

April 19, 2005

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

Re: Docket No. R-1226; Remotely Created
Checks

Dear Ms. Johnson:

Navy Federal Credit Union provides the following comments in response to the Federal Reserve Board's proposed changes to Regulations J and CC on remotely created checks. Navy Federal is the nation's largest natural person credit union with over \$24 billion in assets and 2.5 million members.

Navy Federal appreciates the Board's willingness to address the issue of unauthorized remotely created checks in Regulation CC, with corresponding changes to Regulation J, and the adverse impact these unauthorized checks have on paying banks. We agree that remotely created checks are particularly vulnerable to fraud because they do not bear a signature or other readily verifiable indication of authorization. Further, we acknowledge that there have been a significant number of complaints among both consumers and financial institutions identifying cases of alleged fraud using remotely created checks.

We support imposing transfer and presentment warranties on depository financial institutions for remotely created checks. Under this proposal, a depository financial institution that accepts a remotely created check for deposit from one of its account holders would warrant to all other institutions in the check collection process, including the paying bank, that the owner of the account on which the check is drawn authorized that check. If the account owner later informed the paying bank that the check is unauthorized, the paying bank could pursue a warranty claim with the depository bank. Current check law places the burden on the paying bank to verify whether checks drawn on their account holders' accounts are authorized. The rationale for this is that the paying banks are in the best position to be able to recognize their account holders' signatures. However, remotely created checks do not bear the signature of the account holder; therefore, paying banks are not in a position to be able to verify whether remotely created checks were signed (i.e., authorized) by their account holders. For this reason, we support requiring depository financial institutions to warrant that all remotely created checks they send for collection are authorized. Navy Federal believes this will achieve the Board's

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objective of reducing the number of unauthorized remotely created checks that are introduced into the check collection system.

Further, we support imposing these warranties at the federal regulatory level. Although Sections 3-416 and 3-417 of the Uniform Commercial Code (UCC) already contain similar warranties, these warranties have only been adopted by a handful of states and the specific language the states have adopted has been inconsistent. The relatively slow adoption of these warranties by state legislatures and the inconsistencies among states complicates the chain of liability for remotely created checks. For example, if paying banks are located in states that have not yet adopted the remotely created check warranties into their UCCs, their ability to take advantage of these warranties is, at best, unclear.

The Board requests comment on the proposed definition of “remotely created check.” The proposal would define a “remotely created check” as

“Remotely created check means a check that is drawn on a customer account at a bank, is created by the payee, and does not bear a signature in the format agreed to by the paying bank and the customer.”

We generally support the proposed definition and believe it is important to incorporate the key elements of remotely created checks (i.e., that they are drawn on accounts held at financial institutions and that they are created by the payees) in the definition. However, the Board is concerned that the proposed definition would also include checks with forged drawers’ signatures. We agree. To address this apparent problem, we believe a comparison with the UCC is appropriate. The UCC contains a definition of a similar term, “remotely created consumer item.” UCC Section 3-103(a)(16) currently defines “remotely created consumer item” as

“Remotely-created consumer item means an item drawn on a consumer account, which is not created by the payor bank and does not bear a handwritten signature purporting to be the signature of the drawer.”

It is important to note the difference between the last predicate of the UCC definition and the last predicate of the proposed regulatory definition. Navy Federal believes that the UCC definition would exclude checks with forged drawers’ signatures. Based on our experience as a financial institution in the check collection process, a remotely created check typically bears either (1) a signature of an employee of the company who created the check, or (2) language explaining the authorization, such as “Verbally Authorized by your Depositor,” or “Signature on File – This Check has been Authorized by your Depositor.” They do not typically bear signatures purporting to be the actual signatures of the drawers, whereas a check with a forged drawer’s signature does contain a signature purporting to be the actual signature of the drawer. Therefore, Navy Federal recommends modifying the predicate of the proposal definition to “...does not

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bear a signature purporting to be the signature of the drawer.” Further, Navy Federal supports the proposed Regulation CC Commentary to the definition that states “A typical forged check, such as a stolen personal check fraudulently signed by a person other than the drawer, is not covered by the definition of a remotely created check.” We believe the addition of this language in the Commentary, in combination with the modified definition of “remotely created check” discussed above, can assure the Board that the definition will not cover checks with forged drawers’ signatures.

Navy Federal supports extending the warranties for remotely created checks to checks drawn on nonconsumer accounts. We believe this extension is appropriate because it is consistent with the other warranties in Regulation CC.

The Board also requests comments on whether remotely created checks should contain a special code or other identifier in the MICR lines. Navy Federal believes this code may be somewhat useful for tracking purposes. For example, such a code would permit financial institutions to track the remotely created checks they process, if they choose. Further, some institutions may even want to explore the idea of blocking certain account holders’ accounts from receiving remotely created checks, if the account holder requests such a block. Although Navy Federal’s check processing system would not be able to implement these tracking mechanisms today, systems changes may allow such tracking in the future. However, we do not believe that including specific identifiers in the MICR lines of remotely created checks will provide much immediate benefit to consumers or to paying banks.

It is our understanding that any code that is being considered to identify remotely created checks may be in Position 44 of the MICR line. We strongly encourage the Board to consider requiring other codes in Position 44 first, such as an identifier for checks that draw on credit lines. If credit card convenience checks and checks used to access home equity lines, for example, contain a specific identifier in Position 44, it may solve the current problem of these types of checks being converted to ACH items at the point of purchase (POP) and in accounts receivable (ARC) transactions. These types of checks are ineligible for conversion under the ACH rules; however, merchants and billers cannot tell the difference between checks drawn on deposit accounts and checks drawn on lines of credit. Receiving Depository Financial Institutions (RDFIs) typically return these ACH transactions according to the ACH Rules, which usually inconveniences the RDFIs’ account holders. Navy Federal strongly encourages the Board to work with staff at the National Automated Clearinghouse Association (NACHA) on the issue of requiring a code in the MICR line for checks used to access lines of credit, rather than first pursuing the issue of including specific identifiers in the MICR lines of remotely created checks.

In the proposal, the Board offers some alternative approaches to reducing the burden on paying banks of unauthorized remotely created checks, such as extending the midnight deadline

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for remotely created checks to 60 days. This would be similar to the existing model for ACH returns from consumer accounts, whereby consumers are allowed 60 days to claim a transaction as unauthorized. While we believe a 60 day right of return is appropriate for ACH and other electronic payments, we hesitate to encourage the Board to extend such a time frame to paper items, like remotely created checks. It is our understanding that the purpose of the 60 day right of return for electronic items is primarily consumer protection. However, under existing check law, a paying bank is generally required to recredit its account holder's account for the amount of any unauthorized check it pays. Therefore, imposing a 60 day right of return on remotely created checks would not provide substantial additional benefit to the consumer. Navy Federal believes that 60 day rights of return are unnecessary for remotely created checks and that the proposed depository financial institution warranty is sufficient to protect the paying bank.

In addition, we hesitate to support extending a 60 day right of return to one particular type of paper checks. To maintain consistency with the laws and regulations that govern paper checks, we encourage the Board to simply impose special warranties on depository financial institutions that accept remotely created checks for deposit, rather than extending the midnight deadline.

Navy Federal appreciates the opportunity to provide comments to the Board in response to its proposed changes to Regulations J and CC.

Sincerely,


Cutler Dawson
President/CEO

CD/sb