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Check 21 (the Check Clearing for the 21st Century Act) Potential Opportunities and Implications for Financial Institutions

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On October 28, 2004, the banking industry will experience one of the most sweeping changes to the payment system in recent history as The Check Clearing for the 21st Century Act (Check 21) takes effect. Widely documented and discussed, the projected impacts of Check 21 are exciting — but sometimes confusing — for many financial institutions. With the effective date only months away, many organizations are attempting to understand how the law will affect the greater check payments continuum as well as their individual operations and customers.

What is Check 21 and how will it affect the U.S. payment process?

Signed by President Bush in October 2003, Check 21 aims to facilitate the broader use of electronic check processing, without requiring any bank to change its current check collection practices. Its many proponents believe that the law represents an important step in streamlining check processing and, in doing so, reducing some of the risks inherent in today's heavily paper-based U.S. payment system.

While many people view Check 21 as an end state for the check payments system, in reality it simply expands the clearing options that are currently available to banks. Tactically, Check 21 authorizes the creation of a new negotiable instrument called the “substitute check” (which has also been frequently referred to in various articles as the “image replacement document” or “IRD”).

The substitute check:

- will be a paper reproduction of the original check;
- must be suitable for automated processing;
- can be processed as an original check in that it must be printed out for processing; and
- will be the legal equivalent of the original check for all purposes if it:
 - accurately represents all of the information on the front and back of the original check at the time the check was truncated; and
 - bears the legend, “This is a legal copy of your check. You can use it the same way you would use the original check.”

According to a recent article published on the US Banker Web site (www.us-banker.com), paper checks accounted for about 60 percent of the 80 billion non-cash retail payments made in 2000. Check handling is costly and time consuming. Leading consultants and industry organizations are predicting potentially significant time and cost savings as a result of Check 21.

The advent of the substitute check will bring sweeping changes to payment processing. Through the legal recognition of the substitute check, the law eliminates the prior requirement for an originally issued check to be presented at the paying bank. Instead, if the original check is truncated, a substitute check must be presented in its place.

Also, via the substitute check, any bank that wants to truncate checks will be able to do so, without any authorization from the check writer.

As a result of this electronification initiative, courier transport of checks and many of the manual steps now used to process checks will gradually decline as more and more electronic payments occur.

How should banks prepare for Check 21?

There is no one-size-fits-all road map for preparing for Check 21. Individual banks will need to make different decisions about how to respond to Check 21, considering factors such as their own business case, size, existing imaging capabilities, the capabilities of their business partners and their appetite to participate in image exchange. Each bank should consult with its own legal counsel or other qualified expert to determine the impacts specific to its organization.

Under Check 21, banks are not required to use electronic check processing, receive electronic presentments or to create substitute checks.

However, *all* banks — and especially the larger volume processors — will nevertheless need to accept and process the substitute checks that may be presented for collection after October 28. No one can predict with any level of certainty what the volume will be.

Banks that lack image technology in their check processing operations are likely to make different decisions than the handful of large banks now participating in Check 21 pilots and/or those that have the latest check image and processing technologies and dedicated strategists at their disposal.

Because banks have the option not to accept image files, there may be no requirement to invest in image technology (although recognition and disposition of items through a defined MICR [magnetic ink character recognition] character located in position 44 of the MICR line will be required). However, any check processing operations that fully embrace Check 21 and the corresponding creation of substitute checks may need to manage a potentially extensive printing function that may exist only nominally, if at all, today.

The Check 21 definition of “truncation” includes the provision, “by agreement” to send a recipient “...an electronic image of the original check.” Through the recognition of the substitute check, Check 21 removes the requirement for an originally issued paper check to be presented to the paying bank. Efficiencies may now be achieved by eliminating the need to ship the original check from the point of capture to the point of payment. While Check 21 addresses a clearing process that may include the transfer of images as an essential step, the proposed rule for implementation explicitly excludes the image *per se* as being valid for presentment to the payor bank. Under Check 21, if the original is truncated, a substitute check must be presented in its place. Check 21 is not authorization for the unilateral exchange of images in lieu of paper.

Beyond that, banks that want to take full advantage of the new environment under Check 21 will find that the ability to capture digital images and data for use in workflow optimization and to create substitute checks is a key technology. They also will need to consider myriad issues that include, but are not limited to:

- How Check 21 will affect their businesses overall (e.g., in terms of new business opportunities and risks) and what new products and services they may want to offer.
- How their processes — particularly back office functions — may need to be revamped to accommodate Check 21. For instance, banks need to think about issues including, but not limited to:
 - how they will re-credit improperly charged transactions under the accelerated process;
 - how return check processing will need to be adjusted to handle substitute checks; and
 - how other research will be conducted using substitute checks.

Image capabilities will take on added importance in view of Check 21. Banks should examine their current capabilities or lack thereof to determine if they can produce the high quality images that will be necessary to comply with industry standards.

- If current image technology should be upgraded to produce the high-quality images necessary to support substitute checks while deterring the potential for fraud. While most U.S. banks possess some image capabilities, Check 21’s reliance on image technology will cause most to revisit those capabilities to make sure that they are adequate for the new environment.
- If image technology is not currently used, whether or not it should be purchased or acquired via an outsourcing arrangement with a larger provider.
- How to meet customer notification requirements regarding substitute checks. This is particularly important because some customers, even in the corporate world, have come to rely on their paper checks as an important tool for documentation and record keeping purposes.

To make the decision that is best for their own financial institutions, some banks are opting to enlist support from consultants who position themselves to be experts on Check 21. However, seeking such assistance is by no means a requirement of Check 21. Alternatively, others like Enterprise, are forming internal task forces to navigate the process.

How may banks benefit from Check 21?

Banks may derive several benefits from Check 21, including:

- Reduced check courier fees and transport time.
- The opportunity to reduce operating costs and to accelerate presentment, posting and return notification.
- Lower potential for some types of fraud — the use of substitute checks will accelerate check clearing so that banks can view suspect items sooner and thereby arrive at pay or return decisions faster and with increased confidence. However, banks should also note that Check 21 has a downside related to fraud because the substitute checks (as black and white copies) will not retain many of the original fraud mitigation features that are possible on an original check (e.g., clear void pantograph, special check stock, etc.).
- Better funds availability — through the acceleration of some clearings.

The importance of image: new revenue and fraud prevention opportunities

Despite the demonstrated advantages that image provides to the collection process, to date, some banks still view the service as an option that they aren't quite ready to purchase. With Check 21, the image capabilities of financial institutions will take on new importance. As Check 21 becomes a reality, banks will have an increased opportunity to showcase their image capabilities in a new light, for a new purpose, and thereby to potentially derive new revenue. Superior capabilities and systems may help banks differentiate themselves — particularly from the many non-bank competitors who have been cannibalizing the industry for some time.

Why is image so important in the Check 21 environment? Post-Check 21, image quality will be as important as ever if not more so. If the quality of a substitute check does not measure up to industry standards or if it isn't accurate in some way, it may cause problems for the check collection process as well as for the processor itself. Thus, technology that can create high quality images will be prerequisite and reject and repair provisions for poor quality images will also be vitally important.

So, although Check 21 does not impose requirements that banks become image-enabled, institutions may nonetheless find this an opportune time to assess their current capabilities as well as their post-Check 21 goals.

Some costs may increase under Check 21

By and large, Check 21 has been widely publicized as “good news” in recognition of its potential to carve costs out of the current check processing arena. Clearly, some expenses such as those for courier fees will dissipate to a large degree over time. However, bear in mind that there will also be some new costs to offset these savings to a certain degree and that the cost benefits of Check 21 may not be apparent on your balance sheet for quite some time.

For one thing, any fixed costs that you currently incur to process paper checks will remain after Check 21 goes into effect — and you may face additional expenses as you begin to process substitute checks and/or images. Banks that are slow to embrace an image solution, for instance, may surely see additional and potentially substantial costs.

Overall, maximum potential savings under Check 21 won’t be completely attained until banks are actively exchanging images in lieu of paper checks or substitute checks. For this reason, many banks may choose to reassess their image strategy earlier instead of later.

Research conducted by Carreker Corporation indicates that image exchange and other Check 21-driven changes can save the U.S. banking industry about \$2 billion a year. (The Domino Effect of Check 21 — Paving a Path for Banks to Redefine and Reclaim the Payment System, J.D. Carreker, Carreker Corporation, 2003).

Conclusions

While Check 21 is not the authorization for image exchange without paper, it is the stimulus expected to cause a critical mass of independent check processors to realize the current state of imaging technology and the potential application of that technology in the payments system.

Because the industry-wide roll-out will be gradual and the rate of adoption will vary among banks, it is certain that the U.S. will face a mixed processing environment consisting of images, substitute checks and traditional paper checks for at least the near future.

Within Mellon, Enterprise Cash Management is working diligently to prepare for the Check 21 environment and to help our customers understand its potential impacts. We encourage our customers to proactively prepare for Check 21 and to provide us with your input about how we might further develop our own capabilities to help you. For instance, if one of your partner banks wants to send images to you, but you cannot receive them, would you consider outsourcing this need?

Industry expert Carreker, estimates that today U.S. banks spend about \$8 billion per year on check processing and transportation. This includes receiving the checks at the depositor's bank; processing them; transporting them back to the paying bank; handling exceptions and errors along the way and eventually getting them back to customers.

With the adoption of image exchange and the other Check 21-driven changes, Carreker's research indicates that about one-fourth of these costs could be avoided. This is not only a significant amount but also a critical savings for banks at a time when they are under great pressure to reduce costs because of the revenue declines associated with check volume declines.

Every bank will be affected by Check 21 – with the minimum impact being receipt of substitute checks. So all institutions should be thinking about issues like these today while there is still ample time to take a position on the law. Beyond that, each institution will have to chart its own course based on individual capabilities, goals and financial resources.

A wide range of information is readily available on the Internet. Two particularly robust sites are:

- The Federal Reserve's Web site (www.federalreserve.gov)
- The Electronic Check Clearinghouse Organization Web site (www.eccho.org)

Additional Web resources which you may choose to consult include, but are certainly not limited to:

- The American Bankers Association Web site (www.aba.com), which currently includes a Check 21 “toolkit” designed to walk users step-by-step through the law and its potential effects
- The Tower Group's Web site (www.towergroup.com)
- The Bank Administration Institute's Web site (www.bai.org)

All of these sites currently offer much information about Check 21 and some of the potential activities you may want to undertake.

If you are currently an Enterprise Cash Management customer, your assigned representative will keep you abreast of our own Check 21 plans and preparations ongoing.

As the applicability of Check 21 to each bank could be different, you should consult with an appropriate professional including your own legal counsel or chosen internal or external payments experts to determine the implications of Check 21 for your individual bank. October is just around the corner.

Contact Enterprise for More Information

Whatever your organization's size, business goals, or level of current treasury capabilities, Enterprise Cash Management can help you. A division of treasury industry leader Mellon Global Cash Management (GCM), Enterprise provides a full range of cash management outsourcing solutions to meet the needs of your own financial institution and your business customers — while at the same time addressing your desire for transparency and confidentiality in the marketplace.

You can work with Enterprise to supplement your own cash management capabilities or completely outsource your needs to gain a new source of fee-based revenue.

Our full suite of cash management services includes top quality offerings for:

- B2B receivables collection
- Disbursements
- Data exchange
- Web-based information reporting/transaction initiation

If you would like to learn more about these services or want to discuss the information contained in this whitepaper, please contact one of our Enterprise solutions experts.

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