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CASHING STATE WARRANTS ARTICLE Revised January 2004

The question is occasionally asked why financial institutions are sometimes hesitant to cash State warrants for non-customers, and sometimes charge them a fee for doing so. While there is no answer that will be satisfactory from everyone's perspective, this discussion is intended to provide one from the Department's economic point of view. It is realized that there may perhaps be a different view from the segment of the population that, for whatever reason, has elected to not establish or maintain a banking relationship.

State agencies make payments to employees, vendors, and others by issuing warrants drawn against the State Treasurer, not by issuing checks drawn on a bank. The State warrants are "payable through the Federal Reserve System." This arrangement allows a State warrant to be "presented for collection" through one or more financial intermediaries. Over 20 million warrants are issued annually.

This presentment/collection process affords each party involved in the series of transactions certain protection under the Uniform Commercial Code (UCC), as well as imposing certain obligations and liabilities upon the various parties. These risks and liabilities are related to each party's role of "holder in due course." The protection and liabilities for a "holder in due course" pertain to warrants that may be dishonored and returned by the State Treasurer. The reasons for return may relate to forged endorsement, altered payee, altered amount, counterfeit warrant, payment stopped, among other reasons.

There are two main beneficiaries of the protection afforded by the UCC, the warrant's intended payee, and the State (as issuer). The primary protection pertains to the event of a forged endorsement, in the case of a lost or stolen warrant. The intended payee is protected from loss in nearly all cases, allowing the intended payee to receive a replacement warrant. The State is protected in most cases, usually with the "bank of first deposit" bearing the liability.

Because of the "holder in due course" applicability, a financial institution accepting a State warrant, or any instrument not drawn on that financial institution, assumes a high level of liability upon the acceptance of the instrument for subsequent presentment. This assumed liability on the part of the financial institution accrues to the benefit of the warrant's intended recipient and to the State. On an annual basis, there were over 1,000 incidences of forged endorsement of State warrants, and several hundred occurrences of presented counterfeit warrants. Additionally, there are over 10,000 stop payments placed on State warrants that are lost or stolen. The estimated value of these transactions is in excess of \$10 million. Most of these occurrences result in financial loss to the financial institutions, as well as to retail stores (e.g., grocery stores), with a minimal amount accruing to the intended payees or to the State.

Annually, the financial institutions incur large financial losses due to the UCC provisions. Accordingly, they have implemented various policies to minimize their losses. These policies normally include limiting for whom they will cash warrants and checks. More and more often, traditional financial institutions will not cash instruments for non-customers because they have

no recourse in collecting the instrument should it be returned under the UCC liability provisions. Under the UCC, some instruments can be returned as late as three years after the date of the original presentment. (For example, the statute of limitation for a forged endorsement is three years.)

Some institutions charge a fee to non-customers for cashing instruments. One of the reasons given for the fee is to help offset the institution's UCC losses. Another reason given is to compensate the financial institution for the cost of providing cash to the presenter. When a financial institution cashes an instrument for a non-customer, it is advancing funds from its own coffers. It normally takes at least one banking day before it can collect the funds through the collection process. (In the case of a State warrant, the funds supporting the warrant are held by the State Treasurer in an invested status.)

Some have suggested that a State Treasurer's account maintained with a financial institution should obligate the institution to cash State warrants, and/or to waive any related fees. While the State Treasurer does maintain certain types of accounts with a number of North Carolina financial institutions, none of the accounts contain funds for the purpose of funding State warrant presentments, or for compensating the institutions for offering a check (warrant) cashing service.

One type of account maintained with financial institutions by the State Treasurer are collection accounts, which are established solely for the purpose of providing State agencies (some 775) a convenient place to deposit their daily receipts. However, the State Treasurer withdraws the agencies' receipts on a daily basis, to be invested or used to pay valid warrant presentments. Any transitional balances in the collection accounts are kept at a minimum, with only a sufficient balance left to compensate the financial institution for the depository services actually provided. This calculation process is performed monthly, to ensure that no excess funds are maintained with the institutions. Should a warrant cashing service be desired of the financial institutions, it would be necessary to compensate them by maintaining higher balances, which would result in a decrease in investment earnings for the State.

Another type of account the State Treasurer may maintain with financial institutions is one to accommodate purchases of certificates of deposit (CDs), in accordance with General Statute 147-69.1. Pursuant to the statute, the interest rate on the CD is set by the State Treasurer, not by the financial institution. The rate cannot be less than the rate that can be obtained on US Government or agency securities of comparable maturity. Accordingly, there is no excess value of a CD account accruing to the institution that could be used as compensation for a warrant cashing service.

In summary, there are definite costs and liabilities accruing to financial institutions that elect to cash State warrants, especially for non-customers. The State Treasurer does not maintain any excess balances with financial institutions that may be used to compensate these costs or assumed liabilities. Additionally, implementing requirements that financial institutions cash State warrants and/or waive fees would in many instances shift the UCC liability provisions from the financial institutions to the State, which may then have to be passed on to the recipient of the warrant. Individuals are therefore encouraged to secure low-cost (economy) banking accounts that are offered by financial institutions to negotiate State warrants or other payments they may receive by check.