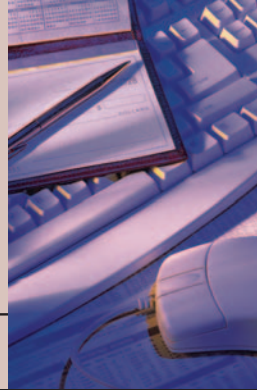


Check Clearing in the 21st Century: Where Are My Checks?

By Desiree Hatcher



Financial institutions are understandably concerned with the technological and procedural implications of Check 21, but smoothing the transition with customers ultimately may prove to be the key challenge. Millions of people still use paper checks and won't be happy to find facsimiles returned in their monthly statements.

Checks are widely used in the United States by individuals, businesses and governments. Research financed by the Federal Reserve indicates that check use in the U.S. peaked in the mid-1990s and has been steadily declining since. But Americans still write about 40 billion checks a year. That represents about half of the nation's non-cash transactions. People see checks as a very convenient, reliable, and familiar payment instrument. So while check volume will continue to decline, checks will not disappear any time soon.

Over the years, banks have become quite efficient at processing paper checks. However, the system is a paper-based, transportation-reliant process whose vulnerabilities were highlighted by the terrorist attacks on the World Trade Center and the Pentagon.

Electronic payment networks were virtually unaffected on 9/11. However, checks are largely transported by air, and commercial air service was suspended nationwide from September 11 to September 13, 2001, as federal aviation officials scrambled to beef up security procedures at airports. The suspension of air service delayed processing of out-of-area checks, perhaps increasing operational and fraud risk associated with checks during that period as they continued to be deposited and accumulated locally. That resulted in a backlog once the restrictions were lifted and checks could once again be moved by air.

The grounding of aircraft underscored the need to make the nation's payment system more flexible. However, other factors, notably significant opportunities for cost savings, have also fueled the push to electronic processing.

Enter Check 21

The Check Clearing for the 21st Century Act, or Check 21, was signed into law October 28, 2003. The law went into effect on October 28, 2004.

The goal of Check 21 is to facilitate check truncation (removing an original paper check from the check collection or return process and sending the recipient a substitute check or, by agreement, information relating to the original check, whether with or without subsequent delivery of the original paper check) and imaging without making it mandatory. Check 21 accomplishes this goal by authorizing, but not requiring, the use of a new negotiable instrument – the image replacement document.

Image replacement documents (IRDs) are "substitute checks" that the law says are the legal equivalent of the original check. A substitute check can be created from an electronic image of an original check and processed by receiving depository institutions just like original paper checks. A substitute check must:

- Contain an image that accurately reflects all of the information on the front and back of the original check.
- Bear a magnetic ink character recognition (MICR) line containing all the information appearing on the MICR line of the original check.
- Conform, in paper stock, dimension, and otherwise, with generally applicable industry standards for substitute checks.
- Be suitable for automated processing in the same manner as the original check.
- Bear the legend, "This is a legal copy of your check. You can use it in the same way you would use the original check."

If these conditions are met, any party may use the substitute check for purposes where an original check is required, such as a court proceeding or proof of payment.

Check 21 does not require collecting banks to truncate or image checks. Nor does it require paying banks to accept electronic images. Check 21 only requires that paying banks accept substitute checks as well as originals. Whether they accept the substitute checks in paper or electronic form is strictly their decision. However, the expectation is that Check 21 will increase electronic presentments at the earliest possible stage of processing.

Check 21 requires depository institutions to provide a specific notice for consumers who may receive substitute checks in their account statements. Notice is not required to those consumers who do not currently receive their original checks back (i.e., statement summaries or image statements), or will not otherwise receive a substitute check. The Check 21 notice must explain that the substitute check is the legal equivalent of the original paper check and describe consumer expedited re-credit provisions for substitute checks.

Potential Challenges for Consumers

No (required) return of original checks

Financial customers will not be able to get some original paper checks back, as not all will be returned to their bank by the payees' banks. If a paper check is not returned, it will be held or destroyed by the payee's bank, not the issuing bank. In lieu of returning original checks, financial institutions can:

- Ask for the return of substitute checks with checking account statements. They are the legal equivalent of the original check, and legal proof of payment.
- Use duplicate checks (usually a chemically treated paper attached to each check that records all writing on the original check). While duplicate checks do not provide legal evidence of receipt of payment, they provide a record of the actual payment amount, date, etc., for checking account balancing.

Double posting

A new potential risk of double posting will be created (i.e., both the original check and the substitute check are posted and twice the correct amount is removed from the payer's account). Under Check 21, a bank that creates a substitute check must warrant that it is not requesting payment on items already paid. However, in the event a substitute check is incorrectly charged to an account (paid twice, paid for the wrong amount, or otherwise paid in error), a consumer may make a claim for expedited re-credit within 40 days from the date the statement is

mailed or the date the substitute check is made available, whichever is later. A depository institution has 10 business days to investigate and resolve a claim for expedited re-credit. If a depository institution cannot determine whether a customer's claim is valid by the end of the tenth business day, the depository institution must re-credit the amount of the substitute check or \$2,500, whichever is less. Any remaining amount must be re-credited within 45 days and include interest if the account is an interest-bearing account.

No float

The processing time under the new law could be 24 hours or less. As a result, checks will clear sooner, increasing the risk that a check will bounce if funds are not in the account when the check is first written. Those who do not ensure sufficient funds are in their account at the time a check reaches the payee can expect bounced-check fees.

Currently, the new law does not shorten hold times, as established by the Expedited Funds Availability Act (Regulation CC), for deposited checks. However, after 30 months from passage, there will be a study on whether banks are making funds available to consumers earlier than required by law. Financial institution customers using checks should:

- Not write a check unless the funds are already in the account to cover it;
- Sign up for direct deposit, under Regulation CC, direct deposits must receive next day availability, while checks may be subject to the bank's check hold policy;
- Consider obtaining overdraft protection, keeping in mind that it should not be used as a line of credit;
- Use a credit card – credit card users have until the credit card bill is due to float the payment.

Stop payment option is reduced

A customer may order his bank to stop payment on a check. However, the request for stop payment must be received before the payment is deducted from the account. With Check 21, the window for requesting stop payment orders will be reduced significantly. Use of a credit card in lieu of a check is an option that affords a greater level of protection in case of a dispute.

The Fair Credit Billing Act allows those paying by credit card to withhold payment on any damaged or poor-quality goods or services purchased with a credit card, as long as they have made a reasonable attempt to solve the problem with the merchant (from UCC code 4-403).

Fraud investigations may be hindered

Faster clearing may mean fraudulent checks may be discovered earlier. However, prosecution may be hindered

as a substitute check is not as useful as the original check for proving forgery or alteration; it cannot provide fingerprints, determine pen pressure or the paper stock used to forge checks, and it is less useful for handwriting analysis. Also, security features built into today's paper checks will not show when the check is electronically imaged. Without the evidence found in analyzing checks, it may be more difficult to convict criminals. Therefore, consumers should take the following measures to safeguard checking account information:

- Never carry a checkbook unnecessarily;
- Never leave bill payments or other checks in mailbox;
- Always review monthly account statements, and report any unauthorized transaction or suspicious activity to their financial institution immediately;
- Report lost or stolen checks and checkbooks immediately to their financial institution;
- Tear or shred any old checks or account statements before throwing them away;
- Never give checking account information to telemarketers or to callers claiming to need to confirm or verify checking account information.

In addition, instead of using checks, consumer should use alternative methods of payment. With a credit card, a debit card, a personal computer or ACH, the transaction is electronic and is governed by the Electronic Funds Transfer Act, or Regulation E. The regulation includes procedures for resolving errors and provides limited liability for unauthorized transactions. However, be aware that liability for credit cards is different than electronic debit transactions. A customer's maximum liability on a credit card is \$50. On an electronic debit, unless the financial institution has been contacted within 60 days of receipt of the monthly statement, there may be no limit to liability for unauthorized transactions.

Benefits to Banks

For banks, the main advantage of Check 21 is cost savings. Estimates indicate that upon full implementation of Check 21, the banking industry could potentially reduce its check processing costs by over \$2 billion a year. That estimate includes a reduction of \$250 million in transportation cost. In addition, banks will benefit from improved availability of funds, and greater efficiency in processing return items. As clearing time shrinks, credit risk is reduced as well. Further, Check 21 will help alleviate the danger of checks being lost or delayed during transport.

Potential Benefits to Customers

The real power of Check 21 imaging is found in integrating check images with other customer service devices and processes. This integration is just now reaching the market and is focused in four areas: the platform (bank office), the Internet, e-mail, and ATMs.

Integration at the platform level

Currently, if a customer needs a copy of a particular cancelled check, a customer service representative (CSR) takes the request and promises to provide a copy to the customer by mail or fax. The request goes to research, the item is recovered from microfilm, and a copy is made and sent to the customer. Next day service is considered outstanding.

However, a bank that uses the workstation integration of check images, a process that makes electronic images of checks available on any terminal in the bank, can offer faster service. Here, the customer approaches the CSR and makes the request. The CSR accesses the customer's account on the bank's online system, reviews the customer's activity on the account to verify the item has cleared, and by "double clicking" the check's serial number on the screen, produces the imaged check on screen. At this point, the CSR can answer any question about the check for the customer. If the customer wants a copy, the image – front and back – can be printed and given to the customer. The time it takes to serve the customer is reduced from days (one day at best) to minutes.

Integration through the Internet

A bank can take customer service to a higher level by delivering check images to customers through the Internet. An Internet banking customer who wants to know whether or not a check has cleared simply accesses their account and reviews the list of cancelled checks. Each cancelled check can be viewed, stored electronically, or printed simply by clicking on the check number.

Integration with e-mail

Still building on customer service, banks can add statements and images to an automated e-mail process, and neither the bank nor the customer has to look for items. E-mail statements let the bank send monthly statements and cancelled checks as an attachment to e-mail. Customers can view the images, save them to their PC, or print and file a hard copy.

Integration with ATMs

A handful of financial institutions have piloted ATMs that allow customers to insert checks and cash directly into the machine. These ATMs are equipped with check-imaging devices and bunch note acceptors (bill scanners).

With envelope-free deposits, an image of the check appears on the screen when a customer inserts it into the ATM, and the customer is asked to confirm the amount. An image of the check also appears on the receipt, along with a breakdown of cash by denomination. The images may be a key to getting consumers, who are generally much more comfortable with taking funds out of an ATM than putting them in, to make more ATM deposits.

Conclusion

Because of Check 21, within the next few years, more banks will be able to transmit digital images of checks and thereby offer faster turnaround on several check-related services. The change will also reduce labor and postage costs for banks. Bank customers, while no longer able to take advantage of so-called "float," (the unofficial grace period once enjoyed while their check was moved physically from one location to another), will benefit from new services and improved or enhanced existing services.

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