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# IMAGE INDUSTRY BEST PRACTICES DOCUMENT

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## INCOMING RETURNS

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# i3G: Image Industry Best Practices Document

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INCOMING RETURNS

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## EXECUTIVE SUMMARY

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Since the passage of The Check Clearing Act for the 21<sup>st</sup> Century, financial institutions have rapidly leveraged image based technologies to facilitate faster and cheaper check collection. Early adoption of image exchange focused on sending and receiving of forward collection items resulting in significant reductions in clearing and transportation costs.

At a much slower pace has been the acceptance of image to image exchange of return items. The slower pace of adoption is a result of lower volumes making a business case difficult to justify and the need for financial institutions to reengineer standalone returns systems.

With recent contraction of the Federal Reserve's paper processing footprint resulting in all checks now being considered local and hold time thresholds contracting as a result, the need for full end to end check image processing – especially in the returns area - is playing an increasingly important role in payments risk.

This document will attempt to identify current and future standards and recommend a set of best practices for a number of known processes, scenarios and issues specific to the receipt and processing of image exchanged incoming returns. It is hoped that the information provided will help banks currently receiving image incoming returns and assist those banks making the transition from paper to image enabled processing. It is not intended to be a comprehensive list as not all processing scenarios can be known at this time and both the Federal Reserve Bank and ECCHO are modifying their respective rules to address the needs of the industry.

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## IMAGE EXCHANGE FILE STANDARDS

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The industry is moving to adopt the Universal Companion Document (UCD) for exchange with a future 'receive' date to be selected by the major exchanges. There are new return reason codes that incoming returns systems will need to handle or need to be mapped. This will be known as conversion to X9.37 plus its UCD or X9.100-187 and its UCD (note the two are planned to be the same, so the difference is only in terminology/naming). One significant change to the standard will be the adoption of new return reason codes that incoming returns systems will need to support.

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## PROPER USE OF RETURN CODES IN IMAGE EXCHANGE

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Check law does not dictate the reasons an item may be dishonored; the UCC and Reg. CC do not provide a standardized list of return reasons. With image exchange, the standard provides a list of return reasons and associated codes that must be used. These return reasons have now become the industry standard and, as such, should be utilized by all participants.

Attached to this document is an appendix, which contains a current list of return codes and their associated reasons as documented in the X9.100-187 standards document. Most return reasons listed in the standard have been in use for many years and are self explanatory. However, some of the newer return reasons and their usage are not as obvious. Below are definitions and explanations of the new and less common return reasons documented by the ECCHO Operating Practices Work Group in an attempt to clarify their proper use.

The standard also segregates the return reasons into two group types: Customer/"Monetary" Returns and Administrative Reason Returns. All returns carry monetary value. **The distinction is returns that have attempted to post to a customer's account (Customer/"Monetary") versus returns made by a bank for some administrative reason.** Alternately, administrative return reasons are usually handled through the adjustment process. If administrative return reasons are handled as a return, they typically would have to adhere to the legal requirements for returns including timeliness and proper

delivery and notification. The identification of the type of return is made through a code in the Cash Letter Header Record (Record 10, Field 14) in the image exchange file.

**Best Practice:**

ICLR files should be reserved only for customer/monetary returns to be handled by Incoming Returns Systems. ECPD files, x9.100.183 files and adjustment channels are the preferred methods for administrative returns.

**Customer/"Monetary" Returns – Used in ICLR Files [from ECCHO Operating Practices Work Group]**

**'J' Endorsement Irregular** – An endorsement is required for the purpose of negotiating the instrument. Various endorsements can accompany a check; these include Payee endorsement, BOFD endorsement and subsequent banks' endorsement. Endorsements can be physical or electronic. This code should be used when a paying bank determines something is wrong with payee endorsements associated with the item. This can include invalid payee name in a payee endorsement or missing information. If an electronic endorsement is in noncompliance with the UCD endorsement record edits, this code is preferred over the use of a '2'. This could have impact to IR since it is not a customer monetary return.

**'L' Signature(s) Irregular, Suspected Forgery** – This code would be used if the signatures do not conform to bank's signature cards, corporate resolution or if the item is a suspected forgery and an affidavit is not available.

**'M' Non-Cash Item (Non Negotiable)** – Negotiability is defined in the UCC and non-cash items are defined in Reg. CC. An item that does not fit either of these definitions can be returned under this code. Clarification: A non conforming IRD (a Substitute check that does conform to the X9.100.140 standard) can be returned using this code, only if the item was created by a customer and not by a Bank. In other words a Customer introduced item.

**'N' Altered/Fictitious Item/Suspected Counterfeit/Counterfeit** – This code is multi-purpose and may be used for any of the identified reasons. These reasons were grouped under one code since it is not always obvious or known to the Paying Bank.

**'O' Unable to Process** - (e.g. Unable to process physical item/Mutilated such that critical payment information is missing). This code should not be used for unusable images or system problems (see Administrative code 'U') – This code is defined to be used when there is an issue with the physical item, such as a mutilated item. However as presentment of the physical item becomes increasingly less common, this code is beginning to be used for system problems. The standard specifically stated that is not the proper use of the code.

**'P' Item Exceeds Stated Max Value** (On item or account) – This code should be used if the amount exceeds a stated limit as defined on the item or within the paying bank's records.

**'Q' Not Authorized (Includes Drafts)** – Unauthorized item such as a draft – This code should be used when a non signature draft was not authorized by the maker.

**'R' Branch/Account Sold (Wrong Bank)** - Divested Account. This code is also multi-purpose and may be used for any of the identified reasons. The most common use is for a divested account. It may also be used when the forward presentment item is not drawn on the Paying Bank and somehow passed check edits and attempted to post. Note: Not Our Item (NOI) carries different interpretations in the Outgoing Returns process versus the incoming returns process. *It is encouraged to use wrong bank vs. NOI.*

**'S' Refer to Maker** – It is strongly recommended that this code should not be used. It is recommended to only use this code when no other code truly applies to the situation. However, it is needed as some state laws privacy acts come into play.

**'X' Refer to Image** – Return reason information is contained within the image of the item. This code can only be used when the creator of the return is certain a return reason already exists on the face of the item. The return reason may have been stamped by the paying bank or printed on the face during the creation of a Substitute Check (not in red ink). If the creator of the return is unsure of the existence of a return reason on the face of the item, this code should not be used until it is verified that a return reason exists.

**'Z' Forgery** – An affidavit shall be available upon request. The code should be used when an item is believed to have a forged or invalid signature(s). Some states require an affidavit be available. If no affidavit is available the proper code to use is 'L'.

**'3' (Rule 8 & 9 claims)** – This code can be used as a Customer/"Monetary" or Administrative Return. Rule 8 & 9 claims are specific warranty breaches. Banks utilizing this claim process needs to be under a rule set that allows these warranty claims. **Note: This code should not be used when exchanging with the Federal Reserve, because the FRB does not accept returns for this reason.**

#### **Administrative Reason Returns – Used in Adjustment Channels, ECPD or X9.100 – 187 Files [from ECCHO Operating Practices Work Group]**

**'O' Unable to Process** – This code is used when there is a non conformance in the exchange file at the item level.

**'Q' Ineligible** – An item was received that is not eligible for exchange. This occurs when a bank receives items on Routing Numbers that they have not opened for image exchange, foreign items, etc. This code should not be used for items that do not conform to the standard specifications or are unusable.

**'U' Unusable Image** (Image could not be used for required business purpose e.g. gross image defects, illegible, etc.) – This code is used for an image that does not conform to industry exchange standards or agreements.

**'V' Image Fails Security Check** – This code was initially established to convey problems with digital signatures in a Record Type 52 of an image item view. This code can also be used for validation failures associated with interoperable security features.

**'Y' Duplicate Presentment** – This code is used when an item is received more than once and is not associated a return. A party in the collection process is being asked to pay the item more than once. If the item has been returned and is being represented this is not considered a duplicate presentment and can only be returned for alternate legitimate return reason.

**'1' Does not conform with ANS X9.100-181 – 2007 Specification for TIFF Image Format for Image Exchange standard** – This code would be used if an image is found to be in non-conformance with the current X9.100-181.

**'2' Does not conform to the Industry's Universal Companion Document** – The banking industry has developed a Universal Companion Document (UCD) for the implementation of X9.100-187 for financial institution exchange of images. This code may be used if an item does not meet required item level edits as specified in the applicable UCD.

'3' **Warranty Breach** – This code can be used as a Customer/"Monetary" or Administrative Return. Banks utilizing this claim process needs to be under a rule set that allows these warranty claims.

**Note: Federal Reserve does not accept administrative returns on ICLR files.**

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## BEST PRACTICE RECOMMENDATIONS FOR OPERATIONAL SCENARIOS, ISSUES AND CONSIDERATIONS

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### 1. 'X' used as a return reason code

Reason 'X', or "Refer to Image" is included in the upcoming Universal Companion Document as an addition to the Image Return Reason. The FRB is using this in their paper to image returns product – Returns Plus. It is anticipated that the volume and use of return reason 'X' will diminish as more volume shifts to image based returns processing.

Legacy incoming returns systems may not be able accept this new reason and could cause processing issues. Many of these items have return reasons other than NSF; such as Stop Pay, Acct Closed, Fraud, ULA, etc. A return reason of 'X' may cause a fraud item to not be reviewed, or items with 'non-redeposit reasons' to be redeposited, to be blanket processed, etc. Moreover, 'redeposited' items need to reflect the original return reason. The risk is high to the bank and a high probability of impacting customers.

#### **Best Practice:**

Only the FRB should be utilizing the return reason 'X'. Returning banks should not be using return reason 'X'.

If a return reason of 'X' must be used, the true return reason must be reflected in black ink on the face of item. Incoming returns systems will need to be modified to identify and process these items correctly by changing the 'X' to the actual return reason code before charging the item to the customer or redepositing the item.

### 2. Receipt, processing and impact of images with qualified strips

Legacy paper processing of outgoing returns required each item to be stripped and qualified [encoded] with the BOFD RT, a '5' in position 44 and the amount. Subsequently, the strip would be removed by the incoming returns operation, at the bank of first deposit, prior to processing the item.

For banks exchanging image returns on ICLR files, either peer to peer or in multi-lateral exchange networks, the strip is no longer used or needed to facilitate automated processing. However, because of the slow adoption rate of image return, banks using the FedReceipt Plus Returns service may receive a significant number of return items with the qualified strip included on the image. This occurs when a qualified paper return item is presented to the FRB for processing. The FRB must capture the return item with the qualified strip to properly forward the image of the item to the correct BOFD. In doing so, the return item image retains the qualified strip.

The qualified strip on the return item image may impact the bank's operational processes and the customer of both the BOFD and paying bank. Specifically, many software applications have no way of detecting the presence of a return qualified strip or a regular MICR correction strip. As a result, shrinkage of the image view will occur in further processing of these items and therefore, will diminish the quality and standards of the IRD.

### **Best Practice:**

Customers viewing images online, receiving image returns files or image returns converted to IRD's, may have questions about the qualified strip. Banks will need to make individual business decisions on how and if they provide an explanation of this issue to their respective customers.

Banks with an IRD print utility should determine if their software has the capability to interrogate and identify, from either the image or the data, the presence of a qualified return item strip. If so, the best practice should be to use the print utility to remove the qualified strip electronically before printing the new IRD. It is recommended that banks consult their vendors and information technology groups to address these scenarios.

### **3. Items with the "/" in the MICR or on the IRD and / or the \* (asterisk) in the MICR Handling of non-numeric, X9.37 valid characters**

As more banks adopt forward image exchange of incomplete, partial and unrepaired MICR lines, incoming returns operations should expect to receive and properly process items returned by the paying bank with valid non-numeric values in the 31 record. The X9.37 standard and UCD allow for the use of the slash '/', the asterisk '\*', and the dash '-', in the 31 record, to represent valid symbols, spaces or unknown characters in the MICR line. The slash can be used on the X9.37 file to represent the on-us symbols for an account number. Some banks are placing an on-us symbol to the left of the account number. The '\*' may or may not occur in a returns file, because banks may choose to return the repaired MICR line or return the original MICR line values. Although few in numbers, the dash in the on-us field is still used by some financial institutions. Incidents of non-numeric characters in the 31 record are increasing in paper-to-image return processing.

### **Best Practice:**

Banks will need to fully test, and modify where necessary, their incoming returns applications and procedures to ensure they can properly handle these non-numeric characters. In order to accurately match deposit history and identify the deposit account, systems should not erroneously add, drop, or replace these characters, but rather utilize automation or force manual interrogation to correct MICR lines.

### **4. Large Dollar Return Notifications**

Image return files expedite returns processing especially in a direct exchange environment. In most instances the actual return item is received before the large dollar notification. To reduce cost and limit risk, each bank must make a decision if it is appropriate to stop large dollar notifications.

Many banks have already eliminated large dollar notifications, or raised the dollar value of notifications, on items sent as an ICLR (image to image) in direct or multilateral exchanges. This practice is allowed under Reg. CC as noted below, as receipt of the item also constitutes notification.

*Reg. CC CFR 229.33 states:*

*§ 229.33 Notice of nonpayment.*

*(a) Requirement. If a paying bank determines not to pay a check in the amount of \$2,500 or more, it shall provide notice of nonpayment such that the notice is received by the depository bank by 4:00 p.m. (local time) on the second business day following the banking day on which the check was presented to the paying bank. If the day the paying bank is required to provide notice is not a banking day for the depository bank, receipt of notice on the depository bank's next banking day constitutes timely notice. Notice may be provided by any reasonable means, including the returned check, a writing (including a copy of the check), telephone, Fedwire, telex, or other form of telegraph.*

**Best Practice:**

It is recommended that the practice of providing a large dollar return item notification, on items exchanged in image to image ICLR files, be a business decision based on each bank's risk tolerance.

Banks sending ICLR files to the FRB should determine if the return item is an image to image or an image to IRD endpoint in making this decision, as image to IRD items could be delayed in their presentment to the collecting bank due to the use of overnight mail or other transportation methods. Large dollar notifications for return of 'traditional' paper should remain in place and unchanged.

**5. Centralized Returns**

Customers who use centralized returns either bank at multiple depository institutions or utilize a third party vendor for returns processing. They provide notification to their depository bank that they have moved their returns processing, and request the re-routing (or re-qualifying) of any incoming returns received to their preferred provider.

Once notified, Incoming Returns staff will establish a process by which they re-qualify these returns to the centralized processor's routing number. This same process also applies to Correspondent Bank depository relationships, where the Correspondent Bank is retaining their own routing number for returns.

Prior to Image Exchange, these customers commonly identified the third party routing number for returns, as a part of the physical endorsement on the back of the item. During that period, this physical endorsement was often referred to as the BOFD. Outgoing Returns staff at the returning institution physically handled these items. The majority of items were returned to the third party BOFD as the customer desired. The rapid acceptance of Image Exchange has changed this process.

Now that Image Exchange is becoming the norm, the '26 record' - not the physical endorsement - is utilized as the primary location to identify the third party routing number for returns. The traditional physical endorsement is no longer regularly applied by many institutions utilizing Image Exchange. The routing number identified in the 26 record is no longer called the BOFD, but is now referred to as the Return Location Routing Number.

If during processing the depository institution places their own routing number in the 26 record, rather than the Centralized Returns routing number, they will receive these items back when they are returned. Due to the industry adopted 'hierarchy of returns' this will be the case even if the Centralized Returns routing number is identified in a physical endorsement. It is important to understand that when a paying institution returns these items to the depository institution in this scenario, the returning institution meets their obligation and the items are considered presented. The institution populating the 26 record, in this situation, should not return the item as a NOI to the returning bank. Any delay in the depository institution forwarding these items to the third party processor may put their customers at risk for delayed returns, but it will not place the paying institution at risk for a late return claim.

**Best Practice:**

Institutions allowing a customer to use centralized returns processing, need to confirm with the third party processor that the relationship does in fact exist for that depository customer. The depository customer may sign an agreement giving the depository bank authorization to direct these returns to a third party routing number.

This agreement can be a part of or in conjunction with a depository agreement or correspondent agreement. In addition, parties that are handling image cash letters on behalf of other banks (i.e. Third Party Providers) should validate that their agreements follow the endorsement practices to avoid misdirected returns.

If possible, technologies should be developed during deposit and collection prime capture to populate the centralized return routing number in the 26 record. The 26 record should be utilized when the Return Location Routing Number is known. Until developing that capability, some institutions apply no 26 record on these specialized items and confirm their depository customer is endorsing the back of the item with the third party routing number. If no 26 record is supplied the 'hierarchy of returns' directs the returning bank to physically review the back of the item to identify and properly assign the Return Location Routing Number. This is a stop gap and will not guarantee the depositing institution will not receive the item back as some automated returns systems do not currently allow for the physical review of items and customers will not always endorse the back of the item. When they are not identified in the 26 record, it is important for the depository institution to identify they are in the forward collection endorsement chain by creating a 28 record with their routing number.

(Note: Standards exist that allow for the true truncating institution to be identified in either the 26 record or the 28 record. It is important that the true truncating institution be identified in case the item needs to be converted to an IRD. Standards are about to be released that will allow the true depository bank to be flagged in the 28 record, when the 26 record is identifying the return location, rather than the true depository bank.)

Practically speaking, depository institutions that allow customers to utilize central returns processors will end up receiving some of those customers' returns. They need to develop processes to identify these incorrectly routed items and re-route them in an expedited manor, while maintaining the endorsement history. Some institutions are utilizing automation within their Incoming Returns systems and are forwarding the items via ICLR to meet these objectives.

## 6. NOIs - NOT OUR ITEM

A "Not Our Item" is an item that was incorrectly qualified, presented and charged to a bank other than the 'Depository Bank', the Depository Bank's agent or any subsequent endorsing bank.

The electronic image return of a check for non-payment should follow the industry standard return hierarchy. The standard hierarchy requires the returning bank to first determine if a BOFD 26 record routing and transit number is present; and if so, qualify and route the returned item to that bank. If there is no 26 record, the returning bank should review the back of the item to determine if a BOFD endorsement is present and readable; and if so, qualify and route the returned item to that bank. Finally, if there is not a 26 record endorsement, and no BOFD endorsement on the back of the item, the returning bank should qualify and return the item to the first 28 record (subsequent endorsing) routing and transit number.

Reg. CC does not allow a bank to refuse a return, and return the item NOI, if that bank is a subsequent endorser of the item. However, under ECCHO rules, if a loss occurs as a result of the returning bank not following the proper "hierarchy of returns", the bank that incurred the loss has a breach of warranty claim against the returning bank.

### **Best Practice:**

The recommended best practice for handling an incorrectly qualified return to a bank that is *not the depository bank or a subsequent endorser of the item* is to follow the established industry best practice of returning the item to the returning bank as a "Not Our Item [NOI]".

The recommended best practice for handling a return misqualified to a bank *that is identified in one of the subsequent endorsing records [32 or 35]* is to determine the correct BOFD, re-qualify and present the item to the depository bank.

## 7. Duplicates

Similar to the industry's experience with forward collection and presentment, duplicate files and items also impact the image exchange of return items. Although the volumes would be lower, financial institutions should be prepared to receive duplicate files and duplicate items in their incoming returns ICLR files. The risk of not identifying duplicate items would likely result in erroneous charges to the bank's customer and impact the reputation of the bank. In addition, mistaking represented items as duplicates and erroneously submitting adjustment cases to the returning bank creates opportunity for delayed returns and operational losses.

### Best Practice:

Incoming return systems and software should be able to detect duplicate files and items much the same way duplicate detection is performed during the processing of inclearings items. Duplicate item review should include visual inspection as items may have common accounts and amounts. Also, the speed of collection, return, and representation of items should be considered in duplicate detection processes to prevent errant adjustments to the returning bank for "false positive" duplicates.

In lieu of sophisticated software changes, incoming returns applications should at the very least be designed to determine if an item has been returned more times than deposited.

Duplicate return item presentment incidents should follow the recently established *best practice* for submitting a duplicate item adjustment case to the returning financial institution with 1<sup>st</sup> and 2<sup>nd</sup> presentment information using Administrative Reason Code of "Y" – Duplicate Presentment. The presenting financial institution should provide "with entry" credit, with no dollar limit.

## 8. Image and Data Mismatches

Financial institutions should be prepared to receive MICR data and image mismatches in their incoming returns ICLR files. The risk of not identifying image and data mismatched items would likely result in erroneous charges to the banks customer and impact the reputation of the bank.

### Best Practice:

Incoming returns system software should be developed to detect these mismatches much the same way MICR data and image mismatches are detected during processing of inclearings and deposited items. MICR data and image mismatch incidents should follow the established *best practice* adjustment procedures for breach of warranty utilizing the Administrative Reason Code of "U" – Unusable Image.

## 9. Return Reasons and Endorsements

Current FRB OC3 and ECCHO rules recommend carrying all electronic endorsements and return reason codes forward when representing image to image returns. Carrying forward all electronic endorsements and return reasons is necessary for the following reasons;

1. Endorsements provide important information in solving research cases and providing evidence in legal disputes (this information replaces sorter endorsements, sequence numbers and other return reason stamps used in paper processing);
2. Return reason codes and endorsements are used by banks in duplicate item detection logic and can eliminate false positives;
3. They allow for the identification of looping items, in particular, looping of redeposits;
4. They provide necessary information to create a properly formatted IRD;

5. They can support the use of return reason codes on redeposits, in creating return reason verbiage as an image overlay or use the return reason value for designating the "item is a representation of a previously returned check" in online banking and statement applications (represented images look the same as the original to the customer because the item was never converted to and IRD).

The current X9.37 standards allow for up to 99 subsequent electronic endorsements. Carrying forward all electronic endorsements and return reason codes is recognized as a significant challenge and expense for some item processing applications. Specifically, banks with applications that require predefined data record formats and lengths would have to increase their data storage costs significantly or require costly application redesign to meet this requirement.

ECCHO rules require a returning bank to carrying forward all electronic endorsements and return reasons from the paying/returning bank to the bank of first deposit or designated return routing number. The rules do not yet require maintaining and inclusion of all previous electronic endorsements for an item collected, presented and returned multiple times.

**Best Practice:**

At this time, all banks should carry forward all electronic endorsements and return reason codes only from the paying/returning bank to the designated BOFD or designated return routing number.

Banks should begin having discussions with application developers, operations, compliance, and internal business units to understand the impacts and decide how they will address a rule change.

Looking forward, banks should determine if they have the technology to store and forward all previous and subsequent electronic endorsement records of multiple presentments and redeposit scenarios, as this provides the complete electronic audit trail of the item.

## **10. Image to Image Redeposits Confusing for the Consumer and Customer Service**

As the speed of collection, return, and redeposit of image to image returns have increased, financial institutions and their customers viewing transactions via on-line banking and statement applications have increasingly mistaken the represented return item as a duplicate presentment of the original item. This is because image to image represented items are not converted to an IRD, and, as a result, the image looks exactly like the original presentment. Untrained customer service and operations departments may also have difficulty properly identifying these items as re-presentments. Additionally, many duplicate item detection tools identify these items as duplicates (a false positive) if the systems are not sophisticated enough to utilize return item history in conjunction with properly applied electronic return reason codes.

**Best Practice:**

Financial institutions should consider the degree of customer impact and make a business decision on how they wish to address this issue. At a minimum, training should be developed and delivered to branch personnel and customer service departments to assist in identifying redeposited items and provide an accurate explanation to the customer.

Additionally, financial institutions should consider developing or partnering with software vendors to expand or update databases to include portions of X9 records in their online banking, image and statement applications to allow for verbiage that clarifies the "item is a re-presentment of a previously returned check".

Lastly, enhancements to check processing applications; creating and applying a visual overlay of the "return reason" or a "re-clear" stamp on the image, have been successfully used by some banks, and should be considered.

## 11. Non-conforming Images (NCI) Adjustments

NCI (Non-conforming Images) or items failing image quality analysis are adjustments and fall under the category of administrative [return] reason codes. Most incoming returns departments are not set up to handle these types of 'returns'. Processing NCI items in the incoming returns department would likely delay getting a 'good' quality image back into the forward presentment stream or increase the risk of charging the customer back in error.

A common NCI item might be due to a poor image (too light or too dark) from the collecting bank, where the paying bank uses the monetary reason channel (outgoing returns) to return the item.

Another NCI item might occur when a "good" quality image is sent to a paying bank. The paying bank returned, for a common reason such as NSF, a poor quality image that failed IQA at the depository or collecting bank.

### **Best Practice:**

While banks have the right to return an item for a "monetary reason", in an ICLR file, it is recommended that NCI adjustments not be included in a customer monetary file. Because the risk is high that these could be charged back to the customer in error, banks should utilize established adjustment channels for these administrative reason returns.

Collecting or depository banks should develop methods of identifying NCI items in their incoming ICLR files and create efficient and repeatable processes to transfer the item to the business unit responsible for a) chargeback or rescan, b) printing and reprocessing IRD's, c) replacing returned image with original image before changing back the return.

## 12. Looping items

Financial institutions participating in full image to image or image to paper/IRD exchange of forward and return items may encounter instance of items "looping" between the collecting and paying institutions much the same way they might see looping items in the legacy paper processing environment. The cause may be system or sort pattern logic or a result of a collecting bank incorrectly attempting multiple re-presentments to avoid a loss and collect on the item.

Given that collecting financial institutions have the right to re-present a returned item to the paying financial institution two additional times; it is likely that an item could be presented and returned one to three times. For the purposes of this discussion, a looping item should be thought of as an item returned *three (3)* or more times.

### **Example of an Image to Image Looping Item (NSF Item)**

A paying financial institution returns an item to the BOFD on an ICLR file with the return reason code "A" (NSF) in the 31 or 35 records. The BOFD receives the returned item and elects to redeposit the item. The paying bank receives the redeposited item on an ICL file, and, the next day, returns the item a second time to the BOFD adding another 35 record with a return reason of "A". This process could continue indefinitely, in effect "looping" the item between the two financial institutions many times and go unnoticed because the item is never converted into an IRD and thus, the image, without multiple return reasons "stamps", is never identified as looping.

## **Best Practice:**

Technologies need to be developed to assist in the identification of looping items, supported by processes and rules, to facilitate the proper handling of these items by the collecting and paying financial institutions. Record 31, field 14, is used to identify the number of times an item has been presented, but the industry has not mandated the use of that field.

Paying and collecting bank systems will need to be able to detect if an item has been presented or returned 3 or more times.

Once the item is detected, it should be handled as follows:

Paying bank process will require “breaking the chain” by converting the item to an IRD and following common adjustment procedures, indicating there has been a breach of warranty and the item is not to be presented again as a cash item or, if applicable, the item is Not Our Item (NOI).

Collecting bank incoming return process will require “breaking the chain” by converting the item to an IRD and charging their customer, indicating item is not to be presented again as a cash item.

## **13. Reclear/Redeposit Return Reasons and Endorsements**

Each financial institution has the responsibility to define what return reasons are ‘allowable’ for redeposit or reclear. Each institution also has the responsibility to define if this process will be done at a ‘bank’ level for all account types, offered as a ‘special instruction’ to select account types, or on a case by case basis.

Return reason values of NSF and Uncollected Funds (UCF) or Unavailable Funds (UAF) are commonly accepted as eligible for redeposit following the first return. However, other reasons that are also used are: Unavailable Funds and Refer to Maker. This process varies between institutions based on the interpretation of the paying bank’s selection of return reason and potential risk to the BOFD bank/depositor. It is expected that if an item is redeposited, that there is a likelihood that the item will be paid.

More recently, and due to a combination of remote deposit and image exchange, more items are being returned for [payee] endorsement missing. A growing number of businesses using remote deposit capture are failing to properly endorse the backs of items and paying banks, using either image quality analysis tools or manual review, are detecting and return items for missing endorsement. Redepositing items received via an X9 file returned for this reason presents a processing challenge. Banks can either charge the item back to their depositor or print an IRD, stamp the item with an “endorsement guarantee” stamp, recapture and represent the item to the paying bank.

Items may only be represented one time, via a monetary cash letter. Once an item has been dishonored twice, it becomes a non-cash item. FRB Operating Circular 3, Section 3.0.f states:

*3.1 A sender should not send to us any item if:*

*(f) The bank on which the item is drawn has declined to pay the item two or more times. For purposes of this subparagraph 3.1(f) only, the term “the item” means a check; any substitute check, electronic item, or ACH entry derived from the check; and any photocopy in lieu of that check.*

X9.37 and ECCHO standards recommend that depositing [redepositing] banks carry forward return reasons and previous endorsements from the 31, 32 or 35 records to the 26 or 28 records on redeposited items.

## **Best Practice:**

Bank operations and risk departments should evaluate and create a re-deposit/re-clear policy and procedures based on bank, customer and account-type.

All items being re-deposited should retain the original electronic return reason and endorsements when representing the item to the paying bank as previously noted in the return reason and endorsements best practice. It is also recommended that if the item is to be returned by the paying bank after the re-presentation, all subsequent return reasons shall be included in the accompanying 31 or 35 records to the BOFD. These return reasons allow for a correctly formatted IRD to be printed for return to the customer.

There are several recommended best practices for items received via an X9 file and returned for [Payee] Endorsement Missing.

Collection – To reduce the volume of missing endorsements, banks should ensure that all deposited items - remote deposited items in particular - have a valid and readable payee endorsement in black ink stamped on the back of the item. This effort should be recognized as an ongoing effort with specific emphasis on business and consumers utilizing remote deposit solutions. Financial institutions should engage their remote deposit software vendors to develop solutions for applying physical or virtual endorsements.

Re-deposit or Reclear – To redeposit an item returned for missing endorsement and absent an automated solution, banks will need to convert the return item to an IRD, physically endorse (stamp) the back of the item with the appropriate endorsement guaranteed verbiage and recapture and present the item for collection. Financial institution risk policies will need to be reviewed and operational policies developed to either apply “endorsement guarantees” or return items to the depositor for a physical endorsement

Banks may also choose to pursue an automated solution by developing the capability to create an electronic ‘overlay endorsement’ on the image and redepositing the item; eliminating the need to convert the item to an IRD.

Additional commentary: Identification and prevention of non-endorsed items continues to be a common practice by bank tellers. With the increase in remote distributed capture, the industry has seen an increase in the number of non-endorsed items entering the collection stream. More banks are refusing to honor items when the stamped customer endorsement is no longer legible or they do not accept the common industry standard “endorsement guaranteed stamp”. The process of reviewing endorsements by a paying bank is likely unnecessary unless there is a claim filed by the payee for non-receipt of funds. The risk/liability for these items lies with the depositing institution.

## **14. IRD of IRD (Ever-Shrinking IRD) Improper Formatting and Cropping/Clipping**

While the focus of this document is on image- to-image incoming returns processing, it is necessary to address the likely possibility of receiving image returns of IRD’s, which may contain a re-qualified encode-line strip and/or be an image of an IRD, of a previously captured IRD, sometimes referred to as the “ever-shrinking IRD”.

While the genesis of these items will often reside with one or more collecting or returning banks not following proper industry standards, it is necessary for the incoming returns application software to be able to properly identify and “crop/clip” these items before printing and delivering them to the banks customer.

## Points about image shrinkage in IRDs

- Image Replacement Documents (IRDs) require the scaling of original check images to reduce the image segment a factor between .65 to .95, depending on the size of the original check. This is necessary shrinkage and is expected and acceptable.
- Each subsequent iteration of an IRD can result in additional compounding shrinkage if the source item is not recognized to be a substitute check. That shrinkage could potentially be up to another .65 for each generation. Unintended scaling on a subsequent IRD can result in total scaling that is effectively between ~.42 to ~.62 of the original check image. This gets worse with compounding on subsequent, subsequent renditions.
- Unrecognized strips and/or carrier documents on original checks may cause anchoring points for clipping image segments, thus leading to unintentional cropping of the tops of the image.
- IRDs should never be placed in carrier documents for presentment and should never be stripped for forward collection. Strips and carriers will affect the ability of an application to easily determine anchoring points for clipping image segments for subsequent IRDs.
- Represented Return IRDs must not bear the optional MICR strip used in the Return presentment cycle. This is the area known as Region 6F/3B. Strips should be physically removed prior to re-imaging, or electronically de-stripped if the technology is available. Failure to do so could result in clipping errors, not to mention misrouting of items.

## Best Practice

There are two ways to tell if the item that was presented was an image format of a former IRD. One is the MICR line data content in the Type 25, and the other is the content of the real estate in the image picture. Of the two, the most obvious and straightforward is the data detection.

Having detected an IRD image, the specifications for the next 'subsequent IRD' are quite clear, although complicated. Once detected, instead of scaling the image according to the rules for an original IRD (.65 - .95, depending on size of check), the image region (1F) should be detected and copied to the new IRD with no scaling. This is known as clipping.

If an application cannot detect that it is working with an IRD, then it makes sense that it assumes it is working with an original presented check image and scaling will occur.

The quality of the EPC field is then the determining factor. The application could act in different ways:

- If it is 4, then this is an IRD, or for any other value it assumes a check
- If it is not 4, then this is a check, and for any other value it assumes an IRD
- If it is blank, then this is a check, and for any other value it assumes an IRD
- Some finer level of checking, which must then include error condition paths for the IRD output, depending on what is found.

**Final Notes: Detecting an IRD really depends on how well the original image file creating application does at ensuring that the EPC field is clean.**

## References for Section 14:

## **15. Correction of Incorrect MICR Line**

Current ECCHO rules allow a paying/returning bank to modify the original electronic MICR line information associated with the image return item information the paying/returning bank received in a forward exchange from another bank. As an example, the MICR line on a check image may contain an error in the account number. If a paying/returning bank decides to return the item, the returning bank can either (a) return the electronic image with corrected MICR line information, or (b) return the electronic image with the same MICR line information associated with the electronic image return as it was received by the paying/returning bank in the forward exchange presentment file. A returning bank modifying the MICR line information may not modify the MICR line information by inserting or replacing characters in fields that are not used in the normal posting process at the paying/returning bank (such as all "1"s or "9"s in a field).

The MICR line changes permitted under ECCHO rules differs from the industry standards that require the paying/returning bank to return the item with the exact MICR line information received on the forward item. However, the Federal Reserve Operating Circular 3 will soon be updated with similar language.

While this helps the outgoing returns process, by providing options for populating the 31 record of a returned item, there are scenarios that should be considered by both the collecting (BOFD) and paying banks.

Examples:

- A) A collecting bank incorrectly captures the account number 12345 as 12348. When the item is presented to the paying bank, the item hits the non-post; it is corrected and manually posted to the correct account. The next business day, the item is returned NSF and the original 25 record data is populated in the 31 record to the collecting bank in an ICLR file.

The collecting bank receives the item in the incoming returns process and code-line matches to the original deposited item. The returned item is then either charged back to the customer, by converting the image to an IRD with the incorrect account number 12348, or the item is redeposited and sent to the paying bank in a forward ICL file with the incorrect account number 12348.

The customer with the IRD may elect to redeposit the item with the incorrect account number and the represented item will hit the non-post a second time before attempting to pay on the correct account.

- B) Same scenario as A above, but the incoming returns clerk notices the incorrect MICR, corrects it, and redeposits the 1<sup>st</sup> time NSF item.

The paying bank receives the represented item, and returns it the next day NSF (2<sup>nd</sup> time). When the return item is received by the collecting bank, certain incoming returns systems, will code-line match on the corrected MICR and the item may be treated as if it was the first-time NSF item, when in fact it would have been the 2<sup>nd</sup> time the item was NSF.

- C) A collecting bank incorrectly captures the account number 12345 as 12348. When the item is presented to the paying bank it becomes unposted/UTLA. The next business day, the item is returned UTLA and the original 25 record data is passed along in the 31 record of the item to the collecting bank in an ICLR file.

The collecting bank receives the item in the incoming returns process and during processing, it is noticed that the account number is incorrect. The operators can either correct the account number and redeposit the item (assuming the incorrect MICR line is the reason the item was returned UTLA) or charge the item back to the customer.

The collecting bank is taking a risk that the reason the item was returned UTLA is because of the incorrect account MICR. However, the paying bank could have tried to post the item with the correct account [from the image of the check] and still returned the item UTLA. By taking this risk the collecting bank is exposing itself to a hold of funds dropping off and delaying the customer chargeback.

By not correcting the MICR line and charging the item back to their customer, the collecting bank risks negatively impacting their customer and the bank's reputation for an error in processing.

**Best Practice:**

In each of the scenarios described above, and scenarios not identified here, financial institutions will need to evaluate their system's capabilities, operating procedures and risk tolerance; and develop their own best practice procedures.

## **(Normative) Return Reason Codes**

### **General Comments**

This appendix provides a list of all acceptable return reason codes used for exchange. The table below identifies all return Reason Codes used in this standard. Some return reason codes and descriptions are used for both Customer/Monetary and Administrative returns and have the same meaning.

There are two codes ('I' and 'Q') that are used in both Customer/Monetary and Administrative returns with different meanings.

### **Customer/ "Monetary" Returns**

The following return codes are used when the Return Indicator (Field 14) in Cash Letter Header Record (Type 10) is equal to 'R'.

- 'A' NSF - Not Sufficient Funds
- 'B' UCF - Uncollected Funds Hold
- 'C' Stop Payment
- 'D' Closed Account
- 'E' UTLA - Unable to Locate Account
- 'F' Frozen/Blocked Account – Account has Restrictions placed on it by either customer or bank
- 'G' Stale Dated
- 'H' Post Dated
- 'I' Endorsement Missing
- 'J' Endorsement Irregular
- 'K' Signature(s) Missing
- 'L' Signature(s) Irregular, Suspected Forgery
- 'M' Non-Cash Item (Non Negotiable)
- 'N' Altered/Fictitious Item/Suspected Counterfeit/Counterfeit
- 'O' Unable to Process (e.g. Unable to process physical item/Mutilated such that critical payment information is missing). This code should not be used for unusable images or system problems (see Administrative code 'U')
- 'P' Item Exceeds Stated Max Value
- 'Q' Not Authorized (Includes Drafts) – Unauthorized item such as a draft
- 'R' Branch/Account Sold (Wrong Bank) – Divested Account, Not Our Item
- 'S' Refer to Maker
- 'W' Cannot Determine Amount – Amount cannot be verified
- 'X' Refer to Image – Return Reason information is contained within the image of the item.
- 'Z' Forgery – An affidavit shall be available upon request
- '3' Warranty Breach (includes Rule 8 & 9 claims)

### **Administrative Returns**

The following return codes are used when the Return Indicator (Field 14) in Cash Letter Header Record (Type 10) is equal to 'E'.

- 'I' Image Missing
- 'Q' Ineligible
- 'U' Unusable Image (Image could not be used for required business purpose e.g. gross image defects, illegible, etc.)
- 'V' Image Fails Security Check
- 'Y' Duplicate Presentment
- '1' Does not conform with ANS X9.100-181 – 2007 Specification for TIFF Image Format for Image Exchange standard
- '2' Does not conform to the Industry's Universal Companion Document
- '3' Warranty Breach (includes Rule 8 & 9 claims)

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## CONCLUSION

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The pace of converting to image returns is growing rapidly as institutions have completed forward collection activities and are implementing returns. This document was developed by industry participants to assist others in understanding the challenges and to provide them tools best apply practices for handling image returns effectively.

To learn more about ECCHO visit their website at <http://www.eccho.org/>

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## ABOUT i3G

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The Image Industry Interoperability Group, i3G, is a US financial services industry collaborative formed in 2008 by a small and diverse set of bank organizations with the mission to quickly solve for lingering exceptions and interoperability issues impeding check payment processing efficiencies. The group's goal is to eliminate a large percentage of industry processing exceptions with a few changes to industry operational practices and procedures. i3G members include Bank of America, The Federal Reserve Bank, Frost Bank, JP Morgan Chase & Co, Independent Community Bankers Association (represented by Midwest Independent Bank), Southwest Corporate Federal Credit Union, Sterling Savings, US Bank, and Wells Fargo. More information can be found about i3G and proposed industry solutions by visiting [www.i3ggroup.com](http://www.i3ggroup.com) and [i3G's linkedin group page](#).

Other i3G best practices documents and industry efforts can be found on [www.i3ggroup.com](http://www.i3ggroup.com) include:

- "Dealing with Duplicates" – An industry wide duplicate file notification system
- Bank of First Deposit Electronic Endorsements
- TIFF Tags
- MICR: Interrogating to populate X9.27 Record 25

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## CONTACT INFO

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