

July 15,2004

Ms. Jennifer Johnson
Secretary of the Board
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. R-1202

Dear Ms. Johnson:

Navy Federal Credit Union provides the following comments in response to the Federal Reserve Board's (Board) proposal to amend Regulation J to include the rights and obligations of banks in connection with the collection of substitute checks and electronic items. Navy Federal is the nation's largest natural person credit union with over \$20 billion in assets and 2.4 million members.

The proposal would provide that each bank that sends an electronic item to a Reserve Bank for forward collection or return would make warranties and an indemnity for that item. The proposed new warranties and indemnity are similar to the warranties and indemnity that apply to substitute checks under the Check 21 Act. Navy Federal strongly supports these proposed changes. As a result of the Check 21 Act, the financial services industry anticipates that the number of financial institutions engaging in image exchange will greatly increase in the coming years. Further, the Federal Reserve Banks are now planning to offer additional image-based check processing services. Due to this growing industry shift to image exchange, we believe it is important for institutions that create check images to be subject to warranties and indemnities that protect the institutions that receive those images. Without such warranties and indemnities, institutions that create substitute checks from unclear or otherwise flawed images could bear the responsibility for consumer losses. We believe that these proposed amendments would allow institutions creating substitute checks to shift the responsibility for those losses to the institutions that originally created the images, if the losses were a result of the images being flawed.

The proposal also would require a sender who sent an electronic item to a Reserve Bank to indemnify the Reserve Bank for losses that the Reserve Bank may incur when it subsequently converts the electronic item into a substitute check. Navy Federal supports the concept that the creator of the original imaged item should bear the ultimate responsibility for the warranties and indemnities associated with that item. However, Navy Federal is concerned that the proposed amendments to Regulation J could be interpreted to mean that Reserve Banks will not be liable for flawed substitute checks that they may inadvertently create from acceptable images sent to them by other financial institutions. We believe that if the sender of the electronic item sent an

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acceptable image, and the Reserve Bank erred in creating the substitute check from that image, the Reserve Bank should be held responsible for the error, not the sender of the imaged item. It is our understanding that the Check 21 Act warranties and indemnities would apply to the Reserve Banks that create such substitute checks. However, the limitation on liability in proposed Section 210.6(c) could be interpreted to exclude Reserve Banks from liability for creation of substitute checks under the Check 21 Act and Regulation CC subpart D. Therefore, in accordance with the Board's goal of promoting clarity in Regulation J, we encourage the Board to clarify in proposed Section 210.6(c) that Reserve Banks are also subject to the Check 21 Act warranties, indemnities, and other responsibilities associated with creation of substitute checks.

Specifically, the Check 21 Act and proposed Regulation CC subpart D provide that a Reserve Bank is a "bank" and is subject to the expedited recredit procedure for substitute checks. However, the limitation on liability in proposed Section 210.6(c) of Regulation J could be interpreted to specifically exclude Reserve Banks from the expedited recredit procedure. We encourage the Board to clarify in subpart A of Regulation J that nothing in this subpart exempts a Reserve Bank from the expedited recredit procedure for banks in accordance with the Check 21 Act and Regulation CC.

In addition, we encourage the Board to clarify in proposed Section 210.5(a)(4)(i) that the information associated with an electronic item must reflect the MICR line of the original check at the time of truncation, and not the MICR line at the time the original check was issued. We believe that inserting this language into Regulation J will clarify that the bank creating the electronic item is not required to "de-strip" the check (i.e., remove the strip containing a repaired MICR line) to determine the check's MICR at the time of issuance. We believe this clarification will allow a bank to rely on the most current MICR line of the check when creating an electronic item.

Navy Federal appreciates the opportunity to comment on the Board's proposed changes to Regulation J.

Sincerely,



W. A. Earner
Acting President/CEO

WAE/slb