



July 23, 2004

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Docket No. R-1202

Re: Collection of Checks and Other Items by Federal Reserve Banks and Funds
Transfers Through Fedwire
69 FR 34086 (June 18, 2004)

Dear Ms. Johnson:

America's Community Bankers ("ACB")¹ is pleased to comment on the proposed rule² issued by the Board of Governors of the Federal Reserve System (the "Federal Reserve") that would amend Regulation J to ensure that it covers the new check processing service options that the Reserve Banks plan to offer when the Check Clearing for the 21st Century Act ("Check 21") becomes effective on October 28, 2004.³

Specifically, the rule would acknowledge the substitute check warranties and the indemnity that Reserve Banks and other banks will make under the Check 21 Act when handling a substitute check or a paper or electronic representation of the check. It would also include new warranties and indemnities that will apply when Reserve Banks and other banks send an electronic item that is not otherwise covered by the Check 21.

ACB Position

ACB supports efforts to increase the efficiency of the nation's payments system while minimizing the effect of unexpected disruptions to air and ground transportation systems. We generally support the Federal Reserve's proposed regulations that would amend Regulation J to provide for the rights and obligations of sending banks, paying banks, returning banks, and

¹ America's Community Bankers represents the nation's community banks. ACB members, whose aggregate assets total more than \$1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

² 69 Fed. Reg. 34086 (June 18, 2004).

³ Pub. L. 108-100, 117 Stat. 1177 (October 28, 2003).

Reserve Banks in connection with the collection of substitute checks and items that have been converted to electronic form.

We specifically recommend that the Federal Reserve:

- Clarify that an item must contain 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.
- Specify that a Reserve Bank may incur liability under Check 21 outside of Regulation J.
- Clarify that a Reserve Bank is not exempt from Check 21's expedited recredit procedure for banks.
- Clarify that the indemnification provision applies only if the sending bank breached one of its substitute check warranties which in turn resulted in a Reserve Bank itself making the indemnity to another institution.
- Emphasize that the delivery of a substitute check should be a pre-condition for any indemnity to apply under Regulation J.

Sending Bank's MICR Warranties

Under the proposal, an institution sending an electronic item (that is not a representation of a substitute check) to a Reserve Bank would warrant that the item "replicates the MICR line of the original check." This approach is not consistent with the current treatment of paper checks and would impose an unreasonable expectation on the check clearing process.

Today, all financial institutions in the payment stream may make MICR line corrections as necessary. As a result, in many cases, it would be impossible for a financial institution to warrant that an electronic item contains the MICR line at the time the original check was issued.

ACB urges the Federal Reserve to clarify that the item must contain 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. Any other interpretation would inhibit the utility of substitute checks and would hinder the payments system.

Reserve Bank Liability

A Reserve Bank is a "bank" under Check 21. As a result, Reserve Banks may incur liability with respect to a substitute check or an electronic representation of a substitute check. The proposed amendments do not identify Check 21 as a source of potential Reserve Bank liability outside of Regulation J. We are concerned that the proposed rule could be interpreted to exclude a Reserve Bank from Check 21 liability to the extent that such liability is different than the liability under Regulation J. Accordingly, ACB requests the Federal Reserve to specify that a Reserve Bank may incur liability under Check 21.

Similarly, we are concerned that the proposal could be read to exclude Reserve Banks from Check 21's expedited recredit procedure. Accordingly, we request that the Federal Reserve clarify that a Reserve Bank is not exempt from the expedited recredit procedure that applies to all "banks."

Sending Bank Indemnity

The proposed rule would establish indemnities that, in certain circumstances, would allow a Reserve Bank to pass back losses to the sending bank when the Reserve Bank is liable for an indemnity.

We are concerned that the proposed rule would allow a Reserve Bank to recover from a sending bank regardless of whether the electronic image or substitute check provided by the sending bank was the cause of the Reserve Bank's liability. For instance, assume a sending bank sends a check image to the Reserve Bank. The Reserve Bank creates multiple substitute checks from that one image and presents the substitute checks to the paying bank. In this example, the Federal Reserve should be responsible under Check 21 warranties, not the sending bank.

Accordingly, we request the Federal Reserve to clarify that the indemnification applies only if the sending bank breached one of its substitute check warranties which in turn resulted in a Reserve Bank itself making the indemnity to another institution. The delivery of a substitute check should be a pre-condition for any indemnity to apply under Regulation J.

Conclusion

We appreciate the opportunity to comment on this very important proposal. ACB supports the Federal Reserve in its efforts to craft a workable implementing regulation for Check 21. We stand ready to work with Federal Reserve staff to develop a regulatory structure that will allow the banking industry to take advantage of the efficiencies contemplated in the statute.

Please contact Rob Drozdowski at 202-857-3148 or via email at rdrozdowski@acbankers.org should you have any questions.

Sincerely,



Charlotte M. Bahin
Senior Vice President
Regulatory Affairs