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May 3, 2005

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

RE: 12 CFR Parts 210 and 229
Regulations J and CC; Docket No. R-1226

Dear Ms. Johnson:

The Independent Community Bankers of America (ICBA)¹ appreciates the opportunity to comment on the proposal by the Board of Governors of the Federal Reserve System (Board) to amend Regulations CC and J to reduce the potential for fraud related to “remotely created checks.” The proposal would establish a uniform and national warranty framework for remotely created checks, also known as telechecks, preauthorized drafts, and paper drafts.

ICBA Position

ICBA appreciates the Board's willingness to revise Regulations CC and J to address issues related to RCCs. Our comments are summarized below.

- ICBA strongly supports the Board's proposal to shift the RCC transfer and presentment warranty to the depository bank.
- ICBA urges the Board to revise the definition of a RCC to read: *“Remotely created check” means a check that is drawn on a customer account at a bank, is not created by the paying bank, and does not bear a signature purporting to be the signature of the customer.*

¹ The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to promoting the interests of the community banking industry. With nearly 5,000 members, ICBA members employ more than 225,000 Americans and hold more than \$778 billion in total assets. For more information, visit ICBA's website at www.icba.org.

- ICBA strongly urges the Board to specifically include checks that are payable-through a bank and are drawn on another bank within the definition of RCCs.
- ICBA urges the Board to provide additional Commentary to section 229.2 (fff) regarding the term “customer account” to include RCCs drawn on any customer account and the banks' own accounts.
- ICBA opposes waiting for state legislatures to individually adopt new UCC transfer and presentment warranties for RCCs.
- ICBA does not support the extension of the midnight deadline to 60 days to give paying banks the ability to file a warranty claim within the check clearing system.
- ICBA opposes using Position 44 of the MICR line to identify RCCs.
- ICBA urges the Board to delay the effective date of the final rule six months.

Background

A remotely created check (RCC) is created when the customer (the holder of an account, either a consumer or a business) authorizes a payee to draw a check on their account, but does not actually sign the check. RCCs are vulnerable to fraud because they do not have a signature to indicate authorization. This vulnerability has led to high profile cases of fraud and subsequent complaints by consumers and banks.

Currently, remotely created checks are subject to state law, specifically Articles 3 and 4 of the Uniform Commercial Code (UCC) as adopted in each state. Under the UCC, a paying bank may charge a customer's account (either consumer or a business) only if a check is properly payable. Additionally, a paying bank has until midnight of the banking day after a check has been presented to return the check to the depository bank.

In 2002, the National Conference of Commissioners on Uniform State Laws and the American Law Institute approved revisions to Articles 3 and 4 of the UCC to create warranties that shift the liability for the loss created by an unauthorized RCC to the depository bank. Fourteen states have since amended Articles 3 and 4 to include these provisions. This state-by-state adoption complicates the liability trail for remotely created checks.

Proposed Rule

The proposed rule would amend Regulation CC to define RCCs and create transfer and presentment warranties for RCCs. Under the proposal, a RCC is defined as *a check 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. The proposed transfer and presentment warranties would shift liability for the loss created by an unauthorized remotely created check to the depository bank. The proposed amendments would not affect the rights of checking account customers. The proposed new warranties would be cross-referenced in Regulation J.

Additionally, the Board requests comment on three related issues – two alternative approaches and the usefulness of a MICR identifier.

Extension of the Midnight Deadline - Under this alternative approach, a paying bank would recover its losses caused by an unauthorized RCC by making a warranty claim outside of the check collection system. The rule could potentially allow the paying bank to return the RCC within the check system by extending the UCC midnight deadline for a period, such as 60 days.

Allow the State Legislatures to Adopt the UCC Amendments - Under this alternative approach, the Board could refrain from acting on RCCs and allow states to adopt the UCC warranty, or some variation, on their own.

MICR Line Identifier - An identifier in the External Processing Code (Position 44) could be assigned to distinguish RCCs so that banks could take appropriate fraud prevention measures.

ICBA Comments

Under the existing legal framework, the paying bank bears the responsibility of a fraudulent RCC. This framework unfairly burdens the paying bank for absorbing losses resulting from fraudulent RCCs as it does not have the information needed to determine whether the RCC is properly authorized. Additionally, depository banks are not legally compelled to exercise due diligence to ensure that the payee is obtaining proper authorization for RCCs. Shifting the presentment warranty holds the depository bank accountable for knowing the payee (their customer) and appropriately shifts liability to the parties deriving the benefits – the depository bank and its payee. ICBA strongly supports the Board's proposal to shift the RCC transfer and presentment warranty to the depository bank.

Definition of RCC

The proposed RCC definition requires that the RCC be “created by the payee.” The proposed commentary provides that a RCC created by the payee's agent would be deemed to be created by the payee. This definition is problematic, as it does not recognize that there are some RCCs that are created by persons other than the payee or its agent. For example, it is common for bill payment

providers to act as the customer or drawer agent to execute payment instructions.

The proposed RCC definition also states that the RCC does not “bear a signature in the format agreed to by the paying bank and the customer.” For consistency, the ICBA recommends that the Board revise this element of the definition to parallel UCC provisions which define a “remotely-created consumer item” as an item “which is not created by the payor bank and does not bear the handwritten signature purporting to be the signature of the drawer.” Additionally, adoption of the UCC definition would appropriately include RCCs that have neither a handwritten or facsimile signature. To incorporate these changes, ICBA suggests the following definition for a RCC:

“Remotely created check” means a check that is drawn on a customer account at a bank, is not created by the paying bank, and does not bear a signature purporting to be the signature of the customer.

Definition of Customer Account

ICBA recommends that the Board modify the Commentary to Section 229.2(fff) regarding the term “customer account” as used in the definition of RCC to include the following types of accounts on which a RCC could be drawn:

- 1) Any customer asset account at a bank;
- 2) Customer credit accounts; and
- 3) The bank’s own accounts, such as accounts used by the bank to pay official checks and teller’s checks.

For example, a customer could give the numbers from the bottom of a credit card convenience check to a payee for use in the creation of a RCC. Similarly, a fraudster could use the account numbers from an official check or a teller’s check to create an RCC that is drawn on an account of the bank.

This Commentary modification would ensure that the transfer and presentment warranty applies to the full range of possible RCCs.

Alternative Approaches

ICBA appreciates the Board’s solicitation of comments regarding alternative approaches to the proposed transfer and presentment warranty. The alternative approach of allowing state legislatures to adopt revised UCC Articles 3 and 4 individually would maintain the status quo patchwork legal framework that the Board’s proposal is seeking to address. ICBA strongly opposes continuing to allow the states the option of revising the governing UCC provisions.

ICBA believes that the alternative approach of extending the midnight deadline for an unauthorized RCC could have unintended consequences, such as raising

issues of payment finality. Therefore, we do not support extension of the midnight deadline at this time.

MICR Line Identifier

Assigning a MICR identifier in Position 44 that would distinguish a RCC would require costly system changes to implement and would not result in significant benefits to paying banks. It could be shortsighted as well. As check processing continues to electrify, there are check products and services that will likely have a greater need for a MICR identifier.

Effective Date for Final Rule

In the event that the Board determines to amend Regulation CC to include a new RCC warranty, ICBA requests that the final rule have a delayed effective date of at least six months. This delayed effective date will give the industry appropriate time to: develop new procedures for handling warranty claims; update customer agreements as appropriate; revise clearing house rules as needed; and, educate large users of RCCs regarding the impact of the new inter-bank warranty. However, if the Board requires MICR line identification of RCCs in the final rule, the industry would need a much longer transition period than six months to make the necessary system and procedural changes.

Conclusion

ICBA applauds the Board's responsiveness to the chronic problem of fraudulent RCCs and the losses incurred by paying banks. We strongly support the Board's proposal to shift responsibility for fraudulent RCCs to the depository bank by creating new transfer and presentment warranties to create a uniform legal framework for RCCs. We urge the Board to adopt our suggested modifications to the RCC definition and the Commentary regarding the term "customer account." ICBA opposes using a MICR line identifier in Position 44 for RCCs. We urge the Board to adopt at least a six-month effective date for the final rule.

Thank you for the opportunity to comment. For questions regarding our position on this issue, please contact me at (202) 659-8111, extension 2449 or by email at cary.whaley@icba.org.

Sincerely,

L. Cary Whaley, AAP
Associate Director, Payments Policy