The Triple Force of Electronic Check Clearing –
ARC ■ Check 21 ■ Image Exchange ■

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Paper and Electronics Converge

The payment industry is in the midst of radical change. Paper payments are in a long-term decline. Alternative electronic payments are gaining ground daily as an acceptable means for customers to transact as almost every major company pushes paperless channels. The decline of checks continues at a steady pace. Volumes are shrinking with about 65% of consumers paying by check or other forms of paper, and about 35% now paying through some means of electronic payment. Some aggressive loan servicing companies are achieving even more impressive rates, 50% plus, by doling out incentives such as reduced interest rates in exchange for electronic payments. Still, paper remains the most popular payment channel – one the industry plans to tackle differently in 2005.

“…35% are now paying through some means of electronic payment.”

As the industry’s largest lockbox provider, Regulus sees firsthand the impact of paper on the processing of consumer and commercial loans. The various types of loans, especially mortgages, are known for complexity and exception processing: stop files, advance principal payments, and mixed payment types. All require manual handling, creating challenges in an automated lockbox environment. Routinely, individuals must decide on how to apply additional principal, late fees, escrow payments, payment overages, multiple loan accounts, and payment shortages. It’s not uncommon for 30% to 50% of loan payments to call for some type of operator intervention to correctly apply payments. Partial payments and handwritten account numbers on checks represent other problematic exceptions. It is easy to see why institutions collecting loan payments entice customers to pay electronically with posting instructions and allocations already preset.
Many interested parties are making great strides in luring consumers toward paying electronically. Consumers are originating electronic payments through the Internet, the phone, or ATMs. Recurring ACH account debits dominate electronic choices with credit cards and pay-by-phone channels climbing in popularity because of pure customer convenience. These electronic preferences hold true for most loan portfolios as well. The Federal Reserve recently reported that the number of payments made by all electronic methods, including credit and debit cards, exceeded those made by checks for the first time in 2003. Despite the excellent job institutions have done getting their customers to agree and pay via alternate means, the issue remains that two-thirds of them still prefer to pay by paper.

But, after years of trying to change consumer behavior, maybe a different tactic from new collection methods may provide just the necessary push to change consumer habits. Recent changes in regulations and clearing settlement tee up new ways to tackle the remaining paper payments that do not need consumer consent. ARC, Check 21 and Image Exchange present alternate electronic vehicles designed to increase the pace of electronic conversion with an underlying goal to eventually make consumers more aware and amenable to new payment forms.

This triple force will overhaul the expensive and antiquated check-clearing process that transports paper checks across the country. The trio will not only cause a re-engineering of the nation’s check processing system, but will also drive most companies to completely reexamine cash collection strategies.

Changing conditions could tip the scales in one fell swoop, making the business case much stronger for outsourcing.

1. **Check Conversion (ARC):** converts original paper check to an electronic Automated Clearing House (ACH) settlement entry governed by NACHA.

2. **Check Truncation (Check 21):** truncates original paper check to image for settlement either electronically or via substitute check for non-image abled parties.

3. **Image Exchange:** the exchange of images within clearing networks (bank groups or 3rd party processors) for electronic, same-day and next-day settlement.

Industry experts express the ultimate goal as 100% electronic payment processing across the country with “real-time posting, real-time exchange, and real-time (guaranteed) settlement.” Yes, it will take time, perhaps many years, but there is an unstoppable drive towards this goal. Part of Regulus’ contribution toward this change came as an early entrant in Check Conversion (ARC) services. Regulus now converts over 15 million-paper payments monthly: a large portion of all ARC transactions in the entire industry. NACHA predicts that 55% of all paper transactions will be converted to ARC by 2007.

### Check Conversion: ARC

Companies can now notify a customer of their choice to convert a check to an electronic entry that can be settled and returned through the Automated Clearing House (ACH). While consumer notification is required, the company, not the consumer, makes the decision to turn the paper into an electronic check. The efficiencies of this type of electronic transformation allow consumers to continue to use checks if they choose. Consumers, again, are being made more aware with automated account debits. But there’s a catch: the normal lag time between writing the check and when it clears will diminish significantly.
For the loan industry, ARC is already a hit. Many of our largest loan clients see enormous financial and operational benefits from deploying this proactive electronic clearing service initiated by them as opposed to persuading customers to participate. These benefits are expressed as the most quantifiable:

- Faster cash collection
- Rapid return item receipt
- Fewer NSF return items
- Lower bank fees
- Late fees collected sooner or waived fees more often
- Extended processing hours
- Earlier notification of potential fraud
- Consolidation of bank relationships
- Increased accuracy
- Speed in research and adjustments (no longer waiting on check copies)

ARC, thankfully, is having little customer service impact indicating that consumers are accepting the change. Even conversion of the larger dollar payments, like mortgage loans, is not causing calls in support centers to climb. Immediate image access plays a major role in the viability and measurable outcomes of this service as well. A notable limitation to ARC is that only consumer checks are eligible for conversion.

Checks not eligible for ARC conversion today will now be able to continue in the form of images and data.

Foregoing the substitute check ultimately by only exchanging the images for clearing is at the core of Check 21’s future goals. Right now, that is a huge issue. Even for the remaining paper payments, many banks are not ready to send and receive electronic images. Pricing varies widely among providers trying to set industry direction. Many in the industry are in “a wait and see” mode. How long it takes before a meaningful portion of financial institutions is ready to send and receive electronic files is a big question mark. Check 21 and Image Exchange may take years to gain real traction, while paper payments will continue to drop.

Paperless solutions bring broader and more complex choices that may mean a change in course for all players. Under Check 21, the fundamental step of physically taking cash letter deposits to a local bank facility is being turned upside down with the onset of electronic settlement. Banks understand too that the day of dependence on centralized bank centers is fading. Geographic borders disappear.

Companies are now able to consider a mixed collection strategy that takes advantage of all three settlement methods (ARC, Check 21, and Image Exchange) to achieve the best routing and lowest cost. The float – the time between when a check is deposited and when the amount is actually available for company use – could be reduced from days to hours as a result of these new clearing methods.

Taking time to decide how best to clear incoming checks is worth the extra effort. For example, by determining the top two or three institutions on which customer checks are drawn, multiple depositories can be used instead of just one. One-day collectable funds now become available immediately upon deposit with more banks. This electronic environment adds another advantage with extended processing windows not dependent on normal clearing.
deadlines. A processor must possess the internal expertise to manage the float component, while also dealing with reconciliation and other issues that may open up. All aspects of any major change must be carefully considered.

No doubt, basic questions on who, what, where and how most likely will be answered differently with new ways of presenting image-based cash letters. The lockbox location, the number of collection sites, as well as the current provider, may be modified to access the new accelerated clearing channels. But all these decisions may be just too much to cope with for in-house payment processing shops facing drastic makeovers. At times like this, firms need to turn to outsourcers for more flexibility, expertise, and solutions in a shifting marketplace.

**Check 21: Remote Deposit Capture**

Currently, there is a buzz in the industry around remote deposit capture, in other words, capture and conversion to electronic images at the first place a check is originally received: a perfect fit for businesses receiving large value checks at nonpayment locations. Consider all the places checks are taken for loan applications or other major customer activities that are at remote offices or locations. Initially, only smaller volumes and high dollar checks are slated for this service, but it will expand to future higher volume clients. Watch this one as a potential blockbuster service as another offspring to Check 21.

**Risk**

Reengineering anything is fraught with risk. A move toward image-based payments and clearing methods, and away from paper, affects every aspect of internal workflows. Each step in the paper process requires an equivalent one in an image-based approach. Reevaluations of equipment, staffing, back-up, redundant systems, fraud controls, service levels, and even negotiated bank pricing are necessary. Shifting to image settlement is not simple, requiring strict quality control features around capture, storage, retrieval, and file creations for adequate operations. While images provide automation and faster detection, the transition period is critical as fraudsters thrive in unsettled times.

There is no question benefits can be realized, but all these changing conditions bring new twists to risk management. Be careful. Don’t make the common assumption that your company has to spend to save. While cost savings may be the primary impetus for change, there are better and more expeditious ways to reach savings with the right lockbox partner. If not already in place, outsourcing may truly be the path to follow for the fastest results.

Regulus will actively lead the way for new solutions while paper and electronics continue to converge.”

_Sandra Williams leads Regulus’ Transactions Consulting team. The team provides consultative services, including on-site assessments and business case development to potential or existing clients who can realize the cost-saving benefits of both document and remittance processing solutions. We call it Transactions². Contact Regulus today at 1-888-747-2877 or visit our Web site at www.regulusgroup.com to learn more about Transactions² and how to take your customer transactions to the next level._

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