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CHECK TRUNCATION ACT OF 2003

JUNE 25, 2003.—Ordered to be printed

Mr. SHELBY, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

R E P O R T

[To accompany S. 1334]

[Including cost estimate of the Congressional Budget Office]

The Committee on Banking, Housing, and Urban Affairs, reported an original bill (S. 1334) to facilitate check truncation by authorizing substitute checks, to foster innovation in the check collection system without mandating receipt of checks in electronic form, and to improve the overall efficiency of the Nation's payments system, and for other purposes, having considered the same, reports favorably thereon and recommends that the bill do pass.

INTRODUCTION

On June 18, 2002, the Senate Committee on Banking, Housing, and Urban Affairs considered original legislation entitled "The Check Truncation Act of 2003", a bill to facilitate the use of check truncation and the electronic collection and return of checks. The Committee voted unanimously to report the bill, as amended by a managers' amendment that was adopted by voice vote, to the Senate for consideration.

PURPOSE OF THE LEGISLATION

Under current law, banks must physically present and return original checks to receive payment unless the bank has an agreement with another bank to do so by electronic means. The electronic process for transmitting information allows banks which have these voluntary agreements to stop, or truncate, the flow of paper checks. Some banks have such agreements and have been able to take advantage of electronic processing using advanced imaging technology. However, since there are over fifteen thousand

banks, thrifts, and credit unions, it is extremely difficult to obtain electronic agreements on a large scale, which has hampered the industry's ability to achieve substantial further improvements in the check collection and return process. As a result, billions of checks continue to be either trucked or flown across the country to complete the clearing process. Given the availability of inexpensive electronic transmissions media, this enormous dependence on ground and air transportation systems makes very little sense. The terrorist attacks on September 11, 2001, underscored the importance of increasing flexibility in the payment system. Truncation could be used to make the process less expensive over the long term. While the bank must make an initial technology investment, the bank saves money on processing and transportation of paper checks.

This bill is designed to facilitate check truncation without requiring banks to fully convert to an electronic process on either end of the clearing process. The primary change in current law is that banks could use electronics to streamline the check collection and return process even in cases in which they do not have electronic exchange agreements. For those banks which do not choose to use an electronic system, a new instrument or "substitute check" would be created from the electronic check image for delivery to that bank. The substitute check would be the legal equivalent of the original check and could be processed by receiving banks just as original paper checks are today. The substitute check, would be machine readable and would bear a magnetic-ink character (MICR) line. It would also include an image of the front and the back of the original check. The bill also imposes warranty and indemnity obligations, which are intended to compensate consumers, banks, and other processors for losses caused by the creation of the substitute check. Finally, the proposal also provides an expedited re-credit provision for consumer accounts in cases where consumers make claims against their banks for improper charges to their accounts for substitute checks that are provided to the consumers.

The bill would apply existing check law, including the Uniform Commercial Code (UCC) and the Federal Reserve Board's Regulation CC, to substitute checks which would be legally equivalent to the original checks.

The Federal Reserve Board believes that the proposed legislation may result in substantial payments system benefits. Banks could use substitute checks to collect and return checks more quickly and to reduce the banking industry's reliance on the physical transportation of checks. Banks might also be able to reduce their infrastructure costs because their branch and ATM networks would no longer need to be tied geographically to their processing centers. Banks' customers may also benefit from these infrastructure changes if they enable banks to offer broader deposit options, later cutoff hours, more timely information, and faster check collection and return.

Credit unions have been using a truncation process since the mid-1970s. Of the checks written, credit unions process roughly 10 percent. Of the credit unions that offer checking (share draft) accounts, 91 percent truncate checks, according to the Credit Union National Association (CUNA). For credit unions, generally the check proceeds through the clearing process to the point where it

is truncated or held by either the credit union or its corporate credit union or other processor. At that point, the information on the draft is stored electronically and printed on the member's monthly statement. In some cases, electronic images of the draft are returned with the statement, but that is not required.

HEARINGS

The Banking Committee's action followed a hearing on the check truncation proposal. On April 3, 2003, the Committee heard testimony regarding the Federal Reserve Board proposal on Check Truncation. The witnesses testifying were Vice Chairman Roger Ferguson, Board of Governors of the Federal Reserve System; Ms. Lindsay Alexander, President and Chief Executive Officer of the NIH Federal Credit Union, representing the Credit Union National Association; Ms. Janell Mayo Duncan, Legislative and Regulatory Counsel from Consumers Union; and Mr. Danne Buchanan, Executive Vice President from Zions Bancorporation, representing the American Bankers Association, the Financial Services Roundtable, America's Community Bankers, Independent Community Bankers of America and the Consumer Bankers Association.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Short title; table of contents

The proposed Act is known as the Check Truncation Act of 2003.

Section 2. Findings and purposes

The purposes of this Act are to facilitate check truncation by authorizing substitute checks; to foster innovation in the check collection system without mandating receipt of checks in electronic form; and to improve the overall efficiency of the Nation's payments system.

Section 3. Definitions

This section defines the terms used in the Act including "indemnifying bank", "MICR line", "reconverting bank", "truncate" and "substitute check".

Section 4. General provisions governing substitute checks

This section permits a person to send a substitute check without the agreement of the recipient and provides legal authority for fully negotiable substitute checks to the extent that a bank makes the substitute check warranties pursuant to the requirement as of Section 5. A substitute check that complies with the requirements of this section is the legal equivalent of the original check. Substitute checks will be subject to the Uniform Commercial Code, Reg. CC and other applicable Federal or State law.

Section 5. Substitute check warranties

The section creates warranties pertaining to substitute checks. A bank that transfers, presents or returns a substitute check and receives payment, warrants that: the check complies with the requirements for legal equivalence under Section 4 of the Act, and; the person that makes payment based on receipt of the substitute check will not receive another version of that check for payment.

Section 6. Indemnity

This section provides indemnities for banks or consumers who receive substitute checks. Any bank that creates a substitute check, and any bank that receives payment for transfer of either an electronic or paper version of that check indemnifies all subsequent persons who receive the substitute check and incur a loss due to the receipt of the substitute check instead of an original check. Damages are limited to the amount of the check (along with interest and attorney fees) unless the indemnifying bank breaches a warranty imposed under Section 5, at which point the claimant is entitled to receive the amount of the loss proximately caused by the breach. Comparative negligence can be counter-claimed to limit damages.

This Act provides a comparative negligence standard for a person making an indemnity claim under this section or seeking damages under section 9. If the person's losses resulted in whole or in part from that person's own negligence or failure to act in good faith, then the damages due to that person are reduced in proportion to the amount of negligence or bad faith attributable to that person.

These comparative negligence provisions are not intended to reduce the rights of a consumer or any other person under the UCC. Rather, these provisions are intended to clarify that the same principles that are currently incorporated in existing law, such as Regulation CC, the UCC, and common law, will continue to apply under the Act. The Congress anticipates that, in the absence of fraud, the comparative negligence provisions generally will not be applicable to consumer check users.

Section 7. Expedited recredit for consumers

This section provides that a consumer may make a claim for a recredit if he or she asserts that the bank charged the consumer's account improperly or the consumer has a warranty claim with respect to the substitute check that was provided to the consumer. The consumer must show that he or she suffered a loss and that the production of the original or a better copy of the original is necessary to determine the validity of the claim.

The consumer is required to make a claim for expedited recredit within 40 days after the financial institution transmits the periodic statement or receipt of the substitute check, whichever is later. Under extenuating circumstances, including extended travel or illness of the consumer, the financial institution shall extend the period for a reasonable amount of time.

A bank must recredit a consumer's account within one day of determining that the consumer's claim is valid. If the bank has not determined the validity of the claim within 10 business days, the bank must recredit the lesser of the amount charged, or \$2,500 plus accrued interest, and any remaining amount must be recredited within 45 calendar days.

A bank may delay the availability of the recredit on claims made on new accounts, on accounts that have repeated overdrafts, when a bank has a reasonable cause to believe that the claim is fraudulent, or in emergency situations. A bank that delays the availability of or reverses a recredit must notify the customer promptly. Notices of invalid claims, recredit and reversal of recredit must be

made to consumers no later than the day following the day on which the bank makes these determinations.

Section 8. Expedited recredit procedures for banks

Section 8 authorizes a bank to make a claim against an indemnifying bank for an expedited recredit if the claimant bank's customer has made a claim for recredit; the claimant bank has suffered a loss; and production of the original check or a better copy of the original check is necessary to determine the validity of the charge. The claim must be made within 120 days of the transaction and the indemnifying bank has 10 business days to produce the original check or a better copy of the original check. The indemnifying bank must also recredit the amount to the claimant bank, or provide information as to why the indemnifying bank does not have to provide a recredit. A recredit does not abrogate other liabilities the indemnifying bank may incur.

Section 9. Delays in an emergency

This section permits banks to delay the time limits prescribed in the Act, if the payment system or telecommunications networks are interrupted by an emergency beyond the control of the bank, if the bank uses such diligence as circumstances require.

Section 10. Measure of damages

This section sets out that, except as provided in Section 6, damages are limited to the lesser of the amount of the check, or amount of loss suffered due to violation of the Act, plus interest and expenses. Comparative negligence applies, and this subsection does not affect the rights of the consumer under the UCC or other applicable Federal or State law.

Section 11. Statute of limitations and notice of claim

This section requires that an action must be brought within one year of when the claimant learned, or should have learned, of the facts and circumstances giving rise to the action. Notice of claim must be given to the bank within 30 days of when a person has reason to know of the claim. A recredit claim under Section 7 constitutes notice for the purposes of this Section.

Section 12. Consumer awareness

The section requires that banks must provide customers that receive original checks or substitute checks with a brief informative notice for the first three years that the Act is in effect. This notice will make customers aware of the legal status of substitute checks and the framework for the recredit process. By three months prior to the effective date of this Act, the Fed will make available model forms of such notice that banks may use.

Section 13. Effect on other law

This section preempts any provision of Federal or State law only to the extent of the inconsistency.

Section 14. Regulations

This section authorizes the Federal Reserve Board to promulgate final regulations necessary for implementation of this Act. Al-

though the CTA gives the Board authority to adopt implementing regulations, the Committee recognizes that the Secretary of the Treasury has broad and long-standing authority to establish and administer the rules that govern payments disbursed by Treasury, including Treasury checks. The CTA does not affect the Secretary's authority to regulate Treasury checks, to the extent those regulations are not inconsistent with this Act. The Treasury cannot adopt regulations, for example, that would condition the payment of a substitute Treasury check on the subsequent delivery of the original check.

The Committee acknowledges the Department of Treasury's concern about the legislation's impact on its ability to continue complying with its ongoing responsibilities and court orders in the *Cobell et al v. Norton et al* case. Treasury is currently operating under a Court order that it retain, among other documents, original Treasury checks for the duration of the litigation unless, and until, relieved of that obligation by the Court. Noting that no judicial relief has yet been granted, Treasury views as problematic the Act's provisions permitting banks, at their discretion, to retain only digital images of checks while destroying original paper checks.

Section 15. Study and report on funds availability

No later than 30 months following the effective date of this Act, the Federal Reserve will provide the Congress with an evaluation of the implementation and impact of this Act. The study will address issues that the Federal Reserve monitors as part of its regulatory responsibilities under the Expedited Funds Availability Act.

Section 16. Evaluation and report by the Comptroller General

The Comptroller General will also report on the implementation and administration of this Act, no later than five years after enactment.

Section 17. Variation by agreement

This section provides that only provisions of section 8 may be varied by the banks involved. That is, banks could contractually vary the interbank recredit provisions and only those provisions.

Section 18. Effective date

This Act shall become effective one year after the date of enactment.

CHANGES IN EXISTING LAW

On June 18, 2003, the Committee unanimously approved a motion by Senator Shelby to waive the Cordon rule. Thus, in the opinion of the Committee, it is necessary to dispense with the requirement of section 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

REGULATORY IMPACT STATEMENT

In accordance with paragraph 11(b), rule XXVI, of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact of the bill.

The Act establishes a framework which would enable banks to achieve many of the benefits of electronic check processing without

mandating that any bank receive checks in electronic form. Banks would be able to truncate, or stop, the flow of checks, process them electronically, and create machine-readable substitute checks, if necessary, that would be the legal equivalent of the original checks. Substitute checks could be processed by receiving banks just as original paper checks are today, thereby not significantly affecting the operations of banks that do not wish to participate in the electronic collection or return of checks. By permitting choice of processing method, the Act represents regulatory reform and should result in reduced costs to the financial services industry and consumers over the long term.

Congress intends this Act to leave a bank and its customer in substantially the same legal and practical position regardless of whether or not a substitute check is used. The Act's warranty, indemnity, and expedited recredit provisions, which provide rights to recipients of substitute checks in the event that they incur a loss due to the receipt of a substitute check instead of the original check, accomplish this purpose.

The Act will improve the efficiency of the payments system by enabling banks to expand the use of electronics in the collection and return of checks, reducing the industry's reliance on transportation to move checks across the nation. Had the provisions of this proposed Act been in effect when air traffic came to a standstill due to the terrorist attacks on September 11, 2001, banks would have been able to reduce the impact of the disruption in air transportation on the check collection system. Because the Act seeks to provide choice of clearing mechanism and update the clearing process, the Committee believes that this legislation will have a favorable regulatory impact.

COST OF LEGISLATION

Section 11(b) of rule XXVI of the Standing Rules of the Senate, and Section 403 of the Congressional Budget Impoundment and Control Act, require that each committee report on a bill contain a statement estimating the cost of the proposed legislation. The Congressional Budget Office has provided the following cost estimate and estimate of costs of private-sector mandates.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 24, 2003.

Hon. RICHARD C. SHELBY,
*Chairman, Committee on Banking, Housing, and Urban Affairs,
U.S. Senate, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for the Check Truncation Act of 2003.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contacts are Mark Booth (for revenues), Matthew Pickford (for spending), and Victoria Heid Hall and Greg Waring (for the state and local government impact).

Sincerely,

DOUGLAS HOLTZ-EAKIN, *Director.*

Enclosure.

Check Truncation Act of 2003

The Check Truncation Act of 2003 would alter the process of clearing checks. It would allow a depository institution that has a check presented to it to choose on its own to provide to the paying depository institution a paper copy of the check, called a “substitute check,” rather than the original check itself. The substitute check would be the legal equivalent of the original check. Under current law, the depository institution presented with the check must transmit the original check to the paying institution for settlement, unless the two institutions have entered into an agreement for transmission of a paper copy of the check or the electronic information from the check. In addition, the bill would require the Board of Governors of the Federal Reserve System and the General Accounting Office (GAO) to conduct studies on aspects of the check-clearing process and the implementation of this legislation.

CBO estimates that enacting the bill would have a negligible effect on federal revenues through its effects on the Federal Reserve’s income and expenses from its check-processing operations and its expenses in producing the mandated study. The Federal Reserve remits its net income to the Treasury, and those payments are classified as governmental receipts, or revenues, in the federal budget. Any additional income or costs to the Federal Reserve, therefore, can affect the federal budget. By reducing the transportation costs associated with clearing checks, the bill would reduce the costs that the Federal Reserve incurs in providing check-processing services to depository institutions. It would change the Federal Reserve’s costs of processing checks in other ways, as well. However, the Federal Reserve is required by law to charge the depository institutions for its check-processing services. Based on information provided by the Board of Governors of the Federal Reserve System, CBO estimates that any reductions to the Federal Reserve’s costs of check clearing as a result of the bill would result in a nearly equal reduction in its income. Furthermore, CBO estimates that any additional expenses incurred by the Federal Reserve in order to produce the mandated report would be negligible. As a result, CBO estimates that the bill would have a negligible effect on the Federal Reserve’s net income and, hence, on federal revenues.

In addition to mandating that the Federal Reserve produce a study, the legislation would require GAO to report on the implementation of this bill, including gains in economic efficiency and benefits to consumers and financial institutions made possible from check truncation. Based on information from GAO, CBO expects that new reporting requirements would cost less than \$500,000, assuming the availability of appropriated funds.

The bill provides that a substitute check would be the legal equivalent of the original check under any provision of federal or state law. It would thereby preempt state laws, including the Uniform Commercial Code, to the extent that such laws require an original check. Such a preemption of state law is a mandate under the Unfunded Mandates Reform Act (UMRA). CBO estimates that enacting this mandate would impose no costs on state, local, or tribal governments and that its cost, therefore, would not exceed the threshold established in UMRA (\$59 million in 2003, adjusted for inflation). The bill contains no new private-sector mandates as defined in UMRA.

On May 30, 2003, CBO transmitted a cost estimate for H.R. 1474, the Check Clearing for the 21st Century Act, as reported by the House Committee on Financial Services. CBO estimated that, like the Check Truncation Act of 2003, H.R. 1474 also would have a negligible effect on the federal budget.

The CBO staff contacts for this estimate are Mark Booth (for federal revenues), Matthew Pickford (for federal spending), and Victoria Heid Hall and Greg Waring (for the state and local government impact). This estimate was approved by G. Thomas Woodward, Assistant Director for Tax Analysis, and Peter H. Fontaine, Deputy Assistant Director for Budget Analysis.