

Check 21 Creates New Challenges

Eliminating Duplicate Payment Postings

By Frank Stokes

The Check 21 law that enables financial institutions to use image replacement documents (IRDs) rather than paper checks to process payments carries with it the initial promise of more efficiency because payment processing no longer has to wait for the transmittal of paper checks. However, the reality is that the law places a significant burden on U.S. banks because item duplication is increasing—and will become an increasingly burdensome expense in the next few years.

Check 21, which became effective October 28, 2004, authorizes substitute checks and IRDs as negotiable instruments and provides that a properly prepared paper reproduction is the legal equivalent of an original check.

Even though the law is nearly one and a half years old and financial institutions knew about the rules before they took effect, the fact is that Check 21 still presents financial institutions with a new payments system environment that is very different from the one that had been in place since before the advent of the telephone. Though the process has sped up due to faster processing technology and improved delivery services, the paper check was still the negotiable instrument.

The lengthy tenure of paper check payments gave financial institutions and others in the payment system plenty of time to devise and refine rules for accounting, posting, payments, and reconciliation. At least initially, Check 21 brings up new issues—in many ways, old issues—for financial institutions to once again consider.

The law's goals were to eliminate the paper and enhance the overall efficiency of the payment system. The concept is sound, but the problems in weeding out duplicate demand deposit account (e.g., checking and savings) postings are a major hurdle for financial institutions to overcome.

An error caused by one party—the financial institution of first deposit, the paying bank, or any party in between—will affect others in the payment system as well as the check writer and the check recipient. Therefore, the financial industry needs to institute processes and procedures to quickly identify duplicate payment requests and immediately reconcile them so they do not result in short-term costs to correct duplicate postings and long-term consequences from disgruntled customers.

The new process of using images rather than paper checks brings with it the possibility that check payments will be processed through multiple channels (i.e., ACH, image, substitute check), rather than the central processing system that had handled paper checks for years. The paper-based system had some issues with duplicates as well, but those problems were easily solved through the exception process.

Item duplication already carries greater concerns and more impact on the bottom line. Financial institutions expect to receive five to seven duplicates for every million payments processed. The majority of a bank's T&O (technology and operation) expense is due to the handling of exceptions.

The Check 21 tsunami has yet to hit. Duplicates will increase at least 10 percent per year for the next three to five years. The direct cost, including management intervention, for a single duplicate is estimated at \$75. Specifically, these costs per exception are estimated as \$40 to cover initial research, \$10 in management time, \$20 to replace accounts that customers close due to Check 21-related payment issues, and \$5 in fee waivers required to satisfy customers who have suffered negative consequences due to double postings of payments.

There are also higher overhead costs from the processing of additional items through the payment stream, including increased research and adjustment work and increased human and technical resources devoted to exceptions.

The indirect cost can be even higher. Duplication in the payment system leads to overdrafts, non-sufficient funds fees, and associated charges for customers. While some customer complaints may be assuaged through waived fees and other concessions, other relationships will be permanently damaged. One in ten customers moves their banking relationship due to a duplication issue, typically resulting in countless lost revenue over the lifetime of the account.

These issues are compounded by the loss of the paper check as a reconciliation mechanism. Once a financial institution converts a paper check into an image, the paper may be destroyed. Theoretically, the financial institution could keep the paper check, but that would defeat the goals of faster processing and paper elimination.

Additionally, some banks are enabling business customers to use their own scanners to make images of checks for deposit. This enables business customers to start the payment process without the need to go to a branch. For businesses that receive multiple checks on a daily basis, this saves time and money, so they are happy to pay fees for this service. Many firms are already enjoying these benefits, which means that many paper checks may never even reach the financial institution.

The potential difficulties in dealing with the Check 21-related duplication issues and expenses have kept some financial institutions from embracing check image processing. To benefit from the efficiencies resulting from Check 21 while protecting against the costs involved in processing payments more than once, banks need an enterprise duplicate detection mechanism. Such a system must have the ability to look across all payment channels, including paper checks (which will never go away entirely), IRDs, images, ACH, and lockbox transactions. The different payment channels need to be compared against one another to prevent duplicate posting because the multiple payment mechanisms authorized by Check 21 heighten the chance that such duplication can occur.

Even the Federal Deposit Insurance Corporation (FDIC) has acknowledged the potential risk of payment duplication. The FDIC cautioned member institutions that "The lack of access to original checks necessitates the need for revised check review procedures and employee training. Additionally, a new risk of potential double posting will be created (the original and replacement check entering the processing stream). A reconvert bank must warrant that it is not requesting payment on items already paid."

To ensure success, duplicate detection must be performed at the item level. Once identified, duplicate payments can be treated like any other exception (i.e., bad image quality, gross dollar error). So existing exception processes are part of the solution.

The duplication detection system needs to recognize and stop duplicate check items from continuing through the payment stream at every handoff point in the process, whether it be in the collection or the return of checks. Therefore, the Electronic Check Clearinghouse Organization (ECCHO), a national clearinghouse owned by member institutions that help develop rules for electronic payments, recommends that financial institutions take steps to avoid duplicate collection and duplicate postings.

According to ECCHO, even though some financial institutions have already implemented duplicate posting and collection processes, there's no solid evidence that such processes help a collecting bank avoid creating and sending duplicate items. Under the rules of Check 21, a bank can send original checks, images, or substitute checks for the identical item. These banks must implement a dupli-

cation detection system that would prevent duplicate requests for check payment. Under Check 21, the reconvert bank will not ask others in the payment system to pay for an item that has already been paid, and, if it does, that bank will be responsible for any consequential damages.

Similarly, paying banks need to develop or implement processes to prevent double posting. Check 21 protects customers against double posting, but there are still customer service issues that need to be addressed in the event of such an occurrence. While the customer's account would be corrected once any double posting error is identified, that does not immediately correct other problems the customer may experience as a result of the double posting, such as subsequent checks being returned for insufficient funds. Those unpaid checks could result in late payment fees and, perhaps, even a lower credit rating. Invariably, the duplicate payments often tend to be the customer's most important, high-value checks for mortgages and similar credit-related items.

Even if the financial institution makes its customer whole financially by paying any resulting fees, the possible credit rating damage could take much longer to correct. At the very least, if the credit rating isn't affected, the time needed to identify and correct any double postings could harm the trust between the customer and the financial institution—an essential element of any account relationship.

Therefore, when duplicates are identified, the financial institution's operational and accounting processes need to quickly facilitate item review and resolution, including the dedication of human and technological resources.

An industry-best duplication detection system will identify duplicates while permitting the acceptance of re-presentments. Such a system must also account for duplicates caused by the customer, including using the same check number for recurring payments like mortgage and budgeted utility payments.

Duplicates will manifest themselves in increased calls to customer support to correct double postings. An ideal duplicate detection system would contain a database of all payments entering and leaving the bank. This database should be adjusted each time research corrects an error in an account.

A duplicate detection system is more than just an operational tool; it hits at the heart of the overall customer relationship. If customers cannot trust their bank to prevent double postings, they will move their business to a bank that can. ■

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