



In This Corner:

A More Efficient Check-Image-ACH System,
Optimized on Customer and Bank Value

by Mike Reagan



In This Corner...

"Everybody wants to go to heaven but nobody wants to die."

This phrase, often attributed to boxing great Joe Louis, is appropriate for a profession in which success requires great personal sacrifice. These days, it is not a far stretch to apply it to the current state of check processing. As in boxing, where two opponents slug it out until only one is left standing, in check processing there seem to be two camps battling over check electrification as if there were only one possible champion. In one corner, Image Exchange. In the other corner, ACH.

But if check electrification is going to win the day, it may be time to forget about winner-take-all, and instead take a lesson from "the sweet science." In boxing, having different classes of champions creates more winners and enriches the sport overall. In payments, instead of classes based on weight, classes could be established on value — value to banks and their customers. Establish selected classes of checks and champion the appropriate solution for that class.

We would like to suggest that the first class of checks be consumer checks. As the number one title contender within that class of check is what we call All-Consumer Check Conversion (ACC): the automatic conversion of any consumer-written check to ACH at the earliest point possible.

Let's look at why ACC deserves a title shot.

Fostering Innovation in the Payments System

Electronification of payments has been the elusive goal of payments system evolution for the past decade or more. Check 21 codified the evolution with a couple of objectives: "to improve the overall efficiency of the nation's payment system" and "to facilitate check truncation by authorizing substitute checks". Most observers would concur that the second objective has been too successful and the first not successful enough. The reasons are numerous, but one obstacle has been the tradition of siloed payments groups driven to champion one payment type over another.

As a result, payment electrification has advanced steadily but staggeringly: a new product here, a rule change here, a bank innovation here, and a non-bank circumvention there.

But concerted change driven by the banking industry has been rare, often with good reason.



IN PAYMENTS,
INSTEAD OF
CLASSES BASED
ON WEIGHT,
CLASSES COULD
BE ESTABLISHED
ON VALUE —
VALUE TO BANKS
AND THEIR
CUSTOMERS.



Each wave of change has had the potential to endanger bank revenues, relationships, and infrastructure. For the conservative, risk-wary business of banking, caution has been the preferred approach.

Taking Stock of the Evolution

But now we believe, and our bank clients concur, that it is time to take stock of the evolution. Why now? Because delay is becoming costly, not safe. Volume shifts are already slaking off revenues. Technologies like remote capture are already putting customer relationships into play. Infrastructure costs are out of balance with volumes. Electronification could outpace risk prevention. International players are embracing electronic alternatives and grabbing market share. There is little to be gained and much to be lost by delay.

According to Federal Reserve, SVPCO, and the National Clearing House Association data compiled by the Electronic Check Clearing House Organization, throughout 2005 monthly substitute check volume climbed steadily from the single-digit millions to more than 40 million by the end of the year, and then to more than 60 million by March 2006.

Two good reasons account for the high volume of substitute checks. Faster clearing of high-dollar items is one. Check 21 anticipated this and provided a logical high-value/low-volume model that made sense. However, recent numbers indicate that the dollar value of images being reconverted into substitute checks is dropping while the volume of substitute checks continues to grow. The other is the rush to remote deposit capture (RDC). The deployment of RDC has outpaced the adoption of image exchange, forcing banks to collect on electronically deposited items by creating substitute checks. But in this case it is a high-volume/low-value proposition.

While these two factors help explain the high volume of substitute checks, they do not explain why the images that were used to create those substitute checks could not have completed their journey as images. That's easy: too few banks will accept images. As with charity so apparently with images — "Tis better to give than to receive." While recent reports suggest that more image-initiated check presentments are moving towards completely clearing via image exchange, the number of substitute checks received is still growing and it continues to outpoint the number of images received. The fact of the matter is that the overwhelming percentage of the checks presented for payment and collection remain as checks throughout the entire clearing system. And this remains an expensive way to process the check payment.

The usual reasons we hear for the slow adoption of image-receive center around implementation: immature technology, lack of standards, complexity of multiple channels, insufficient population of image-enabled Day 2 processes, marginal business cases, undue complexity in



TECHNOLOGIES LIKE REMOTE CAPTURE ARE ALREADY PUTTING CUSTOMER RELATIONSHIPS INTO PLAY. INTERNATIONAL PLAYERS ARE EMBRACING ELECTRONIC ALTERNATIVES AND GRABBING MARKET SHARE.



engaging new channels, etc. In short, many banks seem to find that fully implementing image exchange is too complex and too resource consumptive to make it a priority.

But what about looking at the opportunity less as an implementation issue and more as a business issue? Rather than the technology business case and impediments, how about the customer value and value to the bank?

Volume vs. Value

To that end, we have researched how different customer segments value the check and how they do or do not deliver value to the bank.

According to the Retail Payments Research Project published by the Federal Reserve Banks in 2002, consumers wrote about half of all checks written, and businesses about a third. (The remainder was government issued and "unknown".)

<u>Consumer checks written for</u>	<u>Percent of all checks written</u>
Remittance	17.7
Point of Sale	14.1
Remittance at Point of Sale	6.4
Casual	11.2
<u>Business checks written for</u>	
Income	17.8
Remittance	7.9
Point of sale	4.9
Remittance at Point of Sale	5.5

Consumer checks were written largely for commercial transactions, while the largest category of business checks was for income (paychecks).

As total check volume has declined in recent years, transactions have not. What has replaced checks? Sometimes the payer has chosen a different payment instrument. Various card products and electronic payment origination have, in many cases, supplanted the check as the payment instrument of choice. Some checks have been converted to ARC or POP and been processed as ACH items, a far less expensive way for the banks to process the transaction. Figure I below depicts the trends. As also shown, three of four categories have exerted downward influence on check volumes. Consumers write fewer checks to businesses, and businesses write fewer checks to businesses and consumers.

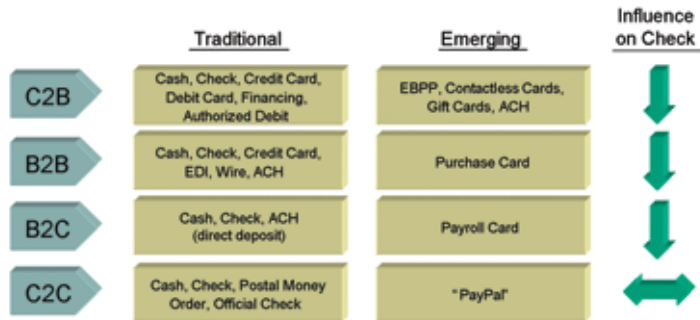


VARIOUS CARD PRODUCTS AND ELECTRONIC PAYMENT ORIENTATION HAVE, IN MANY CASES, SUPPLANTED THE CHECK AS THE PAYMENT INSTRUMENT OF CHOICE.



The only category to go unchanged is the consumer-to-consumer category. So it stands to reason that on a percentage basis consumer-to-consumer check writing has actually risen.

Figure 1



But that merely speaks to volume trends as dictated by customer use. It does not speak to the value of checks to the banks that sell, collect, and process them.

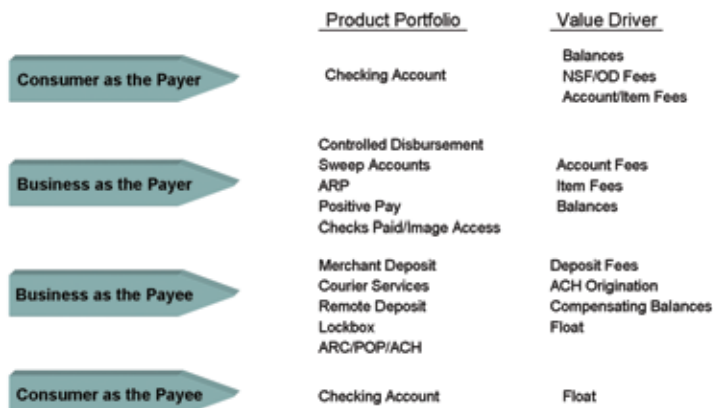
Value of Checks to the Bank

For both groups of customers — consumer and business — banks have developed a number of check-based products. For consumers, these products range from basic to elite checking accounts and money market accounts, with a variety of fee structures (which very often include no fees at all) and an increasing number of options for statement delivery. For businesses, the product list is far more extensive.

For businesses, they include products designed for the payable process (e.g., control disbursements, positive pay), for receivables (e.g., merchant deposit, lockbox), and different offerings for managing the balancing and reconciliation of the accounts (e.g., ARP).

Figure 2 makes it obvious how differently the bank derives value from the two customer groups.

Figure 2



Which of the value drivers delivers the most value? By far the greatest value from consumers comes from balances (Net Interest Income) and the occasions when the account holder exceeds those balances (NSF/OD fees). Very little of the value is derived from the check instrument per se. In most banks, the percentage of consumer customers paying little to no fees for checking would support the concept that the "value" for banks that was specific to the transactional activity has already been surrendered. The same cannot be said for business checks. Certainly business checking accounts deliver value from balances and NSF/OD fees, but there are more transaction-based structures through which the bank delivers value to and derives value from businesses. Banks generate significant revenue from fees associated with the items themselves, both deposited and paid. Some of the revenue on paid items is directly tied to the face of the check itself (e.g., Positive Pay). Account analysis intricately links the various fees to balances.

Further examination, then, says that the check's value to the bank depends on who is writing the check and for what purpose:

- For consumer checking, value is derived through balances in the account and in fees related to exceeding those balances, not in the check instrument per se. Very little value is tied to volume. In fact, consumer check volume is largely an expense to the bank. Where the check has been converted to ACH, the processing expense can be reduced dramatically. The checking account is often the primary reason why consumers establish a relationship with a bank, but it is the transactional capability of the account rather than the check itself that brings value to the consumer.
- Business checking, on the other hand, delivers value in a very different way, and much of it is tied to check itself. Volume is often a fee driver and the content of the check itself is often an integral part of fee-based services, with value to both the bank and the business.

So consumer checking, from the bank's perspective, is overweight on volume and light on value. Driving down check volumes should increase bank value, without diminishing customer value.

Reaching that realization should take some of the "fight" out of the rational debate about check conversion. It should relieve the check people at the bank of the parochial obligation to find the right answer inside of Check 21 trends. It should enable them to look objectively toward ACH as an opportunity, not a competitive instrument.

After several years of deployment, ACH conversion now has a history to examine. Over a billion checks were converted last year and that number is still growing. Rules have been



SO CONSUMER CHECKING, FROM THE BANK'S PERSPECTIVE, IS OVERWEIGHT ON VOLUME AND LIGHT ON VALUE.



adopted and readily accepted, and recently they have been expanded to address back-office conversion (BOC), which should only spur the growth rate. The consumer has apparently accepted this conversion without incident. The piece parts are in place already — a secure, established process, recognized rules and regulations, and customer acceptance. The volume/value proposition makes it reasonable and timely to seriously consider extending the option of converting all consumer checks as soon as they enter the payment stream — ACC, in other words.

How ACC Would Work

ACC would work something like this. A bank would notify its consumer customers that their checks would be eligible for conversion to ACH, à la bill payers in ARC or merchants in POP and BOC. This would be an all or nothing service — within a participating bank, any item defined as a consumer check under the NACHA rules would be eligible for conversion. That bank would then post notice that all consumer checks for its Routing and Transit number(s) would be eligible for conversion.

While a mechanism for registering such information is not currently in place, conceptually it is no different from keeping track of which routing and transit numbers are eligible for image exchange and which require the printing of substitute checks. Furthermore, recent rules revisions have simplified the definition of a consumer check as well as specifying what is not an eligible check. Should a bank desire to do so, it could issue new stock to select account holders for whom they do not want to impose check conversion (e.g. private banking customers).

Many consumers have already accepted truncated accounts with only a description of the check on their statement, either from a commercial bank, a thrift or a credit union. Furthermore, current statement products already accommodate checks converted via ARC or POP, so this would essentially be more of the same both to the bank and the consumer. When copies of converted checks are necessary (e.g., suspected fraud), they could be made available from the 60-day (or longer) archive at the Bank of First Deposit.

Given that the rules and infrastructure are basically intact, the time to implement would be minimal. Each bank could adopt consumer conversion at its own pace and take advantage of the significant expense reduction opportunity as they see fit. Once the weight of consumer checks is removed from the process, banks could free resources to focus on improving the efficiency and enhancing the value of a different class of checks — business checking.

Industry Action: The Key to Success

The key variable is the willingness of the banking industry to move in a direction that looks



ONCE THE WEIGHT OF CONSUMER CHECKS IS REMOVED FROM THE PROCESS, BANKS COULD FREE RESOURCES TO FOCUS ON IMPROVING THE EFFICIENCY AND ENHANCING THE VALUE OF A DIFFERENT CLASS OF CHECKS — BUSINESS CHECKING.



at checks not by the way they are processed but by the value they deliver. It is not a question of championing one payments silo over the other, but advancing the electrification agenda in the manner that delivers to customers and derives for banks the best "win-win" value scenario. Such movement cannot succeed with an individual bank or through bilateral agreements. It will require the resolve and collaboration of the industry as a whole to proactively propel it.

Just waiting on pushes from legislation or the Federal Reserve will only allow the unfettered, non-bank contenders — not just the feared Wal-Mart but hundreds of other companies for whom payments are a major customer issue — to pick their battles and stake their claim to the payments crown. They have proven to be a formidable force in controlling how a payment will be processed, and nothing in recent industry news suggests they won't continue to exert increasing control over which payment type ultimately wins.

It is critical for banks to demonstrate their desire and exploit their position of strength for reclaiming their right to the title of payments champion. It is a fight worth fighting. Our past industry history clearly demonstrates that it is rarely an "all or nothing" transformation (e.g., online banking versus branch, self-service versus full-service). The champions — the winners of customer business and the profitable performers — have historically been those financial institutions that choose the best available configuration options by maximizing the value challenge: what is delivered (customer value) versus what is derived (bank value).

In this fight, how banks handle checks should not be a winner-take-all brawl. If they classify the contenders by the value they deliver, then there can, and should, be champions at multiple levels. We suggest that ACC should wear the championship belt in the class of consumer checks.



Mike Reagan is Managing Principal of Carreker Corporation's Global Payments Consulting, where he helps banks and optimize the value of their payments business and payments customers.

*mreagan@carreker.com, 732.530.0441
<http://www.carreker.com>*

