

Check clearing

Q 5-03. How do checks clear through the banking system?

One of three situations will occur with a physical check or check image to be presented: the check is drawn on the same bank in which it is deposited, the check is drawn on another local bank, or the check is drawn on a distant bank.

Q 5-03.01. How are “on us” checks cleared?

If the drawee bank (the bank on which the check is issued) is the same bank as the depositor’s bank,¹ clearing can be accomplished through an accounting transaction alone. The bank can credit the depositor’s account and credit the drawer’s account. No funds leave the bank.

Q 5-03.02. How are checks drawn on other banks cleared?

If the check is not an “on us” item, the depositor’s bank must take some additional steps. Based on the availability schedule, the bank will increase its bookkeeping account “Deposits” by the amount of the check deposited. This entry is balanced by a new receivable entry, “Items in the Process of Collection.” The clearing process will lead to the eventual conversion of this receivable to cash.

The physical check or check image must be presented to the drawee bank for redemption. If the drawee bank is another local bank, the receiving bank has three options. It may send a courier to the drawee with the check and demand payment. The courier could carry funds back to the depositor’s bank. This is acceptable if the value of the check is very large and can justify the costs of a courier. It is also only practical if there are only a few banks in the city. The number of courier trips grows quickly with the number of banks.²

Q 5-03.03. How do checks clear through correspondent banks?

The depositor’s bank could instead collect the funds through a correspondent bank. A correspondent bank is another bank, usually a larger bank, at which the depositor’s bank holds an account like any other business customer. Instead of presenting the physical check or check image itself, the receiving bank deposits the check in its account at the correspondent bank. The receiving banks account at the

¹This is called an “on us” transaction.

² If there were n banks in the city, using couriers alone would require $n(n-1)$ courier trips to present checks among the banks. For example, 20 banks would require 380 courier exchanges.

correspondent bank is credited with the value of the check. It is up to the correspondent bank to decide how to redeem the physical check or check image. Small banks often choose the solution in which hiring the service from larger banks occasionally is more practical than to expend resources on getting their own facilities.

Q 5-03.04. How do checks clear through local clearinghouses?

Finally, the depositor's banks can present the physical check or check image through a local clearinghouse association. A clearinghouse is a voluntary association of local banks that meet at a fixed location at specified times to present checks drawn against each other. The concept is claimed to have arisen from the realization among seventeenth-century bank couriers in London that if they all gathered at a coffeehouse to exchange checks for presentment, the number of trips required would be greatly reduced. The New York Clearinghouse was formed in 1853 to reduce messenger traffic among its 57 commercial banks.

In a clearinghouse operation, each member bank sends a messenger and a settlement clerk to the daily settlement clearing. The messengers deliver to each of the other banks' messengers batches of checks that have been sorted, listed, and endorsed. The settlement clerks record the dollar amounts of checks presented to each bank by each of the others. Member banks of a clearinghouse association do not settle with each other individually. Each bank, instead, maintains a settlement account with a correspondent or the local Federal Reserve Bank. If a bank delivers to the clearinghouse a larger dollar amount of checks than the total of the checks presented to it, it is owed funds. If it presents a smaller dollar amount than is presented to it, it owes funds to the clearings. The net amount owed from the clearings is transferred among the accounts either at the correspondent bank or through the accounts at the Federal Reserve.

Q 5-03.05. How do checks drawn on distant banks clear?

Finally, if the physical check or check image is drawn on a distant bank³, the receiving bank could present the check in ways similar to the handling of a local check. Although direct presentment, i.e., physically transporting the check to its drawee bank is possible, it would be used under very special circumstances. Alternatively, the presenting bank could also use a correspondent bank. This might become impractical, however, if the presenting bank had to maintain correspondent account in too many cities. The most likely approach would be to use the Federal Reserve System for check clearing.

³Such items are called "transit checks."

Q 5-03.06. How do central bank reserve requirements assist check clearing?

The central bank maintains the integrity of the banking system by setting the reserve requirements for its members. The reserve requirement sets the amount of funds that a bank must hold in reserves, at a minimum, behind its deposits. The mandated reserve rate is likely to be a greater amount than the bank -- under competitive pressures to employ its assets -- would choose to hold if it had complete autonomy. The banks' required reserves are held in accounts at the central bank. The existence of these reserve accounts provides a convenient way to settle funds transfers among banks. Obligations between the banks can be settled by crediting and debiting the respective reserve accounts of the two banks.

Q 5-03.07. How do U.S. banks clear checks through the Federal Reserve?

If the volume is small, the bank may send its unsorted transit checks to its local Federal Reserve Bank. The Federal Reserve Bank will sort the physical check or check images by district using the routing and transit codes. The Federal Reserve Bank will then credit the reserve account (or the deferred account)⁴ of the presenting bank. If the volume is sufficient, the presenting bank may sort its transit checks by Federal Reserve district and send the checks directly to each Federal Reserve bank and notify its local Federal Reserve bank of the amount sent to each district. The Federal Reserve Bank receiving the physical check or check image is in the same position as any bank with a depositor presenting a check. It may be an "on us" transaction to the Federal Reserve Bank if the drawee bank is a member bank in the district. Settlement can be made by presenting the physical check or check image to the drawee or debiting its reserve account. Otherwise, it is like a clearinghouse item in which the clearinghouse is composed of the twelve Federal Reserve Banks. Each Federal Reserve Bank maintains an Interdistrict Settlement Fund to transfer debits and credits between Federal Reserve districts.

Q 5-03.08. What are return items?

Finally, not all checks are honored when they are presented to the drawee bank. The account may have been closed or it may lack sufficient funds. These return items must be sent back to the presenting bank. Customarily, return items are sent to the presenting bank by the same route they traveled to the drawee bank.

The other mechanisms to be discussed follow the logic or flow of funds and accounting treatments in ways that closely resemble check presentation processes. They will not be discussed, therefore, with the same level of detail as the check clearing discussion.

⁴The choice depends upon the availability schedule of each Federal Reserve Bank. Depending upon the drawee bank, funds are classed as zero-, one-, or two-day funds.