

Free of IRDs, Check 21 Challenges the ACH

Linda Punch

The Check 21 law created the substitute check, or image-replacement document. After six years and a brief boom, IRDs are on their way to the payments dustbin, just as Check 21's backers intended. What are the implications for ACH payments?

In a decade overshadowed by economic gloom and doom, substitute checks are emerging as one of the rare success stories.

Congress created substitute checks, formally known as image-replacement documents (IRDs), with the October 2003 passage of the Check Clearing for the 21st Century Act (Check 21). The law, which took effect in October 2004, was a way to keep the check-processing system working in the event of a serious disruption that would prevent paper checks from getting from depository to paying banks. It was sparked in part by the Sept. 11, 2001, terrorist attacks, when the government closed the airports, paralyzing the check-clearing process for days.

Lawmakers designed IRDs as a short-term bridge to full-scale image exchange for banks that weren't yet prepared to receive images. When properly prepared, an IRD is the legal equivalent of a check. The law requires banks or credit unions to accept IRDs. The IRD clearing process is like a fax—paper at the start and paper at the finish, but all electronic in between.

It's that paper at the end, though, that drove up costs for years for banks. But now IRDs are finally waning as

most banks clear electronic images, making Check 21 a highly efficient alternative for check processing.

Now there's a very real prospect that Check 21 could divert volumes from an older road: the automated clearing house with its electronic check-conversion products. The ACH is trying to adapt as the raw material for its paper-based consumer e-check codes continues its inexorable decline and new Check 21 options appear.

Massive Shift

In the six years since Check 21 took effect, IRDs appear to have served their purpose (chart, page 42). IRD volume, which peaked at 310 million items in October 2007, totaled 22.1 million in July 2010, a 93% drop, according to the latest statistics compiled by the Electronic Check Clearing House Organization (ECCHO). What's more, IRD volume has been in a free fall for the past year. July's volume represented an 84% drop from July 2009.

"They're going down rather dramatically across time," says David Walker, president and chief executive at ECCHO, the Dallas-based rules-setting organization for image exchange. "As of July, it was about

what it was in July 2005. That was right at the beginning of this whole process. The volumes were pretty tiny then and they're pretty tiny now."

Experts say that the dramatic drop in substitute checks is a sign that paper checks are poised to go totally electronic.

Other ECCHO data also illustrate the steady growth of image exchange. The tally of routing-and-transit numbers (R/Ts), a proxy for the number of financial institutions receiving check images, hit 23,036 in July, up 16% from 19,775 in July 2009.

Image-exchange items received totaled 1.2 billion in July, up 9% from 1.1 billion a year earlier. In the same period, the average number of images received per day grew 10% to 57.4 million from 52 million. The combined dollar volume of image and IRD items received dropped 6% to \$1.4 trillion in July from \$1.5 trillion a year earlier.

Recent data from the Federal Reserve also show checks' massive shift into the electronic age. Checks written and paid as checks (that is, not converted to electronic transactions through the ACH), dropped to 24.4 billion in 2009 from 30.5 billion in 2006, according to the 2010 Federal Reserve Payments Study released in December.

An estimated 96% of checks are now cleared electronically because of image exchange. That's up from an estimated 43% in only three years. And that trend is expected to continue. "We see no near-term indication

that ACH check conversion will begin growing again,” says Russ Waterhouse, executive vice president of product development and management at The Clearing House Payments Co. LLC, a bank-owned, New York City-based switch operator and check-settlement processor.

“We think the majority of eligible volumes have all been converted,” he says by e-mail. While the industry continues to look for additional sources of ACH check conversion, it “sees little promise, given the continuing silo in bank products between check and ACH, and the low level of interest by corporate check writers to convert,” Waterhouse said.

The ACH’s former largest e-check code is ARC (accounts-receivable conversion) for consumer bill payments mailed to lockboxes. But as consumers switch to electronic bill-pay, ARC is slipping while the ACH’s code for online banking bill payments, WEB, booms (chart, page 44).

Two e-check codes for consumer checks written at the point of purchase, POP and the newer BOC (back-office conversion), are still growing. POP, however, owes much of its success to Wal-Mart Stores Inc. adopting it, and both codes are likely to decline eventually as consumers continue to abandon check writing.

More Versatile

Meanwhile, several factors are playing into the industry’s dramatic swing to image exchange. As long as image exchange brought with it the IRD, it reintroduced paper check clearing

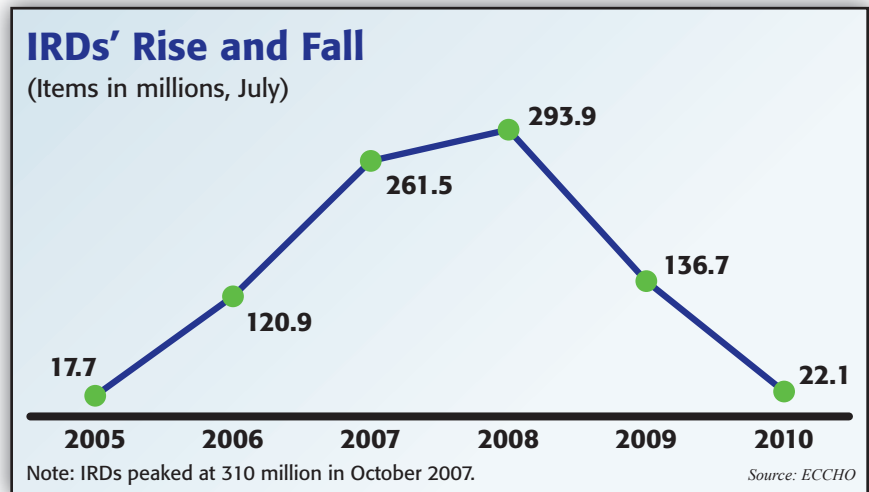
and ultimately drove up expenses. But with fewer and fewer substitute checks in the system, check clearing is largely on images and costs are dropping. That’s paring an historical cost advantage enjoyed by the ACH.

Many banks also offer faster clearing and funds availability with image exchange than on ACH conversions. And, unlike ACH conversion, Check

clearing and settlement time” over paper-based processing.

But with pricing for image-based deposits only modestly more expensive than ACH origination, the business case for check conversion is waning, Meara says.

Experts also warn not to underestimate the fact that image exchange enables any type of check to be cleared,



21 can handle all checks, not just consumer items.

The result is a check-payment system with essentially all the benefits of ACH check conversion with none of its drawbacks, says Bob Meara, analyst with Boston-based Celent LLC.

“Check conversion was viable back in the day, when it was conceived in large measure because there was no other electronic alternative,” he says. “In retrospect, the rules wrapped around check conversion were thought by most participants as being fairly onerous but worth it because of the dramatic cost savings and improvement in

while ACH check conversion is limited to consumer checks and a small number of business checks that are the same size as consumer checks.

“It works with all checks and drafts, not just consumer,” says Aaron McPherson, practice director of financial services for Financial Insights, a Boston-based research firm.

In addition, image exchange is more versatile, McPherson says. “It is near real time so it’s intraday as opposed to ACH conversion, which is more batch oriented,” he says.

Check imaging also offers banks a better way to double check any problems with a check. “If you need to research a problem or understand what the check was for, you can look at the actual document,” McPherson says.

‘Weird Stuff’

The ACH is also lagging in some segments that could lift its volumes. In the business-to-business area, the typical organization in 2010 still made

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57% of its payments by check, though down from 74% in 2007, according to the Association for Financial Professionals' recent e-Payments Survey.

"The business-to-business payment component has been the one that's been very slow to move away

to Remitco and Regulus, who process 80% of retail remittance processing, they haven't had a new ARC customer in a long, long time," says Meara. "So whoever is going to adopt, has adopted."

With paper-originated check conversions either plummeting or likely

rely on real-time settlement. "It would remove one of the big obstacles, one of the big problems ACH has right now," McPherson says.

But same-day settlement may not produce any large increase in volume. Banks don't want to support two separate tracks for electronic checks, especially when the number of check written is declining, McPherson says.

"From a bank's standpoint, they'd rather just have one flow, rather than currently, where they have to have these two separate processes and then reconcile them to make sure the check hasn't been submitted twice or that they don't have weird stuff going on with funds availability," he says.

Significant Savings

NACHA, the Herndon, Va.-based regulator for the ACH network, in August launched a pilot for a payment method that would let banks convert low-value consumer checks into electronic transactions and then clear them through the ACH. The method, called Deposited Check Truncation (DCT), is intended to cut processing costs for banks compared to the cost to clear check images.

NACHA, which declined to make an executive available for this story, estimates the savings could be substantial. A cash letter including 400 items, for example, would cost originating institutions 6.1 cents per item if it were processed through image exchange, assuming 20% of the items had to be cleared as substitute checks. The same batch of checks would cost three-tenths of a cent each if processed via the ACH.

Recent ACH E-Check Volumes

(Transactions in millions)

	3Q '10	3Q '09	Change	Originating Format
ARC	545.0	583.8	-6.6%	Paper
BOC	44.2	41.3	7.0%	Paper
POP	130.1	120.2	8.2%	Paper
TEL	88.7	86.3	2.8%	Electronic
WEB	618.8	562.6	10.0%	Electronic

Notes: ARC is for bill payments mailed to lockboxes; BOC and POP are for checks written at the point of sale; TEL is for telephone-based consumer payments and WEB is for online bill payments. On-us volumes excluded.

Source: NACHA

from paper checks," says Nancy Atkinson, senior analyst at Boston-based research firm Aite Group LLC.

Businesses still favor checks because "you can attach a list or letter to the checks that explains which invoices you're paying, any discounts you've taken, and any overpayments you make to make up for something discounted the month before and concluded you were wrong to do," she says.

As a result of Check 21 and automation, overall check processing also is more efficient and less costly than in the past, Atkinson adds.

"One of the challenges in moving people away from checks is that check processing is not that outrageously expensive," she says.

At the same time, many billers and third-party processors also had been slow to move into image exchange. That's due in large part to a handful of large-volume billers that adopted ACH check conversion early on, Meara says.

But there are signs image exchange is making headway, with several of the larger retail lockbox processors using Check 21, he says. "In talking

to, the ACH is looking for ways to boost volume. In August, the Federal Reserve began offering same-day clearing for certain ACH transactions—consumer check conversions and Internet-initiated or telephone transactions. The move speeds up settlement by one day and applies only to Fed-processed debits. The Fed is one of two switches for the national ACH system and handles 57% of all ACH traffic. (The Clearing House's Electronic Payments Network is the other switch.)

Same-day clearing would erase one advantage held by Check 21 and make the ACH more attractive for emerging channels like mobile payments that

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The expected cost advantage for the ACH grows larger if more of the imaged items must be cleared as substitute checks, according to NACHA's estimates. With 100 of the items processed as substitute checks, for example, the per-item cost climbs to 8.4 cents, fully 28 times the ACH cost.

Bridge Community Bank, one of the six banks participating in NACHA's test, expects deposited check truncation to produce significant savings, says Bob Steen, chairman.

"The Fed is lowering its Check 21 fees at the first of the year, and they've done a great job of bringing those costs down in Check 21," Steen says. "But even with the reduction in those costs for us, we're still going to have a per-item savings of about 90% with truncating an item to ACH."

But deposited check truncation may not be attractive to banks that already have invested in imaging equipment,

'My read is overall check-conversion volumes are going to remain flat for the next few years.'

Aite's Atkinson says. In talks with 11 banks, she found that several of them didn't even know about the pilot.

"Of the three-quarters that were aware of it, one or two of the individual banks had some interest in watching it and seeing if it was going to take off, and if it was, they might offer it," Atkinson says. "Everybody else was pretty dubious as to whether or not the depository check truncation was really going to be meaningful at all."

The Clearing House has announced no plans, but Waterhouse says two areas hold promise for generating new

volume: current check payments originated as "native payments"—those originated and settled in an entirely electronic fashion versus those that start with a paper check—such as direct deposit and direct debits, and health care-related payments.

Whether these new initiatives will create significant new volume for the ACH remains to be seen. But there's doubt that total ACH check conversions will regain any ground.

"My read is overall check-conversion volumes are going to remain flat for the next few years," Meara says. **DT**