

Check truncation and check conversion

Q 5-02. How has technology changed check payments?

Checks remain a popular means of payment for individuals because they are flexible and easy to use in a low-technology environment. The person paying by check only needs a pen and a properly printed check form; it is the recipient of a check payment that needs access to the technology deployed to process the payment.

Despite productivity increases in check processing brought about by automation and reliance on machines capable of scanning, reading and sorting checks, the entire process still relied on handling and transporting physical documents. Communications technology and digital images have opened the way to speed check processing by allowing the information needed to transfer value which is contained on a check to be used independently of the physical document. These two approaches are *check truncation* and *check conversion*. In both processes, the paper check ceases to be used at the point of first deposit. From that point forward, the check process relies on either the digital image of the check or the payment data that the check contains.

Q 5-02.01. What are the U.S. legal requirements in moving away from a physical check?

To go forward with this process, it is necessary to establish that the image of the check or the information from the check have the same validity for payment or evidence of payment as the original paper document.¹ In the United States, the validity of a check image was established under the “Check Clearing for the 21st Century Act” (or “Check 21 Act”), Public Law 108-100, which took effect on October 28, 2004 through its implementing regulation, 12 CFR 229. The law allows the recipient of the original paper check to create a digital version of the original check (called a "substitute check"), thereby eliminating the need for further handling of the physical document.

Q 5-02.02. What is check truncation?

Check truncation is the substitution of a digital image of a physical check; that is, removing an original paper check from the check collection or return. Under U.S. law, a substitute check or an electronic image of the original paper check replaces the original check in the collection or return process and is cleared through the

¹ In North America and elsewhere, paid checks, or scanned images of the checks, are returned to the payer or made available on a bank website to provide the payer with proof of payment.

check-clearing network.

In truncation, both sides of the paper check are scanned to produce a digital image. If a paper document is still needed, these images are inserted into specially formatted documents containing a photo-reduced copy of the original checks called a "substitute check."

Once a check is truncated, businesses and banks can work with either the digital image or a print reproduction of it. Images can be exchanged between member banks, savings and loans, credit unions, servicers, clearinghouses, and the central bank.

Truncated checks, despite their similarity to electronic funds transfers, are not subject to Automated Clearing House (ACH) rules and transactions involving truncated checks are not subject to NACHA rules, regulations, fees, and fines.

Q 5-02.03. What is a substitute check?

A substitute check is a paper reproduction of an original paper check that must

- contain an image of the front and back of the original check,
- bear a Magnetic Ink Character Recognition (MICR) line containing all the information from the original check MICR line, except as provided in industry standards to facilitate substitute check processing,
- conform in paper stock, dimension, and otherwise with industry standards, and
- be suitable for automated processing in the same manner as the original check.

Q 5-02.04. When is a U.S. substitute check legally the same as the original check it represents?

To be the legal equivalent of the original check, the substitute check must meet each of the requirements described above and, additionally, must

- accurately represent all the information from the original check (i.e., must bear a legible image of the original check) and
- bear the legend "This is a legal copy of your check. You can use it the same way you would use the original check."

Q 5-02.05. What consumer protections exist under check truncation?

Customers may have recourse to warranty claims or additionally indemnity claims if they suffer harm from check truncation.

A customer may have a warranty claim if

- the substitute check does not meet the “legal equivalence” requirements (e.g., the image of the original check that appears on the substitute check is illegible), or
- the customer’s account was charged more than once for the same item. A customer may make a warranty claim even if they did not receive a substitute check.

A customer who incurred a loss due to the receipt of a substitute check instead of the original check may have an indemnity claim. The indemnity claim may or may not involve a warranty breach. For example, if the substitute check satisfied the Check 21 Act warranties, a customer that nonetheless suffered a loss because they received the substitute check instead of the original check could have an indemnity claim.

In contrast to the Check 21 Act warranties, which apply regardless of what the customer received, a customer must have received an actual substitute check to make an indemnity claim.

Q 5-02.06. May a financial institution charge a fee for providing a substitute check or a copy of one?

Yes. With the agreement of the recipient, much as institutions do today with paper checks, a fee may be charged when providing substitute checks or copies of substitute checks to their customers.

Q 5-02.07. How are warrants treated with respect to check truncation?

Many states and other municipalities pay their obligations with warrants that are drawn on the state or municipality, respectively. These documents are considered non-negotiable instruments. Even so, these government warrants come within the definition of “check” and may be reconverted into a substitute check.

Q 5-02.08. How long is the truncating bank required to keep the original check?

Check retention and destruction and related requirements are governed under existing check law. In determining which original paper checks should be retained and for how long, a bank truncating the original paper check should consider its business risks, cost structures, and any agreements it may have with customers or other banks concerning check retention in light of the existing legal requirements relating to check retention and destruction.

Q 5-02.09. What is a reconverting bank?

A reconverting bank is the bank that creates a substitute check; or if a person other than a bank creates a substitute check, the first bank that transfers or presents such a substitute check. This is a statutory term and reflects the fact that the original check is converted to electronic form and then later reconverted back to a paper substitute check.

Q 5-02.10. What check conversion?

“Check conversion” generally refers to converting a “source document” (a check) into an Electronic Funds Transfer (EFT) transaction for clearing through an electronic payment network, such as the Automated Clearing House (ACH) or debit card networks. In the process, the check is used only as a source of information and is not processed as a check payment.

There are two common types of check conversions:

- Accounts Receivable Check (ARC) conversion occurs when a consumer mails a check (e.g., the consumer’s payment of his or her monthly phone bill) to a company that, in turn, converts it to an electronic transaction and clears it through the ACH network. Generally, the consumer’s financial institution lists the item on the consumer’s monthly statement as an electronic debit item and does not provide an image of the item.
- Point of Purchase (POP) conversion occurs when a check is submitted for an over-the-counter transaction. The cashier swipes the check to capture account information and often returns the voided check to the check writer. The transaction is cleared through the ACH or debit card network.

Q 5-02.11. What other bank services come with check truncation or conversion?

Check truncation has also led to the development of a new process called remote deposit. This process allows customers with checks to deposit to capture both front and rear images of checks along with their respective MICR data for those checks. This data is then uploaded to their depositing institution and the customer's account is then credited. Remote deposit therefore precludes the need for merchants and other large depositors to travel to the bank (or branch) physically to make a deposit.

Remote deposit can be extended to allow anyone to use legally a computer scanner or mobile phone to capture images of checks and deposit them electronically.

In addition to remote deposit, other electronic deposit options are available to qualifying bank customers through the ACH system. These options include point of purchase (POP) conversion for retailers and accounts receivable conversion (ARC)

for high-volume remittance receivers as discussed above.