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THE IMPACT OF THE FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT OF 1991 ON THE UNITED STATES PAYMENTS SYSTEM

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I. Introduction

Congress spent much of 1990 and 1991 vigorously debating proposed comprehensive reforms to present banking law. However, the package of so-called bank reforms Congress ultimately passed — the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") — hardly represented comprehensive bank reform. Congress jettisoned most of the controversial provisions that would have permitted banks or their affiliates to offer new financial services or expand across state lines, because a sufficient consensus could not be reached on these issues. As a result, Congress largely left the current legislative and regulatory scheme regarding bank powers and interstate banking intact. Congress chose instead to recapitalize the Bank Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC"), strengthen federal regulators' authority to take prompt corrective action with respect to troubled financial institutions, increase supervision of foreign banks, and require "truth-in-savings" deposit disclosures by depository institutions.[1]

Lost amid the hue and cry over bank securities, insurance powers, interstate banking and the like were several important provisions Congress included in FDICIA that will have a significant impact on the United States payments system. Because the rules that govern the payments system critically affect the rights of consumers and commercial parties to payment transactions, it is important that these parties become aware of how FDICIA has modified present payment rules.

This Article reviews the provisions of FDICIA that impact the payments system, including in particular, amendments to the Expedited Funds Availability Act ("EFAA") — the federal statute that provides when a bank's consumers must be provided access to their deposited funds. The Article first provides an overview of the EFAA and the requirements it imposes on depository institutions. The Article next reviews the amendments to the EFAA under FDICIA. Lastly, the Article discusses certain other provisions of FDICIA concerning payments netting arrangements and interbank exposure, as well as certain payments provisions which were proposed but not included in the bill passed by Congress.

II. Overview Of The Act

Congress enacted the EFAA in August, 1987, as part of the Competitive Equality Banking Act of 1987.[2] The EFAA was enacted to address the practice of certain banks of delaying customer access to funds deposited in the customers' own bank accounts for apparently inordinate periods of time. On May 13, 1988, the Board of Governors of the Federal Reserve System ("FRB") promulgated Regulation CC to implement the EFAA.[3]

The EFAA and Regulation CC establish specified time periods within which banks must make funds available to customers for deposits to their accounts.[4] Generally for check deposits, these availability requirements are based upon the type of deposit and the location of the bank at which the check is first deposited relative to the location of the bank on which the check is drawn. The bank where the check is first deposited is called the depositary bank and the bank where the check is drawn is called the paying bank. In certain instances, pursuant to Regulation CC, banks must provide next-day funds availability. Banks must make funds available on the next business day following the day of deposit for deposits of cash, electronic payments, certain government checks, the first $100 of a day's check deposits to an account, certain checks deposited at the bank upon which they were drawn, referred to as "on-us" items, and certain cashier's, certified, and teller's checks.[5]

Pursuant to the EFAA, Regulation CC establishes temporary and permanent availability schedules for deposits of checks not covered under the next-day availability provisions. Under the temporary availability schedule, which was effective from September 1, 1988, until August 31, 1990, a bank was required to make funds available by the third business day after the day of deposit for a local check and by the seventh business day after the day of deposit for a nonlocal check. A local check is a check where the paying bank is located in the same check-processing region as the depositary bank. A nonlocal check is a check where the paying bank is outside the depositary bank's check processing region. A depositary bank was required under the temporary availability schedule to make funds deposited at nonproprietary automated teller machines ("ATMs") available not later than the seventh business day following the day of deposit.[6] An ATM is nonproprietary if it is not owned or operated by the depositary bank, not located on the premises of the depositary bank, and not located within 50 feet of the depositary bank's premises unless identified as being owned or operated by another entity.[7]

Under the permanent availability schedule, which became effective on September 1, 1990 and remains effective today, a depositary bank is required to make

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funds available for withdrawal on the second business day following the day of deposit of a local check and on the fifth business day following the day of deposit of a nonlocal check.[8] The EFAA, as originally enacted, provided that, under the permanent schedule, cash and checks deposited at nonproprietary ATMs were to be treated in the same manner as if they had been deposited to a teller.[9] However, as discussed in more detail below, Congress recently amended this provision of the EFAA to make permanent the treatment of deposits at nonproprietary ATMs as provided under the temporary schedule; this permits all deposits at nonproprietary ATMs to be treated as nonlocal checks.

The EFAA and Regulation CC provide certain exceptions to the mandated funds availability schedules, including exceptions for new accounts, large deposits, redeposited checks, repeated overdrafts, certain instances in which there is reasonable cause to doubt the collectibility of a check, and certain emergency situations.[10] As originally enacted, the EFAA did not permit a bank to invoke these exceptions with respect to items for which next-day funds availability must be given, such as government checks or cashier's checks.[11] However, as discussed below, FDICIA amended these provisions to allow safeguard exceptions to be invoked with respect to checks that otherwise require next-day funds availability and liberalized the customer notification requirements for invoking these exceptions.

The EFAA and Regulation CC require a bank to disclose to its existing and potential customers its funds availability policy, and this disclosure must reflect the policy followed by the bank in most cases.[12] Thus, a disclosure that states that the bank will make funds available consistent with the maximum time periods permitted by the EFAA will not satisfy this requirement if the bank's practice in most cases is, in fact, to make funds available sooner.

Subpart C of Regulation CC was promulgated pursuant to the FRB's authority under the EFAA to improve the check collection and check return system. Subpart C requires a paying bank that determines not to pay a check and a returning bank, which is any bank other than the paying bank or depositary bank that handles a returned check, to return checks expeditiously. A check is generally considered to be returned expeditiously if the return meets either the so-called "two-day/four-day" test or "forward-collection" test. Under the two-day/four-day test, a check is considered to be returned expeditiously if the paying bank or returning bank sends the returned check in a manner such that it would normally be received by the depositary bank not later than the second business day following the day of presentment of a local check, or four business days after the day of presentment of a nonlocal check. Under the forward collection test, a check is considered to be returned expeditiously if the return process is generally as fast as the forward collection process.[13] Subpart C also imposes endorsement standards on banks that are designed to assist the identification of the depositary bank and the prompt return of checks.[14]

III. FDICIA Amendments To The EFAA

Since the EFAA was enacted, the FRB and the banking industry have lobbied Congress to amend the EFAA in certain respects to ease the burdens on banks and to reduce the risks of losses due to check fraud resulting from the EFAA's requirements. Congress recently passed several of these amendments as part of FDICIA. Under FDICIA, Congress amended the EFAA to make permanent the treatment of deposits at nonproprietary ATMs as nonlocal checks, to allow banks to invoke safeguard exceptions for deposits of next-day availability items, and to modify the safeguard exception notice requirements. The FRB has published proposed or interim rules to implement these legislative changes.

A. Deposits at Nonproprietary ATMs

The EFAA directed the FRB to report to Congress in 1988, 1989, and 1990 (collectively, the "ATM Reports") concerning ATM technology and the potential for banks to comply with the permanent availability schedule mandated by the EFAA with respect to deposits made at nonproprietary ATMs.[15] As originally enacted, the EFAA required banks to treat nonproprietary ATM deposits under the permanent availability schedule as if such deposits were deposited to a teller. Thus, such deposits would become available to the customer on a next day, two-day, or five-day basis, depending upon the factors discussed above.

The ATM Reports observed that special problems arise with deposits made at nonproprietary ATMs, because it is often the case that the ATM operator, rather than the depositary bank, initially handles and processes deposited checks. Because the depositary bank does not know the composition of deposits at the nonproprietary ATM, the depositary bank is unable to apply different holds based upon the type of deposit, and where appropriate, invoke the availability exceptions under the EFAA.

Under the permanent schedule as originally enacted, the depositary bank would be forced to provide funds availability in many cases before the composition of the deposits at nonproprietary ATMs was known to it. This requirement could potentially subject depositary banks to an unacceptable level of risk from check fraud and, accordingly, could result in banks no longer permitting their customers to make check deposits at nonproprietary ATMs. Given that ATM technology did not enable banks to ascertain the composition of nonproprietary ATM deposits, the ATM Reports recommended that Congress amend the EFAA to treat nonproprietary ATM deposits under the permanent schedule the same as under the temporary schedule that treated such deposits as nonlocal checks for purposes of funds availability. In 1990, Congress partially adopted this recommendation as part of the Cranston-Gonzalez National Affordable Housing Act.[16]

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Congress revisited the issue of nonproprietary ATM deposits in 1991. Under Section 227 of FDICIA, Congress made permanent the treatment of deposits at nonproprietary ATMs as nonlocal checks permanent.[17] Thus, banks will continue to be able to make deposits made at nonproprietary ATMs available for withdrawal up to the fifth business day after the day of deposit. The FRB published a proposed rule implementing this change in January, 1992.[18] This change to the EFAA and Regulation CC will enable banks to continue to permit their customers to make check deposits at nonproprietary ATMs.

B. Safeguard Exceptions

The EFAA and Regulation CC allow banks to invoke certain exceptions to the mandated funds availability schedules for new accounts, large dollar check deposits, redeposited checks, repeatedly overdrawn accounts, where reasonable cause exists to believe a deposited check is uncollectible, and under certain emergency conditions. However, in exercising a safeguard exception, the depositary bank had to provide notice to the depositor according to the EFAA's requirements. Additionally, the original EFAA requirements generally allowed banks to apply most safeguard exceptions only to local and nonlocal checks, and not to so-called next-day items.

FDICIA amended the rules regarding safeguard exceptions in two respects. First, the EFAA was amended to permit banks to apply the safeguard exceptions to items for which next-day funds availability is required. Thus, banks are now able to apply safeguard exceptions to government checks, "on-us" checks, cashier's checks, certified checks, and teller's checks.

Second, FDICIA amended the EFAA to liberalize the safeguard exception notice requirements. Under the EFAA as originally enacted, a bank was required to provide notice to its customer for each check for which the bank determined to apply a safeguard exception. Under the recent FDICIA amendments to the EFAA, a depositary bank may now provide a one-time notice concerning the large dollar and redeposited check exceptions in the cases of nonconsumer accounts and other classes of accounts as defined by the FRB. A depositary bank also may provide a one-time notice of the applicability of the repeatedly overdrawn account exception at the beginning of each time period during which the exception applies.[19]

The FRB published an interim rule implementing these changes in January, 1992.[20] The FRB requested comment on whether the one-time notice provision for large deposit and redeposited check exceptions should be extended to certain classes of consumer accounts, such as accounts with high balances or accounts that generally have a large number of daily aggregate deposits of checks exceeding $5,000. As of the time of the preparation of this Article, the FRB has not taken further action on this proposal.

IV. Payments Netting

Many banks that regularly clear payments, whether in paper or electronic form, do so through clearinghouses. Contractual netting arrangements normally govern the amounts clearinghouse members pay to, or receive from, other members on any given settlement day. Generally a member would pay only the excess, if any, of the amount it owes to other members of the clearinghouse over the amounts the other members owe it. Conversely, the member would receive only the excess, if any, it is owed by other members of the clearinghouse over the amount it owes the others.

Inherent in any such clearinghouse arrangement is the risk that a member of the clearinghouse will be unable or unwilling to honor its settlement obligations. A failed member, or its receiver, which would include the FDIC in the case of a failed federally insured bank, conceivably could attempt in effect to repudiate the netting arrangement by collecting the gross amounts due from other clearinghouse members while failing to pay its obligations to the other members. In this scenario, members participating in the clearinghouse arrangement with the failed member would end up paying the gross amount each owed to the failed member, while being left in the position of unsecured creditors in their claims against the failed member. The failure of one member of a clearinghouse can cause so-called systemic problems, as the other members' payments of their gross, rather than net, obligations to the failed member could cause these other members, in turn, to fail to meet their own settlement obligations.

To reduce this risk, FDICIA expressly ratified, as a matter of federal law, bilateral and certain qualifying multilateral payments netting arrangements, including net settlement arrangements of certain defined "clearing organizations."[21] For a "clearing organization" to qualify for this treatment, the members and participants in the clearing organization must consist solely of (i) FDIC-insured (or eligible for FDIC insurance) banks, mutual savings banks, savings banks and savings associations, (ii) federally insured (or eligible for insurance) credit unions, (iii) Federal Home Loan Bank system members, (iv) certain U.S. branches and agencies of foreign banks, (v) Edge Act corporations, (vi) brokers or dealers, (vii) futures commissions merchants, or (viii) other institutions approved by the FRB.[22]

If the members and participants of a clearinghouse fall within these categories, the receiver or conservator of a failed member of that clearinghouse will be expressly prohibited under FDICIA from repudiating the clearinghouse's net settlement arrangement.[23] Clearinghouse members would still be at risk for any net, but not gross, amount owed by a failed member on the settlement day on which the member failed. For clearing organizations with at least one member or participant other than the clearing organization itself which does not fall within the above categories, preexisting law would continue to apply. It is important to note that under applicable law other than FDICIA, such as contract law, it would appear quite likely that a netting arrangement of a clearinghouse or other payment system that does not qualify as a "clearing organization" under FDICIA would be enforceable.

V. Regulation of Interbank Exposure

In further addressing the concern that the failure of a large depositary institution could cause the failure of other depositary institutions owed money by the failed depositary institution, which in turn could cause the failure of still other depositary institutions, FDICIA gives the FRB the authority to prescribe standards limiting inter-depositary institution exposure. Exposure is defined under this section of FDICIA to mean (i) all extensions of credit to other depositary institutions, (ii) all purchases of or investments in securities issued by other depositary institutions, (iii) all securities issued by other depositary institutions when used as collateral for other extensions of credit, and (iv) similar transactions determined by the FRB to give rise to exposure. The FRB is authorized to exempt transactions from the definition of exposure if it finds the exemptions are in the public interest and consistent with the purposes of this section.[24] These provisions become effective on December 19, 1992.[25]

In July, 1992, the FRB published a proposed rule to implement these interbank liability provisions.[26] The proposed rule would apply to banks, savings associations, and branches of foreign banks with deposits insured by the FDIC which are all referred to for the purposes of this discussion as banks.

The proposed rule would require banks to develop and implement internal procedures to evaluate and control exposure to the depositary institutions with which they do business, which are referred to under the proposed rule as correspondents. The proposed rule would require a bank's procedures to include limits on both credit and settlement exposure to each correspondent. The proposed rule also would establish benchmark guidelines for daily interday credit exposure to individual correspondents within which a bank ordinarily would be expected to remain, which would be stated as a percentage of the exposed bank's capital. The benchmarks also would depend on the capital position of the correspondent with which the bank was dealing.

Under these benchmark guidelines, a bank generally would be required to limit its credit exposure to an individual correspondent to an amount not exceeding 25 percent of the exposed bank's total capital. However, where the correspondent is "adequately capitalized", the bank's credit exposure to the correspondent could be up to an amount equal to 50 percent of the exposed bank's total capital, but credit exposure with a term to maturity of more than 30 days would be limited to not more than 25 percent of capital.[27] The proposed rule provides no benchmark for credit exposure to "well capitalized" correspondents.[28] In all cases, however, a bank would be expected to establish prudential limits internally within or in addition to the benchmarks.

Under the proposed rule, credit exposure to a correspondent would include assets and off-balance sheet items against which the exposed bank must carry capital under the risk-based capital guidelines. The proposed rule would exclude certain transactions, including the proceeds of checks and other cash items deposited in an account at a correspondent that are not yet available for withdrawal, certain fully-secured transactions and transactions with affiliated banks. The proposed rule would permit netting of obligations under legally valid and enforceable netting contracts.[29] The proposed rule also provides for a two-year transaction period after the effective date for implementation of the rule. The FRB anticipates an effective date of December 19, 1992.[30]

The proposed rule could have a substantial impact on the payments system. It would, at a minimum, force banks to increase greatly their current monitoring of interbank liabilities. Banks that currently do not closely oversee their interbank exposure would be required to implement procedures to limit such exposure and to review interbank credit on an ongoing basis. Additionally, the proposed rule could place relatively weakly capitalized depositary institutions at a significant competitive disadvantage with respect to "well capitalized" and even "adequately capitalized" institutions, because lending banks would be required to be much more careful in extending credit to thinly capitalized banks. The proposal also could, in certain instances, place correspondent private sector banks at a competitive disadvantage with respect to Federal Reserve Banks, because exposure to Federal Reserve Banks, which cannot fail, is not included in the limitations described above. In general, these provisions would increase banks' administrative, record-keeping and transaction costs in the area of interbank credits and liabilities, including overnight credits and liabilities arising in connection with certain payments activities.

VI. Provisions Dropped From Earlier Bills

Not all the payments system provisions contained in earlier versions of the comprehensive bank reform bill considered by Congress survived to enactment. For instance, an earlier version of the banking bill considered by the House of Representatives would have prohibited the use of certain check endorsements as authorizations to make subsequent electronic fund transfers. Earlier versions of the banking bill considered by the Senate would have applied a statute of limitations to actions by the United States in connection with electronic fund transfers received by unauthorized parties. Earlier versions of the Senate bill also would have amended the EFAA to require banks to give next-day funds availability to certain deposits at unstaffed locations, to expand the FRB's authority to allocate liability among participants in the payments system, including liability for finance charges, reasonable attorneys' fees and other expenses related to a deposited check, and to require

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banks to cash government checks for noncustomers. FDICIA did not include any of these provisions; however, these provisions could appear in future legislation.

VII. Conclusion

Although largely overlooked to date, the provisions of FDICIA relating to our payments system discussed in this Article will have a substantial impact on the rights and liabilities of banks and their corporate, business and individual consumers. The users of our payments system must become familiar with these statutory provisions, as well as the upcoming regulatory implementation of these statutory provisions to assure their transactions will provide the best access to their funds while complying with the law.

ENDNOTES

1 Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

2 Expedited Funds Availability Act, Pub. L. No. 100-86, 601-611, 101 Stat. 635-650 (1987) (codified as amended at 12 U.S.C.A. §§ 4001-4010 (1989 & Supp. 1992)).

3 53 Fed. Reg. 19,371 (1988) (codified as amended at 12 C.F.R. pt. 229).

4 The term "account" is defined under the EFAA as "a demand deposit account or other similar transaction account at a depositary institution." 12 U.S.C. § 4001(1) (1988). Section 229.2(a) of Regulation CC clarifies that time deposits, savings deposits, and money market deposit accounts are not "accounts" subject to the EFAA, although these accounts may be subject to certain state law funds availability requirements. 12 C.F.R. § 229.2(a) (1992).

5 12 C.F.R. § 229.10 (1992).

6 *Id.* § 229.11. A "nonproprietary ATM" is an ATM that is not a proprietary ATM.

7 *Id.* §§ 229.2(x), 229.2(aa).

8 *Id.* § 229.12.

9 See 12 U.S.C. 4002(e)(2) (1988); 12 C.F.R. § 229.12(f) (1989).

10 12 U.S.C.A. § 4003 (1989 & Supp. 1992); 12 C.F.R. § 229.13 (1992). Where an exception is invoked, a bank may delay funds availability for a reasonable time. A delay of up to five business days for local checks and six business days for nonlocal checks is considered reasonable under the Regulation. A longer extension may be reasonable, but the bank has the burden of establishing the reasonableness of the longer extension. 12 C.F.R. § 229.13(h) (1992).

11 12 U.S.C. § 4003 (1988).

12 12 U.S.C. § 4004(a) (1988); 12 C.F.R. 229.16 (1992).

13 12 C.F.R. § 229.30 (1992).

14 *Id.* § 229.35, app. D.

15 The Board of Governors of the Federal Reserve System, through its own investigation, research and analysis, presented three reports to Congress about deposits at nonproprietary automated teller machines. 56 Fed. Reg. 7799, 7800 (1991). The first report in October 1988 provided background information on the processing of deposits at nonproprietary ATMs but did not include a legislative recommendation because there was limited research available at that time. *Id.* at 7800 n.2. The other two reports were transmitted to Congress in October 1989 and July 1990. *Id.* These two reports recommended that Congress should treat nonproprietary ATM deposits under the permanent schedule in the same manner as such deposits were treated under the temporary schedule. *Id.* at 7800.

16 Pub. L. No. 101-625, § 1001, 104 Stat. 4424 (1990).

17 Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 227, 105 Stat. 2236, 2307-2308 (1991) (codified at 12 U.S.C.A. § 4002 (e) (1989 & Supp. 1992)).

18 57 Fed. Reg. 3365 (1992).

19 Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 225, 105 Stat. 2236, 2307 (1991) (codified at 12 U.S.C.A. § 4003 (Supp. 1992)).

20 57 Fed. Reg. 3277 (1992).

21 Federal Deposit Insurance Corporation Improvement Act of 1991, 403-04, Pub. L. No. 102-242, § 105 Stat. 2236, 2374-75 (1991) (codified at 12 U.S.C.A. §§ 4403-04 (Supp. 1992)).

22 Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 402, 105 Stat. 2236, 2372-73 (1991) (codified at 12 U.S.C.A. § 4402 (Supp. 1992)).

23 Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 403-404, § 105 Stat. 2236, 2374-75 (1991) (codified at 12 U.S.C.A. §§ 4403-04 (Supp. 1992)).

24 Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 308(a), 105 Stat 2236, 2362-63 (1991) (codified at 12 U.S.C.A. §§ 371b-2 (Supp. 1992)).

25 Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 308(c), 105 Stat. 2362 (1991).

26 57 Fed. Reg. 31,974 (1992).

27 *Id.* at 31,985. Under the proposed rule, a correspondent is "adequately capitalized" if, under the federal bank regulatory agencies' risk-based capital guidelines, the correspondent has a total risk-based capital ratio of 8 percent or greater, a Tier 1 risk-based capital ratio of 4 percent or greater, and a leverage ratio of 4 percent or greater. *See generally* 12 C.F.R. pt. 3, app. A (1992) (risk-based capital guidelines of the Office of the Comptroller of the Currency applicable to national banks); 12 C.F.R. pt. 208, app. A (1992) (risk-based capital guidelines of FRB applicable to state-chartered banks that are members of the Federal Reserve System); 12 C.F.R. pt. 325 (1992) (risk-based capital guidelines of the FDIC applicable to FDIC-insured state-chartered banks that are not members of the Federal Reserve System); 12 C.F.R. pt. 567 (1992) (risk-based capital guidelines of the Office of Thrift Supervision applicable to savings associations).

28 57 Fed. Reg. 31,974, 31,985 (1992). A correspondent is "well capitalized" if it has a total risk-based capital ratio of 10 percent or greater, a Tier 1 risk-based capital ratio of 6 percent or greater, and a leverage ratio of 5 percent or greater under the federal bank regulatory agencies' risk-based capital guidelines.

29 *Id.* at 31,985-31,986.

30 *Id.* at 31,982.