Canadian Payments Association

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HOLDS ON CHEQUES:

A Means of Managing Risk

Revised: January 2002

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I Introduction

Canada has one of the most efficient cheque clearing and settlement systems in the world. Just under 1.5 billion cheques are cleared in Canada annually; in almost all cases, Canadians receive same-day credit for cheques deposited to their accounts and the funds begin bearing interest immediately -- benefits that are not provided by most other industrialized countries.

However, because a financial institution (FI) accepting a cheque on deposit (the negotiating FI) often has no relationship with the person who wrote the cheque (the payor), it has no way of verifying whether the cheque may be dishonoured due to insufficient funds in the payor's account, a stop payment order, a forged signature or any other reason. Only the branch of the payor's FI that holds the account on which the cheque is written can make this determination once it receives the cheque from the negotiating institution. Given that approximately six million cheques pass through the clearing system each day, it is impractical for the payor's FI to notify the negotiating institution immediately whether or not the cheque has been honoured. Instead, if the cheque is dishonoured, the payor's FI returns the actual paper cheque to the negotiating institution using the clearing system.

The negotiating institution is therefore uncertain of the cheque's worth until such time as the risk that the cheque may be dishonoured and returned has expired. Consequently, it may decide to place a hold on the funds represented by the cheque. Even so, as part of building relationships with their customers, FIs have taken steps to minimize the impact of such holds. Based on data received from FIs that participated in preparing this report, less than one per cent of deposit accounts are subject to a hold on a cheque on any given day.

Holds on cheques are a proprietary matter for each FI and are thus outside the scope of the Canadian Payments Association's Rules. However, the timeframe associated with delivering a cheque through the clearing system to the branch holding the account on which it is drawn (and potentially returning it) is an important factor that FIs will take into account in establishing their holds policies.

This paper describes the cheque clearing and settlement system, clarifies why holds exist, provides some insight on current activities to enhance the clearing of cheques and offers suggestions on avenues available to customers who have concerns about this issue.

II An Overview of the Cheque Clearing and Settlement Process

This section of the paper will explain a cheque's travels as it makes its way through the clearing and settlement system. **Clearing** means the process of exchange and reconciliation of payment items and the calculation of the net amounts due to or by members[1] prior to settlement. **Settlement** means the process of acknowledging and extinguishing the obligations between members that arise from the inter-member exchange of payment items.

Although these processes generally occur within one day of a cheque being deposited, cheques and other payment items may spend a significant amount of time in transit after clearing and settlement. As will be explained later in this section, this "time in transit" plays an important role in financial institutions' decisions regarding holds on cheques.

i) The Clearing and Settlement Process

In Canada, 12 financial institutions, referred to as Direct Clearers, handle the clearing and settlement of payment items for their customers, as well as for customers that maintain accounts at any one of approximately 100 other deposit-taking financial institutions in Canada (referred to as Indirect Clearers).

Most cheques in Canada clear overnight. This means that a cheque that is deposited at a branch of an FI today will be sent to a data centre for processing tonight and be *cleared* (i.e., delivered) to the data centre that acts on behalf of the FI that holds the account to be debited, before midnight.

Although the negotiating branch (where the cheque is deposited) is uncertain whether there are funds to cover the item, it generally provides immediate provisional credit to its customer for that item, and the funds will start to bear interest from the day of deposit.

In some circumstances, cheques cannot be cleared overnight. For example, cheques that cannot be processed by automated equipment must be processed manually the next day. As well, because cheque clearing activity takes place on regular business days, cheques deposited at a branch on a Saturday will not be cleared until the following Monday evening. Clearing activity will also be delayed for cheques deposited during extended business hours and for some Automated Banking Machine (ABM) deposits. The subject of ABM deposits will be dealt with in greater detail in Section IV below.

Through accounts maintained at the Bank of Canada, Direct Clearers "settle" or extinguish their payment obligations vis-à-vis one another on the morning following the evening cheque clearing exchanges. Indirect Clearers settle the same day with their respective Direct Clearer through special accounts they maintain with their Direct Clearer. It is important to note that inter-member settlement does not imply finality of payment. If a cheque must be returned because it cannot be paid (e.g., NSF, stop payment), the FI holding the account on which it was written will recover the amount of the cheque from the negotiating institution as part of the settlement process.

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[1] Member means a member of the Canadian Payments Association (e.g. bank, trust company, credit union central, etc.).

ii) Routing to Branch of Account

Once a cheque has cleared, the receiving data centre must identify the branch of account on which the cheque is drawn and start to route the item to that branch, where it is determined whether the cheque will be honoured or returned (this is commonly referred to as making the "pay/no-pay" decision). If the item is drawn on an Indirect Clearer, the receiving data centre must route the item to that FI.

If the branch of account is located in another province, the cheque may be sent by air or ground courier to a data centre that operates in another location.[2] Once the cheque arrives at the branch of account, in accordance with CPA Rules, the branch has until the next business day to determine whether it will honour or dishonour the item.[3] If the cheque is dishonoured, it must be returned to the branch that initially accepted the cheque on deposit, and this process must be initiated within the "one business day" window. The return journey retraces the forward presentment route and may likewise take several days. In other words, the negotiating branch will only learn that a cheque has been dishonoured when it is returned to it. Examples of a cheque's travels under optimal conditions are illustrated in Appendices 1 and 2.

There are many variables to consider when assessing how much time an item might spend in transit (e.g., the time necessary for the item to reach the pay/no-pay unit and return to the negotiating institution) after it has cleared. This period will depend on such factors as:

- the number of FIs involved in the transaction (e.g., are Direct and Indirect Clearers involved?)
- the geographic locations of the negotiating branch and the branch on which the cheque is drawn (will the item have to be transported to another part of the country?)
- the physical state of the item (is the item torn or mutilated and does it require manual handling, which will slow down the presentment process?)

III Risk Management

Managing risk in the financial services sector, particularly in the payments system, is an important consideration for Canadian FIs both domestically and internationally. Efforts are always under way to promote and maintain the safety and soundness of the payments system and its overall stability.

Placing holds on cheques is one form of risk management for individual FIs. FIs must protect their depositors and shareholders from losses due to negotiating bad cheques[4]. When a

2 Clearing activity takes place in six cities in Canada: Vancouver, Calgary, Winnipeg, Montreal, Toronto, Halifax

3 According to CPA Rules, a payor's FI branch of account has until the next business day to make a pay-no-pay decision on an item. However, some FIs have a policy that items must be returned on the same day they are presented for payment, thereby speeding up the return process.

4 One financial institution reported that, through the use of hold funds and other means of fraud detection, it prevents approximately $8 million dollars in potential losses each year.

negotiating FI provides immediate access to funds before a cheque clears and settles, or when it releases funds before a sufficient time to allow for the return of the item, it is accepting the risk that the institution on which the cheque is drawn may not cover funds that have already been withdrawn by the negotiating institution's customer. Given this exposure, the decision as to when funds are made available to clients is often made on a case-by-case basis for the reasons enumerated in the next section.

IV Factors Considered in Placing Holds

When a cheque is accepted on deposit, the negotiating FI will estimate the latest date on which an item might come back for a "charge back" to the account. This time in transit may affect the hold period, if any, that is placed on the cheque. Other factors that may affect whether an item is placed on hold are:

- the depositor's history (have many cheques been returned unpaid?);
- the client's average account balance (are there enough funds in the account to charge back the item if necessary?);
- the length of time the customer has been a client of the FI (the "know your customer" rule-of-thumb may apply);
- the client's relationship with the branch (is the client a customer of that branch or another branch of the same FI?);
- the value of the item;
- the FI's own in-house guidelines for the number of days a hold is to be effective;
- the time of deposit (is this a weekend deposit? an after-hours deposit? a statutory long weekend?);
- the type of cheque (is it a personal or company cheque?);
- unusual account activity.

In essence, the length of time an item is placed on hold is an individual business decision on the part of the negotiating FI and can vary from institution to institution and from customer to customer.

ABM Deposits

A significant number of cheques are deposited through ABMs because of their convenience. Since there is no way to verify immediately the details of an ABM deposit, in most cases it will be considered riskier to an FI and the "hold funds" period may be longer than if the cheque had been deposited through a teller. Contributing to increased risk in these circumstances are additional uncertainties:

- Is the amount the client claims to be depositing the same as shown on the cheque?
- Is the deposit envelope empty?

Because ABM deposits are not necessarily verified at a branch, these questions will only be answered after the envelopes arrive at the data centre for inspection and processing. Only then may the "hold funds" period be readjusted according to the nature of the deposit.

ABMs are emptied on a regular basis and the items are sent to the appropriate data centre for processing that evening. However, if a deposit is made shortly after a machine has been emptied, that deposit will remain in the ABM until it is next serviced, which may be the following day. These deposits will have a longer "time in transit" period.

V The North American Experience

As mentioned earlier in this paper, the decision to place a hold is a proprietary one on the part of each FI. Canadian FIs' holds policies measure up favourably with those of countries, such as the United States, where rules have been put in place to govern the availability of deposited funds and the time an FI may hold a cheque.

In comparison to the requirements set out in the American *Expedited Funds Availability Act* (*EFAA*), Canada's FIs surpass U.S. cash and wire transfer availability standards. For instance, Canadian consumers will generally receive same business day availability for cash deposits or wire transfers, whereas the *EFAA* sets out that U.S. customers should receive next business day availability for the majority of these types of payments.

Although the *EFAA* imposes a timeframe for making funds available to depositors for local and nonlocal cheques, it also provides for a number of circumstances in which these normal availability schedules would not apply. These "safeguard exceptions" include:

- new deposit accounts,
- large cheques,
- cheques that have been returned unpaid and are redeposited,
- deposit accounts that have been overdrawn repeatedly, and
- circumstances where the depository institution has reasonable cause to believe that the cheque is uncollectible from the originating depository institution.

These exemptions from the "normal" availability schedule capture the types of circumstances where Canadian deposit-taking FIs would not follow the practice of providing same-day access to funds deposited and, instead, would place a hold on the funds.

VI Enhancing the Cheque Clearing and Settlement System

Less than 10 years ago, over 85% of all payment transactions were paper-based. With the growth in popularity of electronic payment options in the past decade, paper-based transactions now account for only 35% of all clearing transactions (as at the end of 2000). As can be expected, electronic transactions eliminate the need for some of the manual handling associated with cheques, and they can be routed and returned more efficiently (i.e., "time in transit" is less of a factor for these items).

With regard to processing paper items, a CPA committee spent a considerable amount of time and effort examining the time cheques spend in transit and endeavouring to quantify it to establish a standard "time transit model" or end-to-end timeframes. In the long term, it was anticipated that these timeframes might be helpful to FIs when establishing their proprietary policies on holds on cheques, in that they would help identify the period of potential exposure.

The task is complex given that many factors can affect an item's time in transit, including geographic considerations, the number of FIs involved in a transaction and the physical state of the item. Other factors to be weighed are operational in nature. For instance, the working group considered the additional time in transit required to deal with items that went astray prior to reaching the pay/no-pay unit and "recreating" them for the purposes of continuing the clearing process.

More recently, CPA members have been focusing on the potential of Electronic Cheque Presentment (ECP) to enhance processing efficiency and shorten a cheque's time in transit. Through ECP, key data from a cheque would be captured electronically by the negotiating FI and transmitted to the institution on which the cheque is drawn as the basis for making the "pay/no pay" decision. Cheque images could be made available to both the payor's FI for verification and the customer who wrote the cheque to facilitate record keeping. If a cheque was not honoured, the drawee institution could potentially notify the negotiating FI electronically within a specified timeframe.

However, there are currently legislative impediments that preclude FIs from completely "truncating" or eliminating the movement of paper cheques. The *Bills of Exchange Act* states that a cheque must be duly presented for payment. In effect, this means that a cheque must be physically exhibited to the drawee institution. This provision is intended to give the drawee institution an adequate opportunity to make an informed decision as to whether to honour the cheque, as well as to ensure that entitlement to payment can be demonstrated. Amendments to the *Bills of Exchange Act* could allow FIs to develop electronic alternatives to transmit information on cheques and eliminate the necessity to move the great majority of paper items.

VII Financial Institution Policies on Hold Funds and Statistics

Although policies on holds on cheques vary from institution to institution, there are general principles observed across the industry. For instance:

- Before accepting a transaction that may be subject to a hold, FIs generally require tellers to advise a customer of the institution's policy on cheques and delays that may be involved in accessing such funds. The holds policy is often also explained when the account is opened, or the policy forms a part of the account holder's agreement.
- The rule of thumb for many FIs is "know your customer". A long-standing client at an FI will have a better internal rating than a customer who recently opened an account. The client with the better rating may benefit from a "no holds" policy.
- For some FIs it is common practice to establish a threshold amount for withdrawals against cheques that may be in transit that, if exceeded, will cause only a portion of funds being deposited to be held.
- ABM deposits are usually subject to longer hold periods (in some cases a hold may be extended by two days) because they may spend a longer time in transit.

- Holds on cross-border U.S. and foreign currency items are typically much longer than on Canadian dollar items. In these cases, holds can range from 20 to 30 business days. This is to provide for an even longer time in transit due to the increased number of players involved in the transaction and different regulations in other countries.

To measure the volume of holds on cheques within their institution, Direct Clearers were asked to collect statistics on the subject. A brief review revealed the following:

- Three Direct Clearers were able to determine the number of accounts at their institution that had outstanding holds. They found that, on average, less than one per cent of accounts had an outstanding hold on any given day.
- Less than one per cent of complaints received by the customer relations centres for three Direct Clearers related to holds on funds. Specifically, they reported the following statistics: 0.06%, 0.018% and 0.33%. In the last case, over half of the hold on funds complaints were as a result of an ABM deposit or foreign currency item.

VIII The Role of the Customer

A customer builds a relationship with his/her FI on a daily basis, and healthy account activity helps an FI gauge the risk of accepting deposits and releasing funds to a particular customer.

A customer faced with holds on cheques should discuss the situation with his/her branch manager. Doing so would solidify the banking relationship and lead to a better understanding of why holds on the account may be necessary. The branch manager may suggest various options that could reduce or eliminate holds on cheques (e.g., maintaining a minimum balance in a chequing account or establishing a line of credit). For large-value payments, the manager may suggest cheque certification or a wire transfer to ensure that no holds will be placed on funds.

An excellent payment method that avoids holds on funds altogether is direct deposit. Customers should consider direct deposit alternatives when offered (e.g., for payroll). These transactions are credits to a customer's account and the funds are certain, contrary to a cheque, which is a debit instrument and an unknown quantity. Consequently, direct deposit funds can be accessed immediately on the day of deposit.

IX Government Items

Federal government cheques are handled differently from other cheques and are processed by the Cheque Redemption and Control Directorate (CRCD), which is operated by Public Works and Government Services Canada, in Matane, Québec. If an FI decides to place a hold on a government cheque, it generally does so because there may be a concern about unusual account activity or potential fraud.

Federal government cheque recipients that are concerned about holds on their government funds should apply for direct deposit. The federal government has implemented one of the most successful direct deposit plans in the country.

X Conclusion

Every negotiating FI operates on the basis that, if a cheque is *not* returned within a certain time period, it has been honoured. Holds on cheques help FIs manage the risk in the interim and minimize losses to all parties (i.e., FIs, depositors, shareholders) caused by returned items. When a hold is deemed appropriate, one of the key factors in determining the length is the estimated time an item may be in transit. Each institution, based on its internal processes and risk management criteria, establishes its hold funds policy on a proprietary basis.

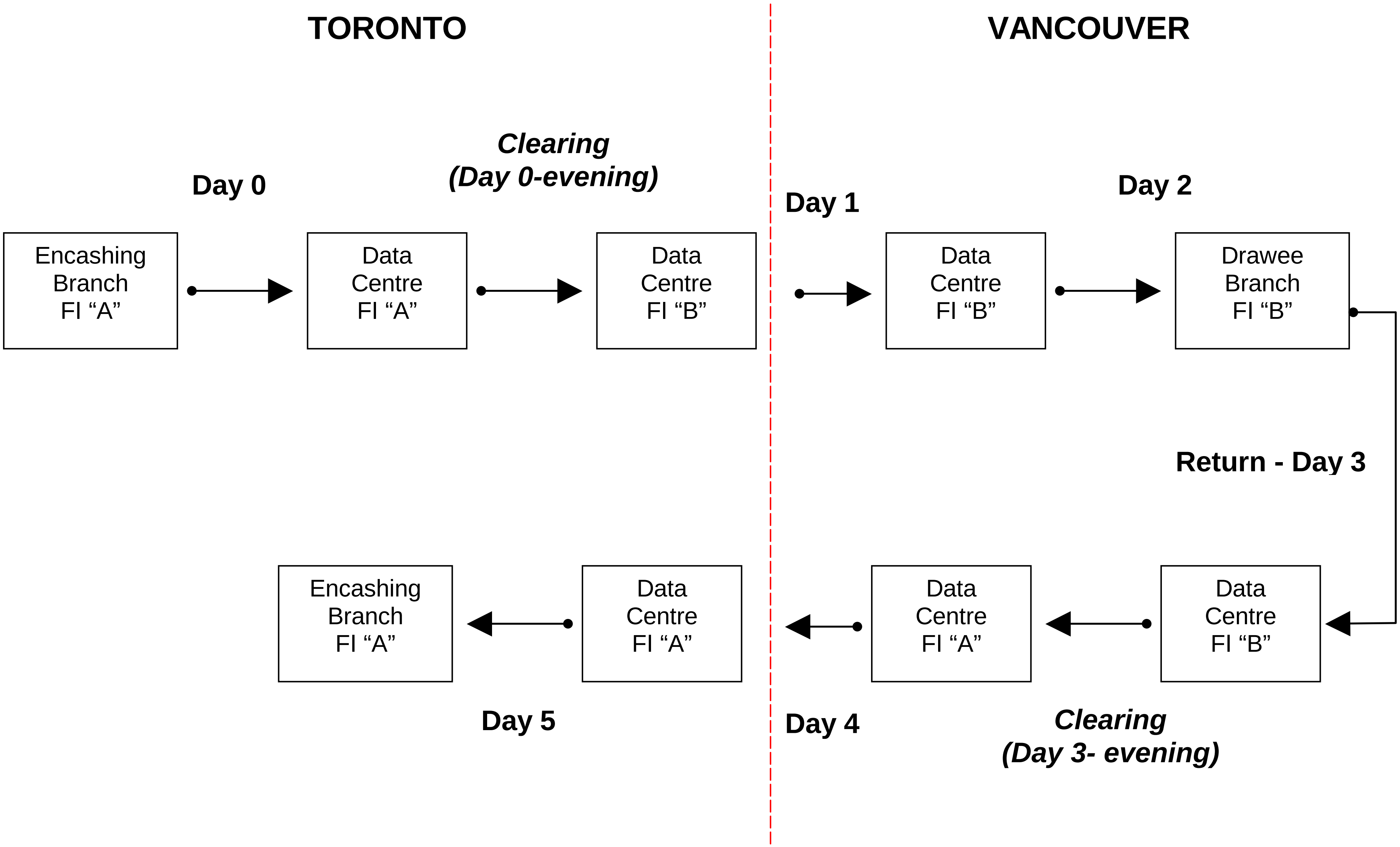
Customers are encouraged to seek out more information from their FI branch staff if they feel that undue holds are placed on their items. Relationship building is an important element of day-to-day transacting. In addition, FIs have well-established procedures to resolve customer enquiries and complaints in the event a solution has not been reached to the customer's satisfaction at the branch level.

CPA members will continue to examine ways to improve paper processing to potentially reduce the time an item may spend in transit, and make the necessary changes to the clearing rules. Members also encourage the continued migration to electronic transactions due to the speed and efficiency of clearing exchanges.

Appendix 1

Clearing Process – Cheque drawn on FI "B" and encashed at FI "A"

(Direct Clearer to Direct Clearer)



Appendix 2

Clearing Process – Cheque drawn on FI "B" and encashed at FI "A"

Indirect Clearer to Indirect Clearer

(via two Direct Clearers acting as Clearing Agents)