

# Banking in the 21st Century

Based on a speech presented by President Santomero at the New Jersey Bankers Association Annual Convention, Aventura, Florida, March 27, 2004

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lthough U.S. consumers are catching up with their counterparts in the rest of the world in their use of electronic payment methods, paper checks remain a popular way to make payments here. How is the Federal Reserve supporting an orderly evolution of the payment system as consumers shift away from paper? One way is the Fed's advocacy of legislation such as Check 21, which is scheduled for implementation in October of this year. In this quarter's message, President Santomero describes some of the implications of this new legislation for both the Federal Reserve System and depository institutions.

The Federal Reserve System has three main responsibilities: conducting monetary policy, supervising and regulating banks, and maintaining an efficient and effective payments system. This third area — the payments system — has seen a great deal of change in recent years. Perhaps the greatest change has been the shift from paper forms of payment, that is, cash and checks, to electronic methods such as credit cards and debit cards.

We know that people's payments choices evolve slowly. It takes time for them to become comfortable with new payment methods. In the meantime, it is important that familiar, well-established payment methods be there for them. The Fed is committed to working with financial institutions to improve the reliability and efficiency of the *current* generation of payment

vehicles and to foster innovation and support the *next* generation of payments vehicles. Both commitments are important.

However, I want to focus on another way the Fed is supporting an orderly evolution of the payments system: through its advocacy of a legal and regulatory framework that enables greater innovation in the marketplace — innovation by banks and other payment service providers — in response to evolving technologies and customer preferences.

The Check Clearing for the 21st Century Act, also known as Check 21, is an example of such legislation.<sup>1</sup> The Federal Reserve

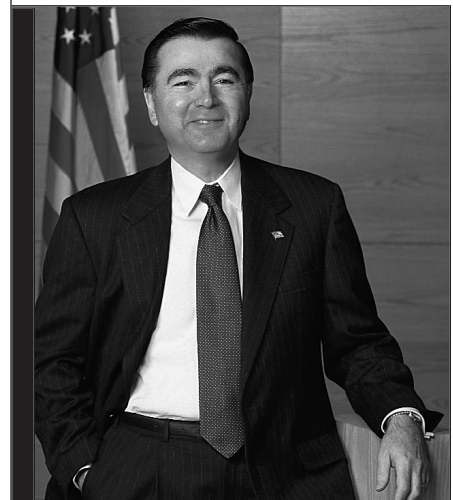
<sup>1</sup> For a synopsis of this act, see the Philadelphia Fed's *Banking Legislation and Policy*, January-March 2003 ([www.phil.frb.org/files/blp/blp103.pdf](http://www.phil.frb.org/files/blp/blp103.pdf)).

vigorously supported Check 21 from the outset. We saw it as a means of enabling the marketplace to achieve greater efficiency and reliability in payments, proceeding at its own pace and in its own way.

## PAYMENTS AND THE CHECK

In recent years, we have experienced a surge in electronic retail payments: credit cards, debit cards, and smart cards, as well as direct deposit and direct debit through the ACH. The emerging shift to electronics has been documented in a Philadelphia Fed Research Department analysis using data from the Federal Reserve Board's Survey of Consumer Finances.<sup>2</sup>

<sup>2</sup> See Loretta J. Mester, "Changes in the Use of Electronic Payments," Federal Reserve Bank of Philadelphia *Business Review*, Third Quarter 2003 ([www.phil.frb.org/files/br/brq303lm2.pdf](http://www.phil.frb.org/files/br/brq303lm2.pdf)).



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According to the survey, less than 18 percent of households used debit cards in 1995. By 2001, nearly half of all households were using them. Meanwhile, the percentage of households using automatic bill payment, although still relatively small, nearly doubled. Not only did usage of all means of electronic payments increase, but the increases were registered across all demographic categories: all age groups and all levels of income and education.

Other statistics show that the conversion of check payments to electronic transactions continues to grow rapidly. In fact, this past year, these so-called electronic check payments more than doubled, and they now exceed 100 million transactions per month.

So consumers are using electronic payments. In effect, the U.S. is catching up to the rest of the world in its use of electronic payments. Undoubtedly, the trend will continue. Indeed, a competitive marketplace will drive banks to offer new electronic payment vehicles in response to consumer demand for greater convenience at lower cost.

Yet, the use of that expressly American payment vehicle — the paper check — remains widespread here. Research financed by the Fed indicates that check use in the U.S. peaked in the mid-1990s and has been steadily declining since then. But Americans still write about 40 billion checks a year. That represents about half of the nation's retail non-cash transactions. Checks are likely to represent a significant share of payments for a long time. People see them as a very convenient, reliable, and familiar payment instrument. Bankers see them as a substantial source of revenue. So while checks will continue to decline, they will not completely disappear any time soon.

Over the years, banks have

become quite efficient at processing paper checks. But as check volumes decline, the pressure will be on to find new processing efficiencies, and processing electronic information is more efficient than processing paper. Recognizing this, the Fed has been committed for some time to enabling greater use of electronics in check processing. Check 21 is an important step in that direction.

#### CHECK 21 AND EFFICIENCY

The goal of Check 21 is to foster innovation in the payments system and to enhance efficiency. It does this by facilitating check truncation and electronification via imaging without making it mandatory.<sup>3</sup> Check 21 accomplishes this simply by authorizing the use of a new negotiable instrument: the substitute check.

**Check 21 does not require collecting banks to truncate or image checks, nor does it require paying banks to accept electronic images. Check 21 requires only that paying banks accept substitute checks as well as originals.**

The substitute check must contain payment information identical to that on the original check and must be in a specific machine-readable format. Properly created, the substitute check is the legal equivalent of the original check. Under Check 21, a collecting bank can truncate and image the original checks it receives for deposit, process the checks electronically, and then print and deliver substitute checks at a location near the paying bank for presentment.

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<sup>3</sup> Check truncation refers to removing the original paper check from the check collection process and replacing it with electronic information related to the original check.

Notice that Check 21 does not require collecting banks to truncate or image checks, nor does it require paying banks to accept electronic images. Check 21 requires only that paying banks accept substitute checks as well as originals. Whether they accept the substitute checks in paper form or electronic form is strictly their decision.

The expectation is that Check 21 will, in fact, increase electronic presentments and foster the electronification of checks at the earliest possible stage of processing. The speed with which this evolution occurs is hard to predict. Like the use of the check itself, it is likely to be a gradual process.

Over time, we should see substantial efficiency gains as a result of Check 21. An article in

the *American Banker* states that once the full effects of Check 21 are realized, it is estimated that the banking industry could potentially reduce its check processing costs by over \$2 billion a year. That estimate includes a reduction of \$250 million in transportation costs alone. In addition, banks will benefit from improved availability of funds and greater efficiency in processing return items.

#### CHECK 21 AND RELIABILITY

Thus far, I have emphasized the efficiency gains we expect from Check 21. Indeed, industry buzz has long expounded on the efficiency gains from the electronification of checks. But there is another benefit: mitigating

risk. Check 21 will help alleviate the danger of checks being lost or delayed during transport. As clearing time shrinks, credit risk is reduced as well.

From the Fed's perspective, reducing the risks associated with the physical transportation of checks is an important benefit of Check 21. Our experience in the aftermath of 9/11 focused our attention on the value of electrification from the standpoint of reliability. The interruption of air travel — and check transportation — in the days after the 9/11 attacks pushed the Fed's check float to over \$47 billion, more than 100 times the normal level.

Clearly, if image exchange had been more prevalent among banks, the impact would have been much smaller. Indeed, it was the opportunity to reduce check processing's dependency on the transportation system that motivated the Fed to approach Congress in late 2001 with the proposal that would become Check 21.

### RESPONDING TO CHECK 21

After much discussion with the industry and consumer groups, Congress passed Check 21 in late 2003 and set implementation for October 28, 2004. It will take some time for the full effect of Check 21 to be realized.

Many banks are already using check imaging, both to streamline internal operations and to enhance services to their customers. Check 21 offers banks the option of using those images to collect from any paying bank by presenting a substitute check. Whether exercising this option makes economic sense, of course, depends on the relative cost of presenting a substitute check rather than the original, either directly or through a third-party provider.

Banks that use imaging must also make some important decisions about aggregating and archiving. As banks begin to receive electronic files

from more institutions, it may make sense to outsource these activities to a third-party provider.

Some banks are not using imaging yet because the internal efficiencies and customer service benefits do not justify the cost. With Check 21, the expanded opportunity to transmit images for presentments may make imaging cost-effective.

But even if imaging does not make sense for some banks, Check 21 will require even non-imaging banks to accept presentments of

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substitute checks. That means bank customers will likely be getting back some substitute checks with their statements. Banks must have ready a plan for how they will familiarize customers with these new instruments and address their concerns.

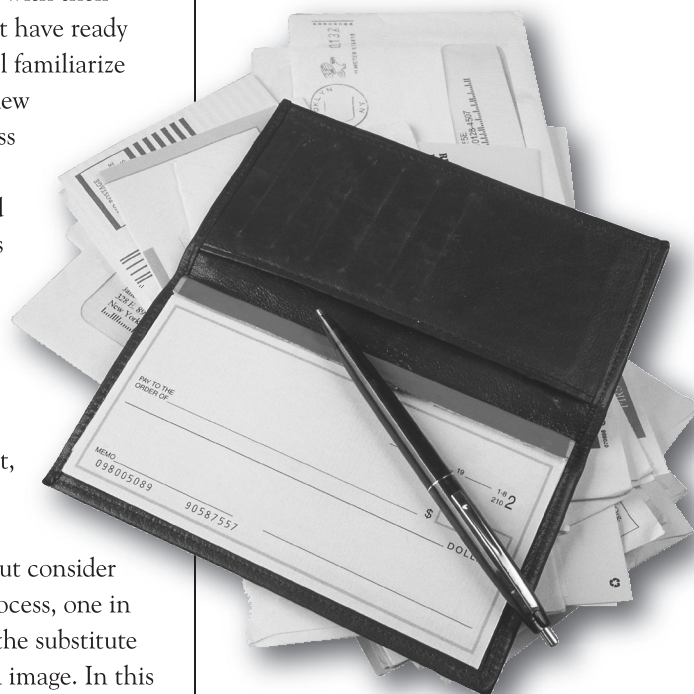
As I indicated earlier, when a check is truncated at its bank of first deposit and a substitute check is created, the collection process is enhanced by expediting presentment, improving availability, and eliminating transportation costs. But consider an extension of this process, one in which presentment of the substitute check is replaced by an image. In this case, further benefits are extended to

the paying bank. Accepting images for deposit eliminates back-office capture of the check as well as the inconvenience of transporting paper checks.

Let's extend this scenario even further. Suppose the bank of first deposit receives images from its own ATMs, from its own branch offices, or even from its corporate customers. Image capture earlier in the process will further benefit the bank by eliminating check transportation and the need for proofing and encoding and processing with check sorters. All this is made much easier with the passage of the new legislation.

### CHECK 21 AND THE FED AS SERVICE PROVIDER

The Federal Reserve will also be responding to market needs during this period of substantial change in the payment patterns of consumers and businesses alike. To make this point, I'll outline how the Fed, as a provider of check services, is preparing to support the banking industry's best use of options under Check 21.



The Fed is investing in technologies that enhance Check 21. We want to provide all customers, regardless of size or location, the opportunity to embrace and take advantage of the many benefits of Check 21 — without significant investment on their part.

The Reserve Banks have recently upgraded and standardized their check platforms so that their bank customers will have access to the same check processing and adjustment services at all of its locations. Philadelphia installed the common platform in the fourth quarter of last year.

Now, we at the Fed are looking to October and preparing the services we will make available once Check 21 is implemented. The Reserve Banks will soon be rolling out a variety of new and improved products, services, and solutions designed to support banks' best use of their new options under Check 21. In addition, we will offer image deposit services and improved deposit deadlines and availability. For our payor services, we will have lower prices for items we collect via images. Also, we will convert paper items to images where we can expedite collection.

Our national archiving service, FedImage, is already available. We are expanding our capability to produce substitute checks, and we intend to increase our services available on the web.

Over time, Check 21 will provide financial institutions

opportunities to broaden deposit options and extend deposit cut-off hours. This will have an effect on the Federal Reserve, too. As the Fed increases its processing efficiencies, it will pass the gains on to its bank customers in the form of accelerated availability and enhanced deposit deadlines. In short, the Fed and its bank customers are both involved in and affected by the changes imposed by the recent legislation, and the Fed is prepared to respond to Check

follow will ultimately transform the U.S. payments system and enable a radical restructuring of its service capabilities.

## CONCLUSION

We at the Federal Reserve are pleased to see Check 21 nearing its implementation date. While people increasingly rely on electronic forms of payment, checks remain an important and trusted payments vehicle. Recognizing this, the Fed proposed Check 21

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21's implications for itself and for the banking industry it serves.

In addition, as part of its public service role, the Federal Reserve is working to develop communication tools that will help banks educate their customers about Check 21.

So, we at the Fed will continue to develop our products and expand our electronic capacity in response to the market's evolution and our customers' needs. At the same time, we will take steps to foster an environment for improved payments system efficiencies and vibrant private-sector innovations. Check 21 is an important step toward this goal, but it is by no means the final step. The impact of this change and those that

as a means of enabling the industry to make check processing more efficient and reliable. Now, banks must consider how to use the new options offered by Check 21 to create shareholder value and improve service quality.

As we move forward, the infrastructure and convention of check processing will evolve, generating new check products and services and new ways to deliver them. We at the Fed look forward to working with banks in achieving a common goal: realizing all of the efficiencies this new legislation offers. 