



## **Managing Payment Risks with ACH Truncation by Richard J. Poje**

With the bloom at least temporarily off the Internet rose, check truncation may be our last great hope for improving the efficiency of payment operations and managing common payment risks.

There are three problems with truncation, however. One is that we use the word to describe at least six distinctly different processes, each with its own rules and purposes. This has caused confusion about what truncation can and cannot achieve. The second is apprehension in the marketplace that banks and other payment system operators will use truncation to bolster profits at the expense of consumers and businesses, reducing or eliminating legal protections associated with check writing as they do so. The third, unfortunately, is that market apprehension may be well founded. Banks make a lot of money processing checks. Their check fraud losses are miniscule compared to those of their customers, and banks sometimes have a way of looking at the world through the wrong end of the telescope, focusing on short-term internal cost reductions instead of long-term systemic improvements that produce returns only with a lot of capital and patience.

This paper will examine the processes most frequently described as "truncation" and attempt to build a case for rapid, enthusiastic implementation of those that will produce the greatest overall economic benefits, short and long term. In our opinion, those are processes based on the fusion of traditional check processing and ACH technologies. The paper will also examine the roots of market apprehension about truncation and offer some suggestions for addressing it in productive ways.

Better risk management and more secure payment making, not lower operating costs, should be truncation's primary drivers. Experts estimate U.S. check fraud costs \$15 Billion a year<sup>1</sup>, about \$750 Million borne by banks and the remainder by receivers of uncollectable check payments. *Fraud is the most significant cost element in U.S. payment processing today, and bad timing is the biggest facilitator of fraud.* Notwithstanding improvements in check clearing since 1970, depositors are often unaware of pending returns for a week or more, by which time recovery may be impossible. Merging traditional check processing with ACH can significantly reduce time lags between deposit and return notification, improving collection opportunities. This is not idle speculation or wishful thinking. Payment system operators like Telecheck, eFunds and Deluxe Check have conclusively demonstrated the link between quick action and improved collections, as have high-volume check depositors like WalMart and K-Mart.

### **Check Clearing Primer**

Americans write 50 Billion checks a year. Check receivers deposit them in banks for clearing and settlement, and there is usually a time lag, called availability lag, before funds may be withdrawn (Figure 1). As a rule, the choice of clearing paths rests with the bank of deposit; that choice is about balancing the value of availability lags against the cost of obtaining value.

At the risk of oversimplifying, assume you can invest money at 5% a year. Investing \$1 Million generates \$50,000 a year or, roughly, \$140 a day. If you are fortunate enough to

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1) Estimates of check fraud are just that, estimates, and they range between \$10 Billion and over \$50 Billion a year. The Federal Reserve estimates check fraud at just below two basis points on the total value of all checks, or \$14 – 15 Billion a year. (The Fed estimates credit card fraud at 18 – 20 basis points on the total value of card transactions). Almost all estimates agree on one point, however, that banks bear about 5% of total check fraud losses; consumers and, primarily, businesses bear the remaining 95%.



receive a million dollar check you may be willing to pay a lot of money for accelerated clearing but would likely make

commercial accounts seldom exceed three business days because depositories grant *provisional credit* to business customers, subject to final clearance and settlement. If a deposit fails to clear successfully, transactions are reversed and physical checks are returned to depositors, usually with penalty charges assessed on both payor and payee.

The lag for consumer deposits is nominally governed by Regulation 4(a) of the Uniform Commercial Code, but is really at the depositing bank's discretion and can be as long as two calendar weeks. Depository banks argue

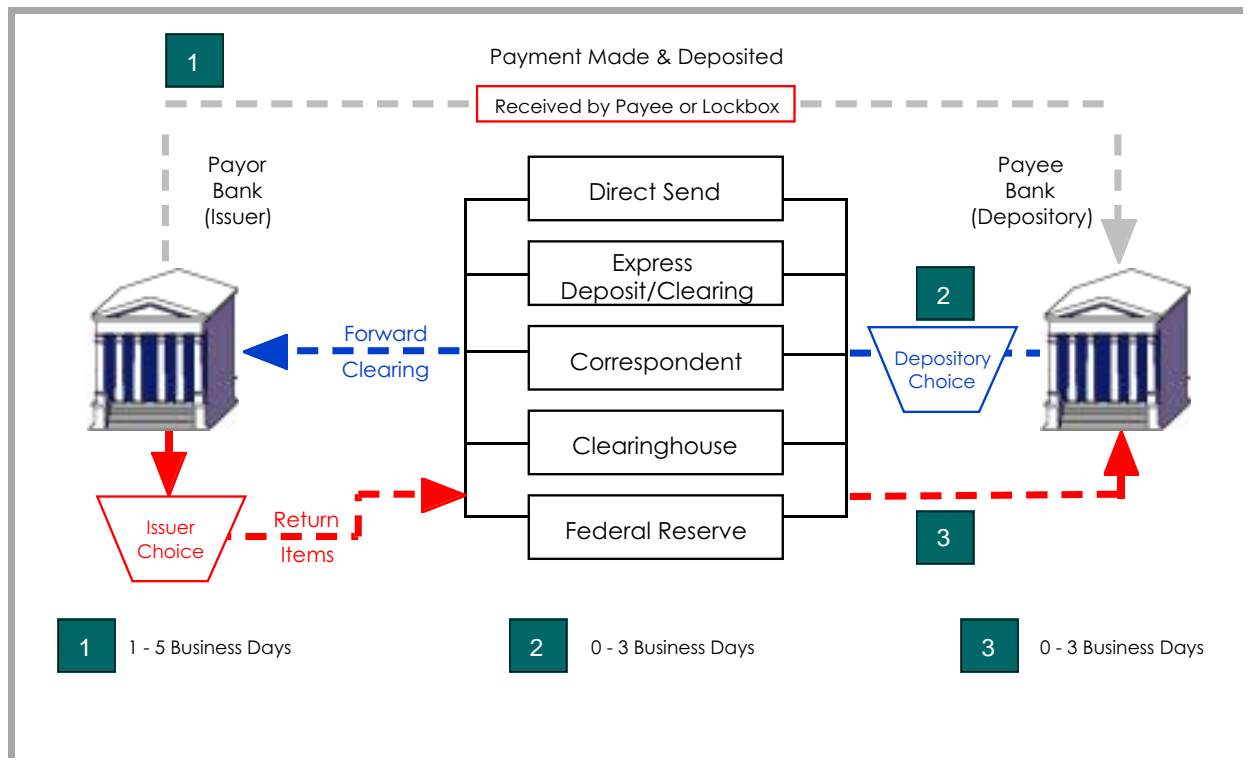


Figure 1

a different decision about clearing the \$10 check Aunt Harriett sent last Christmas. Given a choice, you would opt for the method that produced the highest total return, i.e. income earned less costs. Banks make the same decision billions of times each year.

Availability lags approximate the time it takes to physically present checks at their banks-of-origin. Lags on deposits to

consumer account "holds" are necessary because consumers are more mobile than businesses and the banking system provides no positive signal of successful clearing; only negative signals, i.e. returned checks. (This is not completely true because tools like electronic check presentment (ECP) are available to test the likelihood of a success clearing, but that's the story banks are telling, and they are sticking to it).



There are four traditional options for clearing checks: on-us processing, direct sends, clearinghouse exchanges and correspondent clearing. Figure 1 includes two additional options, express deposit/clearing and the Federal Reserve;

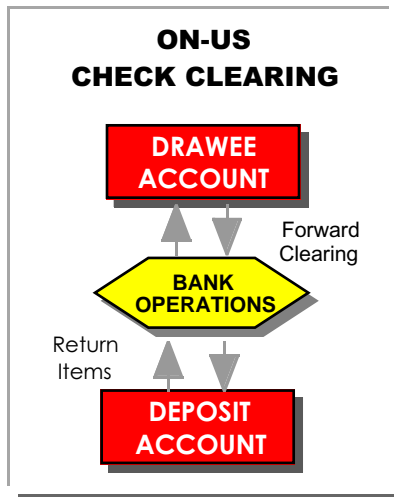


Figure 2

both are special cases of correspondent clearing, differentiated by speed and cost but essentially the same process. Truncation creates additional options discussed in subsequent sections. *On-us* processing happens when checks are drawn and deposited at the same bank (Figure 2). Banks outsource on-us items early in the clearing process, applying debits and credits on their own books. There is typically no availability lag associated with on-us transfers, and returns are identified almost immediately. In addition, depositing bank only infrequently charge for processing on-us checks (for commercial customers, at least). Industry consolidation has added complexity to on-us processing, some transfers may not be immediate within multibank holding companies or even within single banks operating multiple computer systems. The description is adequate for the purposes of this paper, however. About 20% of all checks are cleared on-us, and volume has grown significantly with bank consolidation.

*Direct sends* happen when depositing banks package receipts from individual drawees and deliver them for clearing via courier (Figure 3), high transportation costs offset by reduced availability lags. Direct send programs are especially important to wholesale lockbox banks and other receivers of high value checks, though once a direct send has been established, depository banks typically include all the drawee's items, large and small. Presented for clearing at the drawee bank, direct send checks get on-us (i.e. no availability lag, no cost) treatment, so funds can be wired quickly back to the depository. Banks often combine direct sends with other clearing options like clearinghouse exchanges to optimize their time-cost mix. Notification of

returns is usually, but not necessarily, rapid. Less than 5% of checks clear via direct send, but they represent a significant component of total check value. Despite on-us treatment at drawee banks, depositors may still experience availability lags because in most cases checks are physically transported. There is also a phenomenon called "negative float" that happens when depositories receive funds faster than they tell their customers. "Negative float" means that banks get the use of customer funds for a time, and its value can be substantial. The industry's ambiguous reaction to truncation undoubtedly has something to do with fears about truncation's impact on "negative float."

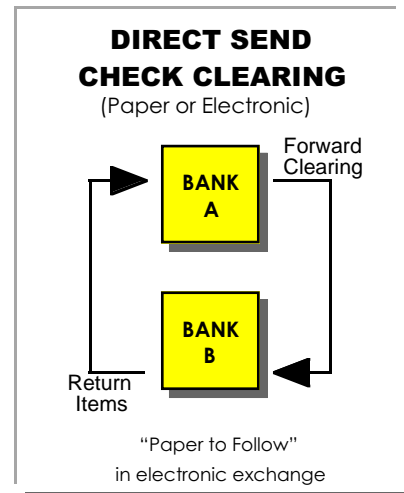


Figure 3

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*Clearinghouse exchanges* (Figure 4) happen when banks join forces to manage the time-cost mix. The tradition has ancient roots and generally involves bank groups in the same geographic markets. Modern exchanges are processed electronically, but traditional clearinghouses meet



once or twice daily to physically exchange deposit items and settle member accounts, including returns. Checks are exchanged on either the day of or the day following deposit with no availability lag. Member dues fund clearing-

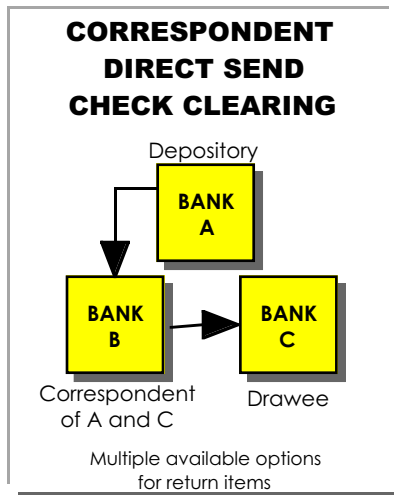


Figure 4

tion has been a major driver of clearinghouse growth.

*Correspondent banks*, (Figure 5) including the Federal Reserve, clear more than half of all checks. Small banks deposit with larger ones that incorporate items into direct sends, clearinghouse exchanges and “upstream” deposits to still larger banks, the process continuing until all checks reach their points of origin. Original depositories may or may not have relationships with the drawee banks to whom checks are ultimately presented, and correspondent clearings generally produce longer availability lags than other clearing processes. Return item notification can be slow because drawee banks bear the cost of returns with

no incentive to deliver them other than as cheaply as possible.

The Federal Reserve is most often correspondent-of-choice for minimizing transaction costs, though availability lags are longer than with other clearing paths and Fed procedures are considered less flexible than those of private sector correspondents. Still, 30% of all checks clear through the Fed, especially lower value items and items drawn on geographically remote banks. The Fed also handles more return items than other processors because its services are typically less costly than those of private sector banks.

house operations and no additional charges are assessed for clearing services. About 20% of all checks are processed through clearinghouses. The number of check clearinghouses has grown as has the volume of clearinghouse exchanges. Cost minimiza-

Designed for special purpose applications, express deposit/clearing services like First Tennessee Bank’s First Express operation process relatively few checks and are not significant to the overall clearing system. They are very significant, however, to the customers whose needs they meet.

The correspondent market is important because of its overall size and the variability of its processes. While depositories and drawees are intimately linked in direct send and clearinghouse relationships, they may have only indirect linkage in the correspondent market. Direct send and clearinghouse rules are clearly defined, relationships are usually reciprocal and most important, the parties are known to one another. That may not be the case when clearing through correspondents, and therein lies the market’s vulnerability and risk, phenomena some have called the return item conundrum. With all its participants, the correspondent market is also potentially fertile ground for “negative float.”

As a rule of thumb, the more a check travels between depository and drawee banks, the more it costs for clearing and settlement. Banks seldom charge consumers explicitly for check clearing, though they do so for business customers. Typically, there is no explicit charge for clearing on-us items, and charges are highest for checks drawn on banks outside the depository’s Federal Reserve District (of which there are twelve nationally), regardless of clearing method.



Absent agreements to the contrary, drawee banks call the shots with respect to return item handling, and drawees have little incentive to respond quickly, especially when there are costs for doing so. Returns are processed as cheaply as possible, meaning they either pass back through the chain of correspondents that delivered them initially or are parceled to the Fed. 80+% of return items are the mistakes of honest people; they become non-events in routine re-deposits, save for the high-margin fees that garnish the process.

**Return Item Conundrum**

Depository banks call the shots in "forward" clearing markets. They want to collect on checks deposited with

The conundrum is that banks make a lot of money when checks bounce and may have no incentive to change.

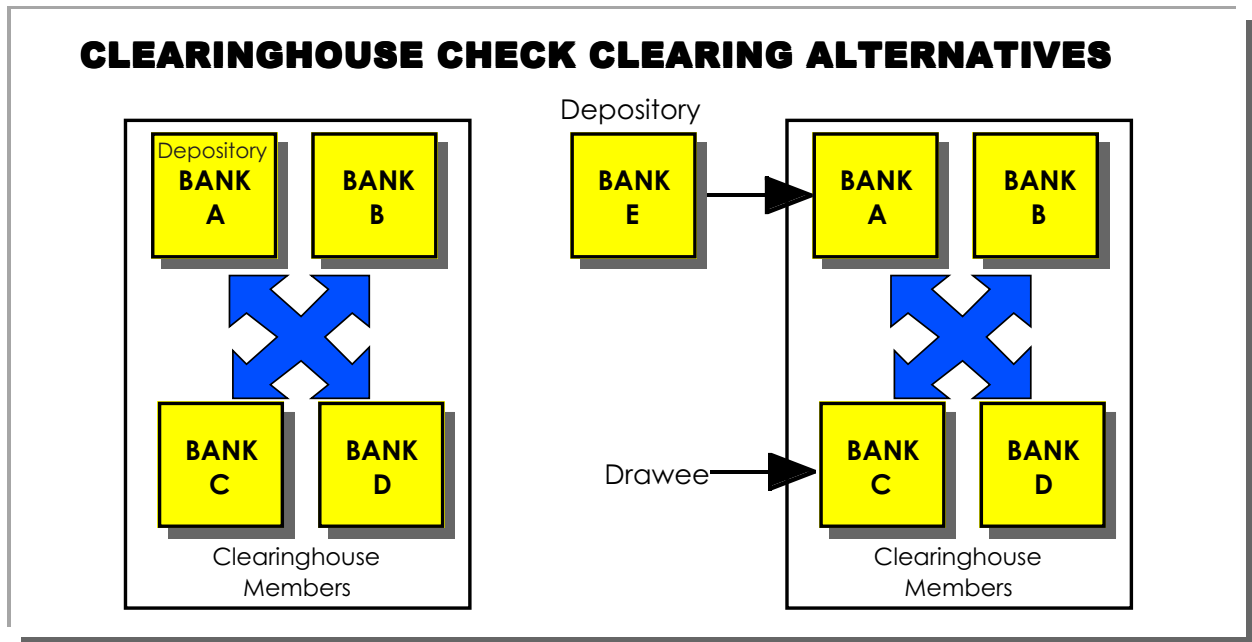


Figure 5

them in the best possible way; and when there are problems, NSF checks, checks written on closed or non-existent accounts or forgeries, they want quick notification, especially if the depository itself is at risk. Depositories and drawees have similar objectives and priorities in direct send and clearinghouse situations because relationships are based on rules and reciprocities. Priorities, especially, may be different when counterparties are faceless and far distant.

The national average NSF charge is \$23; about half a billion checks are returned each year, creating an \$11.5 Billion revenue opportunity for the industry (not counting fees charged to depositors of bad checks) and making \$600 Million in fraud losses an easy pill to swallow. The fact of the matter is bad checks are good business for banks, so profitable some actually make them happen by presorting daily clearings and debiting high dollar transactions before low dollar items. Pity the customer with \$1,000 in his bank



account and \$1,100 in his check register who writes half a dozen \$10 checks before making his \$1,000 mortgage payment. If all seven transactions reach his bank on the same day, the mortgage gets paid and the \$10 checks get bounced, each generating an overdraft charge.

If truncation reduces real losses associated with check clearing, fees and return-related revenues should decline. Were banks just using fees to cover collection and fraud costs, we would expect to see them in the vanguard of almost any effort aimed at making the system work better, especially considering the financial impact of fraud on commercial customers. The industry's reluctance to act more aggressively is a disappointing example of how banks can view the world through the wrong end of the telescope when profits are at stake.

### Truncation Fundamentals

*Webster's Dictionary* defines the verb "truncate" as "to abbreviate or cut off." In the contemporary language of payment processing, it describes any abbreviation of the traditional five step "checking" process (Figure 6). Until recently, though, it was used to describe only the practice of not returning paper checks to account holders with monthly bank statements, and its use was largely limited to credit unions, money market mutual funds and other specialized checking services providers. Traditional truncation has never achieved "killer app" status in the payments business; the majority of check writers still prefer the return of canceled payments with their statements.

Concerns about check fraud, the emergence of image processing and related technologies, along with worries

about the payment system's ability to cope with escalating volumes of paper, spawned new interest in truncation after 1990. And for the first time, conversations focused on real innovation, not just halting the return of canceled checks. In a matter of years five new initiatives surfaced; three have been integrated into the payment system, one is pending congressional approval and one, potentially the most important, is being ignored by the people likely to benefit from its success.

**Represented Check Entry (RCK)**, operational since 1999, was the first new truncation initiative. Similar to electronic check presentment (ECP) and point-of-sale truncation in some ways, it differs in that checks are not truncated until returned by drawees to the original depository, probably reducing its effectiveness in fraud prevention but still providing substantial benefits.

Using RCK, depositories under certain circumstances may convert returned checks into electronic debits for re-submission and clearing. Only consumer checks may be processed through RCK, and they must be checks returned for insufficient funds (NSF). Checks must be less than 180 days old and written for less than \$2,500. Debits may be resubmitted only twice, and check writers must be notified in advance that depositories are using RCK. Fortunately, signs in merchant establishments and statements on bills suffice for this purpose. Because transactions originated as paper checks, the UCC and check laws govern RCK. Depositors may not use RCK to collect NSF fees without first obtaining authorization from check writers, however, and this limitation reduces its value for certain depositories.

Still, response to RCK has been positive from consumers, banks and many merchants. Consumers feel RCK is less embarrassing than other collection methods and triggers faster removal from "negative" databases. Bank costs are less with RCK than with paper resubmission, and some merchants have improved collections so much they have no problem eliminating NSF fees. In an early RCK test, K-Mart reported a 40% improvement in the dollar value of NSF collections on items more than 120 days old.



Payment Solutions to Grow...  
Not Just Survive

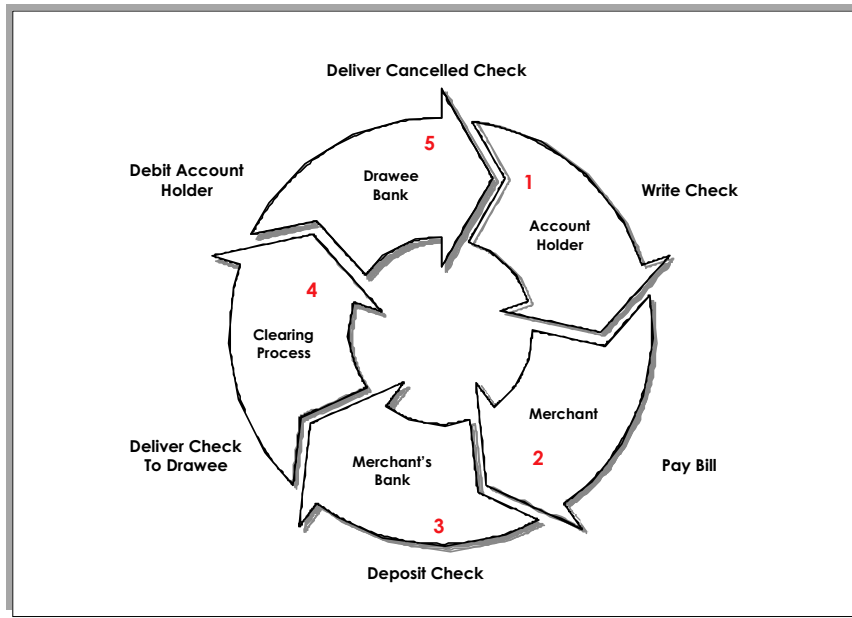


Figure 6

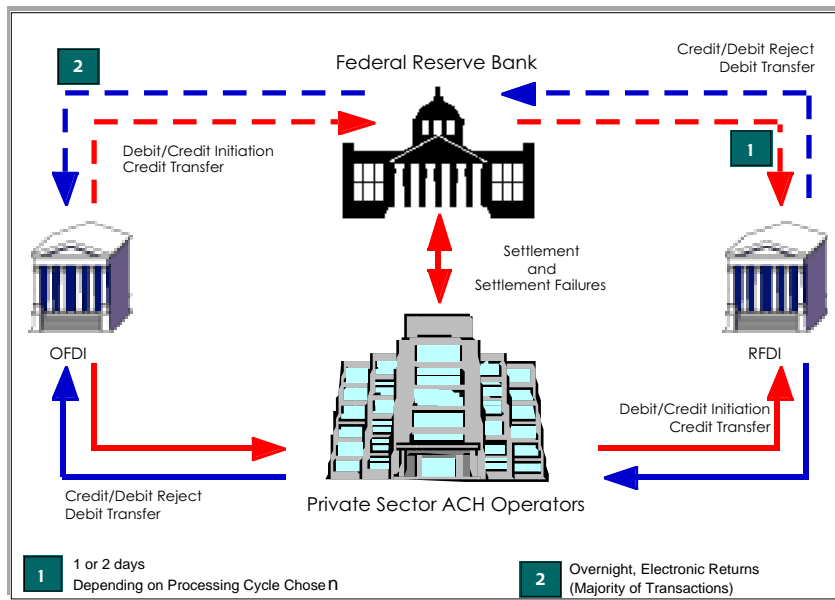


Figure 7



**Point-of-Sale Truncation** has been operational since 2000. There is a continuing debate about who should retain canceled checks, the writer or the merchant, and consumers seem to be winning.

Consumers present checks at point-of-sale. As with RCK, business checks are ineligible, but there is no limit on the check amount. Checks are scanned and data captured from MICR lines and other document areas, transaction amounts key-entered. Consumers provide written authorization for electronic processing, databases are checked to provide verification, if not guarantees, and transactions are entered for processing subject to Fed Regulation E and National Automated Clearinghouse Association (NACHA) rules. NSF returns may be resubmitted. Consumers have sixty days to challenge POS transactions they believe are not legitimate (fifteen days longer than for other ACH debits) but stop payment orders are virtually impossible because POS debits are entered for processing "same day" but current NACHA rules require three days' advance notice for stops.

User acceptance of POS truncation has been positive, with transaction volume more than doubling in 2001. NSF returns declined steadily in 2001, as did administrative returns (scanning errors, etc.). There is anecdotal though not systematic evidence POS truncation reduces total merchant costs, but as yet, little evidence of availability lag reductions.

**Lockbox Truncation, or the Accounts Receivable Check (ARC)**, is a new phenomenon, the result of changes in NACHA rules effective in March 2002. Under the new rules consumer payments mailed to a biller's lockboxes may be

used to originate ACH debits to the consumer's account. Paper checks and images are retained by the lockbox. Billers must notify consumers if they intend to use checks as source documents for ACH debits, but specific authorization is not required and because ARC transactions are governed by EFT law, consumers enjoy more legal rights and protections than would have applied had paper been used for clearing and settlement.

Lockbox truncation has gotten a lot of attention, and deservedly so because more checks are written to pay consumer bills than for any other purpose. Estimates of check use for consumer bill payment range between twelve and nineteen billion transactions a year. No less an expert than Allen Greenspan recommended lockbox truncation in his 2000 keynote address at the NACHA annual conference, and several high volume bill payment receivers have begun truncation initiatives, especially receivers of "time critical" payments like those for cell phone services and cable TV.

"The Accounts Receivable application allows a billing company to take advantage of the inherent efficiencies of electronic payment processing, while allowing consumers to continue to use checks if they choose," explained Elliott C. McEntee, president and chief executive officer of NACHA. "With billions of checks sent to accounts receivable locations every year, the use of e-checks can substantially reduce payment processing costs." Only time will tell, but early signals are very positive, especially in areas like returns and fraud reduction.

**The Check Truncation Act (CTA)** is another new phenomenon and, unfortunately, the source of much confusion. The CTA is not yet law; Congress is considering a bill prepared by the Federal Reserve, and if passed it may have an impact on payment operations within a year or two. Despite conceptual similarities, the CTA has nothing to do with automated clearinghouses. Rather, it is an extension of traditional clearing processes that acknowledge but do not specifically incorporate electronic check presentment (ECP).



these electronic exchange agreements involve transmission of payment data taken from check MICR lines and may also involve delivery or transmission of either the original checks themselves or electronic check images. The CTA will not alter electronic exchange processes but will facilitate using electronics by creating a new type of paper document, called a "substitute check," from an electronic check image that is the legal equivalent of the original check.

The bill in front of Congress has special provisions for processing consumer checks but does not specifically exclude truncating business checks. Also, it sets no limit on the dollar amount of truncation-eligible items.

A legally equivalent substitute check (1) contains an image that accurately represents all information on the front and back of the original check as of the time the original check

<b>INITIATIVE</b>	<b>DESCRIPTION</b>	<b>STATUS</b>	<b>LAW</b>
Traditional Check Truncation	Checks not returned to check writers. Drawee banks provide safekeeping	In use since late 1970's	Check Law
Re-presented Check Entry (RCK)	Electronic (ACH) return processing for consumer checks up to \$2,500. Processors provide safekeeping. Check writer must be notified	Operational since 1999 in 47 states	Check Law
Point of Sale Truncation	Consumer checks converted to ACH at POS. Checks may be returned to account holder who must authorize. No dollar limit.	Operational in all states	EFT Law
Lockbox Truncation	Consumer checks converted to ACH in lockboxes, up. LBX or depository provides safekeeping. Notification Required	Operational since March, 2002	EFT Law
Check Truncation Act	Interim step for speeding consumer check clearing, reducing transportation costs. Uses ECP and "substitute" checks	Congressional action pending	Check Law (w/ mods)
Corporate Check Truncation	If allowed, would permit truncation of business-to-business checks in lockboxes and other venues.	Preliminary discussions only; controversial	?

Figure 8

Under the CTA, banks could agree, as they can today, to electronically exchange check images or information rather than paper checks for forward clearing and returns. Today,

was truncated, (2) contains a MICR line processible on standard check-sorting equipment, (3) conforms to industry standards for substitute checks, and (4) bears a legend



indicating it is the legal equivalent of the original check. As a result, banks could take advantage of electronic check processing technologies by sending check images or information electronically to banks with which they have exchange agreements and by sending substitute checks to those with which exchanges do not exist.

The CTA would govern substitute checks but not checks in electronic form. Today, banks that present or return checks electronically do so under bilateral or multilateral agreements. These agreements would still be necessary for electronic processing under the CTA. Moreover, the CTA proposes a warranty structure to protect against the risk of increased losses associated with using substitute checks. Like current UCC transfer warranties, CTA warranties will “run with the check,” that is, follow the substitute check in any form, just as they would an original paper document.

The CTA may produce substantial benefits, depending on the extent to which banks take advantage of provisions that expand use of electronics in the forward clearing and return of checks. The CTA should result in faster processing and lower long-term costs. In addition, it should reduce dependence on air and ground transportation.

There are several ways banks can take advantage of the CTA to streamline check-processing operations. For example, when a depository needs to present or return checks to a distant drawee that cannot process electronically. Under the CTA, the depository can transmit electronically to an intermediary near the distant drawee, and the intermediary can print substitute checks for physical delivery. Thus, the depository experiences faster collection,

while the drawee continues processing paper because substitute checks are the legal equivalent of original items. Banks could also use substitute checks to improve internal operations. For example, a drawee could run its returned check file against its image system to create substitute returned checks. Doing so would eliminate the need to run all checks presented on the previous day through sorters to pull the small number that must be returned unpaid. Banks might also restructure branch network to reduce infrastructure costs. A bank’s branch and ATM networks would no longer need to be tied geographically to processing centers, because information and images could be transmitted electronically and substitute checks created. Banks could select electronic processing or substitute checks based on cost or convenience, and could transport original checks using less time-critical (and potentially less frequent) transportation options, reducing operating costs.

Branch and ATM network restructuring could also benefit customers. Banks could offer broader deposit options or extended deposit cutoff hours for certain checks, reducing availability lags. Banks could also provide more timely information to both depositors and drawers. For example, banks could provide customers with access to online images of deposits and payments before the delivery of paper statements or provide printed copies of checks deposited at ATMs on ATM receipts.

The Fed has made no projections about economic benefits of the CTA. Clearly, it is an interim, even a workaround, solution to encourage truncation and electrification. The central bank’s CTA promotional materials make arguments banks want to hear, that is, arguments about reducing costs without making capital investments, but they say little about end-user benefits or costs associated with producing substitute checks. Also, internal savings may be smaller than suggested, especially in multibank holding companies already using online image/retrieval and the ACH’s popular “on-us” functionality for internal funds consolidation.

Save for provisions in the CTA, there are few options for **truncating non-consumer checks**, though conversations



have at least begun. A recent Department of Treasury trial balloon about commercial check truncation created a stir among bankers and corporate treasury managers concerned that the payment system was unprepared for business check truncation, especially truncation involving ACH conversion. Bankers talked about the lack of integration between paper and electronic payment systems, while treasury managers fretted about the security of disbursement processes. Neither made constructive proposals nor volunteered to help define truncation approaches acceptable to the business community, preferring, instead, to act like the art gallery tire-kicker who announced, "I don't know much about art, but I'll know what I like when I see it." Granted, there are risks and challenges associated with business check truncation that are not present in consumer transactions, and they need attention. Unfortunately, there will likely be more heat than light in conversations about truncating non-consumer checks until attitudes change. Even more unfortunately, intransigence and lack of understanding may sabotage consumer-oriented initiatives with potentially enormous benefits for the same entities that reject non-consumer truncation out of hand.

### **Why Truncation, and Why ACH?**

There has been a lot of evolution in check processing since World War II but little revolution. The last truly revolutionary change for checks was adoption of the magnetic ink character recognition (MICR) standard in 1952. Equipment is faster today than in the 1950's and software for monitoring performance in check operations more sophisticated. We routinely use digital check images to improve processing

efficiency and provide quickly retrievable documents for problem resolution, and under certain circumstances banks even present checks to one another electronically, facilitating clearing and settlement. Were it not for the increased incidence of check fraud and its devastating economic cost, evolutionary changes would probably sustain check operations and check volume growth indefinitely.

The fact of the matter is three quarters of all checks today are processed the same way they were in 1955. They are physically sorted and re-sorted many times; they are physically encoded with MICR readable information required for clearing, they are physically transported, often via complex routes, through their clearing processes, and they are physically returned to depositors when clearing fails. Time lags associated with physical processing and transportation have increased opportunities for fraud and increased risks in accepting check payments. These are problems requiring revolutionary action, not piecemeal innovation, but we have avoided revolutionary change, arguing the current system still "works" after a fashion.

Reasons are well known and often discussed. Paper processing technology has evolved, making revolutionary change an option, not a requirement for anyone not dealing directly with fraud. In fact, many experts speculate our banking system has raw capacity to process 100 or 150 billion checks a year. Plastic, moreover, provides an attractive alternative to checks in some high-fraud situations like point-of-sale and accessing cash, if not for bill payment. Also, the technologies needed for revolutionary change, like high-speed communications, very-low-cost data storage and digital image capture, have been available for less than a decade, and regulations, like the UCC's pre-1990's requirement to use original documents for clearing and settlement, have made changes that reduce or eliminate physical processing/transportation almost impossible to implement.

Then there is our societal love affair with checks. Americans like using checks and have consistently rejected alternatives



like ACH (as a bill payment tool, at least), electronic data interchange (EDI) and electronic bill presentment/payment (EBPP) that eliminate checks completely. Consumers like checks because they are convenient, self-documenting and, when everything works properly, a cheap, safe way to pay bills. Consumers also like getting their canceled checks back at the end of the month. Banks like checks because they make a lot of money investing customer balances and charging fees, industry protests to the contrary notwithstanding. Businesses like checks for the same reasons as consumers, and their accounting systems, geared to using checks, would require expensive overhauling to accommodate checkless operations. Indeed, businesses have had EDI, a sophisticated tool that eliminates all paper, not just checks, from bill payment processes (including invoices, purchase orders and other documents), available for more than twenty years, though EDI still accounts for less than .5% of total non-cash payments.

Truncation can work because it will not force Americans to abandon check writing or require expensive overhauls to business computer systems. Neither will it reduce investable bank balances, though, properly implemented, balances will move more quickly from bank to bank. It will not eliminate (though it will likely reduce) overdrafts, so banks will still have fee income with lower processing costs offsetting revenue reductions occasioned by faster clearing. Most important, though, truncation will work because it provides payment system operators – banks and businesses that receive check payments – a powerful tool in the form of better, faster information on which they can act to improve collections and recoveries, and in conjunction with other tools, nip check fraud in its bud. This

is the central, if implicit, theme behind most of the truncation concepts described earlier.

Truncation will require some changes; original documents will not be returned, regardless of the processing option that ultimately gets implemented. Rules and regulations are certain to change. Check users will need education to understand and accept whatever new environment emerges. Check users and payment system operators will need to work cooperatively to assure legal rights are protected and the benefits of truncation equitably shared.

Why is the combination of ACH technology and traditional check processing the better vehicle for successful implementation of truncation? There are several reasons.

Many truncation approaches are available, at least conceptually. For instance, debit card networks *could* be used for point-of-sale truncation. The Check Truncation Act, if it becomes law, will use “substitute checks.” Where banks agree to do so, substitute checks can be electronic exchanges, original documents either held at the bank-of-first-deposit or shipped elsewhere but not required for clearing and settlement. Where exchange agreements are not in place, electronic images can be transmitted to drawees or intermediaries and returned to paper as described earlier. The CTA will require drawees treat the substitutes as though they were original checks, meaning they would clear as on-us items if delivered directly to the drawee or as clearinghouse/correspondent items if delivered through an intermediary.

The CTA process *should* reduce transportation and, presumably, availability lags but makes no demands on banks to share benefits with customers. It will require virtually no changes for system operators and, in theory, will eventually encourage greater use of electronic exchanges. Whether or not the CTA reduces *overall* check processing costs remains to be seen. There will certainly be a cost associated with printing substitute checks. The Fed has not projected savings, arguing CTA-related costs and cost reductions will be situational. ACH costs and pricing, on the other hand, are well defined, including its availability lags.



The CTA is a noble effort on the Fed's part to improve safety and soundness in the check processing system, but it is deficient compared to ACH truncation. For instance, it is not yet law and, if passed, implementation will be deferred a year or more. ACH truncation protocols are already in-place and operational for the majority of checks currently written in the United States and for checks with the highest fraud risk.

Also, while the Fed promotes the CTA as a "no change" approach, bankers and their lobbyists may not be listening very hard. In nine single-spaced pages of commentary, for instance, the Independent Community Bankers Association called repeatedly for changes in the bill to protect banks and limit the rights of check writers and depositors. The association also recommended deferring CTA implementation for "a minimum of two years from the effective date..." A Washington lobbyist, cursing the CTA with faint praise, observed the "Fed has articulated realistic and sound benefits, but no one knows the value of those benefits." He recommended further study of the bill's economic impact and deferral of passage. The Electronic Clearing House Organization (ECCHO) which creates rules for electronic check exchanges was simply "less than thrilled" about the CTA. Without putting too fine a point on it, the ACH has been operational for a quarter century; its rules, benefits and even its shortcomings are well-known, and the ACH system securely processes nearly eight billion transactions a year. Why reinvent the wheel?

Most important, the ACH is the only payment mechanism with functionality to effect revolutionary change. Using its time-tested overnight processing "window," transactions

can be entered at point-of-sale, through lockboxes or from return item shops well into the afternoon, then transmitted to drawees and processed overnight, in sufficient time to deliver return notifications the following day. There is probably even room for a new, "same day" ACH processing cycle. And since ACH would remove pressure on payment processing shops for early deposit of checks, there would be time to run remittances against "positive" and "negative" databases for early warnings about potentially serious collection problems. About the only thing the ACH cannot do effectively is deliver original checks to their writers and this can be addressed by printing detailed transaction information on monthly bank statements in lieu of delivering checks or with addenda to ACH transaction records containing digital images of original documents. Both would require consumer education, but neither constitutes rocket science; detailed transaction descriptions on monthly statements are already a reality. The CTA cannot produce equivalent results without replacing paper with electronic checks, and the Fed has already registered opposition to so revolutionary a change.

### **Making it Work**

Truncation can improve payment system efficiency and reduce risk if (1) the process, its benefits and limitations are completely understood by system operators and users; (2) current legal protections for operators and users are, at a minimum, maintained or, preferably, enhanced; (3) dealing with truncation is no less convenient than using current payment mechanisms; (4) there is vocal support for truncation in the communities most likely to benefit from its implementation, and, (5) benefits are equitably distributed between operators and users.

The "push" for truncation must come from the communities most likely to benefit from its broad-based implementation: the Federal Reserve which is charged with making the payment system safe and sound, the business community which bears most of the check fraud burden and consumers who see the cost of fraud reflected in higher prices, penalty fees and inequitable practices when dealing with the



payment system. Banks may be motivated to make changes that reduce their costs or improve efficiency ratios, but they have no incentive to make systemic improvements, and no one should expect banks to promote changes that will cost them money. Consequently, we need to look elsewhere for leadership to drive the change process and, probably, develop creative recommendations for maintaining bank earnings as changes occur.

To its credit, the Federal Reserve has pushed aggressively for improvements in recent years, starting with the Rivlin Commission study of retail payments in 1996-97. Its sponsorship of the CTA makes a dramatic statement about the need for revolutionary change and reflects a new willingness on the central bank's part to play a leadership role in payment system innovation. The CTA itself leaves something to be desired, but it is a step in the right direction, especially in conjunction with the Fed's 2001 study of check usage, its internal check modernization program and its recently announced national check archive. Corporate treasury and consumer advocates should be in direct dialogue with the Fed, sharing their ideas and concerns, offering proactive suggestions and fewer criticisms. As an industry regulator and payment system operator, it is only natural the Fed listen to its confreres and constituents, the banks. The CTA is all about making truncation palatable to "the industry," and industry feedback has mostly been about its own needs, not those of its customers. No surprise!

Businesses and their advocacy groups need to get off the proverbial, and too often parochial, dime on several fronts, starting with educating their members and providing them with better information about truncation's pros and cons.

There should be more testing and feedback about collection/recovery benefits of RCK and creative thinking about reducing RCK-related administrative returns. There should be tools to help businesses perform breakeven analyses that determine how much collection/recovery improvement will be required to offset NSF charges RCK may not collect. More attention must be paid to NACHA initiatives like its effort to include NSF fees with RCK processing, and there should be initiatives around electronifying collection processes when return items are not at issue, like simplifying use of the ACH in collecting overdue payments including late charges. There are already healthy dialogues underway in the operations community, but organizations like the Association for Financial Professionals, the National Association of Corporate Treasurers and representatives from disciplines like credit and collections need to join the conversation as well. And everyone needs to look beyond short-term cost cutting as truncation's only justification.

Businesses and their advocacy groups should also be in dialog with bank and consumer lobbyists to get their issues on the table, like the market's apprehension about banks using truncation to improve profits at the expense of customers. How will availability lags be defined and measured in a world of truncated checks, and how will availability improvements and lower costs be shared between banks and customers? There also needs to be constructive dialog about business check truncation and expedited processing of high dollar consumer items. Advocates like the Consumers' Union need to fret less about their constituents' right to get original checks back at month-end and more about two-week holds on "out-of-state" checks, high NSF charges, bank practices aimed at increasing check returns, and the positive implications of reduced check fraud.

The groups may even explore fundamental changes in the checking "products" offered by banks and third parties, perhaps with banks absorbing greater risk in exchange for higher fees and profits. Such changes could incent the industry to pay truncation more than lip service and could



add real value to the "product." A "same day" processing cycle for ACH could likewise add enormous value, especially for electronic "late payment" processing or high dollar retail remittances that are typically processed overnight and ready for deposit early in the morning.

The bottom line is simple. There is compelling evidence that quick action improves collections/recoveries and reduces fraud losses. Truncation accelerates check clearing and return item notification, facilitating quick action. ACH conversion uses proven technologies, procedures and rules to facilitate truncation and is available now, not a year or two in the future. Doesn't it just make sense?

#### **About the Author**

*Dick Poje formed his own firm, R. J. Poje and Company in 2000 to provide consulting services in the areas of strategy development and technology integration. Previously, he had been a Partner and Director of Treasury Strategies, Inc. since 1985. Dick has been active as an entrepreneur and management consultant in the treasury and payment communities for more than 30 years.*

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