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# CHECK 21 ... Indecision Does Not Equal Immunity

*Understanding the Impact of the Legislation for Community Banks*

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A barrage of information and calls to action continue to surround the recently signed Check 21 legislation. Institutions are urged to “act now before it’s too late.” But the plethora of advice, suggestions and even misinformation are causing many community banks to avoid action altogether. Rather than developing strategic plans to adapt to the changes, community bank leaders are adopting a wait-and-see approach, assuming their indecision and inaction will provide them immunity to the changing tide of the payments world. The choice to do nothing is clearly a mistake. Indecision does not equal immunity to the impact of Check 21.

Consider other recent changes in the payments industry. ACH payments, debit cards and electronic checks have all burst on the scene — each requiring the education of customers and staff alike, along with a defined plan for deployment of processing the various payments. Were you prepared to answer the questions from your deposit customers whose checks — made payable to American Express — were truncated and their accounts charged with an ACH debit? Were you prepared to tell them why their stop payment on that check was ignored by your system and paid anyway? The same preparation, if not on a grander scale, is necessary to navigate the tide of Check 21 effectively.

This paper discusses the immediate and future impacts of the Check 21 revolution for community banks. It also outlines a simple plan for meeting the basic requirements of the law, as well as suggestions for implementing a phased approach that

could enable your institution to reap the benefits derived from the new law with reduced risk. Finally, we’ll explore key Check 21 considerations beyond imaging technology that affect the step-by-step action plan, including changing payment trends, cost impact and long-term strategies.

### **The Impact is Now**

Across the country, community banks are reporting that Check 21-related events are already having an impact on their institutions. One reason for the impact is that image replacement documents (IRDs) are already in circulation in the payment industry today. It is estimated that nearly 100,000 of these substitute checks are being produced daily — but not everyone is prepared to process them. Imagine the surprise of your bookkeeping staff when an IRD appears in the batch of checks they’re reconciling. Your staff must know what to do with this document — both now and post October 28. And you must be prepared

to inform and educate your customers. What will you say to the customer who receives this substitute check today, or wants a copy of their cancelled check when you can only provide an IRD? This is today’s reality.

And what about after the legislation goes into effect? After all, it’s only months away. Consider this scenario: After October 28, an item (which happens to be an IRD) is not automatically re-deposited causing a charge-back of an IRD to occur. Your bank sends that negotiable IRD back to your customer, who promptly appears at your teller window at closing time on a busy Friday afternoon to redeposit the item. Will your teller be prepared to handle this transaction? Will they recognize the IRD as a genuine negotiable item? Will they be trained to detect counterfeit IRDs? Choosing not to educate your staff or have a plan for communicating with customers will not keep you immune from the impact of Check 21.

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## Leveraging a Phased Approach

While inertia is not recommended, neither is frantic, unfocused action. If your institution is not at the forefront of image technology, Check 21 should not cause you to leap ahead to the extreme cutting edge of image exchange. Instead, consider developing a controlled, well-thought-out plan for transitioning your institution to full image exchange.

The following three-phase approach – with immediate, intermediate and long-term objectives – provides a framework for creating a realistic plan that could enable your institution to realize the benefits of Check 21 and the electronic payments age, without the increased risk of impulsive action.

### Phase 1

In the first phase, the immediate goal focuses on being compliant with all the requirements of Subpart D of Federal Reserve Regulation CC, as well as being prepared to handle the processing and expedited recredit of IRDs from an operational standpoint. This could also be called the “Must Do” phase.

### Phase 2

The intermediate objectives are designed to assess the impact that declining check volume and changing customer payment habits will have on your institution's profitability and competitiveness. This is the “Can Do” phase.

### Phase 3

Finally, the third phase focuses on analyzing how to maximize the benefits and opportunities presented by both Check21 and the resulting changes in the payments area. Minimizing overall risk also becomes a long-term objective during this phase. Phase 3 is the “Big Picture” phase.

This phased approach gives institutions the flexibility of determining an appropriate timetable for achieving each of the three objectives. It also provides the opportunity to analyze changing payment trends and devise a plan to differentiate the institution with unique, customer-driven solutions. And if the institution discovers it possesses neither the time nor the expertise to accomplish these tasks alone, there are many qualified change agents available to assist with the process. Whether your institution chooses to meet these objectives and formulate strategies in-house or seek outside counsel, you must take action of some kind. You cannot afford to do nothing.

*Develop a step-by-step plan for transitioning your institution to full image exchange.*



## Phase 1: Preparing for Check 21 Today

So what must your institution do today to be prepared for Check 21 and the immediate changes it will inevitably bring to your payments process? There are a handful of minimum requirements that every community banker must meet. While these requirements affect risk, regulatory and operational issues, compliance with these requirements is neither cost prohibitive nor punitive in nature.

By October 28, 2004, your institution must be prepared to do the following:

- **Notify Your Customers.** If you currently return checks to your customers within their statements, you must provide an education notice that describes a substitute check and the customer's right to request expedited recredit if a loss is incurred due to the receipt of a substitute check. This notice must accompany the first customer communication following October 28, 2004. Alternatively, you may choose to mail an education notice to your entire customer base, even if you do not return cancelled checks, though the regulation only calls for case-by-case notice to these customers.
- **Expedite Recredit Claims.** From an operational standpoint, your staff must be prepared to handle the expedited recredit claims initiated by your customers. You have the potential to greatly reduce your risk of loss by minimizing the time delay between the 10-day recredit window between your institution and your customer, and a similar 10-day window between your institution and the reconverting bank. This requirement also includes knowing your rights as an institution to reject a request for expedited recredit when appropriate.
- **Qualify an IRD.** Your staff must be equipped to qualify an IRD return with a "5" in position 44 of the MICR line, as opposed to a "2" in position 44 for a conventional paper-based check.
- **Identify the Source.** Post Check21, an increasing number of IRDs in circulation will force your staff to be able to distinguish and IRD from an official check and understand the associated limitations. For example, if you are returning an item, you cannot return an IRD of an IRD, you must be able to identify the source.

*Compliance with the minimum Check 21 requirements is neither cost prohibitive nor punitive.*

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- **Train Your Staff.** There are new regulations associated with the passage of the Check 21 legislation. You are responsible for training and educating your staff on the new compliance regulations to ensure they fully understand the new requirements and are equipped to both adhere to the regulations and offer informed explanations to your customers. To avoid having employees offer their own interpretations of the regulation, provide your staff with a Q&A document that addresses the most anticipated customer questions.

Meeting the above requirements will make your institution Check 21 ready. However, simply being Check 21 "ready" will not ensure that you will reap the benefits available from of widespread adoption of image exchange. But once you have met the minimum requirements for Check 21, you can begin to formulate a detailed plan for capitalizing on the opportunities brought about by image exchange. By following the above basic guidelines for preparing your institution for Check 21, you can adapt to the changes quickly and with minimal consequence, and still take the time necessary to properly evaluate all the ramifications to your particular institution.

## **Phase 2: Considering Payment Trends & Cost Impact**

While image exchange is the primary focus of the Check 21 legislation, its existence is forcing institutions to consider other aspects of the digital payments revolution. Among these considerations are payment trends and the associated cost impact. What do the changes mean for your institution? As Federal Reserve Chairman Allan Greenspan stated, "The challenge is both to have a vision for the future and to be grounded in the realities of the marketplace." In other words, understand the trends and where your market is going, but offer the strategic solutions that continue to make sense for both you and your customers.

### **Changing Payment Trends**

Today's financial services industry offers more payment choices than ever. And the choices mean changes in customer behavior and transaction patterns. Understanding these trends is an important part of Phase 2 of preparing for the impact of Check 21.

*Understanding Check 21-related trends is an important part of preparing for the legislation's impact.*

### **Consumer Debit Cards**

One major trend in the payment arena is the increasing popularity of debit cards. A 2003 Dove Consulting study showed a decline in the use of cash, checks and credit cards for in-store purchases, but a significant increase in debit card use. While debit cards have become prominent in the consumer space, statistics show consumers primarily use the cards for a defined dollar range. Research suggests that consumers have a “debit card purchase ceiling” of around \$200. Consumers continue to use either traditional credit cards or checks for payment of any purchase exceeding this amount.

### **Commercial Check Usage**

National trends for commercial customers do not necessarily mirror that of consumers. Despite changing payment trends, commercial customers have fewer payment alternatives, so commercial check volumes naturally surpass consumer checks in volume. In fact, the vast majority of business-to-business payments – 86 percent – are still made by check. True “check” alternatives are not yet available to the commercial customer. If your community bank caters to commercial customers, your institution may see a slight increase, or at least a smaller decline in per-account check volumes as the impact of Check 21 gains momentum in the market.

### **Your Customers’ Preferences**

Regardless of the national data, it’s important to understand the unique payment trends of your institution. What payment instruments are your customers using? Are they using ATMs primarily from your institution or others? Or are they getting cash back at local merchants via their debit card? Do they continue to use checks regularly, or are debit card and ACH payments becoming increasingly prominent on their account statements? Successfully navigating the post-Check 21 world will require a clear understanding of how payment alternatives are affecting your institution’s customer base.

### **Measuring Institution Trends**

How can you measure the impact of payment trends on your institution? Select a control group of accounts, using a sample that best represents your customer base. Next, record the number of checks, deposits, debit card transactions, ATM withdrawals and deposits, ACH debits and credits, and so on for each account. Gathering this data every month and comparing the historical trends can give you valuable insight into your customers’ changing payment trends – insight that can help you formulate well-defined strategies for meeting future customer payment needs.

*Success in the post-Check 21 world will require a clear understanding of how payment alternatives affect your customer base.*

## Changing Revenue & Expenses

Checks remain a significant source of both revenue and expense for community banks — estimated to be as much as 40 percent of revenue and 30 percent of expense. So clearly a decline in volume or a change in account mix could significantly alter the balance of revenue to expense. And there is nothing in the Check 21 legislation that ensures a positive impact on this margin. Therefore, community banks need to fully analyze the impact that declining check use will have on their profitability and competitiveness.

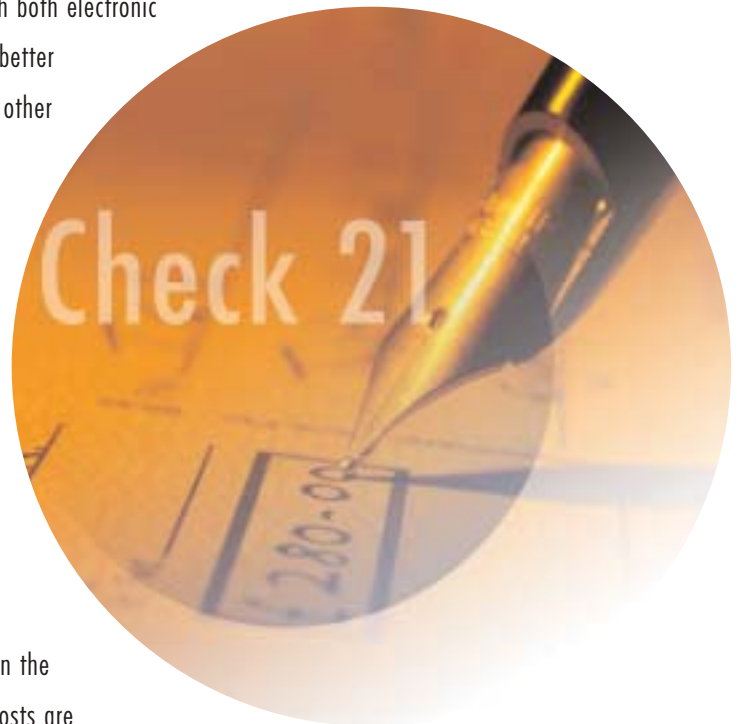
## Revenue Changes

On the revenue side, there are transaction and account-based revenues. Transaction-based revenues include float, NSF/uncollected fees, stop payment charges, account analysis fees and check-up charges. Changes to check volumes — particularly downward trends in check volume — will have a significant negative impact on transactional revenues. How can community banks combat this revenue decline? Check 21 “hype” may have you believe that a decline in check processing costs will offset the lost revenue, but in reality the use of a dual processing track — with both electronic and paper processing — will make process cost savings challenging at best. A better counter strategy to offset declining check revenue is to increase revenue from other payment alternatives, such as the addition fees for debit card, ACH or image-based services.

## Expense Outlook

Fixed expenses such as depreciation, labor costs and floor space are not likely to decline in the early stages of electronic presentment. And variable costs such as clearing fees, supplies and temporary or part-time labor are not significant enough to have a real impact for the community bank. Today there is a sizeable infrastructure in place to process an estimated 40 billion checks annually. And it will be some time before the industry sees either the absorption of the excess capacity or a decline in unit check processing costs. In the short-term, unit costs for check processing will continue to increase as those costs are absorbed by fewer and fewer checks.

*As checks continue to play a decreasing role in the payment system, banks will need to seek revenue elsewhere.*



### Revenue Alternatives

As checks continue to play a decreasing role in the payment system, financial institutions will need to seek revenue elsewhere. Those alternatives may take the form of new services related to check imaging. They might also come from alternative payment instruments or a combination of both. For example, banks may need to take a lead role in the development and sale of “person-to-person” or P2P ACH transactions. Although the adoption of electronic P2P ACH payments has lagged behind credit cards, debit cards and traditional ACH, online person-to-person payment systems like PayPal® have recently demonstrated strong growth, giving rise to the value of this service to customers and the potential revenue stream for banks.

### Third-Party Advice

The critical decisions to be made surrounding this subject are so vast, it will take great deal of time and dedication to achieve optimum benefit. Of course most community banks cannot spare the time nor commit to making major decisions in the midst of managing immediate, day-to-day operational issues. This shortage of time along with a lack of adequate knowledge to formulate a long-term strategy, points to the value of using third-party consultants or change agents to help craft an alternative payment strategy and the associated implementation plan.

### Phase 3: Devising Long-Term Strategies

The decisions surrounding image exchange and Check 21 are unquestionably complex. Developing a comprehensive Check 21 strategy that addresses all aspects of image exchange and the related impact will be a difficult task to accomplish in the next few months. Therefore, the only reasonable course of action for the community bank is to move forward in those areas mandated by the Act (Phase 1) and begin to organize project teams to focus on the large, long-term issues.

### Answering Bigger Questions

Long-term effects of Check 21 bring issues like product offerings and delivery systems to light. What is the right payments product and service mix for your institution in the future? Will check processing remain a core competency or will the decline warrant a move to outsourced items processing? Is this the ideal time to transition from a legacy, batch core system to an online, real-time system? These issues should be addressed as a critical part of the long-term planning phase.

*A solid long-term strategy will establish a plan for preserving the DDA account relationship.*

### **Non-Traditional Competition**

Another area to consider when devising a long-term strategy is competition from non-traditional sources. Companies like 7-Eleven® are actively deploying browser-based financial kiosks that cash checks, dispense coins and even let users order flowers. Costco® is now offering a full suite of low-cost small business services to attract your customer. With such formidable new competition in the midst of the changing face of payment services community banks will be forced to reflect on the very purpose for which they were founded.

### **A Community Bank's Purpose**

The reality is the checking account or demand deposit (DDA) account is the cornerstone upon which the community bank is built. Every form of payment settlement – from Internet transactions to newly invented biometric payment systems – is dependent upon a DDA account. A solid long-term strategy will recognize the fundamental purpose of a DDA account and establish a plan for maintaining its viability in the market of the future through a clear understanding of customers' changing needs and an associated course of action to preserve that DDA account relationship.

### **The Bottom Line**

Action is necessary to thrive and even survive in a post-Check 21 banking industry. All community banks are encouraged to devise their own unique, realistic, multi-stage plans that will enable them to first meet minimum legislative requirements and later realize the full benefits of image exchange – working at a pace that makes sense for your particular institution. And remember, Check 21 and image exchange will impact more than your items processing back-office. Institutions should consider other related affects of the Check 21 legislation and include action plans for addressing those issues in their intermediate and long-term strategies. Leveraging the advice of a third-party consultant can help community banks accomplish these goals and remain successful in the post-Check 21 banking industry.

***Action is necessary to thrive and even survive in a post-Check 21 banking industry.***

### **For more information:**

To learn more about Aurum Technology and the open, integrated and comprehensive solutions we can deliver as you prepare for Check 21, call us at 877.IT.AURUM (877-482-8786) or send an email to [information@aurumtechnology.com](mailto:information@aurumtechnology.com). We look forward to being of service to you, your institution and ultimately your members.

### **About the Author:**

Joe Fouse has been an active member and recognized thought leader in the financial services industry for more than 25 years. Joe began his career as a Bank Examiner for the Office of the Comptroller of the Currency and has since worked in and managed virtually every area of commercial and mortgage banking. A noted speaker and author on the topic of Check Imaging and Fraud and Risk Mitigation, he now serves as Aurum Technology's senior business advisor for check imaging solutions.



## Aurum At A Glance

- ▶ More than 30 years of profitable growth through superior customer relationships
- ▶ Focuses entirely on community-based and mid-tier institutions – from de novos to \$25 billion in assets
- ▶ Employs 1,400 professionals at 36 locations, including 25 “Check 21-ready” image item processing centers
- ▶ Serves the retail and commercial needs of 1,100+ customers throughout North America
- ▶ Delivers integrated, open and scalable solutions comprising:
  - Core Solutions
  - eBanking
  - Check Imaging
  - Business Intelligence
  - Strategic Services
- ▶ Leverages best-of-breed solutions offered by leading industry partners
- ▶ Processes 8 million accounts and more than 1 billion items annually



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