

The Revival of Correspondent Banking

How Today's Tech-Wise Community Banks
Are Reinvigorating Demand

by Cathy C. Glassman

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When correspondent banking takes a cyclical snooze, as it has from time to time after a heyday of vigorous growth, there is often a rush to bury it. But time after time, in the trends that have led to the downturn are found the seeds for fostering new growth.

In recent years, the large correspondents have sensed a competitive threat from community banks in the form of image processing. They have not been mistaken. Smaller banks, now fully image-enabled, can compete with their larger counterparts for cash management business. Sometimes they score wins by getting to market faster with newer products and technology. Sometimes, because image eliminates the geographical advantages of large banks with their money-center locations and proximity to airports, smaller banks have successfully competed for national depositors. Early adopters of remote deposit capture will capture deposits of those late to the game, and large size will be little advantage.

That would be the funeral oratory, if a funeral were in order. But on closer inspection, those same trends can have the equal and opposite effect. The transition from paper to electronics, the new deposit products, the rise of remote deposit — they can also entrain new opportunities for large correspondents.

The purpose of this paper is to explore the new opportunities for correspondent banking by offering insights from the point of view of their customers — the operations and cash management leaders in banks of \$15 billion and under. Based on our research into these markets, there are at least three sources of sizeable revenue increases for correspondent banks.

1. **Solicit paper check volume from local banks to reduce the fixed per-item cost of paper processing.** Local clearinghouses will be cleared as paper until image processing costs decline. In the meantime, large bank processing fixed costs are increasing as paper volume drops below capacity. By taking in more local checks, banks can decrease their fixed costs and increase revenues.
2. **Offer private label image services, such as Positive Pay and ARP.** Banks that are reluctant to make the capital investment in expanding image products are excellent prospects for private labeled products. In the past, these services required separate routing numbers which was a turn-off to respondents, but with image processing, that requirement is lifted.



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3. **Extend deposit deadlines for image depositors.** Later deadlines for image depositors can provide revenue but can also reduce float for the correspondent by moving dollars from next day to same day availability. Multi-state image enabled banks can take advantage of later clearinghouse deadlines in selected markets and share that value with their respondents.

How Smaller Banks Got the Image Jump

In the late 1990s, smaller banks secured an image processing advantage because it was easier for them. They had smaller volumes that were better suited to in-house or third-party processing, to the slower image-enabled reader/sorters, as well as a more palatable price point for complete systems. As a result, today more than 70% of community banks are using image check processing either in-house or through third-party processors and have converted both business and consumer accounts to image account statements¹.

Larger banks were slower to transition to image processing for several reasons. In the early days of image, data storage capacity had to be increased to the point where the bank's large image volumes could be stored for seven years. That hardware took years to develop and was cost prohibitive to all but the very largest banks. But even at that point many of the banks were re-scanning their inclearings to produce image statements, just to stay in the image market. Over the next several years, protocols and requirements for image exchange languished in a morass of disagreement among the stakeholders, as each came to the table with proprietary file formats and transfer requirements.

Then Check 21 and subsequent regulatory changes cleared the way for image exchange by letting non-imaged banks accept a negotiable substitute document, also known as an image replacement document, or IRD. (Note: There are differences between substitute checks and IRDs, but this paper will refer to the printed paper item of an imaged check as an IRD.) Meanwhile, as technology improvements (e.g., courtesy amount read, legal amount read, and artificial intelligence for balancing) helped banks reduce their staff and equipment costs, large banks could justify the cost of refitting or replacing their check sorters.

That left three issues for banks on the path to conversion to full-scale image exchange: how quickly customers would come to accept them, how quickly banks could convert their back-rooms, and how quickly they could compensate for lost revenue from converted services.

- I. Speed of customer acceptance: Larger banks tend to have a wider variety of account



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¹ICBA 2006 Community Bank Payments Survey

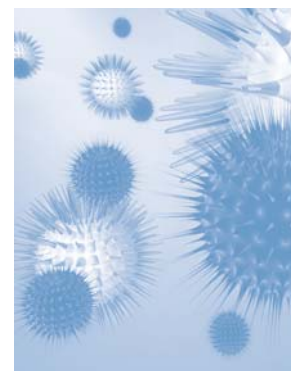
types — consumer, corporate, international, and government — which makes it harder for them to facilitate customer acceptance of image statements. For example, while most consumers were accepting of image statements, municipalities which reprocessed their checks, and escrow companies concerned about security, balked.

2. Speed of back office conversion: Converting backroom processing from a paper-intensive, siloed activity to a horizontal, end-to-end image shop has been a challenge for banks, both technically and politically. Keeping the customer first is paramount if banks are to succeed. "[Banks] must commit to manage payments as a business across the bank, not a separate set of payment types constituting their own disconnected, sometimes conflicting businesses. Another way of saying that is to start with the customer and the customer's payment needs and reshape the payment business across the enterprise accordingly²." Managing a major transition with those two often-competing priorities has not been smooth for most banks. Some community banks implemented image-enabled backrooms earlier, but were delayed in implementing outgoing image returns until Check 21 let them create IRDs for banks that could not receive image returns, so that they wouldn't need a two-tiered return process.
3. Replacement of lost paper-related revenue: Commercial banks have come to depend on revenue from check-related cash management services like lockbox, cash concentration, account reconciliation (ARP), daily balance reporting, and CD ROM delivery. Many of these services are not image-enabled, or are costly to convert, and banks are reluctant to lose paper-based revenue or invest in the conversion when it is not at all clear that their digitized counterparts can command similar revenue.

An Image Exchange Appetite on \$12 Billion or Less

Smaller banks, by adopting image exchange early, made the best candidates for image exchange, before large banks and the Federal Reserve were ready. However, community banks' check volumes tend to skew toward local items, and the larger banks in the market were not ready for image exchange. This left the smaller banks ready to send and receive, but without any functional partners. When the Federal Reserve introduced image check clearing in 2006, few banks were receiving the inclearings in image format, so the Fed was obliged to print large volumes of IRDs just to complete the clearing process.

BancorpSouth is an example of a bank that was ready for image and is pushing for more partners, according to Bill Gully, BancorpSouth 1st VP. A \$12 billion, 8-state bank headquartered



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²The Domino Effect of Check 21: Paving a Path for Banks to Redefine and Reclaim the Payment System by J.D. "Denny" Carreker



in Tupelo, Mississippi, BancorpSouth was one of the first image depositors to the Fed's FedForward image product. The bank is a member of Endpoint Exchange, a Metavante owned image exchange clearinghouse which began with community banks, and Viewpointe, the image archive and clearing exchange owned by a consortium of large banks. (When all of Viewpointe's members are participating in image exchange, their volume will account for 60% of the country's check volume³. Several banks are already participating, and more large banks are coming on line quickly.)

Gully says BancorpSouth is clearing about 25% of its items as images, and is using correspondents and the Fed for their paper clearings. Still, he is looking to exchange with even more partners. He would like to both send and receive all items as images through expanded peer-to-peer, correspondent or clearinghouse relationships. Using check dollar values and transportation savings as a guide, he balances the sends to his clearing partners to take full advantage of the savings. On the receive side, the bank accepts a courtesy release of its inclearings a day early from Fed, allowing the bank to post and begin the return process even earlier.

BankAtlantic on the other hand, represents one of many smaller banks (\$6 billion) that is committed to correspondent services, but is looking for expansion. Headquartered in Ft. Lauderdale, BankAtlantic is currently using a correspondent for its paper clearings, and doesn't anticipate changing when their clearings convert to image in the next few weeks, says Nancy Murphy, Senior VP and manager of deposit services. The Fed owns the wire and ACH products, but check/image belongs to the correspondents, she adds. There was no comparison when choosing a correspondent over the Fed, because the correspondent offers Murphy no-to-low cost on-us items, allows same day draw-downs based on the amount of on-us deposits, and offers other investment services besides. Consequently, a large correspondent bank would have to add image services and revenue sharing to its traditional offerings to gain new customers.

Remote Deposit: A Cornerstone Service of the Payments Transition

Large bank correspondents interested in increasing RDC market share need to be able to help their customers build their RDC business case on three key factors: How much expense is currently devoted to physical deposit, how much of their current physical operation is reasonably a candidate for RDC, and whether the bank can offer the service as a revenue producer.



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³Viewpointe Web site. www.viewpointe.com



Remote deposit, which allows corporate customers to create images of checks at their location and transmit the images to the bank, is rapidly gaining popularity across the country. The implementation of image processing and the passage of Check 21 have freed banks from their geographic confines in terms of both deposit customers and cash management products offered.

Both large and small banks are seeing a growing demand for remote deposit products. "We were surprised at how many customers didn't want to go to the bank," said BancorpSouth's Gully, referring to the acceptance of remote deposit by their corporate customers. In addition to being able to extend their banking day, Gully notes that they have gained customers in rural locations away from the branches. BancorpSouth has seen demand increase from both low and high volume customers and high and low dollar customers.

Remote deposit does not replace lockbox as a cash management service, because lockbox accelerates the receipt of payments and deposits, and includes a sophisticated menu of processing and balance reporting options not commonly available with remote deposit. Corporate customers who were making daily trips to the bank only to make check deposits are finding productivity savings through remote deposit, in productivity, fees, and float, as well as customer service⁴.

Checks can also be scanned and truncated at the teller line, with the image transmitted to the operations center. The physical items are stored at the branch for a short period of time, and then destroyed. BancorpSouth truncates all deposited items at several of their more remote branches, says Gully. The bank has eliminated the courier expense to these rural locations. BankAtlantic also truncates items at its 12 branches in Tampa, and BancorpSouth is planning for the installation of image-enabled ATM machines, further reducing armored courier expense and branch personnel time dedicated to servicing the machines.

Fraud and Risk in Corporate Customer Hands

Banks have risk management in their genetic code. By nature and regulation, mitigating risk is a constant, daily concern for bank operations managers. Not so for their customers, who tend to look to banks for risk mitigation. Now, however, remote deposit has taken some of those responsibilities and procedures and pushed them out to the corporate customer. This can cause some trepidation among bankers whose customers might not be prepared for the balancing, security and risk/fraud deterrents needed for deposit processing.



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⁴"Contemplating Remote Deposit Capture? Assessing Your Business Case" Suzette Massie, President Global Payments Consulting, Carreker



The key, says Gully, is a well-crafted deposit account agreement. It is important that the agreement cover the storage and destruction of the paper items, secured and limited access to the room where images are created and procedures to prevent double posting. It is also important that the deposit agreement shift warranties to the corporate customer for not double posting and for image quality.

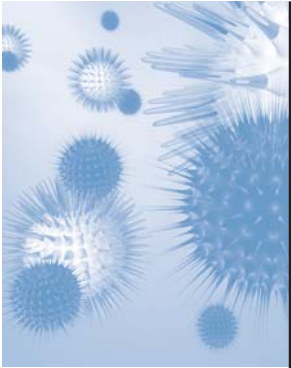
This potential for increased exposure can be viewed, by the proactive correspondent banker, as a way of delivering even more value to smaller banks by private labeling a system which has an 'iron-clad' deposit agreement, documented procedures and experienced personnel.

Backroom Processing

It is reasonable to anticipate that backroom processing will get more complicated before it gets simplified. That is because many banks are attempting to transition from multiple payment type silos, to multi-payment functions that are optimized by technology and productivity. The endgame is tantalizing, but the journey can be messy. This challenge could mean new business opportunity for large banks that can help smaller banks leapfrog the interim chaos. By offering image return services, for example, large banks can maximize their operations and save smaller banks the expense and management of the product.

Transitioning from siloed, paper-based, check-driven backroom functions (adjustments, returns, and statement rendering) to a cross-enterprise, image-enabled suite of products has been a long journey for many banks. That transition has also been one of the delaying factors in the complete shift to image processing. If banks have to re-image incoming items, or have to keep the paper checks longer than needed to provide adjustments, then the cost savings from front-end image processing in float and personnel would be offset by the increase in backroom costs as well as potential risk and fraud loss.

In the past, banks received their paper checks as inclearings from the Federal Reserve, local clearinghouses, or directly from correspondent banks. The items were all paper, regardless of the clearing method. Automated clearinghouse items, like direct deposit payroll, were received and processed through a different payment channel, with different management, budgets, missions and operational goals and objectives. The first crossover between check and ACH began in the mid-1990s when returned or destroyed checks could be redeposited as ACH RCK (returned check) items. That crossover continues today with the conversion of checks at the merchant location by swiping the check through a MICR reader, and then returning the check marked "void" to the customer. These hybrids produced marginal operational impacts, since the ACH departments at the banks were both the originators of the RCK and the receivers of the merchant items, without going through item processing or other areas.



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The newest ACH initiative, ARC (account receivable conversion) has triggered more of an impact on backroom processing. In ARC, companies which receive a large volume of consumer checks, like a telephone company, can convert the checks received into ACH payments at either their remittance processing location or at the bank's lockbox department. The payment is converted to ACH and the checks are held for a short time and then destroyed. One issue for a siloed bank environment was the notification for stop payments, and other after the fact problems. For example, the consumer places a stop payment on a check sent to the telephone company. In the past, the stop payment file was only run against the checks to be paid; now banks have to integrate the ACH and check stop payment systems to insure that the request is honored.

Seizing the Correspondent Banking Opportunity

In the end, respondent banks are looking for the same services they have always wanted from their correspondent: accelerated availability, preferential pricing, quality balance reporting, efficient adjustments and returns, funds sweeps, and Fed funds transactions.

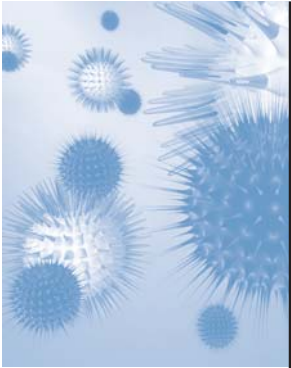
Some respondents, like BankAtlantic are clearing their transit items through their correspondent bank, which is creating IRDs for some of the items and forwarding the images along for other items. Others, like BancorpSouth, are using both correspondents and the Fed depending on the endpoint, time of day and dollar value.

Now, correspondent banks must meet these same requirements for both image- and paper-based respondents and paper- and image-based endpoints. Coordinating these different customers and their own capabilities requires balance and a quick response to changes in the clearing market.

Pricing and availability must now be calculated more precisely in a matrix of type (paper, image) time (peak, off-peak), endpoint (local, transit) and presentation (image, IRD). The correspondent bank must price depository services to meet its current capacities or to encourage different behavior from its respondents to increase desired volume.

For example, fully image-enabled community banks might be prepared to transmit their image files earlier in the evening than paper-based customers. Will the correspondent be offering them discounts by deposit time, or perhaps on those endpoints which can be cleared by image? Will the pricing for IRD creation be billed as an overhead cost, or finely tuned by endpoint depending on the correspondent and the paying banks' capabilities?

These questions require that correspondent banks fully understand the cost of their operations, from the impact of declining paper volume to the increase in IRD production. In



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addition, the correspondent must be able to forecast the changes in costs and profitability as volume shifts to image, and to recognize which endpoints from which customers are the most profitable and design products to attract that volume.

The issue becomes more complicated when that profitability calculation and changes to payment clearing lag too far behind. Correspondent banks must be able to make clearing changes quickly, and be able to reforecast their profitability as interest rates and clearing options change. Sort patterns must be changed quickly as transportation/image/pricing is in flux. For banks without dedicated float and operational staff, outsourcing of float and sort pattern management is a cost-efficient option.

Four New Ways of Viewing your Correspondent Opportunity

It behooves the correspondents, then, to provide the incentive, the products and the industry leadership for community banks as the payment market evolves. Geography is no longer a consideration when selecting clearing agents, which opens the correspondent and third party processors market and should increase competition. For large banks to reestablish or revive their correspondent preeminence, the challenge is to find a new way of looking at the opportunity:

1. Where smaller banks have succeeded in certain areas, it is important to identify areas where they come up short, lacking the scalability of the large bank. (Returns, Archive, etc.)
2. Some of the most lucrative opportunities might be in services with obvious sunset but uncertain timing — that is, services that support the transition game but not the fully electronic end game. (Local check deposits, IRD printing)
3. Correspondents need to include incentives for deposits which also improve their own float position. (Revenue sharing, early draws, extended clearinghouse deadlines)
4. Services, such as technical image conversion support, or developing work flow improvements could be added to the product suite.



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