

OVERVIEW: “Check 21”

Background Information on the Check Clearing for the 21st Century Act

What is Check 21?

H.R. 5414 was designed to make the check payment system more efficient and foster innovation in the financial industry. The legislation gives financial institutions the option to submit electronic images of paper checks – or a paper reproduction of a check – for processing and clearing. The legislation states that “substitute checks” are the legal equivalent of an original check document, and makes it legal for the entire banking system to accept images instead of paper checks. Check 21 passed in October 2003 and is expected to be implemented anytime after October 2004.

Why is this legislation important?

Financial institutions will be able to reduce the flow of checks and process them electronically, by creating machine-readable substitute checks that will be the legal equivalent of an original check. Under the new act, the paper that a financial institution processes and returns to another financial institution may be either the original document or a substitute check. The legislation enables banks to expand the use of electronics in the collection and return of checks, and reduces reliance on the transportation system to process checks. For example, each branch can now immediately capture the image of a deposited check and process that image, rather than physically transport original checks from the branch to central processing sites.

What are the benefits of Check 21?

The new legislation will improve the overall efficiency of check payments. Financial institutions will likely realize significant cost savings from float improvements, fraud detection and more efficient processing. Imaging technology will also decrease dependency on postal and transportation systems. In addition, it will likely shorten turnaround time, improve customer service and increase collection rates on returned checks.

Will this be the end of checks as we know them?

No. Checks will continue to be a significant element of banking in the foreseeable future. There will likely be some significant changes in the check payment process, but this will ultimately have a positive impact on the industry. Check 21 allows us to create new products and improve service for our commercial clients.

What are common misconceptions about Check 21?

The legislation does not mandate that all financial institutions implement check imaging technology in their check processing operations. Each financial institution will still need to weigh the costs and benefits of adopting check-imaging technology.

In addition, the law does not mandate that all financial institutions accept checks electronically from other financial institutions. Check 21 simply gives banks the option to accept electronic images in lieu of paper. Financial institutions still must have an agreement with each other to exchange electronic images of checks rather than physical, paper checks.

The law does, however, require banks to accept a new negotiable paper instrument called a substitute check, which can be used in place of the original paper check without an agreement in place.

What is a “substitute check?”

A substitute check is a paper reproduction of an original check that:

- Contains an image of the front and back of the check.

- Bears a MICR line containing all the information appearing on the MICR line of the original check.
- Conforms with applicable industry standards for substitute checks.
- Is suitable for automated processing in the same manner as the original check.

Does this impact all financial institutions in the same way?

No. As noted above, each financial institution has a choice of creating and processing substitute checks through imaging technology or continuing to process the original paper documents. They will need to determine for themselves if imaging technology is a cost-effective solution for them.

Certain financial institutions have already implemented some version of check imaging technology to facilitate check document archiving or viewing imaged checks online. A financial institution with more advanced check imaging capabilities will have less of a challenge than others in full implementation of Check 21.

All will need to understand the key provisions of Check 21 and its implications for their business. For example, as Check 21 mandates that every financial institution must accept substitute checks presented for collection, all will likely need to examine their check processing operations to determine if changes are needed to accommodate the processing of these substitute checks.

How will a financial institution know about standards for the creation of “substitute checks?”

An ANSI standard is being developed for substitute checks. The title of this draft is “X9.90- Specifications for an Image Replacement Document (IRD).” This standard describes the information that needs to be visible on the substitute checks, as well as where the required information should be placed. This information can be obtained through X9 or ANSI.

How is the industry addressing the issue of check security features in an imaging environment?

Assessing check security features in an imaging environment is important under the Check 21 legislation, in-order to manage risk and limit the potential for check fraud. The industry is reviewing various check security features to determine which will survive image capture and which will be useful in an imaging environment.

NEBS is currently participating in a project sponsored by the Financial Services Technology Consortium (FSTC) which will test the survivability, viability and performance of current and proposed check security features that could be used in this new environment.

NEBS understands that those who administer commercial check transactions are concerned about the potential for check fraud. This concern is based on the fact that in an imaged environment, the size of the commercial check image is reduced to create the Image Replacement Document (IRD). NEBS will be a significant contributor to the commercial security feature testing project because of our expansive line of business checks.

What is NEBS doing to respond and prepare for Check 21?

NEBS is a leader in the industry and has been involved in this issue since its inception in 2001. Since then, our company has been working with other industry organizations to fully understand its effect on our business. As noted above, standards are still being developed by industry organizations and the resulting implications have not yet been identified. However, NEBS will continue to monitor the issue and actively participate in the development process.

In addition, NEBS has recognized that many clients have already started implementing image technology and preparing their infrastructure for new ways of processing checks. In 2003, NEBS also undertook proactive steps to assess the usability of our products with the types of technology used in electronic check processing. Specifically, we:

- Inventoried all our personal designs and each separate check image.
- Reviewed each of our check designs and images for compatibility with the image-processing technology.
- Tested check designs with various external partners to ensure that the check exceeded the levels expected by sorters.
- Modified some of the check stock to enhance image readability.

So far, all of the testing results have been favorable. NEBS will continue to review and assess the industry regulations and guidelines that will be implemented as a result of the passage of the Check 21 legislation, and determine if further testing will be needed.

How will Check 21 impact future check designs at NEBS?

Moving forward, we expect that the market will increasingly adopt imaging technology. As a result, image compatibility and readability will be key factors in determining future check designs at NEBS. All new designs will be created to meet imaging requirements.

All standard checks NEBS provides are image compatible, approved for image processing equipment and conform to industry standards. As new standards are developed and released, NEBS will review its inventory and continue to maintain and update our check designs.

What are the next steps?

The effective date for the legislation is October 28, 2004. In the meantime, the Federal Reserve will draft and release implementation regulations for the legislation. These regulations most likely will be finalized mid-year. In addition, various industry organizations will be revisiting the industry standards around substitute checks.