Check 21: What Does It Mean To Banks & Consumers?

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January 2004

The “Check Clearing for the 21st Century Act” (Check 21) removes legal barriers to check truncation by permitting banks to truncate original checks, to process the check information electronically, and to print and deliver “substitute checks” (also called image replacement documents) to banks and bank customers that want to continue to receive paper checks. Its objective is to improve the overall efficiency of the nation's payments system. What are the implications of Check 21 for banks and consumers? This article briefly reviews the contents of Check 21, discusses its potential effect on the banking industry and examines potential costs and benefits of this Act to banks and consumers.

What It Does

On December 21, 2001, the Federal Reserve Board unveiled draft legislation on Check 21. It was introduced into the House on March 27, 2003, and discussed in the Senate Banking Committee April 3, 2003. It was signed by President Bush on October 28, 2003. Check 21 will take effect in October 2004.

Check 21 authorizes use of a new negotiable instrument, called either a substitute check or an image replacement document (IRD), as the legal equivalent of an original check. This newly created substitute check accurately represents all the information on the front and back of the original check when it was truncated. This substitute check must be magnetic ink character recognition (MICR) encoded, machine readable, and include an image of the front and back of the original check. The IRD also must meet industry standards and bear a legend that states “This is a legal copy of your check. You can use it the same way you would use the original check”. And, indeed, an IRD can be used as a check, but one that is simply transported electronically, in place of the paper check.

Check 21 does NOT provide legal coverage for image exchange, define industry standards for the IRD, nor determine what constitutes legal presentment. It also does not regulate the transmission and exchange of electronic check images. It only addresses the legality of the paper reproductions or

IRDs.

How It Works

[This section draws from a presentation by Terrance Roth, Federal Reserve Bank of Cleveland.]

Before Check 21 was enacted, a collecting bank could choose to clear items via the physical check under direct exchange or clearing house exchange or through an intermediary. Check 21 allows the bank to:

(1) create the substitute checks locally or

(2) create the substitute checks offsite, (this is also know as "harvesting" the check images). Offsite images can be created through centralized point-of-deposit (POD) operations, branch capture, ATM capture or capture at a commercial depositor's site. This will enable banks to expand their use of electronic methods in collecting and returning checks, reducing the industry's reliance on costly transportation options to collect/return checks across the nation.

Currently, many banks use "Accounts receivable conversion" (ARC). ARC allows banks to convert checks to automated clearing house (ACH) transactions at the lockbox. More specifically, this technology uses MICR information from checks to create ACH transactions. The original checks are then typically destroyed. This, too, is a form of check truncation, but is largely used by merchants and billers. Check 21, on the other hand, was enacted to promote use of digital images initially by banks, with the intention that this technology would spill over to merchants and billers. The ARC technology uses check imaging equipment, and many merchants are already scanning checks, which may make conversion go more smoothly for some that use this technology. The main difference between ARCs and IRDs is that IRDs are processed as checks, while ARCs are processed as ACH. Under Check 21, the bank will send check images electronically through electronic check-processing technologies to those banks that own this new technology *and* wish to receive electronic checks. The banks will send IRDs to those banks which do not have the technology yet and/or do not wish to receive the electronic images. It's important to make the distinction between IRDs and electronic check images. A bank can scan a check, create an electronic image, and transmit that image electronically. But this check image is not the same as an IRD – it is not the legal equivalent to the original check, as Check 21 mandates the IRD to be. Therefore, the bank will need to create an IRD, or have a third-party vendor or the Federal Reserve create that IRD from the original electronic image.

Finally, the Act also creates a warranty structure to protect against the risk of increased losses associated with the use of substitute checks. Under existing check law, a bank may only charge a properly payable check to a customer's account and banks must resolve claims timely in order to limit liability. But Check 21 mandates **expedited recredit** for resolving disputes arising from the use of IRDs, such as a customer questioning a check's authenticity. If a customer questions the authenticity of an IRD, the bank has one day to either produce the original check or credit the account for the amount of the substitute check. The bank may reverse the recredit if it determines that the substitute check was properly payable and notifies the consumer (S. Marlin, "Fed Check Proposal Has Banks Worried," www.banktech.com, 1/1/02).

Expected Benefits from Check 21

To Banks

The Federal Reserve Board cites three potential benefits of Check 21 to banks:

(1) <u>More choices for banks.</u> The IRD will be an alternative to the current methods of payments processing. Check 21 does not eliminate any payment method. Other payment methods available include: ACH, FedWire, paper checks, ARC, cash, credit cards, and debit cards. Substitute checks are expected to add a more efficient alternative to the more time-consuming payment methods (such as paper check clearing, which involves physical transportation of the paper checks). Closely related to this benefit is Point (3), lower costs, see below.

(2) <u>Greater technological innovation.</u> This Act facilitates technological innovation by banks, vendors, and also the Federal Reserve Banks. It is expected to speed the transition to electronic check processing, away from the more costly paper check clearing process.

Many small banks do not yet own the technology to create IRDs. It is expected that the smaller banks will either invest in the electronic check imaging equipment or choose to outsource the processing. A couple of the largest banks already own and use the technology and are currently developing tools to make the conversion more efficient. A subsidiary of Zion Bancorporation, NetDeposit, integrates "emerging payments technologies and processes to optimize the clearing and settlement of payments that start out as checks," (American Banker November Supplement, p. 17). A new system at NetDeposit decides, based on a number of criteria, for each payment, whether the most efficient form of clearing is an IRD or an ACH converted check transaction. A group of eight large banks will begin piloting a nationwide electronic check clearing system in early 2004. This system is designed to clear checks (called “forward collection” or “day 1” processing) and to handle some “day 2” processing, such as resolution of returned checks. While many banks, especially the larger banks, have the “day 1” check-imaging technology, many banks do not yet have the “day 2” services in place for Check 21.

Outsourcing to a third party vendor, as discussed above, is an alternative to smaller banks that do not wish to or cannot afford to purchase the electronic check clearing equipment. “If a bank has to spend a lot of capital on technology to support truncation, image exchange and archive technologies, at the same time check volumes are declining, outsourcing becomes a logical option,” (Robert Hunt, TowerGroup, in the American Banker November Supplement). Some vendors are developing tools to aid the bank in converting a paper check to IRD at any point along the check-clearing path, at the bank, offsite, even at the merchant. Other vendors are promoting the “day 2 services”, discussed above, such as resolution of returned checks, adjustments and exceptions.

The Federal Reserve is also promoting it’s new services to assist banks in converting checks to IRDs and presenting those checks to the payees. The Federal Reserve can accept the electronic check images and create substitute checks to present physically to the paying bank. The Federal Reserve also has the capabilities to receive paper checks in some cases and create the electronic image and IRD for check clearing. It’s clients are mostly small banks and credit unions and it currently truncates about 3 million checks a day for client financial institutions (The American Banker November Supplement, p. 12). Banks that are ready to receive electronic images will be able to receive their Federal Reserve presentments earlier than they currently do.

(3) <u>Lower costs.</u> IRDs should reduce costs, delays, and risks associated with ground and air transportation. It is also expected to reduce labor costs in back-office processing and enable faster processing of checks. It will likely allow banks to improve internal operations by allowing, for example, electronic sorting of unpaid checks, rather than physically sorting the

paper checks. Infrastructure costs may be reduced because branch and ATM networks would no longer need to be tied geographically to processing centers. Instead, images of checks could be transmitted electronically to processing centers to create substitute checks. The reduction of time-consuming and costly transportation options and the ability of a bank to selectively use electronic check processing or substitute checks is expected to increase banks' operating margins.

Each bank's use of the new technology will depend on its technology infrastructure and strategy, its physical infrastructure, and its customer and business profiles. Thus the magnitude of the cost savings, which will depend on the rate at which banks begin using the new authority, is difficult to determine. (Ferguson, 2003).

To Consumers

A number of potential benefits also accrue to consumers.

(1) Improved information flow. Faster check collection and return would allow banks to provide more timely information to depositors. For example, banks may be able to provide customers with access to on-line images of deposits and payments prior to delivery of paper statements or to provide printed copies of checks deposited at ATMs on ATM receipts. (*ATM & Debit News*). Consumers would have more information about bad checks sooner, which will enable them to reduce losses incurred from bad checks. (Financial Services Roundtable, letter to Congress, 11/6/02). Consumers will have faster access to their bank transactions since they will have the ability to view their images on-line. For those customers who do not have access to the Internet, their bank representatives will have immediate access to customer check images to resolve customer questions over the phone or in person. (Letter to Congress from banking trade groups, 10/11/02).

(2) Quicker access to deposited funds. Branch and ATM restructuring could allow banks to offer broader deposit options and later cutoff hours for certain checks. Check imaging would allow banks to post ATM deposits in real-time, giving customers almost immediate access to deposited funds (*ATM and Debit News*). These changes could lead to some checks being credited one day earlier, some checks clearing one day earlier, and interest accruing one day earlier for some checks deposited in interest-bearing accounts. (Board Section-by-Section

Analysis).

(3) Reduced costs. Bank savings from reduced operating costs could be passed on to customers in the form of lower fees. This benefit is not guaranteed, however. See the section on costs to the consumers.

Expected Costs of Check 21

To Banks

This Act has been received favorably by most segments of the financial-services industry. (BNA Banking Daily). Substitute checks are not expected to result in problems different from those that are routinely addressed in today's environment. Banks are, however, somewhat concerned with two aspects of Check 21.

(1) Consumer protection under Check 21. Consumer claims must be filed within 40 days of when the financial institution delivers the relevant statement or makes available the substitute check to the consumer. *The bank must then recredit the consumer no later than the day after the claim is determined to be valid*. As discussed above, the consumer's bank must produce the original check (or a better copy of the original check) showing that the substitute check was properly charged, otherwise the bank must provide expedited recredit. This provision clearly benefits the consumers at the expense of the banks. The banks may have to recredit funds to a customer's account simply because someone claimed that the IRD was not authentic. Some banks fear that this provision could be extended to all checking transactions. (S. Marlin, "Fed Check Proposal Has Banks Worried," www.banktech.com, 1/1/02)

(2) Credit Unions. A secondary concern is that most credit unions already utilize a version of check truncation. Prior to Check 21, these institutions were not required to return the original checks to the consumer, so credit union customers were accustomed to receiving the electronic images aleady. Bank customers, on the other hand, are accustomed to receiving the original checks back from the bank. Thus, credit unions have a slight advantage over banks in conversion to Check 21.

To Consumers

[All of the points listed below come from the Consumers Union (www.consumersunion.org).]

Consumer groups have a number of concerns about the substitute checks.

(1) Fraud Prevention. The proposal does not guarantee that consumers can obtain their original checks without a paying a fee to the bank. Although the substitute check would be legally equivalent to the original check under state and federal law, it will not be as useful as the original in proving forgery or alteration because it cannot be used to determine pen pressure, and is less useful in handwriting analysis. Also, with the increased use of automation, it is likely that check signatures will be examined less closely than they are today.

(2) Privacy Protections. Check 21 contains no privacy protections on the secondary use of the information on the check that has been converted into an electronic image. A bank may build a database using check images to determine which of its consumers shop at certain kinds of retailers, or what kinds of suppliers a business customer uses.

(3) Provisions for consumer check clearing. Check 21 may speed up check clearing without shortening the amount of time a bank can hold a consumer's funds. The Act does not contain a provision requiring a corresponding change in the funds availability law, so the bank may clear a check in 2 days, but the Act does not require the bank to make the funds available to the customer any sooner than under present conditions.

(4) Consumer choice. Check 21 would eliminate the consumers' choice to receive their original paper checks.

(5) Potential Risks. Check 21 could expose consumers to new risks, including double processing of a single check or errors in reading dollar amount or account number. This could give banks an unfair ability to deter, delay, or reduce claims for damages that result from bank processing errors.

Selected References:

Ferguson Jr., Roger W. April 3, 2003. Testimony on the Check Truncation Act before the Committee on Banking, Housing, and Urban Affairs, US Senate. http://www.federalreserve.gov/boarddocs/testimony /2003/20030403/default.htm

Proposed Check Truncation Act: Section-by-Section Analysis. July 2003. The Federal Reserve Board. http://www.federalreserve.gov/paymentsystems/truncation/proposed.htm

American Banker. November 2003. "Check 21: From Paper to Imagining." A Supplement to the American Banker, Bank Technology News and US Bankers.

Other information can be found at www.frbservices.org, BNA Banking Daily (available through Factiva) and ATM&Debit News (available through Factiva).