

payments system research briefing

Federal
Reserve
Bank of
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Early Experiences with Check 21

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Since the Check Clearing for the 21st Century Act (Check 21) went into effect in October 2004, there are many signs of changes beginning to emerge across the U.S. payments system. But these changes only hint at what Check 21 could ultimately deliver—a more efficient, electronic system to clear the 37 billion checks still written in the United States. This article looks at some of the early developments since the Check 21 law became effective and some of the remaining barriers to a more efficient and electronic check clearing system.

The promise of efficiency

Check 21 allows banks to capture digitized images of paper checks taken for deposit and transmit them to intermediaries, such as their local Federal Reserve Bank or a check image exchange organization, for presentment to and payment by the paying bank. By truncating the paper check earlier in the clearing process, check clearing times can be accelerated by reducing transportation delays. In addition, many of the steps involved in clearing and returning checks can be automated by using digital images instead of paper checks. As a result, it is expected that check truncation eventually will lead to greater efficiency in the check clearing process and ultimately reduce check processing costs.

Early observations

The move to more efficient electronic clearing under Check 21 will take some time as banks look to reduce costs at various steps of the clearing process. One of the first uses of the new law has been to expedite clearing of large-value checks, which make up a relatively small percentage of checks, but a large percentage of dollars. This process allows banks across the country,

especially West Coast banks that are clearing checks drawn on East Coast banks, to minimize the cost of “float”—an expense incurred by granting credit to depositors before receiving credit from the paying bank or a subsequent collecting bank.

Another more limited use of check truncation is by smaller community banks, particularly those in more remote locations. These banks have found that capturing and transmitting images to clear all of their checks is less expensive, particularly as the cost to clear paper checks has increased. By truncating all of their checks, either at a central operations center or at each branch, these banks can eliminate most or all of their check transportation expenses.

Efficiency through innovation

By removing some of the constraints associated with clearing and settling paper checks, Check 21 has spurred innovative ideas for depositing and processing check payments. ATM manufacturers have begun to incorporate image technology that is lowering banks’ cost to deploy deposit-taking ATMs. These ATMs capture images of checks as they are deposited and transmit them for clearing, eliminating the daily servicing costs.

Corporate customers also are creating demand for efficiencies from Check 21. In response, banks and their vendors are deploying systems to capture images of checks received at the company site and transmit an image deposit to their bank. This process eliminates the time and cost of transporting paper check deposits to the bank. It also provides an opportunity for companies that accept checks at locations across the country to consolidate banking services and eliminate the need for cash concentration services. The image deposit services are already being offered by several major banks and even being used to clear checks received at overseas locations.



In addition, most remittance processors, or lockboxes, already have image capture technology and are beginning to use that capability to clear check images. Even those lockboxes that are converting consumer checks to ACH transactions are exploring ways to truncate their remaining checks (for example, business checks and money orders) and clear the electronic images.

Further, the image capture technology that many banks already have in place to provide image statements to their customers can be leveraged for returning checks and other exception

Barriers

Because Check 21 does not mandate the electronic receipt of check images, banks must weigh the cost of capturing images and creating substitute checks for presentment to banks that do not agree or are not yet ready to accept images. The ultimate goal of a more efficient check clearing system will be realized once a critical mass of banks begin receiving image files instead of paper checks for presentment, creating an end-to-end electronic clearing system.

At this point, almost all of the checks that are truncated, regardless of at what point in the collection process, are ultimately being reconverted to substitute checks by the depository bank or a third party for presentment to the paying bank. Because the overall cost to capture and transmit images and print substitute checks is still higher than the average cost of collecting paper checks, banks are only selectively using their ability to truncate checks.

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check processes. Banks can retrieve check images electronically from an image archive and either print a substitute return check or a send a return image cash letter to the Fed or other image clearing network. Prior to Check 21, the only way a bank could return a check, for example, for insufficient funds or a closed account, was to re-process all of the previous day's posted checks, physically sorting out any checks to be returned.

Widespread electronic clearing of checks through image exchange networks is not likely to occur until more banks begin receiving electronic image files instead of substitute checks. The cost of integrating image receipt capabilities into existing core banking systems can be an expensive and time-consuming process, but many banks see benefits and are working to implement those capabilities.

Conclusion

The opportunity to improve efficiency is often an important impetus for change. It is clear that Check 21 already has begun to change the way banks and corporations look at how they process and clear check payments. While many of the early adopters are using Check 21 to slightly modify or enhance their current check clearing process, others are looking at ways to use new technology and the new law to re-engineer most or all of the process. The fact that most banks cannot yet accept electronic image presentments means that substitute checks will be necessary for some time. It will not be clear for several years the extent to which Check 21 fulfilled its intended purposes, but early indications show promise.

Larry Taft is an assistant vice president at the Federal Reserve Bank of Kansas City where he works on product development efforts related to check and ACH payment services. He has many years of experience in check and ACH operations and support areas, including at the Federal Reserve Board in Washington, D.C., where he worked on the early stages of the Check 21 legislation.

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