What You Need to Know about Reg CC Revisions

An Interview with David Walker

When we think about the changing payments landscape, chances are that checks aren't the first thing to come to mind. Yet, the check continues to play a dominant role in payments infrastructure—B2B payments in particular—and with mobile RDC (Remote Deposit Capture), never before has a check been easier to deposit, nor faster to clear. This RDC capability has both created benefits for the consumer and introduced the potential for duplicate deposits or fraud in the process.

That change has not gone unnoticed by regulators, and Regulation CC is undergoing an overhaul. NEACH sat down with David Walker, currently of Tiller Endeavors and formerly President and CEO of ECCHO, to get the skinny on the key things you need to know about Reg CC revisions.

NEACH: At a high level, what is the single most important thing banks and credit unions need to know about Reg CC changes?

Reg CC created a new indemnification to address the risk associated with duplicate payments created by RDC deposits. The new indemnification is intended to add protections for the second bank of first deposit by placing the responsibility for the duplicate(s) on the bank that offers the RDC service.

Duplicates occur when the FI's customer deposits a check via RDC into its account at one financial institution (FI) and then deposits the original check at a second FI. Under the new Reg CC provisions, when this occurs, the bank of first deposit (BOFD) that offers the RDC service indemnifies and protects a subsequent BOFD, if certain conditions are satisfied.

NEACH: What benefits exist for FIs when considering Reg CC changes?

When there are two or more BOFDs (BOFD A, BOFD B, BOFD C, etc.) Reg CC creates a unique, new legal liability between FIs that may not have any other relationship. For example, when BOFD B (the second BOFD) receives an item returned or adjusted as a duplicate from a paying bank for a check that was deposited as an original paper check at BOFD B, BOFD B may have a legal recourse back to BOFD A who offered and accepted a deposit from its customer via RDC.

Reg CC also created a new indemnification for payments flowing through the check payment system that never existed in paper form. For a number of years, fully electronic payments have been flowing through the check payment system as if they were checks.

These payments are now defined by Reg CC as Electronically Created Items or ECIs. The Regulation creates a new indemnification to protect the paying bank from losses that result from the payments being ECIs. However, ECIs are still not eligible for exchange under the Fed or ECCHO rules.

While almost all unpaid checks are returned by paying banks and received by BOFDs as electronic returns, there are still some FIs returning them via paper. Reg CC has now created a new protection for a BOFD that receives an electronic return but receives it after the expeditious return deadline. If the BOFD can prove that it received the late return in a commercially reasonable manner, then the paying bank is liable for the late return.

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NEACH: What are the biggest points of contention for FIs?

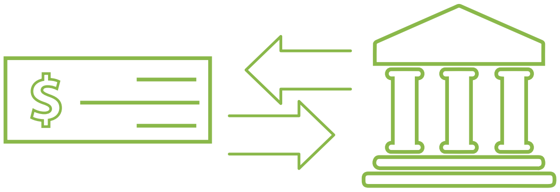
The new RDC indemnification is expected to create a large amount of confusion among FIs in part because it may not be straightforward as to when the indemnification applies, and if it does apply, how an FI should make a claim to another FI with whom it has no existing relationship.

There is growing interest across the industry to allow checks to become fully electronic. Because of this, the Reg CC provisions will create confusion among FIs and their customers, who will now erroneously believe that ECIs are legal and eligible for exchange as checks through the check payment system.

NEACH: There's a liability shift as relates to expeditious returns with electronic checks — from the paying bank to the bank of first deposit. Practically speaking, what does that mean for each FI involved?

It has been and continues to be the paying bank's responsibility to return checks expeditiously to the BOFD. However, the Federal Reserve wanted to encourage BOFDs to accept returned checks electronically.

So, this new provision provides liability protection to the paying bank for late returns if the depository bankdoes not have an appropriate electronic connection. The depository bank must have arrangements to receive return of checks electronically by "commercially reasonable" means.

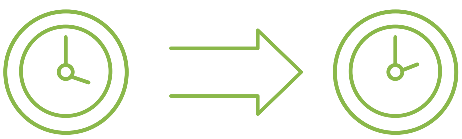


This liability approach encourages depository banks to accept electronic return checks. It does not, however, require direct return arrangements with paying banks. The depository bank's arrangement can be through one or more returning banks. The burden of proof is on the depository bank to prove that it is using a "commercially reasonable" means.

NEACH: What do FIs need to understand about the new expeditious return rule and deadlines?

First, do not return unpaid items as paper checks. Start returning and receiving all checks as electronic returns. Second, either return the unpaid items directly to the BOFDs or through a party that can reliably deliver the electronic return within the expeditious return deadline.

The timeframe for expeditious returns has changed from 4:00 p.m. local time to 2:00 p.m. local time. Based on FI comments to the Federal Reserve's request for comment, this change is not anticipated to have negative impacts on banks.



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NEACH: What about notice of nonpayment changes? What's key for FIs to know?

FIs continue to send notices of nonpayment when they do not need to. Reg CC requires notices of nonpayment to be sent from the paying bank to the BOFD for large-dollar items only if the return will not be received within two days. With the implementation of electronic returns, most returns are delivered within the two-day return deadline, and therefore, notices of nonpayment are not required.

The practice of sending notices of nonpayment for all items in amounts of $2,500 or more is necessary *only* if there is uncertainty about the delivery time frame. For example, if the paying bank sends all returns timely via electronic returns through the Fed, the paying bank can count on the Fed to deliver them expeditiously, and therefore, the notices are just extra insurance/cost. *Please note that this comment is not intended as legal advice and should legal advice be desired, the opinion of a competent attorney should be sought*.

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In addition, Reg CC changes (as of July 1, 2018) the dollar amount above which notices of nonpayment should be sent to the BOFD from $2,500 to $5,000 when the paying bank is uncertain of the timely delivery of the unpaid item.

The new provisions of Reg CC change the content that is required for notices of nonpayment. Reg CC will now require that the MICR line information be included in the notice. Many FIs already do this, so this may not be a change for every FI.

NEACH: What are electronically created items (ECI), how do they differ from electronic checks in general?

The term electronic checks is used to apply to many forms of payments, many of which are not checks and may not even be processed through the check payment system, e.g., some ACH payments. Reg CC now clarifies this and defines an Electronic Check as an image and electronic information derived from a paper check.

ECIs are payments that are created and originated as digital payments (as opposed to ones derived from a paper check) and cleared through the check payment system as if they were checks. For example, rather than an FI customer writing/producing a paper check and mailing the paper check to the payee, the FI customer using available technology, could create a digital payment that never existed in paper form and transmit it directly to the payee. Although original digital payments have been flowing through the check payment system for a number of years, these payments have not been defined in law. Now, Reg CC defines them for the first time. Additionally,
Reg CC creates a new indemnification for the paying bank that receives ECIs as presentments through the check payment system.

ECIs are payments that are created and originated as digital payments and cleared through the check payment system as if they were checks.

NEACH: What are the specialized regulatory considerations for these items?

While Reg CC added a new definition and a new indemnification for ECIs, ECIs are not checks defined by the Uniform Commercial Code or Regulation CC, which is the reason for the new indemnification. Given that they are not legally checks, the BOFD that allows these to enter the check payment system as if they were checks not only makes the new indemnification to the paying bank, it also does not have the expeditious return protections offered checks so paying banks do not have an obligation to return them in a timely fashion.

NEACH: What do FIs need to know about the new indemnity for duplicate payment arising from RDC?

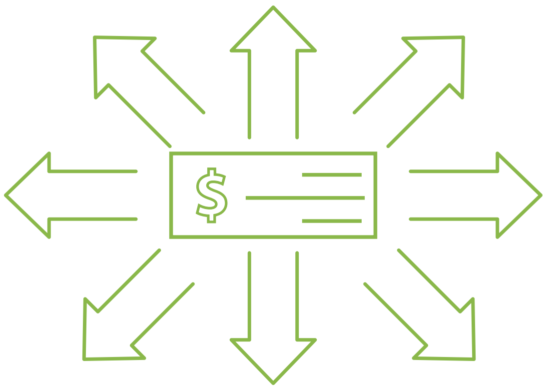
There are four conditions required for the BOFD to make the new indemnification:

1. The BOFD must be the truncating bank; and
2. The BOFD must not have received an original paper check deposit; and
3. The BOFD must have received value from the paying bank (e.g. settlement); and
4. The paying bank must not have returned the item to the BOFD.

Additionally, the second BOFD (BOFD B) is eligible to make a claim under the new indemnification only if:

1. An earlier BOFD made the indemnification; and
2. It took an original paper check as a deposit; and
3. It had no knowledge that the check had previously been deposited as an RDC deposit at another FI (no restrictive indorsement on the check).

Because it is possible for multiple BOFDs to be involved if the check is deposited via RDC at multiple FIs, there are a number of complications that could develop. These complications vary based on the specific scenario, and FIs may need additional help from outside resources to work through these scenarios to determine who is responsible for any losses resulting from these duplicates.



NEACH: What issues are still outstanding as relates to the Request for Comment?

Reg CC has published its changes to Reg CC Subparts A, C and D but not B, which addresses customer funds availability.

With the creation of the Consumer Financial Protection Bureau (CFPB), the Federal Reserve now has shared responsibility with the CFPB for Subpart B. The CFPB has not yet acted to change Subpart B; however, the CFPB has included in its legislative agenda that it plans to send out a request for comment on Subpart B. However, the CFPB is not obligated to follow its legislative agenda and could continue to postpone any action on Subpart B.

The 2011 Reg CC request for comment asked about accelerating the funds availability of check deposits for exceptions to 4 days. The CFPB could request comment on a similar reduction.

In conjunction with the release of the changes in Reg CC, the Federal Reserve issued a request for comment on another provision: a potential rule on the presumption of alteration. In the check image electronic payments environment, it can be difficult to determine whether an item has been altered or is a counterfeit. Altered items are primarily the responsibility for the BOFD and counterfeit items are primarily the responsibility of the paying bank. Various courts have make conflicting determinations in suits involving the question of whether an item had been altered or was a counterfeit.

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NEACH: How do you expect those will be resolved?

The request for comment on a default presumption of alternation is likely to implemented in a future version of Reg CC. The industry has already recognized the need for the judicial guidance and the ECCHO rules already contain this provision.

The changes in Subpart B are likely to be slow in coming, but it is very difficult to correctly anticipate when based on the CFPB's agenda.

NEACH: Is there anything else on these changes that you'd like to add?

While RDC has many positive characteristics, because it is the product of a mixed media environment, it has created a number of new issues for the industry to work through. The new Reg CC RDC provisions address a narrow issue but do not address others, and in fact, create some new issues.

RDC duplicate problems are created by a mixed media environment in which a paper check is created, so it qualifies as a check under check law but then transitions to an electronic payment.

The parallel presence of a paper check and an electronic check for the same payment create the opportunity for mischief and/or unintended errors.

The ultimate solution is to eliminate the mixed media environment. One approach to achieve this is to eliminate the need for the paper at the front end of the process. The new Reg CC provision that recognizes ECIs is a positive first step in that direction. More needs to be done and that can be the subject of another discussion all together.

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NEACH: Given these challenges and opportunities, what is your advice to FIs?

Monitor the educational opportunities offered by NEACH and take advantage of any educational sessions on Reg CC changes and what they mean.

There is a need to learn about the new provisions but also to understand the way the industry is reacting to the changes, given the anticipated state of confusion.

Members of ECCHO should participate in any Reg CC educational/discussion sessions provided by ECCHO.

Overall, ask questions.