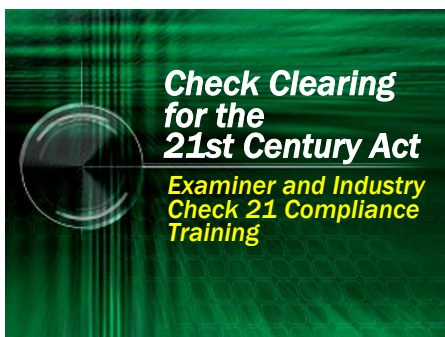


Check 21 Presentations

1.



2.



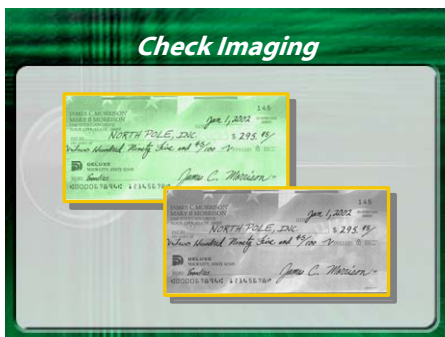
Module 1: Overview of Act and Final Regulation

3.



Just as in other areas of business, technology is changing how the financial industry conducts business. The emergence of ATMs and Internet transactions are just two of the many ways that institutions now use technology to decrease operational expenses and stay competitive.

4.



Industry wide, there are now about 40 billion check transactions a year. Another technology used to cut costs and reduce risk is check imaging, or electronic check exchange—replacing the labor-intensive process of sorting, transporting, presenting, and reconciling paper checks with a faster and potentially less error-prone process.

While some financial institutions have rapidly migrated toward electronic check exchange, others are proceeding more gradually.

5.

General Decline In Paper Checks

- Shift from checks to electronic payments
- More electronic payment options
 - Internet transactions
 - ACH conversions

In addition to the emergence of check imaging, over the past few years there has been a nation-wide decline in the total volume of checks being written. This is because consumers and businesses:

- Have shifted from paper checks to electronic payments methods such as debit cards and
- Increasingly used electronic payment options, such as Internet and ACH transactions for payment.

As a result of these conditions, a situation evolved in which institutions that wanted to engage in electronic check exchange on a widespread basis were hampered in their ability to do so by institutions that were not yet ready to move forward with the technology.

6.

Barriers

- Need for formal agreements among institutions
- Expense and complexity of agreements
- Resistance to accept check imaging

Specifically, barriers to electronic check exchange included:

- The need to establish formal agreements to collect or return checks electronically, which required an unmanageable number of agreements—among hundreds of institutions, and
- Continued insistence by some banks on receiving paper checks, which was slowing down the transition from paper-based to image-based check processing.

7.

Request For Assistance



Because exchanging check images provides so many advantages over using paper checks, financial institutions and consumer groups worked with the Federal Reserve, and later with Congress, to develop a legal framework that would help foster electronic check exchange without penalizing institutions that were not yet ready to move into the exchange of electronic images.

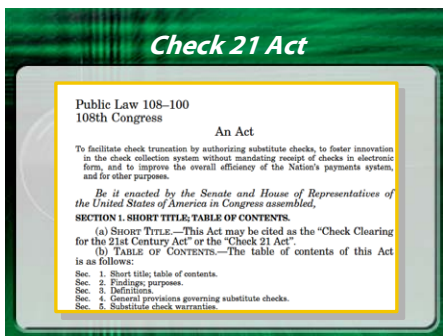
8.

Check 21 Act

- Passed October 28, 2003
- Effective October 28, 2004

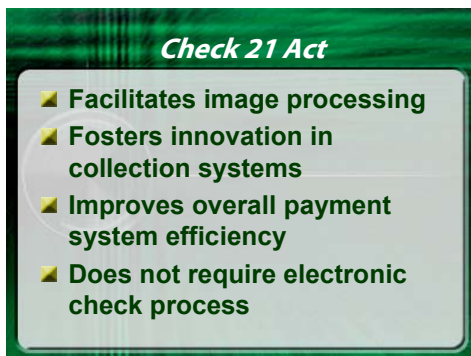
The result was the *Check Clearing for the 21st Century Act*, which passed on October 28, 2003 to take effect October 28, 2004.

9.



The law is designed to foster the transition from paper-based to image-based processing—a transition that is expected to accelerate over the next few years, as banks and consumers gain experience and confidence in the new paperless process.

10.

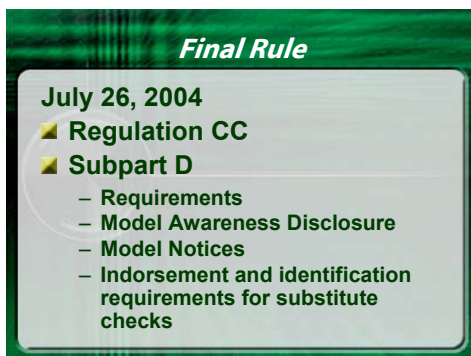


Generally referred to as the *Check 21 Act* or *Check 21*, the legislation:

- Facilitates the use of imaging for check processing;
- Fosters innovation in the check collection system; and
- Improves the overall efficiency of the nation's payments system.

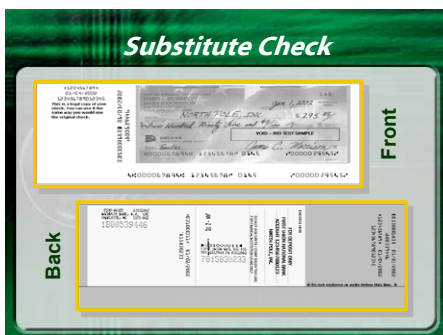
The legislation does not require any individual institution to change its current check-processing methods or to process checks electronically, unless or until it determines electronic processing is advantageous to its particular business operation.

11.



On July 26, 2004, the Board of Governors of the Federal Reserve System released its final rule amending Regulation CC, Availability of Funds and Collection of Checks, to implement the Check 21 Act. A new subpart D was added that details the requirements of the Check 21 Act that apply to banks, provides a model consumer awareness disclosure and other model notices for educating consumer customers about their rights under the Act, and specifies bank indorsement and identification requirements for substitute checks.

12.



The primary purpose of the legislation was to facilitate electronic check exchange by authorizing a new negotiable instrument called a "substitute check."

Substitute checks facilitate electronic check exchange by enabling a bank to create a substitute check for presentation to banks with which it has no pre-existing agreement to exchange electronic images.

Specifically, the regulation defines a "substitute check" as a paper reproduction of the original check that contains an image of the front and back of the original. Since substitute checks are checks, they are subject to existing check law.

13.

SUBSTITUTE CHECK

- Bear standard MICR line, per ANS X9.100-140
- Conform with ANS X9.100-140 standard for substitute checks
- Be suitable for automated processing

In addition, the substitute check must:

- Bear a MICR line containing all the information from the original check's MICR line, except as provided in ANS X9.100-140 to facilitate the processing of substitute checks;
- Conform in paper stock, dimension, and otherwise with the industry standard for substitute checks; and
- Be suitable for automated processing, just like the original check.

14.

Legal Equivalent

- All front and back information on original check:
 - Payment
 - Identification
 - Indorsement information
- Legal equivalence legend
- Bank warranties


The regulation provides that a properly prepared substitute check is the legal equivalent of the original check if it:

- Accurately represents all of the information on the front and back of the original check, including payment, identification, and indorsement information;
- Bears the Check 21 Act's required legal equivalence legend that reads, "*This is a legal copy of your check. You can use it the same way you would use the original check.*"; and
- Has been warranted by a bank, according to the Check 21 Act warranty requirements with respect to the substitute check.

A legally equivalent substitute check can be used in place of an original check, wherever the original check is required.

15.

Payments System



The interdependent nature of the payments system virtually guarantees that every financial institution will at least receive substitute checks. Therefore, financial institutions should understand and be prepared to comply with the relevant aspects of the Check 21 requirements.

Let's look at just which institutions are subject to Check 21 requirements.

16.

"Bank"

- Insured banks
- Mutual savings banks
- Savings banks
- Insured credit unions
- Savings associations
- Agency/branches of foreign banks
- Federal Home Loan Bank members

The regulation creates a unique definition of bank to include insured banks, mutual savings banks, savings banks, insured credit unions, savings associations, an agency or a branch of a foreign banks, and members of a Federal Home Loan Bank.

17.

"Bank"

Person engaged in the business of banking...

- Federal Reserve Bank
- Federal Home Loan Bank
- US Treasury
- US Postal Service

The definition also includes any person engaged in the business of banking, such as a Federal Reserve Bank or a Federal Home Loan Bank, and, to the extent that they act as a paying bank, the U.S. Treasury and U.S. Postal Service. And, that's the way we'll use the term bank in the remainder of the presentation.

There are also a couple of other unique definitions that you'll need to know as you view the remainder of the modules.

18.

Definitions

- Banks
- Truncate
- Truncating bank
- Reverting Bank

The regulation uses the term "truncate" to mean removing an original check from the check collection process and replacing it with information from the original check, including MICR line data, whether with or without the subsequent delivery of the original check.

The bank that's responsible for truncation of the original check is called the "truncating bank."

A "reverting bank" is defined as the bank that creates a substitute check or, if a person other than a bank creates a substitute check, the first bank to transfer, present, or return a substitute check, or a paper or electronic representation of a substitute check.

19.

Reverting Bank Responsibilities

- Losses associated with substitute checks
- Certain established requirements



The Check 21 Act is designed so that losses associated with a substitute check are borne by the reverting bank. Therefore, there are certain requirements established for these banks.

20.

Reverting Bank Responsibilities

- Identify itself as reverting bank on substitute check
- Preserve all reverting bank identifications
- Ensure substitute check bears all previously applied indorsements
- Identify bank that truncated original check

Each reverting bank must:

- Identify itself as a reverting bank on the substitute check;
- Preserve all previous reverting bank identifications;
- Ensure that the substitute check bears all previously applied indorsements; and
- Identify the bank that truncated the original check.

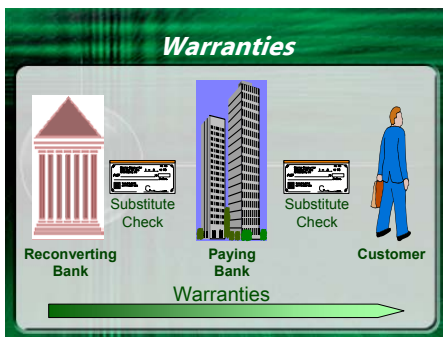
21.



The law also stipulates that a bank that transfers, presents, or returns a substitute check makes two warranties under the Act:

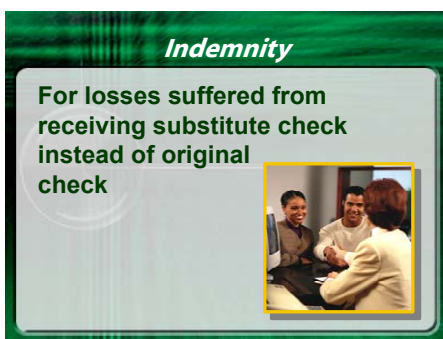
- A legal equivalence warranty—the substitute check meets the requirements for legal equivalence; and
- A duplicative payment warranty—no bank, drawee, drawer, or indorser will be asked to make a payment on a check it already has paid.

22.



Both warranties apply to substitute checks and paper or electronic representations of substitute checks. Whenever a bank transfers, presents, or returns a substitute check for which it receives consideration, the bank is automatically making these two warranties. These warranties can also flow back to the first reconverting bank.

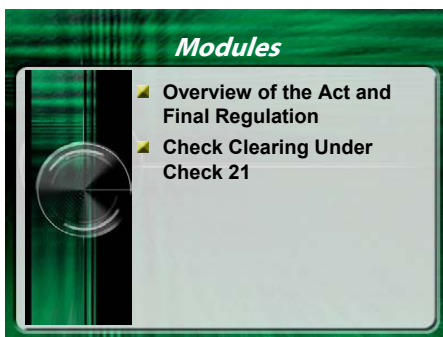
23.



Banks that transfer, present, or return a substitute check, or a paper or electronic representation of a substitute check, also indemnify subsequent parties against losses due to the receipt of a substitute check in place of the original check. A valid indemnity claim can only be made by a recipient of a substitute check.

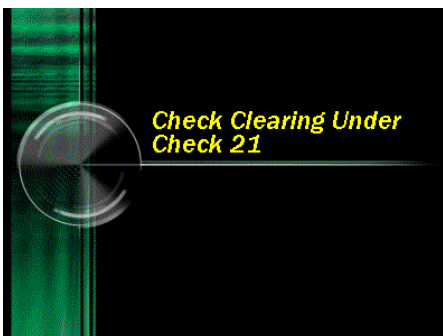
As with the warranties, the indemnities also flow back to the first reconverting bank.

24.



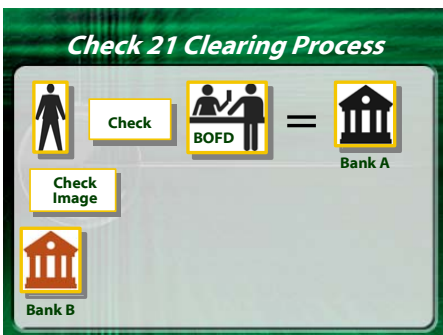
Now that you have a general background of the provisions, let's see how the check clearing might work under Check 21.

25.



Module 2: Check Clearing Under Check 21

26.



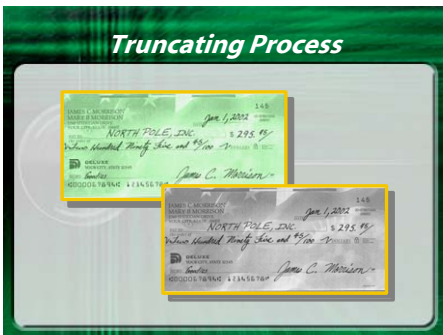
As with all checks, the Check 21 clearing process starts with a person writing an original check.

The payee then deposits the check with the Bank of First Deposit or BOFD, which we will call Bank A. Bank A then stamps its indorsement onto the back of the original check.

Let's assume that Bank A decides to "truncate" the original check and send electronic information about the check to Bank B; therefore, Bank A is the "truncating bank."

Of course, in order for this scenario to occur, Bank B must have previously agreed to accept checks electronically from Bank A.

27.



In order to truncate the original check, Bank A:

28.



- Captures an image of the front and back of the original check;
- Captures the magnetic ink character recognition (MICR) line data from the original check; and
- Sends the image and MICR line data in lieu of the original check to Bank B, its correspondent bank.

29.



Bank B applies its indorsement electronically and transfers the check image and MICR line data to Bank C. Again, in order for this scenario to occur, Bank C must have previously agreed to accept checks electronically from Bank B.

30.



Bank C wants to present the check for payment to Bank D, the paying bank. However, Bank D has not agreed to accept checks electronically.

Accordingly, Bank C uses the information received from Bank B to create a substitute check, and therefore becomes the reconverting bank.

Finally, Bank C presents the substitute check to Bank D for payment.

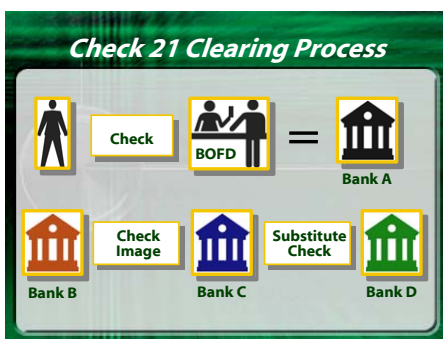
Bank D, the Paying Bank, uses the MICR line data on the substitute check to process it just like an original check.

31.



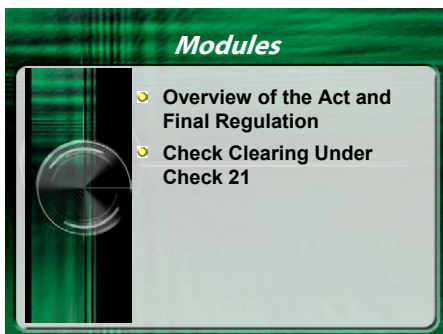
Bank D may provide the substitute check to its customer, who wrote the original check, in the customer's monthly periodic statement.

32.



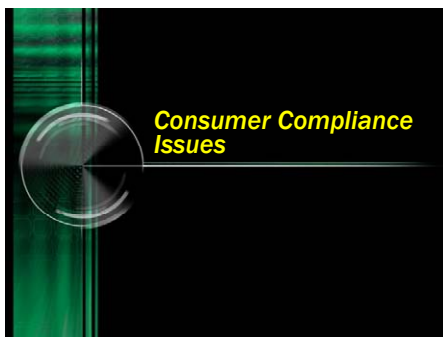
This is only one example of how check processing might work under Check 21. However, the example shows the variety of options that can occur under the new regulation.

33.



In the next module we'll look at the role that compliance plays in the Check 21 process.

34.



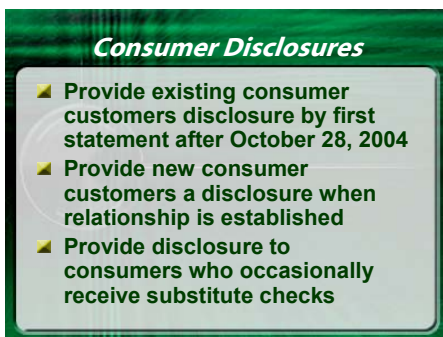
Module 3: Consumer Compliance Issues

35.



Banks that provide their consumer customers with cancelled checks in periodic statements need to comply with a requirement to provide a disclosure of consumer rights under the new law.

36.



Check 21 requires banks to provide this disclosure in a number of circumstances.

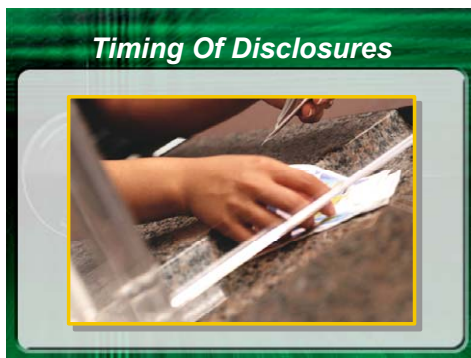
- All existing consumer customers who routinely receive cancelled checks in their periodic statement must be provided a disclosure no later than the first statement after October 28, 2004.
- All new consumer customers who will receive cancelled checks or substitute checks must be provided a disclosure when the customer relationship is established.
- Consumers who receive substitute checks on an occasional basis must also be provided the disclosure.

37.



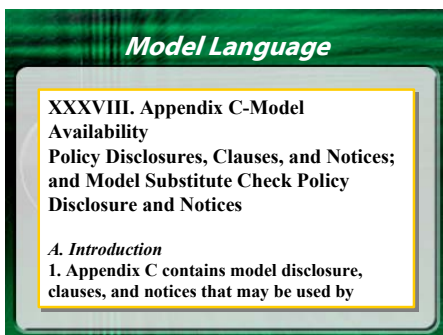
If a bank provides a substitute check in response to a consumer's request for a copy of a check, the bank must provide the disclosure at the time of the request, if feasible, and, otherwise, no later than when the bank provides the substitute check.

38.



If a bank provides a consumer a returned substitute check, the consumer disclosure must be provided at the time the bank provides the substitute check. A bank must provide the disclosure on these occasional bases even if the consumer previously received the disclosure.

39.



Model language for the disclosure is found in Appendix C of the regulation. A bank's use of this model language provides a safe harbor for content requirements. Of course the bank's policies and practices must be consistent with the disclosure.

40.




Consumer Awareness is only one of the compliance requirements set out in the law and regulation. A bank that provides a substitute check to a consumer also must be prepared to comply with Check 21's Consumer Expedited Recredit Rights for addressing errors relating to substitute checks.

41.

Expedited Recredit Rights

- Applies only to “consumers” not business customers
- Applies only to substitute checks charged to consumer deposit accounts



Expedited recredit rights may apply when a bank provides a substitute check to a consumer.

The provision applies only to “consumers,” not business customers, who have received a substitute check and have had a transaction involving a substitute check charged to their account.

Because the Check 21 Act defines “account” as a deposit account, the expedited recredit procedures only apply to substitute checks charged to a consumer deposit account.

42.

Not A Trigger

- Credit card checks
- Checks drawn on home equity line of credit
- Checks drawn on a brokerage clearing account

Generally, credit card checks, checks a consumer draws on a home equity line of credit, or checks a consumer draws on a brokerage clearing account would not trigger the expedited recredit rights.

43.

Use Of Expedited Recredit

- Account charged for substitute check
- Account improperly charged or warranty claim
- Consumer suffered loss
- Original check or copy needed to determine claim validity

To use the expedited recredit process, the consumer must be able to assert in good faith that:

- The consumer’s account was charged for a substitute check that the consumer received;
- The consumer’s account was improperly charged or the consumer has a warranty claim related to the substitute check;
- The consumer suffered a loss; and
- The consumer needs the original check or a “sufficient copy” to determine the validity of the claim.

44.

Consumer Must Provide

- Description of situation
- Statement of loss and estimate
- Necessity of original check or sufficient copy
- Sufficient identification information

In addition, the consumer must provide:

- A description of why he or she believes the account was improperly charged or the nature of the warranty claim;
- A statement that a loss occurred, including an estimate of the amount;
- The reason why producing the original check or a sufficient copy is necessary to determine the validity of the charge; and
- Sufficient information to identify the substitute check and to investigate the claim.

45.

Loss And Recredits

- **Breach of substitute check warranty or indemnity**
 - Damages up to the amount of substitute check
 - Interest and expenses
- **Both breach of warranty and indemnity**
 - Damages up to amount of the substitute check
 - Interest and expenses
 - Other proximately caused damages


In determining the amount of loss and related recredits a bank must consider:

- If the loss only involved a breach of the substitute check warranty, or only involved the indemnity, the claimant is entitled to damages up to the amount of the substitute check, plus interest and expenses, such as reasonable attorney's fees and other expenses of representation.
- If the loss involves both a breach of warranty claim and an indemnity claim, the claimant is entitled to damages up to the amount of the substitute check, plus interest and expenses, as well as other proximately caused damages.

46.

Time Limitations

- **Bank receipt within 40 calendar days of bank mailing the:**
 - Account statement
 - Substitute check
- **Required Extensions**



A consumer must file an expedited recredit claim so that the bank receives it within 40 calendar days from the date that the bank mailed, or delivered by a means agreed to by the consumer, the:

- Account statement showing the transaction that gave rise to the claim or
 - Substitute check that gave rise to the claim,
- whichever date is later.

Banks are required to extend the time limits in extenuating circumstances, and have latitude under the final rules to extend the 40-day time period for any reason. A bank may choose to extend the 40-day time period, so that it parallels the 60-day claim period under Regulation E, which involves claims for disputed electronic fund transfers.

47.

Claim Versus Complaint



A complaint is not a "claim," for purposes of the expedited recredit procedure, until the claim is complete; and the bank's "clock" for responding does not begin to tick until the consumer submits a complete claim. However, the bank has a duty to tell the consumer that the complaint is incomplete and must identify what information is missing.

48.

If bank requires written claim...

- **Bank must:**
 - Inform consumer of requirement
 - Include requirement in consumer awareness disclosure
- **Consumer must submit for receipt within:**
 - Within 10 business days of notification of requirement or
 - Within standard 40-calendar-day requirement

Other bank requirements concerning Consumer Expedited Recredit Rights include requirements for claims:

- If a bank requires a written claim and the consumer attempts to submit a claim orally, the bank must inform the consumer of the requirement for a written claim at the time the consumer attempts an oral claim. The consumer awareness disclosure that the bank distributes also should inform the consumer of the written claim requirement.
- If the bank requires the claim to be in writing, the consumer must submit the written claim so that the bank receives it either
 - Within 10 business days of the date of notification of the written claim requirement or
 - Within the basic 40-calendar-day time period, previously discussed, for filing a claim
 whichever is later.

If an oral claim is made within the 40-day period and the consumer meets the 10-day written notification requirement, the consumer's claim is timely even if the written claim is received after the basic 40-day period.

49.

Response Options



Banks have certain options for responding to consumer claims. If an expedited recredit claim is received, the bank must take one of three options.

50.

Response Options

- **Notice of recredit – business day after banking day of recredit to consumer account; or**
- **Deny claim - business day after banking day on which determination is made; or**
- **Provisionally recredit consumer account - 10th business day after banking day of receipt of claim**

It must:

- Send a notice of recredit no later than the business day after the banking day on which the bank recredits the consumer's account; or
- Deny the claim and demonstrate to the consumer why the claim is not valid—no later than the business day after the banking day on which it makes this determination; or
- If the bank has not determined the validity of the claim by the 10th business day after the banking day on which the bank received the claim, the bank must provisionally recredit a consumer's account pending further investigation.

The bank must provide a notice of the provisional recredit no later than the business day after the banking day on which the bank recredits the consumer's account.

51.

Provisional Recredits

- **Recredit amount of loss** - up to amount of the substitute check or \$2,500
- **Recredit remaining amount** - by 45th calendar day after receiving claim
- **May reverse recredit**

If the bank provisionally recredits a consumer's account pending further investigation, the bank is required to recredit the amount of the consumer's loss, up to the amount of the substitute check or \$2,500, whichever is less. The bank would recredit any remaining amount (plus applicable interest) on the 45th calendar day after receiving the claim, unless before that time the bank had already made a determination concerning either the validity or invalidity of the consumer's claim.

If the bank later determines that the claim was not valid, the bank may reverse the recredit. The bank must provide a notice of reversal of recredit no later than the business day after the banking day on which the bank makes the reversal.

52.

Expedited Recredit Notices



The Federal Reserve Board has provided model notices in appendix C that banks may use in responding to consumer expedited recredit claims. Unlike the model consumer awareness disclosure, however, use of these model notices does not provide banks with a safe harbor.

53.

Interbank Expedited Recredit

- **Recover losses associated with consumer expedited recredit claim**
- **Claimant bank**
 - Within 120 calendar days
- **Indemnifying bank**
 - Within 10 days after receipt of the claim

The law also gives banks certain Interbank Expedited Recredit Rights that allow a bank to recover losses associated with a consumer expedited recredit claim from the indemnifying bank that sent the item in question.

The claimant bank can submit a claim to cover losses associated with providing an expedited recredit to a consumer or another bank involved in the collection process.

This claim must be submitted by close-of-business on the 120th calendar day after the claimant bank processed the problematic substitute check. And the indemnifying bank has 10 days after receipt of the claim to provide a recredit, the original check, or a sufficient copy. These provisions can be varied by agreement.

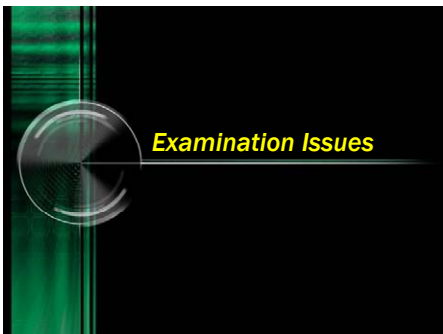
54.

Modules

- **Overview of the Act and Final Regulation**
- **Check Clearing Under Check 21**
- **Consumer Compliance Issues**
- **Examination Issues**

In Module 4, Examination Issues, we'll take a look at how all of the information we've covered in the previous modules relate to compliance examinations.

55.



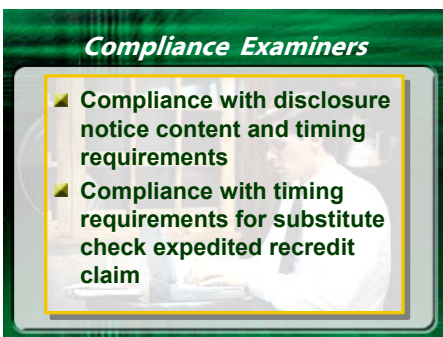
Module 4: Examination Issues

56.



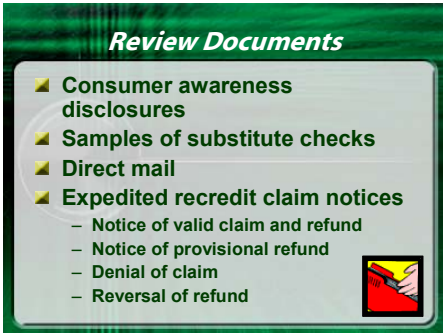
Working within the guidelines of each agency's risk-focused examination processes, examiners will generally focus their Check 21 evaluations on meeting two objectives when evaluating a financial institution's compliance with the provisions of Regulation CC:

57.



- Determining the financial institution's compliance with subpart D disclosure notice content and timing requirements, and
- Ascertaining whether the financial institution complies with timing requirements for acting on a substitute check expedited recredit claim.

58.



Documents relating to preliminary review of the financial institution's compliance with the disclosure requirements can include, but are not limited to:

- The actual consumer awareness disclosure or disclosures
- Samples or tests of substitute checks, if available
- Direct mail correspondence and statement stuffers that describe Check 21 and/or substitute check implementation to customers
- Notices relating to expedited recredit claims, such as:
 - Notice of valid claim and refund
 - Notice of provisional refund
 - Denial of claim
 - Reversal of refund

59.



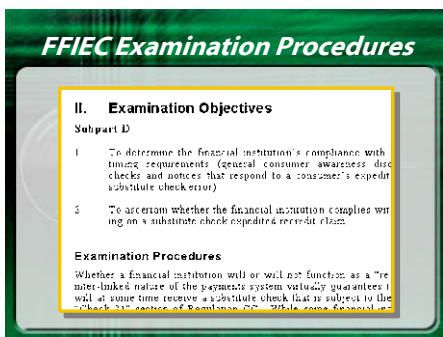
Review of the financial institution's training manual, internal audit reports, and board meeting minutes can also reveal the extent to which the financial institution's compliance risk management program has responded to the Check 21 provisions.

60.



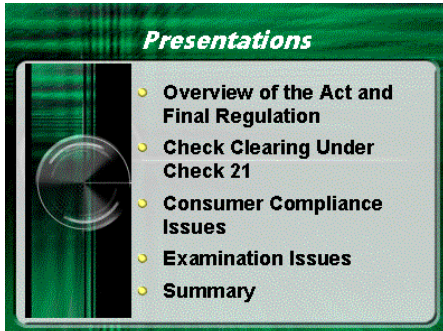
Additionally, interviews with key staff members, including new accounts personnel and deposit operations, can identify how effectively the institution's management has communicated its response to this new regulation to the individuals responsible for ensuring compliance.

61.



The FFIEC has approved examination procedures that discuss specific steps for examiners to follow when evaluating a financial institution's compliance with consumer protection provisions of the regulation. Those examination procedures are available through the Examination Procedures Link at the top of this training site.

62.

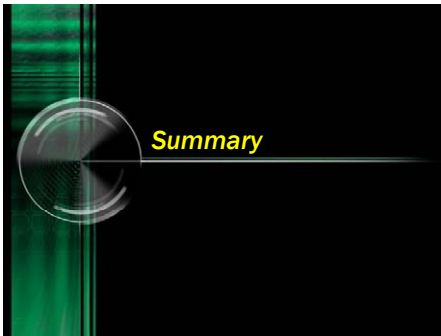


The previous modules have presented an overview on:

- The Act and final regulation,
- The Check 21 clearing process,
- Consumer compliance, and
- The compliance examination.

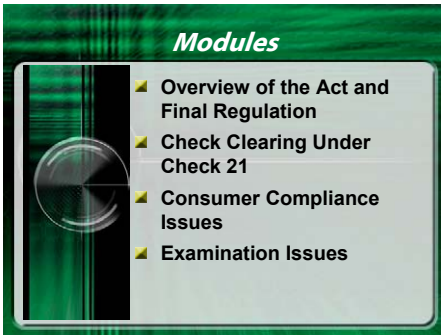
The summary module reiterates the main points we've covered under each of these topics.

63.



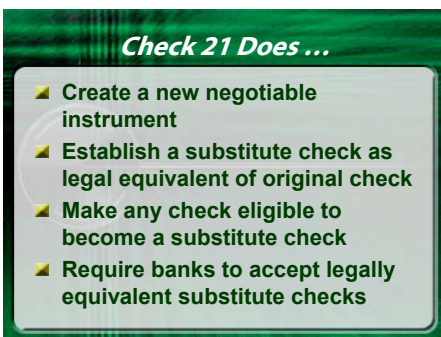
Module 5: Summary

64.



One way to review the material we've covered is to summarize just what Check 21 does and what it does not do.

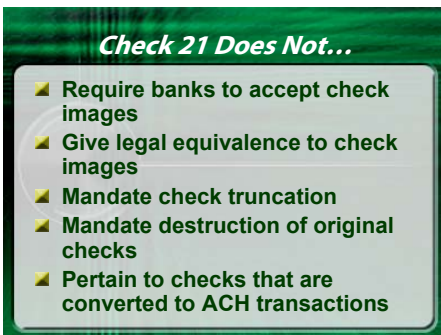
65.



Check 21 does:

- Create a new negotiable instrument (called a substitute check)
- Establish that a properly prepared substitute check is the legal equivalent of the original check
- Make any check eligible to become a substitute check
- Require banks to accept legally equivalent substitute checks as they would an original check

66.



Check 21 does not:

- Require banks to accept check images, which must still take place under agreements
- Give legal equivalence to check images
- Mandate check truncation
- Mandate destruction of original checks
- Pertain to checks that are converted to ACH transactions

67.

Substitute Checks

- Authorized not required to create
- Must be accepted as negotiable instrument

We can also say that, while the regulation authorizes and defines substitute checks, no person or entity is required to create a substitute check.

On the other hand, a properly prepared substitute check that a bank has transferred, presented, or returned, is the legal equivalent of the original check, and, as such, a paying bank must accept a legally equivalent substitute check just as it would the original check.

68.

Recipient Protections

- Two warranties
 - Legal equivalence warranty
 - No double debit warranty
- Indemnity against losses due to substitute check
- Expedited recredit processes

The Act and regulation protect recipients of substitute checks in three ways.

First, Check 21 provides a legal equivalence warranty and a no double debit warranty.

Second, it includes an indemnity against losses due to the receipt of a substitute check in lieu of the original check.

And, third, the regulation provides expedited recredit processes.

69.

Consumer Disclosures

- Provide existing consumer customers disclosure by first statement after October 28, 2004
- Provide new consumer customers a disclosure when relationship is established
- Provide disclosure to consumers who occasionally receive substitute checks

The regulation also requires banks to provide consumer disclosures.

- All existing consumer customers who routinely receive cancelled checks in their periodic statement must be provided a disclosure no later than the first statement after October 28, 2004.
- All new consumer customers who will receive cancelled checks or substitute checks must be provided a disclosure when the customer relationship is established.
- Consumers who receive substitute checks on an occasional basis must also be provided the disclosure.

70.

Conclusion



FFIEC CHECK 21 INFOBASE

This concludes our Check 21 compliance training presentation. Please visit the Resource Page, FAQ, Examination Procedures, and the Foundation Document for additional information.