



## Check 21: Ready or not?

The industry is abuzz with talk of Check 21 readiness. You can find seminars, websites, conferences and consulting services all focused on readiness. But as you may know by now, being ready to comply with Check 21 implementation on October 28 requires very little.

You must be able to process substitute checks. You need to notify your customers of their rights related to substitute checks. And you need to develop procedures and train staff to respond to customer questions and requests for recredit. As you work to ensure your institution's compliance, information on the law and its requirements is available at [www.frbervices.org](http://www.frbervices.org) or on the Board of Governors of the Federal Reserve System site at [www.federalreserve.gov/paymentsystems/truncation/default.htm](http://www.federalreserve.gov/paymentsystems/truncation/default.htm).

The true challenge before us is to map a strategic plan for our business that capitalizes on the dramatic changes taking place in the payments world. This task is not tied to a deadline, but driven by competitive pressures and the changing cost structure of payments processing. The Federal Reserve Banks' response to these changes encompasses a comprehensive suite of electronic clearing services designed to improve availability, reduce transportation and processing costs, and help reduce risk through faster clearing. These services include the ability to deposit items or receive presentments in the form of image cash letters.

As you consider the opportunities that the Check 21 Act presents for re-engineering your check processing operation, consider first the business case, and second, the technical requirements.

### Evaluating the business case

As you explore the Federal Reserve Banks' Check 21 services, first assess the dollar value benefit to your institution in terms of 1) improved availability and resulting

investment income, 2) reduced costs of collection, transportation, staffing, infrastructure, etc. and 3) increases or decreases in vendor fees for processing, maintenance, technical support or consulting.

For example, what would be the cost and benefit of achieving one-day availability on your deposits that currently generate two-day funds availability? Improved funds availability can be achieved using FedForward<sup>SM</sup> services such as Mixed Image Cash Letter Deposit or the Cull from Mixed and Other Fed Paper Cash Letter Deposits. You might analyze the business case for electronic clearing of all deferred availability items as well as a subset of large-dollar items. Typically, improving funds availability for higher value checks provides sufficient financial benefit to offset any potential increase in deposit fees.

When evaluating image cash letter deposit services, you should also consider your current infrastructure capabilities and the cost of required investments, as well as the potential for transportation and operational cost savings. Because of the per-item deposit fee differences for items drawn on electronic receipt endpoints compared to substitute check endpoints, the business case for electronic deposits will grow stronger as the Reserve Banks' network of electronic receivers grows. If you determine that your business case doesn't support image cash letter deposits today, you might regularly reevaluate the business case as more and more paying banks agree to receive items in image cash letters.

### Destination Check 21-ongoing online information series

The Federal Reserve Banks invite you to participate in *Setting Your Course for Success*, part one of our Destination Check 21 online information series. This free seminar series is ideal for community bank and credit union CEOs, presidents, CFOs and other senior managers.

The online seminar will help you:

- Consider your business case for Check 21 opportunities
- Learn more about the Federal Reserve Banks' value-added Check 21-related products (FedForward, FedReturn<sup>SM</sup> and FedReceipt<sup>SM</sup>)
- Assess where you are on your check-image-clearing journey – and determine where to go next!

Even if you've attended one of our Check 21 seminars in person, you won't want to miss this valuable online seminar! *Setting Your Course for Success* premiered September 16 and will be available until March 14, 2005. To reserve your place today, visit [www.destinationcheck21.com](http://www.destinationcheck21.com).

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FedReceipt and FedReceipt Plus services provide financial institutions with the potential to eliminate processing of some or all paper inclearings presented by the Reserve Banks. The benefits of these services must be evaluated in light of your current check truncation practices, given that these services replace paper presentment with image presentment. Thus, if you provide many customers with physical checks today, these services would not likely offer full value due to your need to return physical items to your customers. On the other hand, you may want to take this opportunity to reevaluate your truncation strategy in light of the efficiencies made possible by the Check 21 Act. An aggressive truncation strategy may offer more benefits than it has in the past.

To support your efforts to evaluate the costs and benefits of FedForward, FedReturn and FedReceipt services, product information, fee schedules and endpoint lists are available online in the Check 21 section at [www.frb services.org](http://www.frb services.org).

#### Assessing and testing your technical readiness

If you identify a strong business case for image cash letter deposit services, you will next need to assess your technical readiness for these services. In order to take advantage of FedForward image cash letter deposit products, your institution must be able to generate an image cash letter in the Federal Reserve Banks' version of DSTU X9.37-2003. Your technical staff or image services vendor can access Reserve Bank requirements on the Check 21 and Vendor pages at [www.frb services.org](http://www.frb services.org). Once you determine that your system is capable of producing an appropriate format image cash letter, testing with the Reserve Banks can be scheduled. Movement to production will follow shortly after successful testing.

Even if you are unable to produce image cash letters in the near future, you may have a strong business case for using the FedForward paper cull service. This service, which will be offered in a phased approach across Reserve Bank check processing offices, provides expedited funds availability for certain large dollar checks by culling them from your traditional mixed and other Federal Reserve Bank paper deposits. Implementation of this service must also be scheduled several weeks or more in advance of the service live date to allow adequate time for Reserve Bank programming and capacity planning.

When you determine your institution is ready to receive image cash letters from the Reserve Banks, you will need to complete testing to ensure that your internal systems can effectively process an image cash letter in DSTU X9.37-2003 format. The Federal Reserve Banks will support your internal testing efforts by providing sample files of generic image cash letters for phase one of the testing and sample files of your actual inclearings for phase two of the testing.

#### Ensuring adequate network connectivity

To deposit or receive image cash letters, your financial institution must have sufficient network capacity to support your anticipated volume of activity. If you are planning to use an Internet connection for sending and receiving files, you should assess the additional traffic generated by the image cash letters to ensure your current connection can support it. Such assessment requires evaluation of the hourly transfer needs based on delivery deadlines. If you are planning to use a direct connection to the Federal Reserve Banks' network, you should complete a similar assessment in order to determine the appropriate circuit configurations. Circuit imple-

mentation lead times of 60 to 90 business days will impact when you can begin image cash letter testing.

#### Surveying your opportunities

While there is relatively little your institution must do to be ready on October 28, 2004, most financial institutions are developing a Check 21 payments strategy that helps ensure their long-term success in a competitive marketplace. As you begin to assess your opportunities for leveraging Check 21 to your benefit and to identify the costs and changes required to implement new strategies, your assessment should evaluate the Federal Reserve Banks' new Check 21 clearing services with a focus on:

- 1) Determining the value proposition of the FedForward, FedReturn and FedReceipt services for your organization;
- 2) Creating an implementation plan to support deployment of those services that offer a winning business case, working with your internal staff and vendors to ensure you have the appropriate infrastructure and processes to support your plans;
- 3) Evaluating your current network connectivity for its ability to support the anticipated volume and implementing new network options as necessary; and
- 4) Working with your Account Executive to plan and implement your new services.

As you work to evaluate your opportunities and plan for the future, you can count on the Federal Reserve Banks to deliver the information, advice and services you need to help bring your Check 21 plans to life. For more information, visit [www.frb services.org](http://www.frb services.org) or contact your Account Executive.

# Regulations provide roadmap for Check 21 implementation

If the Check Clearing for the 21st Century Act has you feeling lost in the wilderness, you now have your map and compass. The Board of Governors of the Federal Reserve System has published final amendments to Regulation CC that add a new subpart D, with commentary, to implement the Check 21 Act. The Board also has proposed amendments to subpart A of Regulation J. Together, these regulations and their commentary will help guide your institution through the new check processing landscape.

## Regulation CC amendments

The Board in July 2004 added to Regulation CC a new subpart D that would incorporate the requirements of the Act applicable to banks that create, receive, or provide substitute checks or paper or electronic representations of substitute checks. Subpart D contains provisions concerning:

- Requirements a substitute check must meet to be the legal equivalent of an original check
- Reconverting bank duties
- Warranties and indemnity associated with substitute checks
- Expedited recredit procedures for consumers and banks
- Liability for violations of subpart D
- The interaction between subpart D and existing federal and state laws
- New model notices in appendix C

The Board's amendments would affect some existing provisions of Regulation CC and its commentary. For example, the Board supplemented some existing defined terms in the regulation for which the Check 21 Act had slightly different definitions and defined several new terms used in subpart D. The Board amended the MICR-line requirements

for qualified returned checks to allow for differences that facilitate the processing of substitute checks and revised appendix D to include endorsement and identification standards for substitute checks.

The Regulation CC amendments are effective on October 28, 2004, except for model form C-5A in appendix C, which was effective immediately, and paragraph (4) of appendix D, which is effective on January 1, 2006.

## Regulation J amendments

The Federal Reserve Board has also proposed changes to subpart A of Regulation J, which governs Reserve Banks' collection of checks and other cash items, to cover the wider range of electronic check processing services that the Reserve Banks will offer once the Check 21 Act takes effect.

The proposed amendments bring electronic items within the scope of Regulation J and establish new warranties and an indemnity that apply to electronic items for which there is no other warranty and indemnity protection. This subpart includes the warranties and indemnities that are given to the Reserve Banks by parties that send items to the Reserve Banks for collection and return, as well as the warranties and indemnities for which the Reserve Banks are responsible in connection with the items they handle. It also describes the Reserve Banks' security interest in the assets of banks for which they collect items, as well as the amounts and methods by which the Reserve Banks may recover for losses associated with their collection of items.

Subpart A of Regulation J authorizes the Reserve Banks to issue operating circulars governing the details of the collection of checks and other items

and makes these operating circulars binding on all parties interested in an item handled by a Reserve Bank.

Beginning on October 28, 2004, the Reserve Banks will offer a wider variety of services that involve handling items electronically and, in some cases, acting as "reconverting banks" by creating substitute checks and providing the associated substitute check warranties and indemnity. The amendments to Regulation J are primarily designed to:

- Cover the Reserve Banks' handling of electronic items explicitly under Regulation J
- Acknowledge that Check 21 warranties and indemnity will apply with respect to a substitute check or a paper or electronic representation of a substitute check handled by the Reserve Banks
- Include new warranties and indemnities that will apply with respect to electronic items handled by the Reserve Banks that are not otherwise covered by the Check 21 Act

Comments on the proposed amendments to Regulation J were accepted through July 26. The final amendments are scheduled for release in September.

For complete copies of Regulations CC and J, see the Board's website at <http://www.federalreserve.gov/regulations/default.htm>.

# Check 21 Q & A

## Plotting your Check 21 strategy

As the October 28 implementation date for the Check 21 law approaches, you are likely fully engaged in evaluating your organization's long-term payments processing strategy in light of the changes it will bring. Federal Reserve Bank Account Executives talk to hundreds of customers every day, answering questions about Check 21 and helping identify opportunities to leverage technology to improve the bottom line. In this and future issues of *FedFocus*, we will share answers to some frequently asked questions in hopes of providing you with valuable information and insight to support your strategic planning efforts.

**Q | We are a Federal Reserve Bank truncation customer. How do your new Check 21 services fit with what we're doing now?**

**A |** Your institution has a great opportunity to benefit from the Federal Reserve Banks' new inclearing services without significant changes to your services or operations. As you know, the greatest industry-wide efficiencies will only be realized when a critical mass of institutions agrees to accept electronic presentment, significantly reducing the need to produce costly substitute checks. To encourage electronic receipt, we plan to reward institutions like yours that agree to accept MICR presentment without paper checks to follow and using FedImage seven-year archive services. If you sign an electronic receiver agreement to accept electronics without paper to follow, you will receive discounts on your payor bank services. You will have the option to continue receiving the electronic file formats you receive today or to receive files in the new DSTU X9.37-2003 format that the Reserve Banks will use for image cash letters. So depending on your current truncation service arrangement, if you join our electronic receiver network, the only real change you may see is a reduced bill for payor bank services.

**Q | How is FedReceipt different from the FedImage Delivery service we have today?**

**A |** FedReceipt and FedReceipt Plus services present all or a portion of your inclearings electronically in an image cash letter in DSTU X9.37-2003 format. The image cash letter constitutes legal presentment and is presented without paper to follow. This file format provides you with all of the information you would need to produce substitute checks. Your FedImage Delivery service provides images of your inclearing checks that have already been legally presented to you. These images are in COF 1.3 format and may be used only for informational purposes. This file format does not provide you with the information needed to produce substitute checks. However, FedImage Delivery lets you control how, when and what you receive by offering flexible delivery schedules, several media options, and a variety of criteria for identifying the items you wish to receive. While both services deliver check images, the right solution for your institution will depend on your unique needs, preferences and capabilities. Your Account Executive can assist you in evaluating our new inclearing options and choosing the best mix of services.

**Q | We receive all of our inclearings in paper cash letters. How would we benefit from moving to electronic receipt?**

**A |** Electronic receipt of your inclearings can reduce your check processing costs and resources by decreasing in-house sorting and image capture. Electronic presentments are usually received earlier than paper presentments, which can help reduce risk through earlier posting and improve balance reporting for your business customers. Moving to electronic presentment will be an important step in your organization's long-term ability to control costs and provide superior service to your customers. The Reserve Banks offer a variety of flexible solutions that can support a quick or gradual transition. Talk to your Account Executive today for help in getting started.