

# CHECK 21 AND STATE GOVERNMENT BANKING

October 28, 2004

## Purpose of Article

“Check Clearing for the 21<sup>st</sup> Century Act” (*Check 21*) became effective October 28, 2004. Over the next several months, the public will be receiving information and disclosure statements from various sources regarding *Check 21*. The purpose of this article is not to explain *Check 21*, but to give a brief explanation on how it will affect agencies for which the State Treasurer acts as “State Banker.” Details of *Check 21* can be found on various web sites, some of which are listed at the end of this article.

## Brief Explanation

*Check 21* allows financial institutions, on a voluntary basis, to exchange checks between each other electronically, by creating “substitute checks.” This means that the original check issued against a payor’s bank account may never be presented to the payor’s bank for payment. Instead, a “substitute check,” which is a reproduction of the original check may be presented to the payor’s bank for payment. *Check 21* is not the same as “electronic check conversion,” where a check is converted to an ACH transaction, making it subject to Regulation E, instead of Regulation CC. (State warrants are not eligible for electronic warrant conversion.)

In summary, *Check 21*:

- Creates a new negotiable instrument, called a “substitute check,” sometimes referred to as an “Image Replacement Document” (IRD).
- Provides that a properly prepared substitute check is the legal equivalent of the original check.
- Provides that any check (including a State warrant) is eligible to become a substitute check.
- Requires banks (including the State Treasurer) to accept equivalent substitute checks.

## Effect on State Warrants Issued by Agencies

Beginning November 1, 1999, the State Treasurer made arrangements with the Federal Reserve Bank (FRB) for State warrants to be “truncated.” This means that the FRB creates images of the warrants and destroys the original warrant after 60 days. Therefore, State agencies currently do not receive their original warrant, but are able to retrieve from the State Treasurer an image of the original.

Under *Check 21*, there may be cases where the image retrieved from the State Treasurer is not an image of the original, but an image of the substitute check (warrant). In these cases, the following points should be noted:

- The image of the substitute check is the legal equivalent to the original.
- The substitute document may be 67% smaller than the original, and denoted as a substitute check.
- The image quality may not be as good as current, as the image will be black and white instead of gray scale.
- Some of the security features (e.g., watermarks) may not be viewable.
- There is a potential risk that the original check may be presented at a later date, if not destroyed as required by the law, under which there is a duplicate payment warranty period of 40 days for the item to be detected. This makes it imperative that agencies reconcile their disbursing accounts timely. This risk is minimal for accounts protected by the State Treasurer’s Positive Pay program.
- Warrants may clear quicker, as the clearing process is shortened.

Anticipations are that it will be several years before agencies see a large number of such “substitute checks” being presented against their account. This is because the option is voluntary, and it will take some time for banks to get geared up to utilize the option.

## Effect on Checks Deposited by Agencies

There may be instances where a check deposited by an agency will be returned as a “bad check” (e.g., NSF), and the returned check is one that was converted to a “substitute check” before it ever got presented to the bank drawn on. In such cases the check that is returned will not be the original, but the substitute check. The substitute check, which is a paper document, should be treated the same way as if it was the original.

## Links for Check 21 Information

<http://www.ffiec.gov/exam/check21/default.htm>

<http://www.federalreserve.gov/paymentsystems/truncation/default.htm>