Check 21 Compliance Requirements

Minimum Compliance Requirements

Version 3 – Updated January 2005

Banks began receiving substitute checks on October 28, 2004, the effective date of the Check Clearing for the 21st Century Act (Check 21). Under Check 21, banks must accept substitute checks and cannot require that other banks present original checks to them. Some banks will want to take full advantage of the Act and begin producing substitute checks for certain applications. Other banks however may want to only implement the absolute minimum changes necessary to comply with the Act and associated Regulation.

Check 21 does not mandate receipt of check images, or electronic checks. Banks that want to create substitute checks and take advantage of the Act will need to have implemented at least some level of image technology. For those banks selecting the minimal compliance approach image technology will not be needed. Many vendors view Check 21 as an opportunity to sell image in many forms, and some of those applications may be appropriate for many banks, but Check 21 minimal compliance does not require them.

This document addresses the minimum requirements under the Act. These minimum requirements are applicable to banks both as paying banks or depository banks, unless otherwise indicated in the description. For banks that want to be more active in regards to the Check 21, please refer to Other Processing Considerations on this web site.

The Act – The Act creates a new legal instrument, a substitute check that is the legal equivalent of the original paper check. It may be presented, sent for collection or returned without an agreement with the recipient, so long as the substitute check meets the requirements defined in the Act. Under the Act, the bank creating the substitute check is known as the reconverting bank and the warranties and indemnification in the Act begin with the reconverting bank and is made by and to each party in the payment process.

The Regulation – The Act allowed the Federal Reserve Board to write regulation as the Board determines to be necessary to implement, prevent circumvention or evasion of, or facilitate compliance with the provisions of the Act. The Board modified Regulation CC and added a new Subpart D to accommodate Check 21. The regulation also includes the safe harbor language for the consumer awareness as required by the Act.

Substitute Check – A bank that creates a substitute check is known in the Act as the Reconverting Bank. A substitute check means a paper reproduction of the original check that contains an image of the front and back of the original check, bears a MICR line conforming to industry standards for substitute checks, conforms in physical specifications with industry standards for substitute checks and is suitable for automated processing. In order for the substitute check to be the legal equivalent of the original check it must accurately represent all information on the front and back of the original check and bear the legend “This is a legal copy of your check. You can use it the same way you would use the original check.” All indorsements must appear on the substitute check and the reconverting bank must be identified on the substitute check.

Absolute Minimum Requirements

For purposes of this document, minimum bank processes assumes that the bank does not create substitute checks but only receives substitute checks. Receive includes forward collection, return and redeposit.

Processing Substitute Checks – The MICR line on a substitute check under the ANSI X9.100-140 standard for Image Replacement Documents (IRD) must contain a value of “4” in the EPC (External Processing Code) field (also known as position 44) of the check. Banks need to ensure that their check processing equipment will process these checks the same as original checks. They must ensure that checks with a “4” in the EPC field will not be rejected. It is believed that banks already process some checks that contain values in this field.
While not absolutely necessary, some banks may want to not only process the substitute check as they process any other check they may also want to recognize and store the "4" from position 44 to identify which checks are substitute checks.

**Consumer Awareness** – Under the Act and Regulation CC each bank shall provide to each consumer customer a brief notice about substitute checks that describes:

- That a substitute check is the legal equivalent of an original check.
- The consumer recredit rights when a consumer believes in good faith that a substitute check was not properly charged to the account of the consumer.

The safe harbor language for the consumer awareness appears in Regulation CC in Appendix C as C-5A. A bank is considered in compliance with the requirements of the Act, if the bank uses the published model form and clauses from the Federal Reserve as long as the information in the notice accurately describes the policies and practices of the bank. Banks are not required to use the model language as developed by the Federal Reserve.

The consumer awareness notice required by the Act shall be provided to each consumer that is a customer of a bank as of the effective date of the Act and who receives original or substitute checks along with their periodic account statements. The notice is not required to be sent to customers who do not receive their paid original checks returned to them in their statements (e.g. they might receive image statements). The notice is only required for consumer accounts. Banks may choose to provide the notice to all customers whether consumer or corporate or regardless of whether they do or do not receive their original checks returned to them. For existing customers this communication must be sent with the first regularly scheduled communication with the customer after the effective date of the Act. For new consumer customers, the notice shall be provided when the customer relationship is initiated.

The Federal Reserve defined two situations they refer to as receiving substitute checks on an occasional basis. Under these two situations notice must be provided each time a consumer receives a substitute check, regardless of whether the bank previously provided the disclosure to that consumer. These two situations are when a bank provides a substitute check to a consumer in response to that consumer’s request for a check or check copy and when the depositing bank returns an unpaid substitute check to a consumer depositor.

Customers of the bank who request a copy of a check and receive a substitute check, are required to receive this notice at the time of the request if feasible or otherwise it must be provided no later than the time at which the bank provides a substitute check in response to the request. Banks in most situations can decide whether to provide the customer with a copy or with a substitute check. For example, a safekeeping customer (customers who do not receive their paid checks in their statement) who is not required to receive the notice has requested a copy of a check and receives a substitute check. When the bank provides that substitute check (not a copy) to the customer, it is now required to provide that customer the notice.

Depositing consumer customers that receive substitute checks, as unpaid returned items would also be required to receive notice even if they previously received notice with their periodic statement. These notices can be included on the return notification form or as a separate document with the returned item.

The notice may be sent by U.S. mail or other means through which the consumer has agreed to receive account information. This allows the banks to provide the notice electronically, as long as that is how the customer has agreed to receive account information.

**Deposit Agreements** – Banks may want to consider amending their deposit agreements to include the required consumer awareness notice.

Banks may also want to consider amending their deposit agreement to protect them from deposits of substitute checks by customers without the bank’s agreement. Under the Act, when a person who is not a bank creates a substitute check the first bank that transfers or presents the substitute check becomes the reconverting bank and therefore makes the warranties and indemnification under the Act. Customers that create and deposit substitute checks without any prior agreement with the bank, puts the bank at risk. Amending the deposit agreement can reduce this bank risk.
Customer Service/Education/Training – Banks will need to train their internal staff regarding the Act and the enabling Regulation. At a minimum pertinent sections of the Act and Regulation CC with its related commentary should be reviewed which might include:

- Section 4 and §229.51 - General provisions governing substitute checks
- Section 7 and §229.54 - Expedited recredit for consumers
- Section 8 and §229.55 - Expedited recredit procedures for banks
- Section 12 and §229.57 - Consumer awareness

Once the bank has determined its internal procedures for each aspect of the Act, those procedures need to be included in the training. A sample of a substitute check and explanation of it should be included. Various sample substitute checks can be found on this web site under Standards in Implementation Aids under Check 21. Information regarding substitute checks can be found in Processing and Quality Standards on this web site or by purchasing a copy of the ANS X9.100-140 standard.

Customer Service areas for both retail and corporate customers will need to receive training about Check 21. Tellers must be able to recognize that a substitute check is a valid item for redeposit (reclaim, representment) and that the check cannot be refused because it is a substitute check. The reconverting bank for substitute checks being redeposited is the bank that originally created the substitute check. Customer service units will need to identify when the expedited recredit would apply.

Other areas of the bank that receive payments from customers (i.e. mortgage payments, credit cards, etc.) should also receive training. They need to understand that the substitute check is the legal equivalent of the original check and that a customer may use a paid substitute check as proof of payment.

Expedited Recredit -M A new consumer protection provision under the Act is the Expedited Recredit provision.

This expedited recredit provision for consumers and banks are similar to Regulation E claims. Many banks may be able to modify their internal forms and procedures currently used for Regulation E claims. Expedited recredit only applies to consumers that receive a substitute check (either in the forward or return process). However, banks may elect to utilize or vary these procedures for other bank customers who have claims under the Act.

For Consumers – Under the Act a consumer may make a claim in good faith for expedited recredit. To make a claim, the consumer must have been provided a substitute check that was not properly charged to his/her account or there must have been a breach of warranty and the consumer must have suffered a loss and that the original check or a better copy of the original check is needed to resolve the claim. The claim must be made within 40 days from when the bank mails or delivers the periodic statement that contains information concerning the transaction giving rise to the claim or the substitute check giving rise to the claim. This 40-day period can be extended by a reasonable amount of time under certain extenuating circumstances or banks can choose to give a consumer a longer period than the required 40-day period.

In order for a consumer to make a claim, it shall provide to the bank:

- A description of the claim including
  - Why the substitute check was not properly charged to the consumer account or
  - The warranty claim with respect to the check
- And a statement that the consumer suffered a loss and an estimate of the amount of the loss
- And the reason why production of the original or a better copy is necessary to determine the validity of the charge or the warranty claim
- And sufficient information to identify the substitute check and investigate the claim

The bank in its discretion may require the claim be in writing. Customers, who have agreed to communicate with their bank electronically, may be allowed to submit the claim electronically.
The bank must produce the original check or a copy of the original check and show the account was properly charged or provide expedited recredit. The recredit must be made not later than the end of the business day following the business day on which the bank determines the claim is valid. However if the bank does not determine that the claim is valid before the end of the 10th business day after the day of the claim, the bank must recredit the amount of the check up to $2500 with the remainder credited not later than the 45th calendar day after the consumer has submitted the claim. The funds must be available to the consumer on the next business day after recredit unless:

- The account is a new account
- The account has had repeated overdrafts
- The bank has reasonable belief that the claim is fraudulent

Banks delaying availability may not impose overdraft fees for five days. Banks are required to notify their consumer customers when the claim is not valid, when they make recredit to a consumer or when they make a reversal of a recredit. Model notices are included in Regulation CC Appendix C; these are not safe harbor notices since the Act does not provide banks that use these models with a safe harbor. However the Federal Reserve published these models to aid banks’ efforts to comply with the consumer notification requirements relating to consumer expedited recredit claims. When the bank determines that the claim is not valid the bank must send the consumer the original check or a copy of the original check that accurately represents the information on the original check or is sufficient to determine the validity of the claim and an explanation of the basis for determining that the substitute check was properly charged. The consumer may request copies of any information or documents that the bank used to make its determination. In the case of a recredit or reversal, the bank must also provide notice to the consumer with the amount of the recredit or reversal and the date of the reversal or funds availability for withdrawal on a recredit. Banks may reverse the recredit to a consumer’s account if the bank determines that the substitute check was properly charged to the account and notifies the consumer. All notices must be sent to the consumer not later than the business day following the business day the bank took action. The notices can be delivered by U.S. mail or any other means to which the consumer has agreed.

For Banks – A bank may make a claim against an indemnifying bank for expedited recredit if the claimant bank received a claim for expedited recredit from a consumer or would have been subject to a claim if the consumer’s account had been charged, the bank suffered a loss or must provide an expedited consumer recredit and the original check or better copy is needed to resolve the claim. The claim must be made within 120 days of the date of the transaction that gave rise to the claim. The claimant bank shall send to the indemnifying bank a description of the claim including an explanation why the substitute check cannot be properly charged to the consumer’s account or of the warranty claim, a statement that the claimant bank suffered a loss or is obligated to recredit the consumer account, the reason why production of the original check or a better copy is necessary to determine the validity of the charge to the consumer account or warranty claim and information sufficient for the indemnifying bank to investigate the claim. If the claimant bank sends a copy of the substitute check, it must take reasonable steps to ensure that the copy cannot be mistaken for the legal equivalent or handled for forward or return collection.

An indemnifying bank may require the claimant bank to submit the information in writing, which can be by electronic submission.

Within 10 days of receipt of the claim, the indemnifying bank must produce the original check or a copy of the original check or recredit the claimant bank or provide information as to why the indemnifying bank is not obligated to do either.

Banks handling a substitute check, even if they did not create the substitute check are indemnifying banks and may receive expedited recredit claims. Therefore all banks that act as correspondent banks must also implement expedited recredit claim procedures.

The Expedited Recredit provision for banks is the only section of the Act that can be varied by agreement of the parties.

Below is a matrix of the key points of the Expedited Recredit process for Consumers. Also below is a high level pictorial overview of the Expedited Recredit process for Consumers and Banks.
An expedited recredit will be required when the consumer asserts in good faith that either the:

- check was not properly charged to the consumer’s account, or
- consumer has a warranty claim with respect to such substitute check

The consumer must also assert that

- they suffered a resulting loss and
- the production of the original check or a better copy of the original check is necessary to determine the validity of any claim described above.

<table>
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<tr>
<th>Statement or agreed upon delivery system</th>
<th>Consumer reviews check via delivery system</th>
<th>Bank’s research period</th>
<th>Bank to recredit consumer</th>
<th>Funds available to consumer</th>
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<tr>
<td>Later date of mail or delivery of physical statements, or substitute check.</td>
<td>Consumer has until the end of 40 days to submit claim pertaining to substitute check. Additional time for extenuating circumstances (ill or travel) — time to extend reasonable amount.</td>
<td>End of 10 business days, after the business day of consumer’s claim.</td>
<td>By the end of 10 business days after business day of claim. Recredit the lesser amount of check or $2500 plus interest for interest bearing accounts. Remaining amount over $2500 to be recredit not later than 45th calendar day after business day of claim.</td>
<td>Start of business day after business day of recredit.</td>
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There are ‘safe guard exceptions’ for a recredit to a consumer’s account, in which a bank may delay availability to a consumer’s account up to 45 calendar days, after the business day of the consumer’s claim. They are:

- New accounts
- Repeated overdrafts
- Prevention of fraud losses
Return Processing

Incoming Returns – When banks receive commingled incoming checks, they must sort the incoming returns from other checks. Currently they do this by testing for a “2” in the EPC field. After Check 21 banks will have to edit for both a “2” and a “5” in the EPC to out sort incoming returns.

Return of Unpaid Substitute Checks – A substitute check for forward collection, conforming to industry standards will have a “4” in position 44 of the MICR line. Position 44 is also known as the External Processing Code (EPC) field. This digit identifies the item as a substitute check, allowing other parties in the collection and return stream to properly handle the item. In most cases, when a bank receives a substitute check and it is properly posted to a customer’s account, the bank will not know that a substitute check was processed rather than the original check unless the bank has programmed a process to identify substitute checks. The substitute check is suitable for automated processing in the same manner as the original check.

When a substitute check does not pay to the customer’s account, it must returned. Typically when a bank returns an item, they qualify the item by placing strip along the bottom of the check. Normally a qualified return item contains 2” in position 44 of the MICR line to identify it as a qualified return item.

In order for the returned substitute check to be handled properly by other parties in the payment system, a qualified returned substitute check must contain a “5” in position 44 of the MICR line on the qualified strip.

Below is an example of a substitute check with a qualified return strip.
**Statement Rendering** – The size of a substitute check will be the equivalent of the size of a corporate check. This means many consumer accounts will receive both their regular, smaller size retail checks and the larger size substitute checks. It is possible that bank’s statement rendering equipment may have difficulty with various check sizes for the same account. Since substitute checks are larger then regular retail checks the overall throughput may be slower.

Image statements themselves may also need to be examined. The number of checks on customer’s statements may vary depending on whether the checks are retail checks (smaller) or corporate checks (larger). Depending on the number of images per page, the larger substitute checks, when displayed on the bank statement, may be more difficult to read if reduced to fit on the current retail statement page. Some banks have discussed clipping the image of the check from the substitute check for placement on the bank statement rather than displaying the entire substitute check on the statement.

**Additional Requirements**

While not required, banks choosing to only receive substitute checks, and not create substitute checks may want to consider some additional requirements for their operations.

**Corporate Products** – Many banks offer a variety of products to their corporate customers.

Some of these products require code line (MICR line) matching, matching the code line from the check to some internal information. Some times this match must be exact for the particular service to work properly. When a bank receives a substitute check that now contains a “4” in position 44 of the MICR line, the code line match will no longer be an exact match. Banks and their customers may need to modify their programs accordingly to take this into account. Other times the match is accomplished field by field, in which the presence of a “4” will probably not have any effect on the product.

Other disbursement products may depend on certain information on the check to be a specific font size or in a specific location on the check. Substitute checks must be shrunk somewhat from their original size, so both the location and size of data elements will not be as they were on the original check. These products will have to adjust for the amount of shrinkage of a substitute check.

Banks may want to allow certain companies to produce substitute checks and deposit them with the bank. Banks need to develop customer agreements for these products to properly allocate liability and responsibility when creating substitute checks.

**Duplicate Identification** – It is possible with Check 21 to have multiple copies of the same item, in various forms (substitute checks and original images). Banks may need to develop processes to detect and avoid double posting. Under Check 21
customers are protected by a warranty against double posting, but banks may wish to avoid the customer service issues that might be created should duplicate postings occur by implementing a double post protection to examine items presented over a period of time and recognize potential double debits prior to posting to their customers’ accounts. This double post protection may also take into account the potential for duplicate transactions as a result of check conversion under the various ACH products.

**Repair of Substitute Check** — In the course of normal business, certain checks may reject during processing. Banks will repair those items in one of two ways. They will either repair the R/T and dollar amount for non on-us items, so that they can clear the item, or they will perform full field repair. Full field repair means repairing the R/T, dollar amount and on-us fields of the check. There are certain liabilities that banks may incur by performing full field repair. In the Check 21 environment, if a bank chooses to perform full field repair on the check, they will need to ensure that they include the EPC digit. Without the EPC digit identifying that the item is a substitute check, a subsequent bank creating another substitute check will inappropriately shrink the check a second time. For banks that choose to perform repair of the R/T and amount only, they are encouraged to also include the EPC digit. However there is no scenario envisioned in which the lack of the code would cause either legal or operational risk. Substitute checks can be repaired the same as any other check. UCC and Regulation CC encoding warranties apply to the repair, as well as any clearing house rules that may affect the item.

**Exhibit — Summary**

**Minimum Requirements (High Level)**

**For Check 21**

The law will enable the use of a substitute check to replace the original check and banks and their account holders will be required to accept such items without agreement. Additionally, the law provides for an expedited recredit process if the account holder can substantiate a claim for loss because the original check was converted to a substitute check.

The requirements of the law pertain to any bank as a receiver of a substitute check. There is no requirement for a depositary or paying bank to create a substitute check. Use of a substitute check in the forward collection by a depositary or intermediary bank or use as a return item by the paying bank is optional.

Below is an overview that identifies areas where a bank must prepare for the implementation of Check 21 as well as some optional considerations.

**Check 21 — Minimum Requirements**

**Staff Training**

- Education of staff:
  - understand processing implications
  - understand the expedited recredit process
  - know when consumers must be made aware of Check 21
  - address customer service needs
  - teller training as points of entry into the bank

**Consumer Awareness**

- Education of customers regarding:
  - the potential of having an original check converted to a substitute check
  - that a substitute check is the legal equivalent of the original check for all purposes
  - the expedited recredit only applies to consumer accounts
  - the process for making a claim in the event the payment of a substitute check creates a loss
• Federal Reserve has created Safe Harbor language to be used by banks to facilitate consumer awareness
  o Changes to depository agreements to reflect the law
  o Changes to return notices
  o Creation of notice documents for receiving substitute checks on an occasional basis

**Expedited Recredit**

• Develop the process that allows for the consumer submission of a claim through to the request of obtaining a “copy” from the indemnifying bank and resolution of the claim.

**Item Processing**

**Inclearings**

• No required change. Substitute checks will process as normal in a capture run even though the EPC field (position 44) will contain the value “4”.

**Reject Reentry**

• Missing/unread information can be entered as normal.

**Outgoing Returns**

• When returning a dishonored substitute check as a qualified return, the value of “5” must be entered in position 44 on the strip affixed to the item. This notifies a subsequent processor that the item is a substitute check in the event they might create a subsequent substitute check.

**Statement Rendering**

• **Check Return Customer** Substitute checks will intersort with original checks presented for payment within the statement cycle.
• **Image Statement Customer** Substitute checks will image normally but will be of the size of a corporate check and be intermixed with retail size images for a consumer account.
• **Truncated Statement Customer** Normal text information will be displayed on the statement.

**Image Archive**

• No required change.

**Posting System**

• No required change
Check 21 — Optional Considerations

Item Processing

Inclearings

- Modification of the capture run to recognize the EPC field (position 44) and store the value “4” in the item record.

Reject Reentry

- Modification of the reject reentry process to require the entry of the EPC field (position 44) if it is missing/unread from the MICR capture and store the value “4” in the item record.

Image Archive

- Storing the EPC field (position 44) as an index to the image.

Posting System

- Acceptance of the value “4” from the EPC field of the item record can be used:
  - to include in the transaction history for identification during an inquiry, particularly in the event of a claim by a customer
  - to detect duplicate posting in the event the reconverting bank entered both the original check and substitute check in the forward collection process