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June 3, 2011

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington D.C. 20551

Re: Docket No. R-1409 and RIN No. 7100-AD68
Availability of Funds and Collection of Checks (Regulation CC)

Dear Ms. Johnson:

The following comments regarding the Board of Governors of the Federal Reserve System's (the "Federal Reserve") Notice of Proposed Rulemaking – Availability of Funds and Collection of Checks ("Proposed Rule") are submitted on behalf of the Independent Bankers Association of Texas ("IBAT"). IBAT is a trade association representing approximately 500 community banks domiciled in Texas. Most of IBAT's member banks are family owned or closely held and several are public traded. All of IBAT's members will be affected by this rule.

The purpose of this letter is to address the Federal Reserve's proposed changes to the Expedited Funds Availability Act ("Regulation CC"). The Proposed Rule implements the requirement to increase immediately available funds for withdrawal from $100 to $200 as required under the Dodd-Frank Act. The Proposed Rule also carries out a "clean-up" function to Regulation CC to make the rule comport with the fact that due to the Federal Reserve's consolidation of physical check processing facilities there are no longer any checks that are "nonlocal."

However, the Federal Reserve has apparently leveraged the Proposed Rule to also implement changes that are not necessarily dictated by law or technical changes to Regulation CC that will accomplish the Federal Reserve's goals of: (a) further "encouraging" electronic check clearing and return; (b) addressing electronic items not derived from checks; (c) revising funds availability provisions to shorten the time period for safe harbor for exception holds; and (d) making changes to model disclosures and notices relating to funds availability.

Part I of the Proposed Rule would enact amendments to encourage electronic check clearing and return and addresses changes in the following areas:

*Expeditious Return Requirement*

The current rule regarding the expeditious return requirement is that a paying bank must return unpaid checks expeditiously to the depositary bank[1], regardless of whether the depositary bank has agreed to accept returned checks electronically. The Federal Reserve argues that currently physical check transportation networks have largely been discontinued as an increasing proportion of checks are collected and returned electronically. Therefore the paying bank now bears the increased cost of returning checks expeditiously to depositary banks that will not accept electronic returns, or faces the increased risk of not doing so expeditiously. The Federal Reserve also argues that the "full benefits and costs savings of electronic check-return methods cannot be realized if paying banks and returning banks must incur substantial expense to deliver returned checks to the banks that continue to require paper checks to be returned." Fed. Reg. Vol. 76, No. 58 (Friday March 25, 2011) at 16883. The Federal Reserve is of the opinion that small depositary banks now have low-cost options to accept returns electronically, and that from an over-arching "system" standpoint, it would seem more efficient to place the risk of non-expeditious return on the banks that *choose* not to accept electronic returns.

Under the Proposed Rule, a paying bank would have the duty of expeditious return only if the depositary bank agrees to accept returned checks electronically. The Proposed Rule would define a new term, "electronic return," and would establish requirements for an item to qualify as an electronic return.

While it is clear that the Federal Reserve believes that these changes will "encourage" banks, particularly smaller banks, to change their systems to accept returned checks electronically, IBAT questions why the Federal Reserve believes it has to use changes to Regulation CC as a means to encourage the electronic transmittal and collection of checks. If the adoption rates of electronic transmittal and collection of checks continue to increase, then eventually all financial institutions will be accepting returned checks electronically.

It is not realistic for the Federal Reserve to expect, given all the other numerous regulatory and compliance challenges faced by community banks and small financial institutions, that all financial institutions will have the money and staff time and resources to implement electronic processing. It also appears that the Federal Reserve has not given any consideration to the smaller community banks and financial institutions whose check volumes may be at levels such that it is not economically feasible for those institutions to go to the expense of acquiring the required electronic processing equipment. Rather than mandate these changes through amendments to Regulation CC, the Federal Reserve should let the marketplace determine how banks choose to accept check returns, and make such a proposed change only after all institutions have moved to accepting check returns electronically.

*Notice of Nonpayment Requirement*

Under the current rule, a paying bank that declines to pay a check over $2,500 must provide notice of nonpayment to the depositary bank by two business days after the day the check was presented to the paying bank. Such notice must be provided by 4 p.m. local time on the second business day following the banking day on which the check was presented by the paying bank. Return of the check itself satisfies the notice of nonpayment requirement if the return meets the timeframe requirement for a notice of nonpayment.

The Proposed Rule would eliminate the notice of nonpayment requirement. The Federal Reserve argues that a depositary bank that accepts electronic returns will receive the returned check as fast as the notice, so there is no

[1] Under the revised definition contained in § 229.2(r) of the Proposed Rule, a "depositary bank" means the first bank to which a check is transferred even though it is also the paying bank or the payee. A check deposited in an account is deemed to be transferred to the bank holding the account into which the check is deposited, even though the check is physically received and indorsed first by another bank. A bank that rejects a check submitted for deposit is not a depositary bank with respect to that check.

need for a separate notice of nonpayment, and that this change in the Proposed Rule will provide further incentives for depositary banks to accept returns electronically.

Again, it is not realistic for the Federal Reserve to expect, given all the other numerous regulatory and compliance challenges faced by community banks and small financial institutions, that all financial institutions will have the money and staff time and resources to implement electronic processing.

The Federal Reserve also appears to have given no consideration to the possible overdraft and check losses that financial institutions are exposed to if the requirement to notify a non-electronic processing bank of large dollar returns is eliminated. The protections of notification under the current version of Regulation CC are there to protect all institutions against operating losses and it is currently working well, so IBAT does not see a pressing need to change these provisions. Rather than "encourage" adoption of all electronic methods via new penalties under Regulation CC, the Federal Reserve should let the marketplace determine how banks choose to accept items and returns, and make such a proposed change only after all institutions have moved to accepting check returns electronically.

The notice of nonpayment requirement should be retained for banks that do not agree to accept electronic returns until such time as all banks have made the business decision to accept electronic returns.

*Same Day Settlement Rule*

Under the current rule, banks and financial institutions must provide same-day settlement for paper checks presented in accordance with certain reasonable delivery requirements established by the paying bank and presented at a location designated by the paying bank and by 8 a.m. (local time of the paying bank) on a business day.

Under the Proposed Rule, the Federal Reserve would allow a paying bank to require checks presented for same-day settlement to be presented electronically as "electronic collection items." A paying bank, however, must have agreed to receive electronic collection items under the new proposed § 229.36(a). The Proposed Rule includes a new definition of "electronic collection item" that is similar to "electronic returns" and would establish the substantive requirements for an item to qualify as an "electronic collection item." Under the Proposed Rule, the timeframes, deadlines and settlement methods for same-day settlement of electronic collection items would be the same as those currently in effect for same-day settlement presentments of paper checks. The Proposed Rule would not preclude interbank presentment of checks in paper form and settlement for such presentments would be subject to the UCC, § 229.36(d) (if the paying bank has not specified that checks presented for same-day settlement be presented as electronic collection items), or Regulation J.

The argument in favor of this change is that many paying banks want to receive all checks electronically so they can eliminate their paper-check processing infrastructure. Some collecting banks, however, continue to present paper checks under Regulation CC's same-day presentment rule, and this is problematic to those financial institutions attempting to streamline their processes.

What is confusing about this provision of the Proposed Rule is that it appears that one bank can, unilaterally, force other banks to present checks for same-day settlement electronically if that same paying bank has agreed to receive electronic presentment items from the presenting bank under § 229.36(a). While this situation might exist, for example, when both banks are members of the same check clearinghouse organization, IBAT is concerned that one bank's decision could unilaterally dictate what other banks are required to do.

Again, it is not realistic for the Federal Reserve to expect, given all the other numerous regulatory and compliance challenges faced by community banks and small financial institutions, that all financial institutions

will have the money and staff time and resources to implement electronic processing. This appears to be yet another issue where the Federal Reserve is using the Proposed Rule to "encourage" adoption of all electronic methods via new penalties or disadvantages under Regulation CC. The Federal Reserve should let the marketplace determine how banks choose to accept items and returns.

Part II of the Proposed Rule would enact amendments to address electronic items not derived from checks. Electronically created items currently have no clear legal framework. Although they are cleared through the check system, they never existed as paper checks. An electronically created item is not derived from an original paper check and therefore cannot be used to create a substitute check under the Check 21 Act and Regulation CC.

The Federal Reserve points out that there are current industry practices where an electronic image of a "check" is created, but a check never existed in paper form (and the Federal Reserve defines these as "electronically created items"). For example, a payee may collect payment by means of an electronically created item (*i.e.* items that never existed in paper form) that resembles images of remotely created checks. Or a drawer's bank (the paying bank) may supply a smart-phone application through which the drawer is able to execute a "handwritten" signature on the smart-phone's touch screen, and through which that signature is then attached to an electronic "check" that the drawer sends via the Internet to the payee for the payee's subsequent electronic deposit to its bank. As a practical matter, a bank cannot distinguish these types of items from any other image of a check that it receives electronically.

Regulation CC currently addresses neither electronic items derived from paper nor electronically-created items; it only addresses substitute checks created pursuant to the Check 21 Act.

The Proposed Rule would address two types of "electronic items": those electronic items derived from a paper check, and those electronic items that are purely electronically created. An electronic item that is derived from a paper check is typically an electronic image of the front and back of a paper check accompanied by electronic information related to the paper check. The collection and return of these items are governed by private agreement (*e.g.*, clearinghouse rules) or by Regulation J and Operating Circular 3 if handled by a Federal Reserve Bank.

An electronic item that is electronically created is an electronic image that resembles an image of the front and back of a check, accompanied by related electronic information, but no paper check ever existed (such as the scenarios discussed above). Like remotely created checks ("RCCs"), these electronic items in many instances do not bear the drawer's signature, and may carry a fraud risk similar to RCCs.

Under the Proposed Rule as IBAT reads it, electronic items derived from paper would be treated as checks for purposes of Regulation CC's collection and return provisions. Regulation CC's transfer and presentment warranties would apply to electronic items derived from paper, and would also apply to electronically created items.

Under the Proposed Rule's new language in § 229.34 (a) ("Transfer and presentment warranties with respect to an electronic collection item of an electronic return"), each bank that transfers or presents an electronic collection item or an electronic return and receives a settlement or other consideration for it warrants (a) that the electronic image is accurate, contains all information on the front and back of the original check and an accurate record of the MICR line, (b) that no other person will receive a transfer, presentment, return of, or will otherwise be charged for, an electronic collection item, electronic return, original check, substitute check or paper or electronic representation of a substitute check that has already been paid.

Applying warranties to electronic items derived from paper provides a legal framework within Regulation CC for electronic returns and electronic collection items presented for same-day settlement. A bank that receives an electronically created item likely will be unable to distinguish it from an electronic image of a paper check and related information, and therefore will transfer or return the electronic item *as if* it were derived from paper. Warranties will protect a bank that unknowingly received an electronically created item from potential liability (*e.g.* from creating a nonconforming substitute check or improperly paying an RCC).

These provisions of the Proposed Rule address a current problem and gray-area with respect to these items, and to the extent that the Proposed Rule will provide greater protections and tools to banks and financial institutions who may be unknowingly accepting and/or transferring such items, then IBAT supports making such electronically created items subject to the same warranties that currently apply to substitute checks created under the Check 21 Act.

Part III of the Proposed Rule would enact amendments related to the elimination of nonlocal checks from Regulation CC. Under the current rule, local and nonlocal checks must be made available for withdrawal within 2 and 5 business days, respectively. The Proposed Rule eliminates references to nonlocal checks and the nonlocal check hold schedule. As a rationale for the changes in the Proposed Rule, the Federal Reserve states that as check collection has become increasingly electronic, the Federal Reserve Banks have closed their check processing offices. According to the Federal Reserve's figures, in 2003 there were 45 check processing offices and in 2010 there was only 1. The federal Expedited Funds Availability Act (the "EFA Act") defines nonlocal checks as checks payable in a different Federal Reserve check processing region than where they are deposited. The Federal Reserve Bank's consolidation process has resulted in the de facto elimination of nonlocal checks. IBAT understands the reasons and rationale for these "clean-up" changes to Regulation CC and therefore has no comment on these provisions of the Proposed Rule.

Part IV of the Proposed Rule would enact amendments to reflect new provisions of the Dodd-Frank Act. The first Dodd-Frank Act provision addressed by these provisions of the Proposed Rules is that the dollar amount of funds "immediately available for withdrawal" is increased from $100 to $200 dollars. Section 1086(e) of the Dodd-Frank Act changed the EFA Act to require financial institutions to raise from $100 to $200 the minimum amount of funds deposited by check or checks on a given day that a bank must make available by opening of business on the next business day pursuant to Section 603(a)(2)(D) of the EFA Act. The increase is expected to take effect on July 1, 2011 regardless of whether Regulation CC has been amended.

IBAT understands that the Federal Reserve must enact this change to Regulation CC based upon the requirements of the Dodd-Frank Act, but points out that raising the amount that must be available from $100 to $200 will increase a financial institution's fraud exposure. For those situations where there is an item returned unpaid, all banks, including community banks, are effectively going to double their immediate losses on these items. While banks may still have a right of setoff against other funds in the customer's account, the amount of cash that the customer can walk away with is doubled, and thus the losses of community banks and financial institutions will undoubtedly increase as a result of this change.

The second provision of the Dodd-Frank Act addressed by these provisions of the Proposed Rules addresses rule writing authority. Section 1086 of Dodd-Frank amends the Federal Reserve's rule-writing authority under the EFA Act by making certain rule-writing authorities joint with the Consumer Financial Protection Bureau ("CFPB"). Specifically, as of the transfer date, the Federal Reserve's authority to implement the EFA Act's provisions, to reduce hold periods, establish exceptions to the funds-availability schedule, and public model disclosure provisions will become joint with the CFPB. Accordingly, after the transfer date, any rules promulgated pursuant to these authorities will be done so jointly with the CFPB.

Given that the transfer date is July 21, 2011, IBAT wonders whether it is appropriate for the Federal Reserve to propose all of the modifications and changes to hold periods and model disclosures discussed in Part V of the rule if there is even the slightest chance that additional changes will be made to these provisions through joint rulemaking by the Federal Reserve and the CFPB at a later date either this year or next year. It would be extremely inefficient, and costly to banks and financial institutions, to adopt one set of changes to these provisions now, and then turn around and make additional changes 6 months or a year from now. That would create a waste of staff time and expense for community banks like IBAT members, especially if there are a continuous series of changes to model forms and disclosures.

Part V of the Proposed Rule would enact "other proposed amendments," including shortening the safe harbor period for exception holds and revising model disclosures and notices regarding funds availability and holds.

*Shortening The Safe Harbor For Exception Holds*

Under the current rule a bank may apply a long exception hold to a check deposited in certain circumstances where there is higher risk the check will be returned unpaid. The safe-harbor period for exception holds is currently 7 business days.

Under the Proposed Rule, the safe harbor period would be shortened from 7 business days to 4 business days. As support and rationale for this shortening of the safe harbor period for exception holds, the Federal Reserve states that a bank that accepts electronic returns will receive virtually all returned checks within the proposed 4 business day timeframe. The Federal Reserve also states that this provision would provide further incentives to depositary banks to accept electronic returns so that they would essentially be "forced" to better protect themselves from potential fraud risk. The Federal Reserve notes that the Proposed Rule would continue to permit a longer exception hold, but the bank would have the burden of demonstrating the hold was reasonable.

IBAT strongly opposes implementing any changes that would reduce its community bank members' ability to guard and protect against fraud losses. The purpose of holding items is to reduce the risk of an item not being collected. Under the current rule, items that are not returned electronically can take 5+ days to make it back to the bank of first deposit. Shortening the period to 4 days ignores the fact that not all banks are currently processing electronically. The Federal Reserve should use other means to work toward total electronic check processing instead of creating "incentives" through new penalties and potential increases to fraud losses under the Proposed Rule. Any shortening of the safe harbor period for exception holds should be delayed until the market evolves such that all items are being processed electronically.

Furthermore, IBAT believes that the Federal Reserve has completely ignored the fact that a longer hold period can provide a bank with valuable time to track down fraud issues with a particular customer or within a particular payment channel. Instances of fraud continue to rise, and new check acceptance methods such as customer remote deposit capture (both commercial and consumer) and mobile deposit capture (both commercial and consumer) will introduce new types of fraud activity that banks will have to address, and investigation time is critical to sorting these new fraud challenges out and protecting the bank. The last thing the Federal Reserve should do is eliminate tools that can help community banks mitigate risk of loss of funds due to fraud within and across new and evolving payment channels. In addition, shortening the safe harbor period for exception holds may also result in a situation where the bank is cited in a functional regulator exam for not appropriately monitoring and taking mitigating action regarding high-risk payment channels such as consumer remote deposit capture.

Again, it is not realistic to assume that all institutions will be able to quickly switch to electronic processing, and until this happens, under the Proposed Rule such financial institutions will unfairly be forced to accept more fraud risk, which can, in turn, have very real and detrimental effects on the institution's safety and soundness.

In addition, it would be extremely helpful to get more clarification or examples from the Federal Reserve regarding what constitutes a "reasonable cause" hold.

The Federal Reserve has also requested comment "on the extent to which banks continue to find it useful to apply case-by-case holds to check deposits and on whether Regulation CC's provision for case-by-case holds should be deleted." The Federal Reserve has stated that "in the absence of nonlocal checks, the extra hold period that a depositary bank may obtain by applying a case-by-case hold is generally not sufficient for the bank to learn that a deposited check has been returned unpaid before making funds available to the depositor." The Federal Reserve states that while the 1 extra day that a depositary bank may obtain by applying a case-by-case hold may not be sufficient in many cases to learn of the return of a deposited check, some banks continue to apply such holds to mitigate the potential risk of loss. And many banks that have a general next-day funds availability policy continue to disclose the potential for case-by-case and exception holds.

For all of the reasons stated above with regard to shortening the safe harbor for exception holds, IBAT is also opposed to eliminating case-by-case holds as banks need this risk mitigation tool. Additionally, such a change could have the unintended consequence of banks which generally make funds available the next day changing their policy to one of holding funds deposited by check for the full statutory limits and reserving the right to place exception holds. That shift in policy could, in turn, result in a delay of next-day availability to second-day availability, which would be an unintended consequence of this provision.

*Revising Model Funds Availability Disclosures and Notices*

The current model disclosures and notices contain obsolete references to local and nonlocal checks and were developed over 20 years ago. The Proposed Rule would revise model forms and disclosures to remove the obsolete references to local and nonlocal checks and reflect a proposed, simplified funds-availability schedule. The Federal Reserve states that the proposed new forms and disclosures reflect insights gained from recent consumer testing. Under the Proposed Rule, a bank that bases its disclosures on the existing models would have 12 months to switch to the proposed forms.

It appears that while on the whole the Proposed Rule hold notices and disclosures are simpler and easier in some respects, reinstating a requirement to state the "total amount deposited" may be re-introducing an old problem. The total amount deposited was eliminated as a requirement before because it created confusion. If a customer presents multiple items, it may be confusing to give one "total deposit amount" on three different checks if the bank has to use one hold notice *per check*. It is also going to be confusing regarding the first $200 when there are multiple checks and one total amount of deposit and banks have to give one hold notice *per check*.

New language under the Proposed Rule that would be added to § 229.13(g) ("Notice of exception") states that "[i]f the customer has agreed to accept notices electronically, the bank shall send the notice such that the bank may reasonably expect it to be received by the customer no later than the first business day following the day the facts become known to the depositary bank, or the deposit is made, whichever is later."

While IBAT believes that having an option to send an electronic notice of exception is good, it is not reasonable to require that a bank send an electronic communication regarding any notice of exception. Such a requirement would take a great deal of staff time and be very costly to implement; therefore this provision should be optional (change the "shall" to "may") to allow the bank to make its own internal business decision regarding the most effective and efficient solution. In addition, IBAT would like the Federal Reserve to clarify whether the electronic notice of exception would include text messages sent to the customer's mobile device.

Also under these provisions of the Proposed Rule, language would be added to § 229.15(b) to require that the bank make reference in its disclosures and notices about day of availability rather than saying that the funds will be available for withdrawal "on the ___ business day after" the day of deposit. Instead the bank would be required to "specify the business day on which funds are available for withdrawal by describing that day in relation to the banking day on which the bank received the deposit." The required language under the proposed rule would be "the same business day" if funds will be available for withdrawal on the banking day of receipt of deposit, or "the next business day," or "X business days" after the banking day of receipt of deposit. IBAT is not sure why this proposed change is absolutely necessary at this time.

It is IBAT's understanding that banks using current model forms would have a 12 month safe harbor after the final rule becomes effective to adopt new forms. However, updated notices would be required for new accounts and upon request.

Again, however, IBAT is concerned that the changes in Part V, other than those changes relating to elimination of references to nonlocal checks, are premature if there is even the slightest chance that additional changes will be made to model disclosures and forms through joint rulemaking by the Federal Reserve and the CFPB at a later date either this year or next year. It would be extremely inefficient, and costly to banks and financial institutions, to adopt one set of changes to these provisions now, and then turn around and make additional changes 6 months or a year from now. That would create a waste of staff time and expense for banks like IBAT, especially if there are a continuous series of changes to model forms and disclosures. The constant change in forms and terms is confusing for all financial institutions. Banks barely have time to complete the last updates and yet the Federal Reserve continues to require more with little regard for the time and cost involved in handling the large amount of time and energy expended by staff to implement such changes.

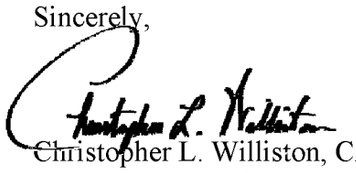
Texas community banks provide important services and play a critical role in many communities across the state. Such banks provide deposit, investment and loan products to local consumers and businesses, stimulating economic activity in their local communities. The Proposed Rule will cause community banks to incur additional significant costs and expenses (both in real dollars and employee time), to comply with this rule.

Banks of all sizes throughout the country would face additional new regulatory burdens due to the expansive scope of some portions of the Proposed Rue. And this would come at a time when community banks are facing unprecedented regulatory costs, burdens and expenses due to financial reform set forth in other provisions of the Dodd-Frank Act.

In conclusion, IBAT does understand the rationale and necessity for some of the changes in the Proposed Rule, but, as explained above has serious reservations about and opposes other provisions of the Proposed Rule that are not critical to implement at this time. We strongly urge the Federal Reserve to look at this rulemaking in the context of the cumulative rulemaking and regulatory changes that all banks are facing as the Dodd-Frank Act continues to be implemented, and consider that certain portions of the Proposed Rule are not required nor critically necessary to implement at this time.

Thank you for this opportunity to comment.

Sincerely,



Christopher L. Williston, CAE
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