

A satellite-style photograph of the Earth, showing the curvature of the planet and the dark ocean. The landmasses are visible in shades of grey and white, with some clouds. The image is positioned at the top of the page, partially overlapping the title.

SMART SOLUTIONS ELECTRONIC CHECK CONVERSION

Synopsis

For businesses that sell to consumers, electronic payment technology offers an opportunity to cut operating expenses and minimize the risk of fraud. The benefits of moving to electronic payments include lower processing costs, expedited transaction processing and reduced paperwork.

However, despite these alluring benefits, many retail businesses have been unable to take full advantage of this technology because of consumers' continued reliance on paper checks. Though that reliance was expected to disappear, it shows no signs of doing so any time soon.

During a 1998 speech to the American Financial Services Association, Federal Reserve Bank of Chicago President Michael H. Moskow noted that electronic transactions were growing at a rapid pace in the U.S. while check growth rates were slowing. This observation led him to speculate that "after decades of unfulfilled promise, electronic payments are tantalizingly close to achieving critical mass."

Today, however, that critical mass appears no closer than in 1998. A story entitled "Checking out E-Payments" in the March/April 2000 edition of BAI's Banking Strategies magazine claimed that annual check volumes have more than tripled since the 1970s and are "expected to grow by as much as 2% annually through 2005."

Similarly, the Green Sheet, a financial services newsletter, reported in its "United States Check Study 1999" that check volumes now exceed 68 billion annually with more than half of those checks written by consumers. The same study also cited evidence that U.S. check printers have actually increased production in recent years.

In addition, TowerGroup research estimates that the volume of checks used for retail point-of-sale purchases hit 14 billion in 1999. So it's not surprising that in a jointly researched white paper entitled "Banks in the New Economy" the Carreker Corporation and the Gartner

Group claim that “despite the tremendous gains banks have made in automating payment processing, despite customers’ increasing confidence in electronics, checks will remain a dominant form of payment for years to come.”

Fortunately, today’s new technology enables retailers to move to electronic collections while still allowing customers to pay by check. This new technology, known as electronic check conversion (ECC), allows retail businesses to convert paper checks into electronic payments at the point of purchase. This capability has enabled retailers to pursue the advantages of electronic payments without forcing their customers to abandon checks, which they clearly desire as a payment option.

How Electronic Check Conversion Works

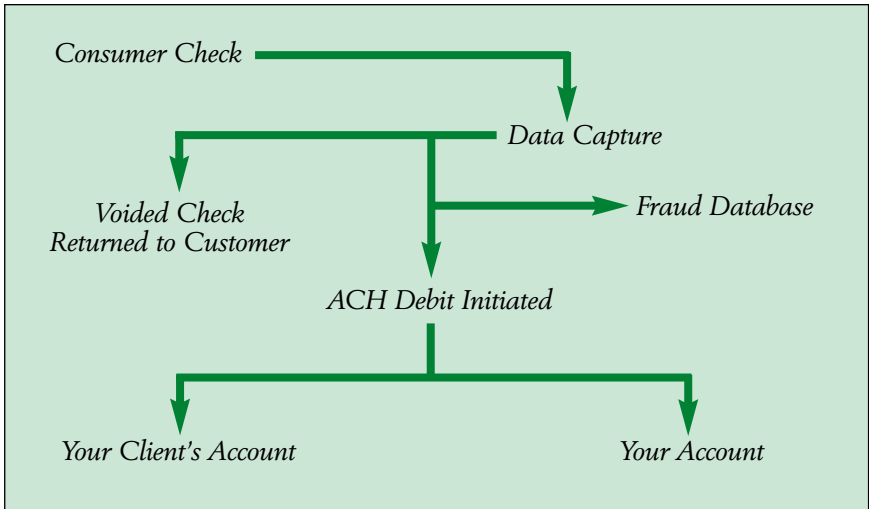
Electronic Check Conversion links two existing technologies: a magnetic ink character recognition (MICR) scanner and the Automated Clearing House (ACH) electronic payment network. With ECC, when a consumer pays with a check at the point of purchase, the cashier scans the check through a MICR device, which captures the bank account number, routing information and serial number. The cashier then stamps the check “VOID” and returns it to the consumer.

The consumer signs a receipt that authorizes the electronic transaction and serves as a record of the purchase. The retailer then uses the check data and transaction amount to initiate a debit from the consumer’s bank account, which is electronically processed through the ACH network. A complete description of the transaction appears on the consumer’s monthly bank statement.

In its present form, ECC is strictly a point-of-purchase, consumer check service. The possibility of expanding it to include business-to-business purchases has been discussed. However, the complexity of dealing with a number of issues presents some roadblocks. These issues include how to limit authorizations for ECC transactions, how to handle positive pay accounts or accounts with ACH debit blocks, and a NACHA rule that allows businesses only two days to reverse an unauthorized business-to-business debit.

Under its initial implementation rules, all ECC transactions were limited to a \$2,500 ceiling to conform to Federal Regulation CC, which governs check payments. However, during the course of ECC pilot programs, it was determined that

Regulation CC does not apply to point-of-purchase items. Therefore, as of September 15, 2000, there is no longer a dollar limit on ECC point-of-purchase transactions.



Current ECC Models

A number of operating models have been proposed for ECC, but the only one permitted by NACHA is the “consumer as keeper” model. With this model, voided checks are handed back to consumers once they have been scanned. This requirement saves retailers from having to archive the checks and banks from having to mail them back to consumers after processing. However, this process can make it difficult to easily track down the consumer in the event of a returned ACH debit. One enhancement actively being explored is to offer check image at point of purchase, with information then stored to facilitate any future research required.

One proposed alternative ECC model is the “merchant as keeper” model, which would require the retailer or its financial institution to retain the voided checks. The benefit of this model is that it simplifies the identification of returned items. However, opponents contend that the process entails additional storage and handling expenses for the designated check keeper. Currently, this alternative process has not been approved for use, and with the likelihood of check image capability being incorporated into the “consumer as keeper” model, it isn’t expected to be.

In 2000, SafeCheck LLC, a for-profit company owned by a number of large banks and three EFT networks, introduced its own check electrification system, SafeCheck. In pilot until March 2002, this system will allow member financial institutions to utilize EFT networks rather than the ACH for real-time checking account verification. Real-time debiting of retail customer checking accounts following point-of-sale ECC transactions is expected in 2001.

In an upcoming research report entitled "Check Electrification at Point of Sale in the U.S.: Reducing the Costs of Accepting Personal Checks," the TowerGroup indicates that while NACHA's ECC model has benefited from being first to market, "we predict that retailers will favor the certainty of payment provided by the SafeCheck real-time debit option."

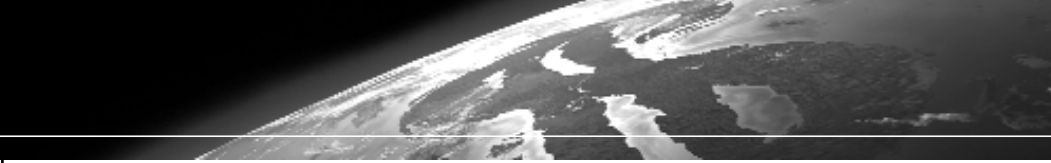
Advantages for Retail Businesses

Converting checks to an electronic format allows businesses to realize the cost savings produced by eliminating the handling and processing of paper checks. It also facilitates faster information processing and deposit, which in turn provides quicker access to funds.

In addition, ECC can help minimize fraud risk. In many cases, scanned checks can be verified at the point of purchase against closed accounts or accounts with bad-risk histories. Also, when checks are converted to an ACH format, retailers generally are able to initiate collection efforts on return items faster than in a paper environment.

Furthermore, many retailers have used ECC to simplify cash management and consolidate bank accounts, since they no longer are required to physically deposit checks at a bank branch.

Another potential benefit associated with ECC is the ability to gather data regarding consumer buying habits. While such data has been tracked on credit card transactions for years, up until recently there hasn't been a means to track paper-based transactions.



Because ECC converts a paper transaction into an electronic transaction, retail businesses can now track that purchase information. At present, businesses have been slow to invest in the technology needed to extract that data from the ECC process. However, there is, in theory, nothing to prevent businesses from doing so in the future and using such data for targeted marketing efforts.

Issues for Retail Businesses

Typically, ECC costs businesses approximately \$300 to \$500 per register to use. Obviously, for smaller retailers and service providers with only a few registers, ECC offers a fairly cost-affordable way to provide an electronic payment option. However, some larger retailers that operate numerous registers in each store are concerned about the costs of using ECC. This concern is especially valid, they believe, since the ECC option is considered to be a “bridge” technology to be used only until truly paperless transactions become more prevalent. However, given the projected increase in check volume, this may not be a real issue.

On the other hand, the Green Sheet in its “United States Check Study 1999” questioned whether the retail industry as a whole has the desire and investment capital required to make such point-of-purchase systems common.

Using ECC also requires retailers to install a check reader, adding another piece of equipment to what are already, in some cases, crowded register areas. While a number of retailers have also expressed concerns about whether they can integrate ECC into their current point-of-purchase systems, it appears that it integrates with most such systems. In fact, many point-of-sale terminals, such as TeleCheck, already incorporate check readers.

Consumer Convenience

Consumers may also realize a number of convenience-related benefits when their checks are converted to electronic payments at the point of purchase. From a security perspective, ECC helps tighten security by reducing the number of individuals involved in processing each check.

It is also worth noting that the enhanced information capacity inherent in ECC transactions allows consumers to receive more detailed transaction descriptions on their monthly bank statements.

In addition, faster ECC processing at the point of purchase can reduce checkout times for consumers. Some smaller retailers are reporting that ECC clearly expedites the checkout process. These businesses tend to be service providers, such as hair salons, which have more intimate contact with fewer customers.

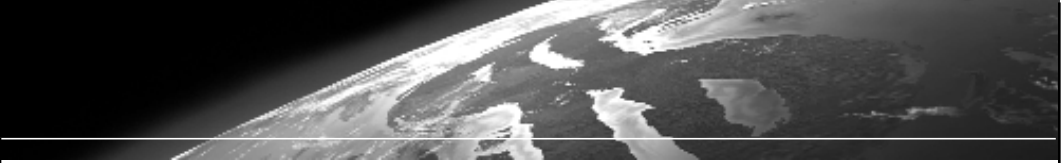
However, large retailers, such as supermarkets, that deal with large volumes of customers and long checkout lines have raised concerns that ECC may initially slow the checkout process. These larger volume retailers question the willingness of customers to wait patiently in line as the ECC process is explained to first-time users.

This concern makes deciding whether to move to ECC a tougher call for larger retailers who daily deal with thousands of customers at multiple locations. Still, many of these large retailers would like to take advantage of ECC's benefits if they can find a solution to the delays created by having to educate first-time users about the process.

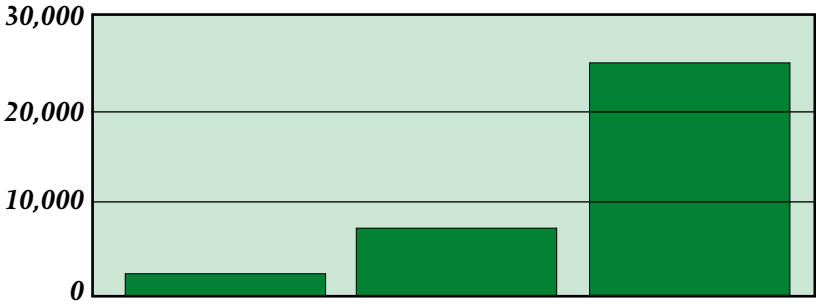
Consumer Acceptance

When ECC was introduced, few industry analysts doubted that it would produce the processing and cost benefits promised. There was, however, some concern that consumers would be confused by the process or distrustful of it and balk at participating. Surprisingly, recent statistics indicate that consumers have been quick to embrace ECC.

For example, NACHA reports that the number of retail locations using electronic check conversion reached 24,656 in January 2000, up nearly 400% from January 1999. In the same time period, NACHA reports the number of checks being converted to ACH debits on a monthly basis more than doubled to 1.5 million.



Merchant Locations Converting Checks

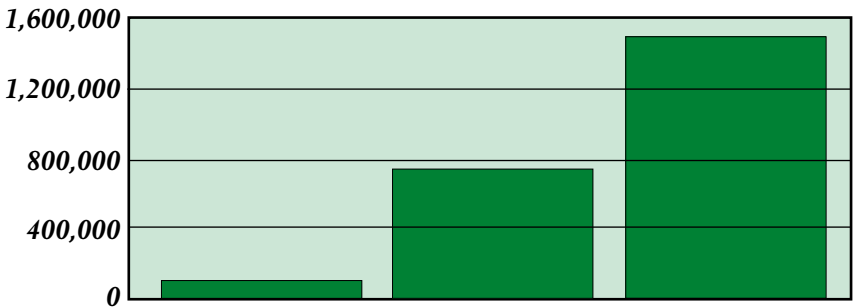


Merchant Locations

January 1998	January 1999	January 2000
515	6,215	24,656

Source: NACHA – The Electronic Payments Association

Checks Converted to ACH Debits



Checks Converted

January 1998	January 1999	January 2000
41,800	719,000	1,506,935

Source: NACHA – The Electronic Payments Association

In addition, NACHA projects that at present growth rates, close to 25 million checks will have been converted into electronic formats at the point of purchase during 2000. In addition, both financial service providers and national consumer businesses have reported that they are encouraged by initial consumer response to ECC.

As a result, the TowerGroup predicts that check electronification volume will grow at a 110% compound annual growth rate over the next three years, with volume exceeding 230 million in 2003.

Going Forward

Although the e-commerce revolution may ultimately lead to a purely electronic point-of-purchase environment, it appears that for the near term at least, consumers are not prepared to switch entirely over to electronic payment methods. Rather, they seem inclined to use a variety of payment options depending upon the circumstances.

The development of ECC technology provides retailers with many of the competitive benefits of electronic payments without having to mandate payment options to their customers. This advantage should help ensure that as retailers and consumers make the transition from paper to electronic commerce, the journey will be neither disagreeable to consumers nor competitively disadvantageous for retailers.



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