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# CHECK 21 ... No Decision Does **Not** Equate to No Impact

by Joe Fouse



Today's credit union is being inundated with a near endless stream of messages on Check 21. But while intended to spur action, the constant drumbeat of "Act now before it's too late" is actually having the opposite effect on many of its recipients. For under the weight of continual advice, nonstop information and even the occasional instance of disinformation, the initial momentum surrounding the Check 21 movement appears to have slowed considerably, catching many credit unions in a precarious "wait and see" trap.



The purpose of this paper is to express that—when it comes to Check 21—"wait and see" is simply not an option. But just as important, this paper is also intended to set the record straight on Check 21—that the coming October 28th date does not necessarily require wholesale and costly changes to your payment services infrastructure, at least not to the extent that current hype would suggest. So, let's start by gaining an understanding of why the increasingly pervasive "wait and see" attitude just doesn't make good business sense for your institution or your members.

In discussions with our clients today, events are already taking place that preclude a decision to "do nothing." For example, did you know that image replacement documents (IRDs) are already in circulation today? Imagine the surprise in the bookkeeping department when, in the process of reconciling the credit union's official checks, an IRD is discovered — a

full six months before they are legalized! A decision to do nothing can't stop this from occurring.

Consider another example. After October 28th, a charge-back of an IRD occurs. Your credit union sends that negotiable IRD back to your member, who promptly appears at one of your teller windows just before closing time on a busy Friday afternoon to redeposit this item. Will your teller be prepared to handle this transaction? Will he recognize the IRD as a genuine negotiable item? Will he be trained to detect counterfeit IRDs? A decision to do nothing can't stop this from occurring.

Or, how many credit unions are prepared to answer questions from their deposit members whose checks made payable to American Express are returned—not as a check—but as an ACH item? Are you prepared to tell your members why the

requested stop payment on their check was ignored by your system and paid anyway? A wait-and-see attitude that equates to no decision is not an option.

Events like these are inevitable, but certainly not cataclysmic. Compliance with the Check 21 requirements—as clearly spelled out in the legislation—will not only help your institution avoid potential regulatory and/or operational issues, but will position your institution to take advantage of the opportunities Check 21 represents. The key is to be in a position to take advantage of these opportunities according to your timetable and in the most appropriate ways to benefit your institution and, ultimately, your members.

Because, just as it is not recommended to sit by and do nothing, it is equally not recommended to throw your institution on the bleeding edge of image exchange. As Fed Chairman Allan Greenspan is quoted as

saying "The challenge is both to have a vision for the future and to be grounded in the realities of the marketplace." Your reality may be you are not ready for image exchange today, and that's okay. A controlled, well thought-out and realistic approach to moving your institution to Check 21 and image exchange—such as the three step approach described below—may instead offer the opportunity to benefit from Check 21 while minimizing the risks of either doing nothing or doing something hastily.

### **Taking One Step at a Time**

Having listened to the concerns expressed by so many credit unions and witnessed first-hand the near panic from coast to coast, it has become abundantly clear that a practical and credible approach needs to be brought to the table—even if such an approach is contrary to the current punitive message that expounds the virtues of "acting now or forever wearing the scarlet letter 'e' emblazoned on your forehead" (designating a failure as an operations officer in the electronic age). This advised simplistic approach consists of a three-part plan that includes clear and concise immediate, near-term, and long-term objectives. As Bill Murray's character in the movie "What About Bob?" frequently repeated to himself, "Baby steps."

The immediate goal focuses on being compliant with all the requirements of Section D of Federal Reserve Regulation CC, and operationally prepared to handle the processing and expedited re-credit of IRD's. The near-term focus is on assessing the impact that declining check volume and changing member payment habits will have upon your institution's profitability and competitiveness. The final step will prepare you to maximize the opportunities presented by Check 21—as well as the many other changes occurring in the payments area—as part of a longer-term, more complex strategic plan.

The following approach will allow you the flexibility of determining your own timetable for achieving these three objectives, as well as the opportunity to differentiate your institution via its own unique strategy and solutions approach. Alternatively, your institution may conclude at any point, that it does not possess the time or expertise to successfully carry out this process. There are an abundance of qualified change agents readily available that can assist you in formulating your strategies to meet these objectives.

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## Step One: October 28th Compliance

At a minimum, by October 28, 2004 (or in the case of the required compliance notification, at the time of the first member communication after October 28th), your institution must be able to do the following:

- if checks are being returned to your member within their statement, an education notice that describes a substitute check and their rights to request expedited recredit should an error arise must be provided. (NOTE: You may provide this notice in advance as opposed to the case-by-case basis also allowed within the regulation for those members who do not receive their checks back. But why not take this opportunity to review your account agreements to make changes that may apply to future changes in areas such as ACH?)
- operationally handle the expedited recredit claims of your members. Minimizing the time delay between the 10 day recredit window between your institution and your member and the 10 day window between your institution and the reconverting bank or credit union has the potential of greatly reducing your risk of loss. This also includes knowing your rights as the institution to reject a request for expedited recredit
- qualify an IRD return with a "5" in position 44 of the MICR line
- train and educate your staff to adhere to compliance regulations as well as to be informed when dealing with your members
- identify the source and form received of an item that you will be returning since you can't return an IRD of an IRD.

Your ability to meet these 5 minimum requirements, in essence, makes you Check 21 **ready**. Will being Check 21 "ready" ensure that you reap all the benefits attributable to image exchange? Absolutely and emphatically - NO. But if your goal is to decelerate the process—to buy time to properly evaluate all the ramifications to your particular institution—then focusing on Check 21 readiness will help you achieve that immediate crucial step. Once the "must do's" are complete, then attention can be focused on future impact and benefits.

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## Step Two: Market Readiness

The variety of payment mechanisms is expanding daily. What remains an unknown is the level of acceptance any of these payment instruments will receive from the consumer and business members.

To help you understand your environment, begin by analyzing historical trends within a control group of accounts (call them your "Future 500"). Such analysis will provide empirical evidence of what is transpiring within your own account base. You will need to map your member trends versus national data, because you are concerned with the payment habits of **your** members and prospects within **your** market, not those of a demographic that is far different from the group you are targeting. Record the number of checks, deposits, ATM withdrawals and deposits, ACH debits and credits, debit card transactions, etc. by account monthly for your representative sample. You will have clear evidence of your member's changing payment preferences and can use this valuable information when formulating strategies to meet future member payment needs.

There is little doubt that the consumer has significantly more payment choices than ever. The 2003 Dove Consulting study showed a decline in the use of cash, check and credit card for in-store purchases with a significant increase in debit cards. It has been suggested that members have a "debit card purchase ceiling" which today is hovering around \$200 (will use debit card for purchases below that ceiling) but demonstrate a reluctance to exceed that amount. For the larger in-store purchases, credit cards and checks are still most prevalent.

It is not surprising that consumer check usage surpasses commercial check usage in terms of volume because commercial customers have fewer payment alternatives. However, commercial customers still rely heavily on checks. As an example, 86% of business-to-business payments are made by check. Because the commercial customer appears willing to pay for

services and is highly tied to check writing, credit unions that cater to commercial clients may see a slight increase, or at least, a smaller decline, in their per account check volume – until a ‘check’ alternative is readily available to the business member.

It is because of the variety of consumer payment alternatives and the continued use of checks by commercial customers that credit unions need to fully analyze the impact that declining check use will have upon their profitability and competitiveness. Checks remain a significant source of both revenue and expense to a credit union—estimated to be as much as 40% of revenue and 30% of expense. Either a decline in real numbers or a change in account mix could significantly alter the balance of revenue to expense. Nothing contained within the Check 21 legislation assures a positive effect on this margin.

On the revenue side, there are transitional and account based revenues. Examples of transactional based revenues are 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. Credit unions can only hope this decline in revenue is either countered by an increase in revenue from other payment alternatives such as debit card fees, or a decline in check processing costs—which is unlikely so long as there is a dual processing track—electronic and paper. Fixed expenses such as depreciation, labor costs and floor space are not likely to decline in the early stages of electronic presentment. Relatively speaking, variable costs such as clearing fees, supplies and temporary or part-time labor are not significant enough to make much difference to the credit union (as opposed to the top 25 banks in the U.S.). Unit costs to process checks will continue to increase as the costs to process will be absorbed by fewer and fewer checks. There is a significant infrastructure in place today to process the estimated 40 billion checks. It will be some time before the industry sees absorption of the excess capacity or a decline in unit check processing costs.

With checks clearly becoming less significant to the payment system, credit unions will have to seek revenue elsewhere. That may take the form of new services related to check imaging,

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or from alternative payment instruments or more likely a combination of both. Credit unions may need to take a lead role in the development and sale of P2P ACH transactions for example. The magnitude of the decisions credit unions will have to face surrounding this subject are so immense, it will take significant time and dedication to achieve optimum benefit. Neither of which are available while distracted with the resolution of the more immediate, day-to-day operational issues. Again, credit unions may need to turn to consultants to help them craft an alternative payment strategy and implementation plan.

### **Step Three: Long-term Value Creation**

It is in the area of strategy and value creation that the credit unions can truly differentiate themselves. Examples include the following:

- The long-term affects of Check 21, including but not limited to the decline of the check itself, may lead the credit union to conclude that check processing in any form is no longer a key competency. In this case, the outsourcing of item processing may become even more attractive.
- The strategic outlook faced by credit unions may expand beyond the apparent opportunities presented by Check 21 and may also include transitioning from legacy batch core systems to becoming online, real-time institutions.
- Your strategy may also need to address competition from previously non-competitors such as 7-Elevens who are actively deploying the Vcom browser based financial kiosks that cash checks, dispense coin, even allow the user to order flowers and pay for them. In essence, you may be forced to focus on the very purpose upon which the credit union was founded.

Finally, and possibly most importantly, is the fact that credit union leaders must acknowledge that the checking account is truly an “asset” of the credit union—in fact, its very foundation—and that the settlement of all these newly invented payment systems from biometrics



to the Internet, are dependent upon that same checking account. Only then will the credit union begin to fully realize that their account franchise—the checking account—is not only a fundamental building block of the institution but also a piece that is very much in jeopardy. Only through a disciplined strategy of continual product development, built upon a thorough understanding of your members, can a clear course of action be chartered to preserve the checking account relationship.

The decisions surrounding Image Exchange and Check 21 are significant and complex. It will be extremely difficult to develop a comprehensive Check 21 strategy to address all aspects of image exchange and Check 21 over the next few months. For this reason, the only logical course of action is to move forward in those areas mandated by the Act, and to organize project teams around the bigger issues of ultimate product offering and delivery systems.

## The Bottom Line

Check 21 will take effect October 28, 2004 and nothing is going to change that fact. However, your commitment to adopting a near-term plan to meet the minimum requirements, embracing the opportunities that image exchange presents and keeping an eye toward the future of payments in general will ensure that the current state of “action paralysis” is neither your fate nor the fate of your institution. Because while it may be easy to not make any decisions or take any action surrounding Check 21—or to declare that nothing ‘really’ needs to be done to be ready for Check 21—in the very real terms described in this paper, for both your institution and, most importantly, for your member, clearly “No decision does not equate to No impact.”



### For more information:

To learn more about Fidelity Integrated Financial Solutions (IFS) and the innovative and integrated solutions we can deliver as you prepare for Check 21, call us at **877.482.8786** or send an email to [info.ifs@fnf.com](mailto:info.ifs@fnf.com). We look forward to being of service to you, your institution, and ultimately your customers.

### 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 Fidelity IFS’ senior business advisor for check imaging solutions.



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