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**Before the Subcommittee on Financial Institutions and Consumer Credit
House Committee on Financial Services**

Hearing on Implementation of the Check Clearing for the 21st Century Act

April 20, 2005

Introduction

As a law professor specializing in the law of consumer payment systems, I am deeply concerned about the impact of the Check Clearing for the 21st Century Act (Check 21). Payments law should treat people in similar positions in the same manner, unless there are compelling reasons not to. Check 21 violates this fundamental principle; it makes arbitrary distinctions among check customers, depriving more than half of them of important rights to which the others are entitled. It establishes obligations and deadlines that are different from those imposed by other payment laws. The result is law that is confusing and unfair. As a result of this confusion, people cannot understand their rights and obligations. Unfairness undermines consumers' trust in financial services institutions and in the law itself. The good news is that Congress can greatly improve this situation by preserving the substance of the law, but modifying some of the details, using the Electronic Fund Transfers Act as its model. That statute, together with the Federal Reserve Board's Regulation E, has served the test of time, producing little litigation and no substantial controversy.

The major issues addressed in my testimony are the following:

- Check 21 treats persons who agreed to truncate their checks (that is, those who agreed not to receive their original checks with their bank statements) far less favorably than those who did not agree, even though both types of customers are exposed to the same risk of errors due to check image exchange and the creation of substitute checks.
- Tremendous confusion is engendered by the differences in the way Check 21 and other laws deal with error resolution, both in terms of the banks' duty to investigate and deadlines for consumers to report errors.
- Check 21's requirements for submitting a claim are unduly stringent.

- Because of the similarities between Check 21 transactions and electronic check conversion (known as ARC), consumers confuse the two and are unaware of the vast legal differences between them in regard to their rights and obligations.
- Consumers are exposed to increased risk and cost as a result of Check 21's faster processing times and resulting bank fees for insufficient funds.

In order to ameliorate these problems, Congress should:

- ★ Enact statutes that introduce greater uniformity into the law of payment systems. The Electronic Fund Transfers Act provides the best model.
- ★ Incorporate into the law the rules of the National Automated Clearing House Association (NACHA) that provide consumers greater protection than current law.
- ★ Amend the Expedited Funds Availability Act to ensure quicker access to depositors' funds.

Putting Check 21 in Context

In the last few years financial institutions have taken advantage of technological advances to develop and market a proliferation of new payment systems and devices. These have been accompanied by several new laws and regulations. Substitute checks and ARC are two new methods to process payments. My testimony focuses on these two. However, in assessing Check 21's impact on consumers, it is important to understand that consumers are being barraged with many new payment products and ways of transferring funds. These include new payment devices such as payroll cards, gift cards, and prepaid phone cards. Many types of payments are being taken out of the consumer's bank accounts through on-line bill-paying, account aggregation, pre-authorized electronic transfers, pre-authorized drafts (telechecks), electronic check conversion, including ARC, substitute checks and ordinary checks. The monthly bank statement has become as arcane as the typical cell phone statement.

Another characteristic of today's payments marketplace is the consumer's loss of control. Approximately 40% of consumers have entered into account agreements with their banks whereby the bank is obligated to return the original checks to the consumer along with the monthly statement. Those consumers have refused the inducements many banks have offered to persuade their customers to agree to truncation of their checks. Check 21, however, nullifies that contractual guarantee. That law says the consumer has no right to receive original checks if substitute checks are produced instead, regardless of what the bank's contract guarantees. While Check 21 makes substitute checks the legal equivalent of original checks, the Federal Reserve and law enforcement have warned of new types of errors and fraud that will result from the electronic processing that creates substitute checks, still more activity over which the consumer

has no control. Consumers who agreed to have their checks truncated have even less control over what may happen to them; not only are they also exposed to the risk of new errors and fraud, but they do not get Check 21's limited protections.

Consumers lose control in other ways as well. Checks are clearing faster than ever, and many different types of fund transfers are being made in and out of the consumer's account at various times, making it difficult for consumers to keep track of their account balances. Consequently, it is easy for consumers inadvertently to have insufficient funds in their accounts. This results in bounced check fees or the imposition of very expensive "courtesy overdraft" protection that the consumer never agreed to and that can be triggered, not only by writing checks, but also for ATM and point of sale transfers.

Check 21 should be viewed within the context of these many new and different types of developments. Moreover, the Check 21 Act has special characteristics that make it particularly confusing to consumers.

The Impact of Check 21

The Check 21 Act has the beneficial objective of facilitating the processing of checks by means of image exchange, increasing the speed and efficiency of getting checks from payees to the consumer's bank. However, Check 21 has a negative impact on consumers. As a result of the greater speed, consumers have less time to ensure that they have adequate funds in their accounts. If their accounts have insufficient funds, they will be subject to expensive bounced check fees or overdraft protection charges. It is easy to blame consumers, saying it is their fault for writing checks without having enough money in their account. However, it is difficult for consumers to keep track of the transfers taking money out of their account since it can happen in so many new ways. In addition, consumers have no control over some sources of funds: unanticipated medical expenses, a late child support check, the delayed direct deposit of a paycheck, etc.

Another detrimental effect of Check 21 is the confusion it produces among consumers. When I speak to consumers, the aspect of Check 21 that confuses and discourages them the most is the different treatment of consumers who agreed to truncation and those who have not. Because of Check 21, all consumers' checks may be transferred to images and reconverted into substitute checks. As the Federal Reserve Board has acknowledged, many errors may occur as a result of these transformations of the original paper check into other forms. Representatives of law enforcement have warned that new forms of theft are now possible and it will be far more difficult to investigate check fraud criminals. However, only those consumers who have not agreed to have their checks truncated get the benefit of the recredit and indemnity rights granted by the Check 21 Act.

Consumers also are confused by the different deadlines by which consumers must notify their bank of errors in their monthly statement. For electronic transfers the consumer has 60 days to notify the bank. Under Check 21, the consumer must notify the bank within 40 days in

order to make a claim for a recredit where the bank provided a substitute check. But if the bank provided the consumer with the original paper check, the deadline is specified in the bank account agreement, and may be as short as two weeks.

The bank's duties when the consumer reports an error is another source of confusion. For electronic fund transfers where the consumer claims an error, the bank must recredit the entire amount in dispute if the bank cannot complete its investigation within ten days. Under Check 21, the bank is required to recredit only \$2500 if the consumer is provided a substitute check. However, consumers who have agreed to have checks truncated are not entitled to a bank investigation and cannot get any recredit, even if the error was caused by a substitute check. Those consumers are treated the same as the consumer who receives an original check. The Uniform Commercial Code applies, and it does not require the bank to investigate or recredit any amount. If the bank refuses to investigate and recredit, the consumer's only remedy is to sue the bank, and usually the amount in dispute does not justify the cost of litigation. The investigation and recredit provisions of the Electronic Fund Transfers Act and Check 21 provide consumers with a reasonable non-litigation remedy. That remedy should be available whenever there is a dispute, not only for electronic fund transfers and one category of check writers.

Finally, Check 21 imposes stringent requirements upon consumers submitting a claim for a recredit. For example, the consumer is required to inform the bank of "the reason why production of the original check or a better copy of the original check is necessary to determine the validity of the charge to the consumer's account or the warranty claim." I have yet to find a consumer who has any idea what that means. In contrast, the Electronic Fund Transfers Act provides consumers with a simple procedure for notifying banks of errors. That statute should serve as the model for future legislation.

All the consumers I have tried to educate about Check 21 have been well-educated, middle class people. They seemed quite well-informed about credit cards and the basics of traditional check transactions. But they were understandably baffled by the complications introduced by Check 21. I have spoken to consumer organizations who hear from far more consumers than I, and they confirm my finding that consumers are indeed confused. For example, many consumers started registering complaints about Check 21 even before it went into effect. They had actually encountered problems with ARC, but due to the similarities between Check 21 and ARC transactions, they did not realize that different rules apply when checks are processed through that system.

ARC

When consumers mail a check to pay a bill, some businesses use the check as a source document from which they take data in order to process the payment as an electronic fund transfer via the automated clearing house system. Those transfers are subject to NACHA's ARC rules. Consumers lack any understanding of how ARC works and what their rights are when their payments are processed in that manner. The superficial similarities between ARC and

Check 21 transactions add to the confusion engendered by Check 21. Moreover, consumers have no control over how the check is processed.

Consumers reasonably assume that when they send a check in the mail to pay a bill, one set of legal rules apply. In reality, depending upon how the business deals with the check, it may be subject to the Uniform Commercial Code, Check 21, or the Electronic Fund Transfers Act and NACHA's ARC rules. If subject to either Check 21 or the ARC rules, the consumer who never agreed to have checks truncated nevertheless does not receive the original check that the consumer's agreement with the bank said he was entitled to. If the check has been processed through electronic image exchange, the consumer will receive a substitute check. If processed through ARC, all the consumer receives is a notation on the monthly statement. There is no required labeling or description. My bank calls it an "automated check," a term that does not adequately describe the transaction.

If a business wants the option of processing a check under the ARC rules, Reg. E (issued pursuant to the Electronic Fund Transfers Act) requires the business to notify consumers that their checks may be processed electronically. Two of my credit card companies provide that notice. One has it buried in a very long dense paragraph that addresses many topics having nothing to do with ARC. The other company has the notice in the portion of the statement that I return when I pay the bill. Consequently, I have no record of that notice to refer to once I mail the payment.

NACHA recently enacted an opt-out rule, enabling consumers to choose not to have their checks processed as an ARC. Unfortunately, the rule does not require businesses to notify consumers of their ability to opt out. The opt-out rule is not the only one that NACHA has adopted that provides consumers with greater protection than current law. There also are favorable rules on what businesses do with checks that will be processed electronically and rules on stop payment and recredits. The problem is that NACHA could change or withdraw them at any time. Congress should incorporate them into the law.

Expedited Funds Availability

Congress enacted Check 21 because financial institutions wanted a law that would facilitate quicker and more efficient check processing. Congress' purpose was not to create a new profit center for banks. However, because checks are cleared faster, consumers lose float and have less time to exercise their right to stop payment. As described above, they also are more likely to be subject to bounced check and overdraft protection charges, as well as the risk of double debits and other errors. A good law is one that is fair. A measure of the fairness of a law is one that is balanced. Congress could strike a better balance by requiring that banks give consumers quicker access to funds they deposit.

Financial institutions claim no action should be taken yet. They say that it will be years before Check 21 becomes fully effective and most checks are processed by means of check

image exchange. But Congress should not wait until the vast majority of checks are processed electronically. Congress should not wait because apparently banks are already clearing checks much faster than the law requires. Some industry estimates are that 95% of checks are cleared in one day. (Andrea McGlinn, "Check Clearing for the 21st Century Act: The Impact on Consumers," 9 North Carolina Banking Institute 179 (2005)). According to the Senior Policy Counsel at the American Bankers Association, "[t]he vast majority of banks already allow access to deposits earlier than the law requires; most banks generally allow consumers to withdraw funds on the day of deposit or the day after deposit for funds drawn on both local and nonlocal checks." (Letter from ABA posted on the ABA's web site, www.aba.com). Furthermore, the law includes major safeguards for banks. The deadlines for availability do not apply if a consumer opens up a new account, has repeated overdrafts, makes large deposits, has checks redeposited, or the bank has reasonable cause to doubt collectibility.

The second reason Congress should not wait is because the future is now, or pretty close to now. Major financial institutions have joined companies such as SVPCo and Endpoint in order to take advantage of Check 21. JP Morgan Chase and Key Corp. started exchanging checks electronically last August. Bank of America, Wells Fargo, and Electronic Data Systems started doing so last December. The General Manager of CheckClear stated last month, "Imaging is about to do that hockey-stick curve of growth...It's going to become very big, very fast." (Daniel Wolfe, "Endpoint Agrees to use ECCHO's Exchange Rules," American Banker, March 24, 2005). It is not only the biggest banks that are taking advantage of Check 21. For example, Independence Community Bank Corp. recently announced that starting this summer it will convert most of its customers' checks into digital images at the teller window.

Finally, I urge you to ask your constituents how they feel about a law allowing banks to hold onto their funds for many days after the check has cleared. The law permits a five day hold for nonlocal checks, but the law's terms are defined such that in addition to the five days, usually the hold will include a weekend. The consumers I talk to often mention this delay. They are quite angry about having to wait to be able to use their money.

Conclusion: Recommended Changes in the Law

Congress should improve the law by mandating uniform rules modeled after the Electronic Fund Transfers Act and Regulation E. Substantially the same rules should apply when a consumer mails a check to a business, regardless of whether a payment is processed as a check transaction or an ARC transfer. If an error occurs when checks are converted to digital images and reconverted into substitute checks, the same Check 21 protections should apply to both consumers who agreed to truncate and those who did not. If consumers believe an error occurred, they should be able to notify the bank of the alleged error and trigger a mandated investigation, regardless of whether they paid by check or debit card. The procedure to trigger the investigation should be easy to understand and comply with, no matter what type of payment instrument consumers use. Financial institutions should be required to recredit the consumer's account after ten days if they cannot resolve the consumer's claim, with a maximum of 45 days to investigate the claim if the consumer paid with a check as well as when the consumer uses a

debit card. NACHA rules providing greater protection to consumers should be enacted into law.

Finally, the Expedited Funds Availability Act should be amended to require banks to give consumers access to their funds more promptly.

The Check 21 Act and advances in technology have combined to make the world of payment devices and systems far more complex, confusing and problematic than ever before. In addition, consumers have less control than ever. Congress should not enact laws that would stifle the development of new products and systems made possible by technology. But Congress also should not, and need not, make consumers the losers when financial institutions implement these innovations. As the Electronic Fund Transfers Act demonstrates, it is possible to strike the appropriate balance.

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