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CHECK CLEARING FOR THE 21ST CENTURY ACT

TO: CHIEF EXECUTIVE OFFICER (also of interest to Chief Information Officer)

SUBJECT: Check Clearing for the 21st Century Act

Summary: The FDIC is notifying FDIC-supervised institutions that they should begin planning for operational changes needed to implement the Check Clearing for the 21st Century Act. The Act facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a "substitute check."

The Federal Deposit Insurance Corporation (FDIC) is notifying FDIC-supervised institutions to begin planning for operational changes needed to implement the Check Clearing for the 21st Century Act (Check 21 Act), Pub. L. No. 108-100, 117 Stat. 1177, codified at 12 U.S.C. §§ 5001-5018. The Check 21 Act was signed into law on October 28, 2003, and will take effect on October 28, 2004.

The Check 21 Act facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a "substitute check." The Act provides that a properly prepared substitute check is the legal equivalent of the original check for all purposes. This law supercedes contradictory state laws (i.e., state laws that allow consumers to demand the return of original checks).

Although the Check 21 Act does not require any "bank" (defined by the Check 21 Act to include insured banks, savings banks, credit unions and savings associations) to create substitute checks or to accept checks electronically, it does require banks to accept a legally equivalent substitute check in place of an original check after the Check 21 Act's effective date of October 28, 2004. Accordingly, banks should begin planning for operational changes needed to implement the Check 21 Act.

In addition, the Board of Governors of the Federal Reserve System has proposed amendments to Regulation CC (12 C.F.R. § 229) that implement the Check 21 Act. The amendments will affect banks that create or receive substitute checks or paper or electronic representations of substitute checks. The proposed amendment can be viewed on the Internet at:

<http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20031222/default.htm>.

Customer Notice

The Check 21 Act requires each bank to provide its customers with a notice that describes substitute checks and the rights consumers have when they receive substitute checks. This notice must be sent to customers who receive original or substitute checks with the bank's first "regularly scheduled communication" after the Check 21 Act becomes effective on October 28, 2004. For new account holders, the notice must be provided when a customer relationship begins. In some circumstances, the notice must also be provided to consumers who later receive substitute checks in response to requests for copies of checks. As banks develop the notice required by the Check 21 Act, they may wish to consult the model notice published with the

amendments to Regulation CC proposed by the Federal Reserve
(go to <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20031222/default.htm>).

However, banks should recognize that this model may change when the amendments to Regulation CC are finalized.

Operational Considerations

Each bank must decide, based on its own assessment of risk, the extent to which it will utilize the features of the Check 21 Act. At a minimum, banks must be prepared to handle substitute checks. All banks and their customers will begin to see substitute checks after October 28, 2004, whether or not they decide to truncate or exchange electronic check images. Preparations should include updates to policies and procedures, employee training, and any needed equipment modifications. Special operational considerations unique to substitute checks include:

- * Expedited recrediting procedures: The Check 21 Act requires banks to provisionally recredit a customer's account when the customer claims that a payment represented by a substitute check was erroneously paid and the original check or a better copy is necessary to determine the validity of the claim.
- * Check encoding: Substitute checks must include special identifiers in the MICR (magnetic ink character recognition) line (i.e., position 44 of the MICR line must be encoded with a "5" for qualified returned checks, or a "4" for forwarded items).
- * Revised endorsements: Substitute checks must identify the reconverting bank. The new requirements also include changes to the ink color of endorsements.

Additionally, banks that choose to adopt electronic exchange of check images will need to address infrastructure changes needed for check truncation, check safekeeping and image exchange.

Risk Assessment

Any bank that creates a substitute check (known as the "reconverting bank"), or transfers a substitute check to another party, is required to warrant that the substitute check meets all of the requirements for legal equivalence to the original. The reconverting bank may bear a risk of loss resulting from the original check not being available for examination. The potential for false consumer claims and check fraud will continue to exist after the implementation of the Check 21 Act. The lack of access to original checks necessitates the need for revised check review procedures and employee training, and a review of check security features such as watermarks. Additionally, a new potential risk of double posting will be created (i.e., both the original check and the substitute check enter the processing stream). A reconverting bank must warrant that it is not requesting payment on items already paid.

For additional information on operational considerations associated with the Check 21 Act, please contact your FDIC Division of Supervision and Consumer Protection Regional Office, or William H. Henley, Examination Specialist, on (202) 898-6513, or Donald Saxinger, Examination Specialist, on (202) 898-6521. For information about consumer compliance issues, please contact April Breslaw, Chief, Compliance Section, on (202) 898-6609.

For your reference, FDIC Financial Institution Letters may be accessed from the FDIC's Web site at <http://www.fdic.gov/news/news/financial/2004/index.html>.

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Distribution: FDIC-Supervised Banks (Commercial and Savings)

NOTE: Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 801 17th Street, NW, Room 100, Washington, DC 20434 (1-877-275-3342 or 202-416-6940).