Check Truncation Act (CTA) and the September 19, 2002 Check Clearing for the 21st Century Act. The Check Clearing Act appears to be based on the CTA, but the Check Clearing Act is significantly worse for consumers than the Federal Reserve's CTA, because it offers a far weaker right of recredit when there is a dispute about payment of a check. The discussion in this testimony applies to both versions of the Act, except where noted.

These national consumer organizations oppose both versions of this Act for these reasons:

- The Act would make it impossible for the estimated 45.8 million U.S. households who now get their paper checks back to get all their paper checks back every month.
- The Act does not effectively protect consumers from new errors that could be caused by electronic imaging of checks.
- The one new consumer right offered by the Act does not apply to all consumers whose checks will be affected. In addition, that new right could be easily eliminated by a bank through a simple change in the account agreement.
- Particularly in the Check Clearing Act form, the Act gives consumers who write checks which are turned into electronic images weaker rights than consumers who initiate electronic funds transfers.
- Th Act gives no right to get back the original paper check if it is needed for a reason other than an error in payment.

¹ Each of the groups submitting this testimony is described at the end of this testimony.

- Information on the electronic image of a check could be used to invade consumer privacy.
- The Act does not protect against high fees when the consumer needs to request the original check or a so-called “substitute check.”
- The Act does not require banks to credit the depositor’s account more quickly if electronic imaging of checks speeds up check clearing.

Congress Should Not Destroy Consumers’ Ability to Get Our Checks Back

If Congress adopts the Act, it will destroy the ability of millions of U.S. consumers to get back and keep their original paper checks. At an August 2002 meeting, bank representatives stated that approximately 60% of consumers east of the Mississippi River, and 30% of consumers in the West, receive their original checks back. Since approximately 90% 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. Indeed, some consumers want their checks back so much that they are willing to pay a fee, often \$1 per month, to receive them.

The Act will make it impossible for consumers to regularly receive back original paper checks, because the consumer’s bank will no longer receive the original paper check in the ordinary course of business. Instead, the consumer’s bank will receive either an electronic image of the paper check, or a paper “substitute check.” The substitute check is a paper item made from an electronic image of the check. The consumer’s original check may be at some other bank in the check collection process, and that bank is free to destroy it.

The Act would also change the system for consumers who don’t get their checks back now. Today, consumers who agree not to get their checks back can still request the original check from their own bank, which can provide it if it hasn’t yet been destroyed. Under the Act, the original check would never be sent back to the check writer’s bank. So, a consumer who asks his or her bank for an original check back would have to wait longer while the consumer’s bank tries to determine which bank in the check collection chain has the original check.

Banks are allowed to destroy original checks not returned to consumers now, but a consumer can shop for an account with returned checks, or for an account where the bank promises to keep the original checks for a designated time. This would be impossible under the Act. Because the consumer’s bank won’t have the original checks, it won’t be able to promise to keep those checks for a customer.

What the Check Clearing Act and its Predecessor, the Federal Reserve Board's Check Truncation Act, Would Do and How They Would Increase Practical Problems for Consumers

Approximately ninety percent of consumers have checking accounts. Over 35 billion checks a year are written on U.S. banks. Both the Check Clearing Act and the Check Truncation Act would fundamentally change the way checks are processed, making it impossible for consumers and businesses alike to get their original checks returned with checking account statements each month.

Each Act would encourage check truncation, the practice of stopping or "truncating," the movement of the check somewhere in the check collection process. The original check would no longer be sent back to the consumer or to the consumer's bank. Consumers, businesses, and banks who desire original checks would instead be given a paper copy of an electronic image of the original check. This paper copy of the electronic image is called a "substitute check."

The substitute check would show all of the information on the front and back of the original check, but it would not show things that can't be copied, such as the pressure applied to the pen by a forger. The substitute check would be legally equivalent to the original check if it contains the required information. The Act places no limit on what banks could charge for a substitute check. The Act also doesn't require that the original check be returned to the consumer on request. Instead, because the Act makes a "substitute check" legally equivalent to the original check, a consumer who asks for the original check might be told by his or her bank, "all we will give you is this paper substitute check." It will be up to the consumer to persuade a landlord or another person to accept the substitute check as proof of payment. The practical inconvenience will fall on the consumer, since many persons to whom consumers have to prove payment won't know that under the new law the substitute check is supposed to prove payment to the same extent as the original check.

The Federal Reserve Board suggests that consumers will be no worse off, because consumers who get their checks back now will get substitute checks instead, and the Fed's proposal would give these consumers a one day right of recredit if they claim a check was improperly paid. However, the Check Clearing Act provides for a recredit after ten business days, not one business day. In addition, under both versions of the Act, consumers with voluntary check truncation won't get the recredit right. Banks can insist on a truncation agreement that takes away the right to receive any paper with the account statement, even paper "substitute checks." Consumers whose accounts are governed by a truncation agreement and receive back no paper also will not receive the right of recredit.

Consumers with account agreements calling for non-return of checks or for return only of printed or online check images but not substitute checks would not receive the one day right of recredit. Instead, those consumers could wait weeks or months to get their funds returned, since neither the Act nor state law places a time limit on how long a bank can take to resolve a dispute about a check which is not a substitute check.

If the consumer alleges that a check was improperly paid, such as paid twice or paid for the wrong amount, then the consumer who got back a substitute check is entitled, under both the Check Clearing Act and the Fed's CTA draft, to a recredit of funds, but the recredit right is weak under both versions, and there are additional flaws in the Check Clearing Act version.

If a consumer needs the check for a reason other than a claim that it was improperly charged to the consumer's account, such as to show it to a landlord or other person who refuses to accept the substitute check as proof of payment, the Act does not give that consumer any right to ever receive the original check. If a bank does track down the original check on request as a customer service, the Act places no limit on what the bank can charge for finding and returning the check. Even if a particular bank decides, as a matter of customer service, not to charge for returning a single original consumer check on request, a bank further up the collection chain which is holding that check might decide to impose a fee for returning it.

The Act also places no limit on what a bank can charge for regular return of so-called "substitute checks," paper copies made from the electronic check images.

Why Change a Working System?

We estimate that 45.8 million U.S. households now get their paper checks back. The Act would force all of those households to change the way that they manage their finances. The current check system works for consumers, with some exceptions. Not everyone can get a checking account, in part because prior difficulties in managing an account can prevent a consumer from getting an account for up to seven years. The types of fees associated with checking accounts have expanded, and some types of fees have risen rapidly.² The Act does not fix any of these ongoing consumer problems with checking accounts.

² For example, the monthly fee for a low balance, single-fee bank checking account went from \$6.34 in 1996 to \$7.12 in 2001 (a 12.3% increase), Depository institutions', including banks', fees for overdrafts rose over the same time period from \$16.28 to \$20.42 (a 25.4% increase), for NSF items from \$16.36 to \$20.73 (a 26.7% increase), and for stop payment orders from \$13.68 to \$18.08 (a 32.2% increase). Board of Governors of the Federal Reserve Board, *Annual Report to the Congress on Retail Fees and Services*, June 2002; B). Board of Governors of the Federal Reserve Board, *Annual Report to the Congress on Retail Fees and Services*, June 1998.

Why Give Consumers Who Write Checks that Are Changed Into Electronic Images Weaker Rights than Consumers Have Under Regulation E for Other Electronic Payments?

Today, consumers with a checking account and a debit card can choose between writing a paper check and paying electronically. The Act allows banks to treat a check more like an electronic funds transfer, but it doesn't give all consumers who write checks protections of the type that apply to an electronic funds transfer. There are two key differences. First, all consumers who initiate electronic funds transfers get a right to recredit of funds after a set time period, while the Check Clearing Act and the Fed's CTA proposal give a recredit right only to consumers who receive substitute checks, not to consumers whose checks are voluntarily truncated. Second, the Federal Reserve Board's CTA adopted a shorter, one business day, recredit time period than Regulation E, and offset this shorter time period with a \$2,500 dollar cap on the amount of the recredit. However, the Check Clearing Act chooses a longer, ten business day, time period but keeps the dollar cap, thus making the consumer remedy weaker for electronically imaged checks than for electronic funds transfers.

There is No Guarantee that Consumers Will Benefit from Check Imaging

Check imaging technology is expensive. Some large banks have recently announced major investments in this technology, but smaller banks may not have this technology. We have not seen any numbers suggesting that there will be a net cost savings in the banking system under the Act. More importantly, nothing in the Act guarantees that if there is a net cost savings, it will be passed on to consumers in lower fees or mandatory faster funds availability. Instead, the Act's push toward check imaging seems to be a way to reward large banks that have already made an independent business decision favoring check imaging.

Some bankers assert that check imaging enhances customer service. If consumers want check imaging, they are free to choose it without the Act. The Act does not enhance consumer choice. Instead, the Act *takes away* the consumer's choice to receive regular return of original paper checks.

The Act Will Make it Easier to Create Large Databases with Information from Check Images, but it Does Not Restrict What a Bank Can Do with Data from Its Customers' Checks

When databases exist, they will be mined for secondary use of the data unless that use is prohibited by law. Checks reveal a host of very personal information about individual shopping patterns. If the Act encourages check imaging, it could

lead to more information from checks being stored, sorted, and used for other purposes by banks. While checks have always contained personal information, the fact that the information was on paper rather than in electronic form has provided some practical protection from bank snooping in a consumer's check spending patterns. When more banks use electronic check images, a bank could amass a large database of information about its check writing customers. A database of check images could even allow a bank to determine which of its customers write checks to a religious institution, who gives to particular groups that reflect particular lifestyles or interests, or who makes political contributions to a particular party.

The CTA's New Consumer Protection Provision Has a One Significant Loophole, and the Check Clearing Act Has Additional Loopholes

The Act would take a system that works relatively well for consumers and change it in a way that saves money for banks and imposes new risks and new inconveniences on consumers. Act promotes the conversion of paper checks into electronic images. The Federal Reserve's proposal seems to acknowledge that when checks are converted into electronic form, existing check law is inadequate. This is not surprising, since existing check law assumes the existence and close availability of a paper original. The Federal Reserve Board's proposal quite properly provides for a new consumer one business day right of recredit when there is a dispute about the payment of a check and other conditions are met. The Check Clearing Act is far worse for consumers, because it allows the bank to wait ten business days before recrediting the funds.

Both forms of the Act contain a large loophole in the recredit obligation. That loophole is that the consumer does not receive the protection of the one-day recredit right unless the consumer has received a substitute paper check. A consumer who received an image of the check, or no copy at all of the check, gets no recredit right.

The right of recredit is the key feature in this Act. A properly drafted recredit right could address part of the concern that converting check information between paper and electronic images offers new opportunities for error. However, a recredit right strictly limited to substitute checks that were provided to the consumer makes this Act a bad bargain for consumers. The recredit right is of extremely limited value when a bank can eliminate the recredit right simply by requiring that the consumer waive the right to receive back original or substitute checks.

Recredit should provide a simple, easy, low-cost consumer remedy for improperly charged checks. It makes no sense to give this remedy only to those consumers who receive substitute checks because they have declined to accept "voluntary" check truncation. Indeed, excluding voluntarily truncated checks from

a recredit right would have perverse results. Consumer organizations would have to advise consumers that they will be better off if they refuse to agree to truncated checks, even though the effect of the refusal would be that the Act would force substitute checks on consumers who asked for original checks. Restricting recredit solely to substitute checks would increase the incentives financial institutions already have to try to induce or impose “agreements” for check truncation. We cannot support a statute that creates an incentive for financial institutions to induce waiver of the key right provided by that statute. The only way to avoid this is to make the right of recredit broad enough to apply to every check where the original is not returned to the consumer and there is an allegation of improper payment.

The recredit provision of the Check Clearing Act has this weakness and additional weaknesses. These include a delay of ten business days to give the recredit, and a shorter time to seek recredit. The time for the consumer to request a recredit of disputed funds is 30 days, with exceptions, under the Check Clearing Act. The Federal Reserve Board had recommended 60 days, with exceptions.

The Act Has Other Flaws

Many other provisions of the Act are of concern. Here are a few examples. The ceiling on any one day recredit amount should be \$5,000, not \$2,500, because a \$2,500 amount is too low and likely to quickly become out of date. If the much longer ten day time period is used, which we oppose, then there should be no dollar cap on consumer recredit, just as Regulation E has no dollar cap. Another weakness is that the Act imposes a comparative negligence standard in determining who should bear a loss from a substitute check. Although a comparative negligence standard is used in parts of the Uniform Commercial Code, it is not a good standard to use between a bank and a consumer. The fact-based nature of a comparative negligence inquiry inherently favors the party with experienced counsel and the ability to bear litigation costs. Finally, the Act gives broad discretion to the Federal Reserve Board to modify the requirements of the Act with respect to substitute checks. This could be read to reach the content of the substitute check, yet it is a key premise of the Act that the substitute check must contain all of the information on the original check. The delegation of this power to the Federal Reserve Board, permitting it to use regulations to modify the Act’s requirements, is too broad.

Congress should not take away from consumers the ability to get back and use their original paper checks. If Congress does wish to eliminate the paper check, over the opposition of consumers, it should at least do so in a way that gives all consumers who do not receive back the original paper check a clear right to recredit in the event of a dispute about whether a check was properly charged. This right should cease to apply only when the bank demonstrates that the check

was properly charged to the account, not merely because there is a voluntary truncation agreement.

Following this testimony is an analysis of the consumer impact of the Act, presented in the form of the kinds of questions your constituents might have about the impact of the Act on their checking accounts.

Description of Groups Submitting this Testimony

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; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and services, and from noncommercial contributions, grants, and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications and services carry no outside advertising and receive no commercial support. Consumers Union maintains offices in Yonkers, New York; Washington, D.C.; Austin, Texas; and San Francisco, California, where it works to promote the consumer interest. Consumers Union participated in a working group convened by the Federal Reserve Bank of New York, and later facilitated by the Federal Reserve Board, to try to develop a check truncation act that would eliminate the movement of checks without harming U.S. consumers. The CTA, which came out of that process, does not meet that goal. The Check Clearing Act is even further away from that goal.

The Consumer Federation of America (CFA) is a nonprofit association organized in 1967 to advance the interests of consumers through advocacy and education. CFA's current membership is comprised on almost 300 national, state, and local consumer groups throughout the United States, which in turn represent more than 50 million consumers. CFA advocates on fair banking practices, credit consumer protections and consumer protection in the payments system.

The National Consumer Law Center ("NCLC") is a Massachusetts nonprofit corporation established in 1969. One of its primary objectives is the provision of assistance to legal services attorneys, governmental agencies, and private attorneys in advancing the interests of their low-income and elderly clients in the area of consumer law. NCLC staff write and publish sixteen legal treatises on various federal and state statutes that affect consumer law. For over twenty years, NCLC staff have provided oral and extensive written testimony on numerous occasions to Congress, the Federal Reserve Board, the Federal Trade Commission, the Department of the Treasury, and other federal agencies

regarding issues of importance to fair treatment and consistency in the marketplace for low-income consumers. NCLC staff have been members of the Federal Reserve Board's Consumer Advisory Council and participate on the American Bar Association Subcommittee on Consumer Financial Services of the Business Law Section.

U.S. PIRG serves as the national lobbying office for state Public Interest Research Groups, which are independent, non-profit, non-partisan research and advocacy groups with members around the country.

Conclusion

An estimated 45.8 million U.S. households should not be forced to make a change in the way they use their checking accounts to track personal finances particularly in the absence of a clear benefit to all consumers. The Check Truncation Act proposed by the Federal Reserve Board does not provide that benefit. The Check Clearing Act is even worse for consumers, because the bank can wait ten business days to recredit any funds. The Act should be rejected unless it is modified to provide a real and substantial benefit to consumers through a much broader right of recredit applicable whenever original checks are not returned, and other changes are made. Without a broader right of recredit, the Act would force a technological change on consumers without appropriate consumer protection. Banks would save money on check processing; consumers would experience new risks of delay, improper payment, inconvenience, and loss of privacy. Consumers Union, the Consumer Federation of America, the National Consumer Law Center, and U.S. PIRG respectfully suggest that this is a bad bargain for American consumers.

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