



FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

August 18, 1988

DALLAS, TEXAS 75222

Circular 88-55

TO: The Chief Executive Officer of all
member banks and other financial
institutions in the Eleventh Federal
Reserve District

SUBJECT

**The Expedited Funds Availability Act and Compliance with
Regulation CC Indorsement Standards**

DETAILS

Attached is a special notice prepared by the Board of Governors of the Federal Reserve System outlining necessary procedures to comply with the indorsement standards mandated by Regulation CC. The regulation implements the provisions of the Expedited Funds Availability Act. All financial institutions that offer transaction accounts are affected by this act and must be in compliance with the new indorsement standards by September 1, 1988.

ATTACHMENTS

The Board's special notice on indorsement standards is attached.

MORE INFORMATION

For more information on Regulation CC or the Expedited Funds Availability Act, please contact Dean Pankonien at (214) 651-6662.

Sincerely yours,

A handwritten signature in cursive script that reads "William H. Wallace".



Special Notice

Board of Governors of the Federal Reserve System • Washington, DC 20551

Regulation CC - Expedited Funds Availability How the Indorsement Standard Affects Depository Institutions and Their Customers

August 1988

TO: Member Banks of the Federal Reserve System
and other Depository Institutions

FROM: Board of Governors of the Federal Reserve System

SUBJECT: Compliance with the Indorsement Standard Contained
in Regulation CC

In May 1988, the Federal Reserve Board issued Regulation CC to implement the Expedited Funds Availability Act. The regulation contains a standard that is to be used by depository institutions in indorsing checks starting on September 1, 1988.

There appears to be a great deal of confusion about the consequences of not indorsing checks in accordance with the standard. It has been reported that institutions have informed established customers that they will not accept for deposit a check simply because the check was not indorsed properly and that institutions are instructing their customers to discontinue using checks containing carbon bands. It has also been reported that some institutions are requesting customers to sign indemnification agreements, and others are planning to assess special fees when customers do not follow these instructions.

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We understand that institutions are taking these steps because the institutions believe that these steps will reduce the potential risk associated with an unpaid check being returned untimely. Many of the above actions appear to be unnecessary considering the small additional risk faced by depository institutions in handling a check that is "improperly" indorsed or contains a carbon band. The regulation does not impose any civil penalty for failure to comply with the indorsement standard. Failure to comply primarily means that the depository institution is not taking advantage of the standard to expedite the return of checks. The expeditious return and the indorsement standard reduce the risks to depository institutions.

The purpose of the standard, which affects all depository institutions and their customers, is to make it easier to identify the depository institution into which the check was first deposited. By making it easier to identify the depository institution where the check was first deposited, checks that are being returned unpaid (for example, due to insufficient funds) will get back to that depository institution faster than is possible today. More expeditious return reduces the likelihood that the depository institution and/or its customer will suffer financial losses because a check is returned unpaid. Depository institutions are required by Regulation CC to use new procedures designed to return checks expeditiously, and the indorsements that make it easy to identify the depository institution where the check was first deposited are important to the success of these new procedures.

This indorsement standard goes into effect on September 1, 1988, in conjunction with the other requirements of Regulation CC. (For further information about the other requirements of Regulation CC, see Regulation CC issued in May 1988, and the Special Notice issued by the Board in June 1988.) Because of the relatively short time period between publishing the indorsement standard in April 1988 and the effective date of September 1, 1988, the Federal Reserve realizes that many depository institutions may not be able to comply with the standard immediately because the depository institution may need to modify equipment. In some cases, these changes cannot be made in a cost effective manner by September 1, 1988. Other efforts to make indorsements easier to read, such as changing consumer and retail indorsements are longer-term initiatives.

The attached notice discusses the indorsement standard and its impact on depository institutions and their customers. It also discusses the consequences of failure to adhere to the standard.

If you need further assistance or information, contact your local Federal Reserve Bank or the Federal Reserve Board.



Regulation CC - Indorsement Standards

Why are checks indorsed and why does Regulation CC impose a standard for indorsing checks?

Checks are indorsed in order to transfer rights to obtain payment for the check. Payees often indorse checks to the bank¹ in which the payee deposits the check. Banks also indorse each check as the check is transferred from bank to bank in the course of presenting the check to the paying bank in order to obtain payment.

Currently, there are no standards with regard to how such indorsements should be applied to the back of the check. As a result, many times the indorsements are faint, blurred, incomplete and overlapping, making the indorsement difficult, if not impossible, to read. This difficulty in reading indorsements is a major hindrance in returning unpaid checks to the depository bank promptly.

The indorsement standard established by Regulation CC specifies the locations on the back of the check for bank indorsements, requires bank indorsements to contain certain information, and specifies the colors of ink for bank indorsements. **THE STANDARD DOES NOT IMPOSE SPECIFIC REQUIREMENTS ON PAYEE INDORSEMENTS OR ON BANK CUSTOMERS ISSUING CHECKS. FURTHER, THERE ARE NO PENALTIES FOR FAILURE TO MEET THE INDORSEMENT STANDARDS. NEVERTHELESS, IT IS IN THE INTERESTS OF BOTH BANKS AND THEIR CUSTOMERS TO ENSURE THAT CHECKS ARE CLEARLY AND PROPERLY INDORSED.**

¹Regulation CC defines "bank" to include commercial banks, savings banks, savings and loan institutions, and credit unions; "depository bank" as the bank where the check is first deposited; and "paying bank" as the bank on which the check is written.

The Depository Bank and Its Customer

The indorsement standard requires the depository bank to place its indorsement in a specific location on the back of the check, to include certain information in its indorsement, and to use either black or purple ink to apply its indorsement. Other banks may not indorse in the location specified for the depository bank indorsement. These requirements should make it easier for paying or returning banks to identify the depository bank and return an unpaid check or provide notice of nonpayment directly to the depository bank.

Making it easier for paying or returning banks to identify the depository bank will benefit both the depository bank and its customer. New expeditious return procedures established by Regulation CC are designed to get returned checks back to the depository bank and its customers more quickly than is the case today. Giving a depository bank and its customer greater assurance that it will learn of a returned check in a shorter time period than it can today will decrease the likelihood that one of them will suffer a loss in connection with a returned check.

Prompt return of checks is particularly important to bank customers. Although banks can generally charge checks back to their customers' accounts, a bank customer often must contact the check writer to obtain reimbursement. The sooner that a depository bank's customer can learn of a returned check, the sooner the bank's customer can begin the process of searching for the check writer to obtain payment. Generally, a depository bank's customer should have more success in recovering these funds when beginning the recovery process sooner.



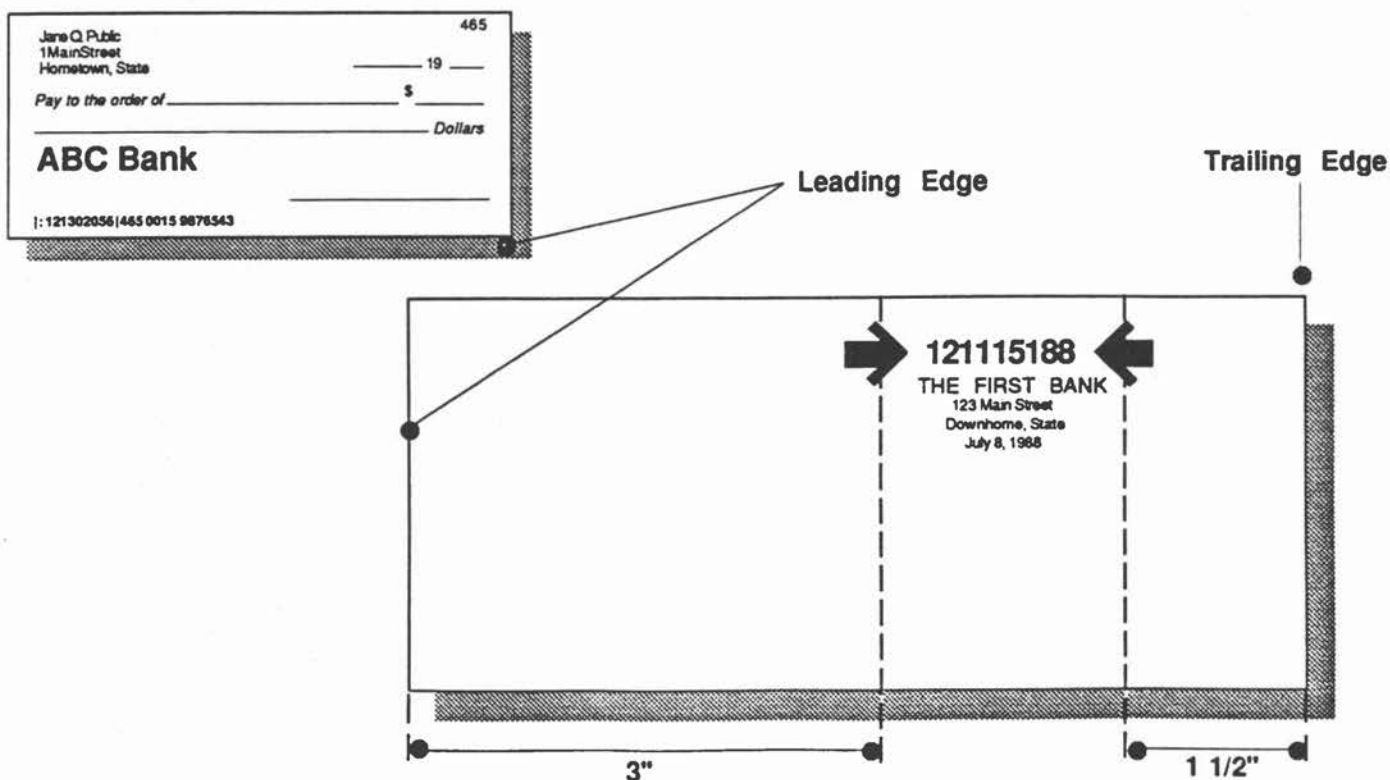
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Thus, both the depositary bank and its customer will benefit when the paying or returning bank is able to identify the depositary bank accurately and easily from the indorsement placed on the back of the check. Therefore, even though the indorsement standard does not specify a specific location or other requirements for payee indorsements, both the payee and the depositary bank may benefit when the payee indorsement is applied outside of the location specified for the depositary bank.

The depositary bank indorsement is to be made in the area beginning 3.0 inches from the leading edge of the check and ending 1.5 inches from the trailing edge of the check. (See Figure 1.) The entire indorsement need not be within this area; however, the indorsement must be placed so that the nine-digit routing number of the bank (set off by arrows) is wholly contained within this area. The routing number is the principle piece of information that is needed by the

Figure 1. Indorsement Standard: Depositary Bank



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paying or returning bank to identify the depository bank. To the extent that the depository bank does not want to risk having other indorsement information over stamped by other bank indorsements, that information should also be placed in the location reserved for the depository bank indorsement. However, the only piece of information that is required to be in this area is the depository bank's nine-digit routing number (set off by arrows).

If a depository bank and its customer adhere to the indorsment standard, they will not be responsible if a paying or returning bank fails to return a check timely due to an error in reading the depository bank's indorsement. This does not affect a depository bank's right to claim untimely return for violations of the paying bank's "midnight deadline" rule from the Uniform Commercial Code.

Some depository banks have informed their customers that they will not accept some checks for deposit simply because they do not indorse wholly within the payee indorsement area. However, payee indorsements may be placed anywhere on the back of the check outside of the location specified for the depository bank.

Referencing Figure 1, this means that the payee should indorse either in the area from the leading edge of the check to 3.0 inches from the leading edge or in the area from 1.5 inches from the trailing edge of the check to the trailing edge of the check. Today, most payees conventionally indorse in the 1.5 inches closest to the trailing edge of the check. It is anticipated that most payees will continue to indorse in this area, however, they are **not required** to do so. Indorsing in the payee area merely reduces the risk that the payee's indorsement may be obscured by other indorsements.

Depository banks are encouraged to inform their customers that the 1.5-inch area closest to the trailing edge of the check will not generally be used by depository banks and will not be used by subsequent collecting banks when applying indorsements. This means that payees receiving returned checks and relying on information contained in their indorsement about the identity of the check writer will most likely find it easier to read such information if the indorsement is placed in this area. The Federal Reserve understands, however, that many retail indorsements and other information necessary to help identify check writers may not fit into this location. Therefore, it is still acceptable for the payee indorsement to be placed in the 3-inch area closest to the leading edge of the check; however, payee indorsements in this area may be over stamped by a bank indorsement applied during the process of collecting the check (see discussion of subsequent bank indorsements below); however, this occurs today and should not present any significant problems to the payee of the check.

Some depository banks have retail customers who deposit large numbers of checks that have already been prepared for automated processing. The retail customer of the bank may apply the depository bank indorsement in addition to its own indorsement. This is perfectly acceptable under the regulation, but is not required. This could be done by the retail customer by either applying a separate indorsement on behalf of the depository bank or by incorporating the requirements of the depository bank indorsement into a joint payee/depository bank indorsement. When the retail customer applies the depository bank indorsement, the retail customer can control placement of the depository bank indorsement, thereby insuring that any payee indorsement information that might infringe into the location reserved for the depository bank does not render the depository bank indorsement unreadable.



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In other cases, a smaller depository bank may desire to have its correspondent indorse as the depository bank so that its correspondent will receive all returned checks and notices of nonpayment on behalf of the depository bank. Regulation CC allows banks to make such arrangements, by agreement. In these cases, the correspondent will serve as the depository bank for purposes of Subpart C of Regulation CC. When the correspondent will be indorsing as the depository bank, the respondent bank (the actual depository bank) should not indorse as a depository bank. The regulation does not require the respondent bank to indorse the check in any particular manner in these cases. The respondent bank should indorse the check and is not prohibited from doing so either as a payee of the check or in the subsequent bank indorsement location.

The Paying Bank and Its Customer

The paying bank is not required to indorse the check by Regulation CC, however, it is not prohibited from doing so. If the paying bank indorses the check, it would benefit most by staying clear of the location specified for the depository bank because, if it decides to return a check, the paying bank and returning banks would be better able to identify the depository bank.

The paying bank's customer, while not an indorser of the check, may still be affected by the indorsement standard. Many checks are issued with markings on the reverse side of the check. These markings are applied for a variety of reasons and include preprinted information, cross-hatching applied for security to prohibit reading the check information from the reverse side or through a mailer, and carbon bands that are used to transfer information to a ledger when the check is written.

These checks are a legal, negotiable, and acceptable form of payment. The Board also recognizes, however, that depository banks may be unable to apply indorsements that would avoid such markings. Nevertheless, it is to the benefit of the depository bank to avoid these markings whenever possible so that the depository bank can be assured of receiving returns as quickly as possible. In some cases, when markings are applied to the backs of checks in a standard fashion, such as carbon bands, banks should be able to anticipate where these markings will occur and would benefit by designing indorsements such that the nine-digit routing number in the indorsement avoids such standard markings.

Responsibility for the Back of the Check

In order to assure depository banks that their rights would not be affected by accepting for deposit checks that have markings on the back or bank customer indorsements that affect the depository bank indorsement area, Regulation CC provides that the depository bank is responsible for markings on the back of a check after the issuance of a check and the paying bank is responsible for the back of a check when it is issued. In certain instances, this responsibility may affect who bears the loss for a check that is returned untimely due to inability to read the depository bank indorsement. For example, if:

1. The paying bank's customer issues a check with markings on the back and the check bounces;
2. The paying or a returning bank is unable to identify the depository bank because the markings on the check interfere with the depository bank indorsement;



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3. The returned check gets back to the depository bank later than it otherwise would have because the paying or returning bank cannot identify the depository bank;
4. The depository bank cannot charge back the return to its depositing customer's account and, therefore, experiences a loss;
5. The loss would not have occurred had the return been timely;
6. The loss is of an amount sufficient for the depository bank to file an untimely return claim; and
7. The paying bank is unable to pay the check or recover the funds from the customer that issued the check.

The paying bank would suffer a loss on the check. The likelihood that the paying bank would actually experience a loss for most customer accounts for customers that issue checks with markings on the back is relatively low because of the sequence of events that must occur before the paying bank is exposed.

Subsequent Bank Indorsements

Subsequent collecting bank indorsements must avoid the location specified for the depository bank indorsement, must provide only certain information in the indorsement, and must not use purple ink. These indorsements must include **ONLY** the nine-digit routing number (without arrows), the indorsement date, and an optional trace/sequence number.

The abbreviated information content of the subsequent bank indorsement is another indicator that that indorsement is not that of the depository bank. In addition, the reduction in information contained in subsequent bank indorsements will assist in the readability of multiple indorsements (possibly including the payee indorsement, see discussion above) applied in that location.

Returning Bank Indorsements

The indorsement standard for returning banks is less strict than that for depository and subsequent banks. There are no information content or color requirements for returning bank indorsements. Specifically, returning banks are required to stay clear of the area from 3.0 inches from the leading edge of the check to the trailing edge of the check. This requirement will protect the location specified for the depository bank location as well as the area commonly used, but not required, for payee indorsements.

