What Does Check 21 Mean for Banks?

Basics.

Check 21 facilitates electronic clearing of checks by giving legal status to "substitute" checks, i.e., images of checks that meet special standards and include MICR encoding.

Reasons for Check 21.

One of the main impediments to electronic check clearing is state UCC law, i.e., provisions that say the consumer generally must agree not to have checks returned. Thus, banks may "truncate" checks at the paying bank level because account agreements can so provide. However, it is difficult for banks to truncate at any other point in the check clearing process because they do not know whether the writer of the check has agreed not to receive checks. For example, if Joe deposits a check from Mary, Joe's bank does not usually know whether Mary, the writer of the check, has agreed not to receive back her checks. Thus, Joe's bank must send the original check to Mary's bank, the paying bank.

Effect of Check 21.

Check 21 provides, in essence, that the consumer (or bank) is not entitled to the original check and conveys legal status to substitute checks. Thus, under Check 21, banks can electronically clear checks because the original check no longer has to travel from the bank of deposit to the paying bank. Because substitute checks have the legal equivalence with original checks, they can be used to satisfy the IRS, courts, merchants, etc.

Origins.

A banker was looking to avoid the costs of daily ATM servicing necessitated by Regulation CC's general requirement that deposits be retrieved each day, even when the ATM does not need cash replenishment. He calculated that processing the ATM-deposited checks electronically and converting them to an image with MICR cost less than the daily ATM servicing costs. He approached the Federal Reserve Board about developing regulations or legislation that would permit such a scheme.

The Federal Reserve Board, over two years of meeting with bank representatives including ABA and consumer groups, refined the concept and drafted legislation. For the most part, the final legislation addressed bank concerns, especially those of small institutions and paying banks and potential fraud concerns. The legislation passed 28 October 2003 and is effective one year later.

Bottom line.

1. ***No bank must process checks electronically.***
   There is no need for new equipment.
   All banks can continue to process only paper documents.

2. ***All banks must do something.***
   Banks must:
   - Provide informational notices to customers.
   - Handle substitute checks (All banks will potentially receive substitute checks).
   - Understand expedited recrediting, whether bank-to-bank or customer-to-bank.

3. ***Banks must be prepared to answer customer questions.***
   Even if a bank does not return checks (which could include substitute checks) to customers, customers will be exposed to substitute checks, e.g., a returned deposit in the form of a substitute check or an image of a substitute check on their image statement.

   Customers used to receiving original checks may be alarmed that they no longer will receive originals. They may also be concerned that they need original checks for legal and other purposes.

Opportunities.

- ATM processing and servicing.
- Remote branch processing.
- Continued check processing during difficult weather conditions.
- Obvious benefits of eliminating need for actual check to travel to paying bank.
- Competitive advantages.

Controlling Risks

- There may be new risks associated with the fact that the paying bank no longer will be able to examine the paper check, including, for example, security features on cashiers' checks.
- The legislation anticipated and addressed potential new risks, but banks need to understand how to manage risks under the Check 21 environment and understand their rights and responsibilities.
- Check 21 may help reduce fraud by expediting processing so that checks are returned sooner.