



PHOTO ILLUSTRATION BY GARY BARBER

Checks: The end of an era

The evolution from paper to electronic payments prompts change

“Sorry, no checks accepted.” Notices denying check writers seem ubiquitous these days, posted at the cash registers of eateries and shops alike. A literal sign of the times, perhaps, but one that’s driven by consumers, who more frequently reach for their debit and credit cards in lieu of their checkbooks.

Although check use peaked about 10 years ago, electronic payments are rapidly taking over and all but completely replacing checks. Electronic payments now make up more than two-thirds of all noncash payments. Since 2003 check payments nationwide have declined 6.4 percent per year, according to a 2007 Payments Study conducted by the Federal Reserve System.

“Consumers are simply writing fewer

checks in favor of faster, more convenient electronic methods,” says Rich Rasdall, first vice president of the Federal Reserve Bank of Kansas City. “This shift is certainly affecting the payments system, which must adjust accordingly.”

Because check volume is dropping so significantly, the Federal Reserve’s check processing sites around the country are being consolidated and remaining sites are changing the way they operate. Additionally, relatively new legislation known as Check 21, coupled with industry advancements, are prompting financial institutions to clear customers’ checks electronically rather than by manual methods that traditionally have been relied upon.

For consumers and banks alike, this means faster, more efficient payments and processing. And for the payments system, this means

making adjustments ranging from manpower to operations.

“We are seeing an electronic evolution,” Rasdall says. “While checks may never become completely obsolete, perpetual change in the payments system is inevitable—and is already well under way.”

Evolution of checks

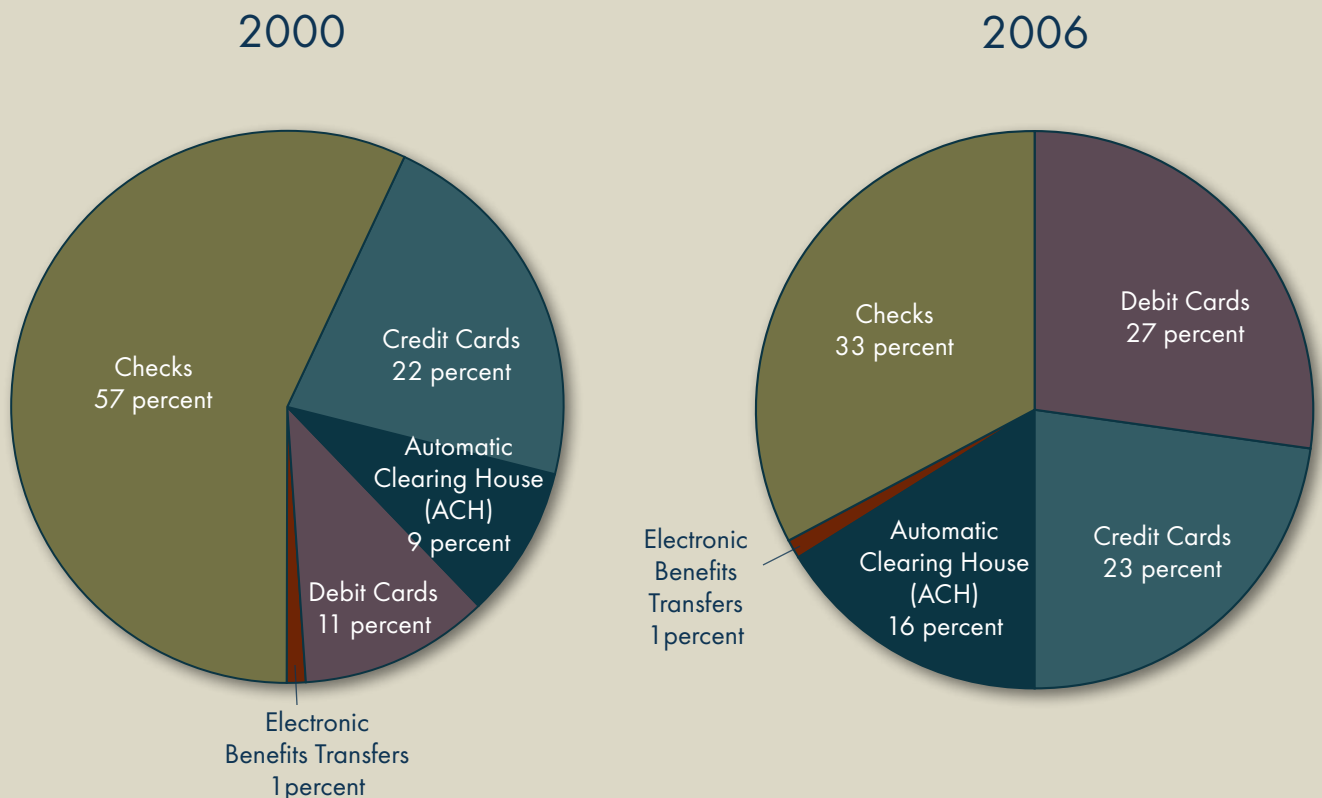
Check volume at the Kansas City Fed, which is the headquarters for the Tenth Federal Reserve District, was at its height in 2002. At that time, staff processed an average of 1.8 million paper checks a day from banks around the region. But just one year later, the volume began declining significantly and by mid-2007, roughly half that amount was processed. Even more drastic, the average daily volume of paper checks processed in January was just 451,000, or roughly 25 percent of the amount processed in its peak.

“Until this decade, consumers hadn’t fully accepted the electronic payments system,” Rasdall says. “But by 2003, the number of all electronic payments had surpassed the number of check payments.”

Electronic payments grew 12.4 percent per year from 2003 to 2006, according to the study. The value of these payments has also steadily increased. Debit card payments now exceed credit card payments, and card payments in general make up more than half of all noncash payments.

As a result of this shift in consumer behavior, the Federal Reserve System has consolidated its 45 check processing sites around the country to 17 sites. Further consolidation is planned and by 2010, there will be four locations: Philadelphia, Cleveland, Atlanta and Dallas. Each will serve as a regional, full-service check processing site at least through 2011. Three “print only” sites will dispatch substitute checks (legal images of the originals), down

The shift of noncash payments



from about 21 sites currently. Scaled back or closed sites all will print substitute checks and some will electronically capture paper checks and transmit the images to the fully operational sites.

Further consolidation in the future is a possibility, Rasdall says.

Around the country, the Federal Reserve said it would cut 1,740 jobs from its 3,300-employee unit, whose main task is to help banks clear checks. In Kansas City, the Fed stopped processing paper checks in April and consolidated those operations into the Dallas Fed. The restructure coincided with the Kansas City Fed's move to its new headquarters, and eliminated 93 check processing-related jobs. Electronic processing and substitute check printing operations remain in the Tenth District.

At the Kansas City Fed's three Branches, checks operations were closed in Oklahoma

Check 21

Now, when a customer deposits a check it's no longer necessary for the bank to physically transport that check to the paying bank to clear it.

The Check Clearing for the 21st Century Act, or Check 21, implemented in 2004, makes the substitute check the legal equivalent of an original check. This authorizes financial institutions to use images when processing customers' checks. For all financial institutions that accept digital images instead of the original checks, the manual handling and physical transportation needed to clear the billions of paper checks each year is eliminated. Electronically processing not only makes clearing checks more efficient, it also saves money as courier and fuel costs continue to rise, says Korie Miller, assistant vice president of financial services at the Federal Reserve Bank of Kansas City.

“ **Every day, more and more paper checks are converted to electronics.** ”

City and Omaha in 2005 and 2004, respectively, while processing in Denver is scheduled to transition to a “capture and print” site in 2009.

“Reducing staff is certainly the most difficult aspect of this move away from checks,” says Barbara Pacheco, senior vice president of financial services at the Federal Reserve Bank of Kansas City. “Each office in the District has always been successful in meeting its objectives and other challenges through the years, but consolidation is simply necessary as the need to clear paper checks decreases.”

Technology has changed the need for labor.

“The Federal Reserve System and our District are well-positioned to manage these changes, which are inevitable,” Pacheco says. “Every day, more and more paper checks are converted to electronics.”

“Bankers were really hungry for an electronic system,” Pacheco says. “We began offering some electronic services back in the '80s and at that time, some of our smaller, remote customers were the pioneers that laid the foundation for acceptance of our Check 21 services.”

The Kansas City Fed facilitates the electronic movement of check images from one financial institution to another. This year, the Fed's price for clearing a check electronically is 2 to 3 cents, while a paper check costs 5 to 6 cents to clear.

As the largest provider of Check 21 services nationwide, the Fed also is helping banks transition to electronic processing. For banks, this includes changing back-office systems (including upgrades and new hardware and software), and working with customers who may notice receiving substitute checks, which



PHOTO BY CHRIS SCHOENHALS

AFTER A DRAMATIC DROP IN VOLUME, the Kansas City office stopped processing checks in April and consolidated those operations with the Dallas Fed. Payments are increasingly becoming electronic worldwide.

are a slightly larger copy of a standard check printed under specific guidelines in order to be used as proof of payment. The substitute check will eventually be obsolete as electronic processing becomes end-to-end.

There is no deadline and image processing under Check 21 is voluntary, although eventually all banks will need to comply in order to do business. However, the rapid adoption of Check 21 has surprised the Kansas City Fed.

As of January:

- Electronic image items made up 76 percent of all District deposit volume. For the Federal Reserve System, electronic images made up 62 percent of deposit volume processed.

- The District sends electronically 41 percent of its outbound volume; the Federal Reserve System sends out electronically 40 percent.

“We’re looking at 60 percent of Tenth District depositors using Check 21,” Miller says. “It’s much more than we originally projected. By 2009, we’re estimating 90 percent.”

Miller attributes this “positive snowball effect” to good business sense. Because much

of the District is rural, geographic isolation demands the efficiency of Check 21, she says. But that’s not to say the largest banks aren’t jumping on board, too.

“It’s not really feasible for any bank not to adopt Check 21,” Miller says. “Check 21 is something better for bankers, the payments industry and consumers. ... It’s not if a bank uses image exchange, it’s when.”

Future of payments

As part of its mission, the Federal Reserve monitors payments, emerging methods and significant innovations.

Innovation is making transactions cheaper and easier to carry out, whether they are established payments methods, such as checks or debit and credit cards, or new and emerging methods, says Stuart Weiner, vice president, economist and director of payments research at the Kansas City Fed.

“The United States has seen an increase in new types of payments in recent years,” Weiner says, citing paying via mobile device, contactless credit and debit cards, and pre-paid stored-value cards.

Even as check use continues to decline, it is likely there will still always be a need to write checks. Check 21 makes that process efficient.

“The future is going to be largely electronic,” Weiner says. “There’s no doubt about that.”

And the Fed will be a part of this.

“We want to promote the efficiency and effectiveness of the payments system,” Pacheco says. “That’s our job.”



BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

“THE 2007 FEDERAL RESERVE PAYMENTS STUDY”

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