

Checks Enter the Electronic Age

BY JOHN R. WALTER

The majority of the 40 billion checks written each year in the United States must be returned in their original paper form in order for the bank to release the funds the check represents. This may soon change, though. The recently enacted Check Clearing for the 21st Century Act (Check 21) will remove legal impediments to electronic check collection, likely bringing with it a lower cost collection mechanism.

Check Collection Under Current Law

When Susan Watson, who lives in Baltimore, Md., recently mailed a \$6,015 check to Arizona State University (ASU), in Tempe, Ariz., to pay her son's tuition bill, the original paper check was transported over 2,000 miles back to Ms. Watson's Baltimore bank. The process the Watson check followed is fairly typical for a check sent to a recipient in a distant location, and usually involves a series of steps.

For instance, ASU delivered the check to the Tempe branch of its Arizona-headquartered bank. Then the Arizona bank sent the check to the Los Angeles branch of the Federal Reserve Bank of San Francisco, which handles check collection for many Western states. The Fed then sent the check, along with several thousand others, back to Baltimore by air.

The original check was returned to the Baltimore bank (the "paying bank" in this example), which removed \$6,015 from Susan Watson's account and ordered it transferred to the Arizona bank. Specifically, the interbank movement of funds occurred over the books of the Federal Reserve. Following the instantaneous shift of funds on the books of the Federal Reserve, with which all banks hold balances, the Arizona bank credited \$6,015 to the account of the University.

How Check 21 Will Change Check Collection

Check 21 will allow the "collecting bank" (the Arizona bank in this example) to "truncate" the check. Truncation occurs when an original paper check is stopped before being physically presented to the paying bank. The collecting bank scans the check, creating an electronic copy of the check, and then sends that electronic copy to the paying bank.

Since transporting electronic information over telephone lines or computer networks is far less expensive than delivering a physical piece of paper across the country, why aren't

banks already doing this for all checks? The reason is that under current law electronic means of collection can be used only if the collecting bank has a standing agreement with the paying bank to present checks electronically. Otherwise the paper check must be physically presented. Few standing agreements exist, so electronic collection is not widely used. (Any U.S. bank can expect to receive checks written on any other bank in the country. And since there are about 8,000 banks in the United States, uniform use of electronic presentment would require each bank to establish agreements with 8,000 other banks. In total, 64 million—8,000 x 8,000—agreements would need to be struck. This may be one reason why standing agreements are not commonplace.)

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Check 21 will modify the agreement requirement. Beginning on October 28, 2004, paying banks no longer may demand the original check before making payment. Instead Check 21 specifies that as long as the collecting bank delivers a "substitute check," and that the substitute check meets certain size, legibility, and informational requirements, the paying bank must release funds, even though it has entered no prior agreement with the collecting bank.

A substitute check is also a piece of paper. But it is a scan of the original, not the original itself. So in our example, the Arizona bank might make an electronic copy of the original check when it first receives it from its customer, ASU. The Arizona bank then would transmit the electronic image over a computer network to Maryland. The electronic transmission could go directly to the paying bank in Maryland, if the paying bank were willing to accept electronic check information directly. Or the information from the scan could be sent to a substitute check printing facility near the paying bank. At that point, the paying bank would be required to release funds in return for the substitute check.

Check 21 specifies that substitute checks enjoy the same legal standing as original checks. So if a dispute arises between ASU and Susan Watson over whether the tuition bill was paid, Ms. Watson's production of the substitute check is proof of payment just as the original check would have been.

Check 21 should greatly lower check-processing costs. Over time, as banks and their customers adjust to the new law, greater use likely will be made of electronic check presentment and the current expensive system of delivering the original checks to paying banks may disappear. **RF**