



PHOENIX-HECHT
Measurements of Performance, Quality & Pricing

Fraud and Disbursement Practices

Positive Pay Pays

This Phoenix-Hecht report contains results on fraud and check imaging implications on disbursement practices from the latest *Corporate Treasury Management Monitor*.

Phoenix-Hecht conducts surveys of the treasury management practices, attitudes, behaviors and beliefs of corporate treasury managers. Throughout this report there will be references to the Middle Market defined as corporations with annual revenues from \$40 million to \$500 million and the Large Corporate who have revenues in excess of \$500 million.

The segments are weighted to reflect the full U.S. population of corporations in that market. The margin of error varies slightly from market to market, but is generally in the 3% - 3.5% range at the 95% probability level. Responses to rating type questions are solicited on a scale of 1 to 5, with 5 being high.

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Fraud

Various forms of corporate electronic payments are gaining some ground but by a substantial margin, checks are still the dominant payment mechanism used for corporate transactions. Industry sources quoted by the Federal Reserve System estimate that check fraud costs businesses in the U.S. between \$10 and \$14 billion a year. The volume of these losses is reported to be growing at a rate of 2.5% to 3% per year. These losses are unevenly absorbed by corporations and banking organizations.

Respondents to the latest survey indicated a high level of concern about fraudulent checks and less concerned about unauthorized ACH (Automated Clearing House) transactions or fraudulent wire transfers. Twenty-two percent of all respondents reported a major fraud issue in the last two years. As expected, the overwhelming majority (88%) of these issues involved fraudulent checks. Less than 1% involved wire transfers. Respondents rated their level of concern as a 4.37 in the Middle Market and 4.41 in the Large Corporate Market (on a scale where 5 represented "being most concerned").

To better understand what constitutes a major fraud issue, the survey asked what *per-item* dollar value represented a significant concern about fraud to the respondents. The response suggests that treasury managers have a low tolerance for fraud.

Results from Phoenix-Hecht's surveys show that middle market corporations have recently become much more aware of both the magnitude and rate of growth of check fraud and are finally catching up to the level of concern shown by larger corporations.

Payment Transactions

	% of Payments Made BY Corporation			% of Payments Made TO Corporation		
	2009	2010	Diff	2009	2010	Diff
Middle Market						
Check	72.9%	74.1%	1.2%	62.9%	63.5%	0.6%
ACH	14.3	13.1	(1.2)	16.0	15.6	(0.4)
Wire transfer	7.1	7.7	0.6	9.6	10.4	0.8
Credit/debit card	3.9	4.6	0.7	8.0	7.2	(0.8)
Cash	n/a	n/a	n/a	2.8	2.7	(0.1)
Other	1.8	0.5	(1.3)	0.7	0.6	(0.1)
Large Corporate						
Check	59.3%	61.8%	2.5%	50.3%	51.4%	1.1%
ACH	24.0	23.2	(0.8)	22.5	23.2	0.7
Wire transfer	11.8	10.7	(1.1)	14.7	12.2	(2.5)
Credit/debit card	4.1	3.9	(0.2)	9.0	8.5	(0.5)
Cash	n/a	n/a	n/a	3.4	4.1	0.7
Other	0.8	0.4	(0.4)	0.1	0.6	0.5

Fraud Concerns for 2010

Scale 1=Not important, 5=Very important

Concern about fraud from specific sources

	Middle Market	Large Corporate
Checks	4.37	4.41
ACH debits	4.03	4.12
Wire transfers	3.75	3.77
Internet fraud impacting retail payments	3.04	2.98

*Statistically significant.

Fraud Issues by Dollar Amount

Dollar Amount (per item)	Significant Concern
Under \$1,000	41.6%
\$1,000 - \$10,000	40.1%
\$10,000 - \$100,000	16.9%
\$100,000 - \$1,000,000	1.3%

Fraud Loss Deterrents

To protect against check fraud, corporations historically have adopted procedures such as monitoring check printing, check signing and blank check stock. The increasing sophistication of forgers, availability of technology and changes to the check clearing system allowed by recent legislation will require even more diligence. Many corporations are turning to their treasury management banks for services such as positive pay with payee verification, electronic reporting of checks paid information and very frequent account reconciliation services to detect and reduce their potential fraud exposure.

A positive pay service should be purchased for every check disbursement account. Use of the service reduces the corporation's liability for losses under UCC. Positive pay requires that when checks are printed, the check generation software creates a transaction file that is transmitted to the disbursing bank. The file contains information such as check number, date, amount, and (in some cases) payee name. When a check is presented to the bank for payment, the bank first refers to the company's positive pay file to see if the check is valid. Only if there is a match of the check details will the check be honored. The bank will present the following as suspects, for the company's decision:

- Checks not on the company's "issued" file
- Checks that do not match the issued dollar amount, serial number, and issue date
- Duplicate checks
- Checks over a specific number of days from the date of issue (ie. 180 days)

To prevent alterations to the payee field, banks are offering positive pay with payee verification.

Large corporations are more likely to use a positive pay product than smaller corporations. Corporations who do not use positive pay were asked *why* they're not using it. By a slim margin, they mention cost of the service as the most important reason. Slightly less important reasons for non-use were a perception that there was a low risk of check fraud and the complexity of converting to positive pay. As would be expected, larger corporations were less put off by the complexity of positive pay. When they chose not to use the service, it was equally likely to be due to the cost and the perceived lack of check fraud. The cost issue may be rather short sighted given the risk exposure. The Phoenix-Hecht Blue Book of Bank Prices™ reports that the actual prices paid for positive pay and controlled disbursement checks are very comparable.

Utilizing a positive pay service has become increasingly more important as the banking industry has moved to settle check payments by clearing check images rather than the original paper checks.

While the vast majority of middle market corporations still reconcile bank statements monthly, a significant minority now reconciles more frequently.

It is important to reconcile your account statement as soon as you receive it and report suspicious activity immediately. Image exchange has the

Account Reconciliation Frequency

Monthly Reconciliation	78.6%
Weekly Reconciliation	4.6%
Daily Reconciliation	16.2%

potential to increase certain types of check fraud because the conversion process may destroy the physical evidence of fraud. Many of the fraud prevention measures built into some check stocks will not survive the conversion to an electronic image. Frequent reconciliation is often your last line of defense to prevent fraud.

Electronic imaging makes it possible for a bank to replace paper paid checks with accurate electronic representations. Image delivery systems consist of image-based document processing products used to convert paper documents into digital images that can be stored, retrieved and delivered in a variety of manners. Images generated by the disbursement bank are delivered to customers via the Internet, CD-ROM or File Transmission. An increasing number of banks provide check images up to 7 years via the internet.

With regard to check fraud, imaging is used in conjunction with positive pay to allow on-line approval of "suspect" items that do not match the check issue file. Customers can view an image of both sides of a check and determine appropriate action. Imaging is also used to provide same-day retrieval of recently paid items for research. Both of these uses of imaging have become more important to corporations over the last few years.

Check Image Clearing Systems

Check imaging takes on a new meaning for banks and their customers with the implementation of the Check Clearing for the 21st Century Act (Check 21). The legislation provides the legal framework for depositing banks to truncate the physical check. Converting the paper check to a clearable image can occur at any point in the check deposit preparation, capture, check clearing or check return process.

Eliminating the physical transportation of the paper checks results in significant cost savings for depositing banks. The term "check truncation" more accurately indicates actions which "interrupt" the delivery of the original check to the paying bank for settlement. Check truncation differs from check "conversion" (so-called "e-check" ACH transaction codes such as POP, TEL, WEB, ARC, RCK) in that check law continues to be in force (Reg CC versus Reg E). The e-check conversion programs being conducted are all currently focused on checks written by consumers, per NACHA regulations.

The impact of check truncation and image exchange on corporate check disbursements is somewhat mixed, depending on an individual company's current use of checks and check images. The banking industry derives considerable revenue from providing controlled and other disbursement services and protects corporate customers. The warranties and indemnities that a depositing bank makes in converting a check to an image does not seem to deter conversion of high dollar checks even though the depositor is liable for consequential damages arising in a dispute. The following discussion examines how check truncation will impact corporate disbursement practices and services.

Security Features on Check Stock

Most sight review security verifications that occur at the paying bank are compromised by image presentment. This might lead one to conclude that security features on check stock become less important, but actually the reverse may be true. The indemnity provided by the Check 21 legislation against loss "due to the receipt of a substitute check instead of the original check" applies when security verification of the original check likely would have detected a fraud. Similar provisions are also likely in the bank agreements that govern full image exchange. Also, it is important to remember that the original check made it partially through the clearing process and was available for fraud detection until being truncated. Thus, for example, a teller at the bank of deposit might still detect a fraudulent item. As truncation moves outward beyond the first handling, fraud detection based on check security features becomes more problematic.

Positive Pay

Most banks will argue that positive pay with payee verification can offset any additional exposure to fraud that occurs due to loss of check stock security features. Positive pay is becoming a mandatory feature for corporate disbursement accounts, even when the bank requires an additional fee for the service. Corporations should consider positive pay a "necessary" feature of corporate disbursement.

Controlled Disbursement Notification

The sanctity of the controlled disbursement service is preserved (i.e., a morning notification of total funding requirements), and banks mutually protect their controlled disbursement endpoints in all bi- and multi-lateral agreements that govern image exchange. This will also be independent of the repeal of Reg Q in July 2011, which will allow the payment of interest on corporate checking account balances.

Disbursement Float

The disbursement clearing float enjoyed by the corporation on an account is impacted by the sum of checks that are cleared by the depositing bank the same day (0-day), next day (1-day) or the second business day (2-day). Actual clearing times for individual checks are based on many factors, including day of week, time of deposit, dollar size, drawee bank and deposit bank.

Holder in Due Course and Positive Pay

Section 3-302 of the UCC defines a holder in due course as the holder of a check that does not have evidence of forgery or alternation "so irregular or incomplete as to call into question its authenticity". A holder in due course has three years from the date the check was dishonored or ten years from the date the check was issued, whichever is first, to sue the maker for recoupment.

A check cashing company is a holder in due course when one of your employees cashes his or her paycheck and endorses the check to the check casher. This section of the UCC would allow a check cashing company to sue the issuer of the check for the full amount of the check, if it was not paid when presented to your bank. Reasons for nonpayment include forgery, fraud, and if there was a stop payment order placed on the check.

To minimize the chance of your company being a victim of holder in due course, we recommend that you do three things:

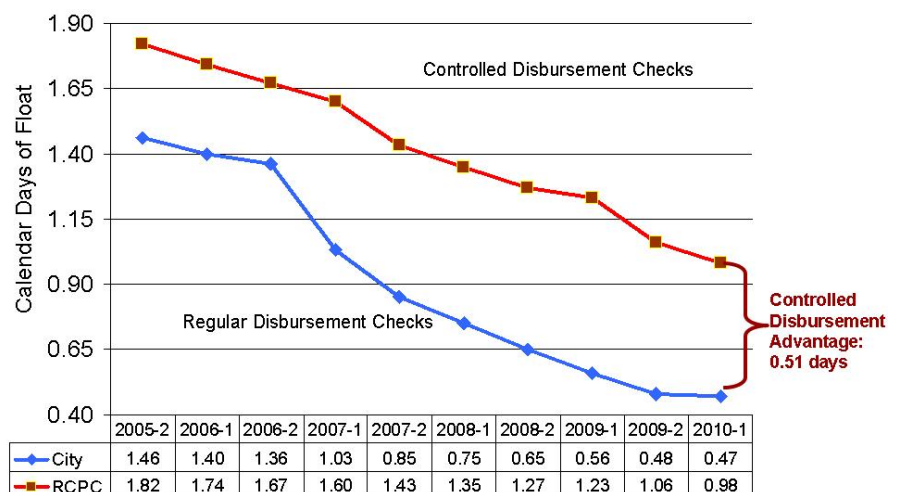
1. Print "This check expires and is void after 20 days from the issue date" on the face of your checks and use Positive Pay with Payee Verification. With Positive Pay, your bank should give you the choice of returning the item or showing it as a suspect if it is presented after the number of days from the issue date that you specify when you set up Positive Pay. Minimizing the time period that your check is valid will reduce your holder in due course risk.

Stop payment orders are only valid for 180 days and must be renewed. To decrease the need to renew stops, you should print the above legend on the check, use Positive Pay, and have the bank hard code the number of days that you specify that triggers when the item will either be automatically returned or shown as a suspect.

2. Section 4-406 of the UCC requires the account holder to exercise "reasonable promptness" in reviewing bank statements and reporting unauthorized signatures or alternations. Reasonable promptness is considered by many to be 30 days from the receipt of the bank statement. We recommend that you reconcile your account more frequently than this. Consider receiving a file of paid check data weekly that you can upload to your general ledger and reconcile checks issued and checks paid on a more automated basis.
3. Use high security checks that include a number of safety features, but more importantly, are printed on very tightly controlled, true-watermarked security paper. Do not purchase blank check stock. All check stock should first be customized for each specific company.

A consortium of banks, which clear the majority of controlled disbursement checks, are utilizing check image exchange using existing ECP (Electronic Check Presentment) deadlines. Settlement is next day and controlled disbursement endpoints are protected from unfunded postings late in the evening. As long as the ECP model drives image exchanges, large-scale 0-day presentments are unlikely. However, the ECP model will eventually evolve into periodic exchanges of image files to reduce the bandwidth capacity that would be required by all-evening exchanges. Thus it could be possible for a wholesale lockbox to

Check Clearing Time Averages for Lockbox Deposits



capture controlled disbursement items by an early morning deadline and transmit an ECP file to the paying bank in time for controlled disbursement funding reporting. In this way, 0-day presentments will occur and will deteriorate disbursement float.

Disbursement Fees

We anticipate that the expenses of maintaining a controlled disbursement account will actually increase as the banks charge more for the value of the notification.

There also may be higher fees for anti-fraud services (positive pay with payee verification) and the fees associated with maintaining an online image archive.

Service Price Summary <small>2009-2010 Blue Book of Bank Prices</small>	Average List	Average List Increase	Median Price Paid
Checks Paid	\$0.18	6.4%	\$0.150
Controlled Disbursement Checks Paid	\$0.17	(0.1%)	\$0.14
Positive Pay Checks Paid	\$0.18	6.7%	\$0.160

While paid item costs will eventually decrease, for the near term they may actually increase. Banks, after all, will have incentives to recover both increasing paper unit-costs and the investment in image equipment and software. Longer term, overall paper volume will decrease and there will be winners and losers among bank participants. Thus, there will be differing cost pressures for the individual providers. We anticipate corporations will see increasing pricing differentials among disbursement banks.

Conclusion

Longer term there is real question about the survivability of some disbursement practices. The now stated goal of the Federal Reserve Bank is to evolve a payment system where the legitimacy of any payment is known upon its initial presentment. This goal implies real-time verification at the point of initial presentment, including adequacy of available funds. The goal also subtly implies real-time “posting” against the paying account so that subsequent presentments receive similar assurance.

In the short-term, treasury managers need to take the necessary steps to reduce their exposure to fraud in the payment system. The best solution currently offered by the banking industry for check payments is positive pay with payee verification. Once exclusively available to large corporations, it is clear that companies of all sizes should be using the service.