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CHECKING IN:

Check 21 starts strong in Tenth District, Kansas banks lead conversion

The few thousand residents in Norton, Kan., may not know it, but their banks are leading technological advances in the nation's check clearing system.

The three banks in this small, rural town near the northwest corner of the state have been among the first to take full advantage of the Check Clearing for the 21st Century Act, known as Check 21, to electronically convert manual paper check processing.

The Check 21 legislation implemented two years ago authorizes a new legal document, called a substitute check. The substitute check is created from a digital image of the original check if it's needed to complete the funds collection process. As long as the bank whose customers write checks agrees to accept digital images instead of the original, the manual handling and physical transportation necessary to clear billions of paper checks each year can be eliminated.

The volume of checks processed electronically through the Federal Reserve System continues to grow. In November 2004, an average of 40,000 check images was deposited each day. By July 2006, an average of 6.2 million items (\$20 billion) was processed daily. And now, almost 15 percent of the checks cleared through the Federal Reserve are deposited as electronic images by about 1,300 banks and credit unions, says Korie Miller, assistant vice president of financial services for the Federal Reserve Bank of Kansas City.

Banks in the Tenth Federal Reserve District—especially those in Kansas—make up a relatively large percentage of early adopters of Check 21, Miller says. The Federal Reserve Bank of Kansas City receives check images from about 179 financial institutions, second only to the Federal Reserve Bank of Chicago, which receives check images from 212 banks.

"If you think about those numbers, it's pretty amazing," Miller says. "I would say it's a huge success so far."

The Federal Reserve is taking an industry leadership role to help all banks transition to electronic processing, although the legislation does not mandate a deadline for this conversion.

Because Check 21 is still in its inception stage, it will take time for banks to adapt. Barriers associated with end-to-end check image exchange include changing back office systems and customer readiness.

"It's a bank-by-bank conversion," Miller says. "Industry collaboration is a must. Exchanging images requires willing partners."

Making the move

Until just a few months ago, The (Norton) Bank, a community bank with 10 branches in Kansas, had to cut short business hours every day.

Because customers' checks were physically transported by courier, The Bank had to hand over checks their customers deposited by mid-afternoon and any deposits customers made later would wait 24 hours until the next pickup. Meanwhile, courier and fuel prices have surged.

“The costs (of time and money) are just going to keep going up,” says Don Bolt, senior vice president of The Bank. “By doing this electronically, we can eliminate that.”

In early June, The Bank joined “this paperless society” of Check 21 and has saved time and money since, Bolt says.

It’s really not a juxtaposition that small banks in rural areas are on the forefront of this advancement. The majority of his customers are farmers whose preferred payment method is still checks, Bolt says, adding that remote banking locations are the ones most in need of fast

Subtle differences

Many banking customers may not have noticed Check 21 even went into effect, Miller says. Some might receive a substitute check in lieu of the original check, or a mixture of canceled-original and substitute checks.

A substitute check is a slightly larger copy of a standard check and is printed under specific guidelines so that it can be used as the original check would be, such as for proof of payment.

Substitute checks assist in the transition from paper to electronic processing, so that banks could send check images for collection

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connections with other banks.

“Check 21 overcomes the disadvantages from geography,” Miller says. “It eliminates those barriers and gives rural banks an opportunity to provide cutoff hours and reduce transportation costs to be in line with banks in larger metropolitan areas.”

While there are startup costs for most institutions, such as system upgrades and new hardware and software, it will eventually be cost prohibitive for banks not to be Check 21 enabled, Miller says.

Bolt says The Bank will recoup expenses in less than two years—and it’s worth it.

It’s the benefits of Check 21 that Joni Hopkins of the Federal Reserve Bank of Kansas City attributes to early and widespread adoption throughout rural areas.

“Kansas banks are pretty much on the forefront,” says Hopkins, who along with a team of others from the Federal Reserve helps banks set up for Check 21. “It just became a windfall. They knew, ‘this is the direction we need to go.’”

As the largest provider of Check 21 services, the Federal Reserve acts as a middleman of sorts, facilitating the electronic movement of check images from one bank to another.

“The Federal Reserve has an objective to electrify payments for efficiency,” Miller says. “Check 21 is in line with this objective.”

even though not all banks were ready to receive them. The Federal Reserve is working with customers to encourage the use of electronic end-to-end processing so the substitute check becomes obsolete.

Customers should be aware that electronic check processing is faster and may mean money is deducted from accounts quicker. However, the interest paid on funds deposited via check isn’t affected. Banks generally begin crediting interest no later than the business day that they receive credit for the funds.

Joe Herman, executive vice president of First Security Bank & Trust, says his customers both in Norton and at the bank’s nearby branch are receiving enhanced customer service since First Security began creating images of checks and sending them to the Federal Reserve for clearing about a year ago.

“And that’s really what we’re here for,” he says. “When you put a pencil to it, you realize you can’t afford not to do it. It’s just a win-win situation.”

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COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.