

Preventing Check Fraud

Paper checks are still a major player in the payment system, and managing risk includes finding ways to prevent check fraud. Here's what the Philadelphia Fed is doing in this area.

Estimates of check fraud's cost to consumers, merchants, and the financial services industry range from \$5 billion to \$10 billion a year. Whatever the actual number, check fraud is a costly and growing problem in the United States and around the world.

In 2005, the Philadelphia Fed undertook several efforts to prevent check fraud, such as promoting the exchange of technologies and data throughout the payments system. The Bank also encouraged collaboration in the financial services industry to address certain challenges. But before we talk about that, some history is in order.

For many years, the Federal Reserve Bank of Philadelphia, along with the Treasury, tested technologies that would help the financial services industry deter check fraud. The Treasury made a logical partner because it issues approximately 250 million checks a year for payments such as Social Security benefits and tax refunds.

In 2003, after testing several technologies, the Philadelphia Fed and the Treasury adopted one for use with Treasury checks. This application allows the Treasury to encrypt a code on each check at the time of issue. The code describes the dollar amount, the date of



Blake Prichard, Executive Vice President

issue, the account number, and so forth, and it is invisible to the human eye. But when the check is digitally imaged, this technology survives the imaging and allows the hidden data to be compared against the information written on the check, then confirms whether the check is genuine. The Philadelphia Fed found it to be effective in identifying altered

checks and payment and processing errors. Today, all Treasury checks include this technology.

Blake Prichard, executive vice president, Retail Payments, points out that an important aspect of this partnership between the Philadelphia Fed and the Treasury is that “none of this would have happened without the perceptive leadership here at the Bank and the industry focus that has long been emphasized by top management at Treasury.”

Role of Check 21

Another motivation for implementing such new technology was Check 21. This law allows a substitute check, created from an electronic image, to serve as the legal equivalent of the check itself. A collecting bank can create an electronic image of a check, transmit the image to the paying bank’s location, and then present the paying bank with a paper reproduction or with the electronic image.

Philadelphia Fed management anticipated that this law would bring special concerns: Once banks started electronic imaging of checks and truncating the original paper checks, how could the industry adapt to the loss of the anti-check fraud features on the originals? The concern was that Check 21 might unwittingly invite greater check fraud unless the industry could find new technologies that would render fraud prevention measures “image survivable.”

That’s why the Philadelphia Fed addressed this issue well in advance of Check 21’s implementation. The technology chosen by the Philadelphia Fed and the Treasury has solved this “survival” problem. Now, Prichard states, “Using this technology, we detect fraudulent

checks almost every day in this Bank.”

Recent Events

In 2005, the Bank took the next steps in fighting check fraud: promoting standards for the exchange of check fraud technologies and encouraging the broad adoption of these standards throughout the payments system. Prichard notes, however, that “the Fed doesn’t plan to impose standards. Rather, we support efforts to create new technologies, and we want the marketplace to evaluate them.”

To further support the development of new technologies, the Bank joined forces with the Financial Services Technology Consortium (FSTC), a research organization based in New York. FSTC encourages collaboration among various players in the financial services industry to find solutions to challenges facing the industry.

The Bank and FSTC launched a project to create interoperability standards for fraud detection applications. Right now, if one bank uses, say, bar codes to verify a check’s authenticity, it may not be able to verify a check issued by a bank that relies on other types of check fraud technologies. An interoperable system would allow any financial institution—and eventually merchants and others—to verify a check regardless of who issued it and what type of security measures were used. One of the biggest benefits is that fraudulent checks will be intercepted much earlier in the payments stream.

In 2006 and beyond, the Philadelphia Fed will continue to support efforts to develop new and better ways to detect fraudulent checks.

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