

Is ARC a Good Collection Method For My Company?

Is ARC a Good Collection Method For My Company? is a question on the minds of many treasury managers in recent months. ARC is the conversion of checks mailed to an external or internal lockbox to an ACH standard entry class called ARC. ARC has the potential to radically changed the way payments from consumers are handled. But is it good for all companies? That depends. When considering whether or not ARC is right for a company, a number of factors should be taken into consideration. Of particular importance are the impacts on the company itself, its customers, and the processor/software used for the conversion process.

**ARC
impacts
your
customer**

Before exploring these impacts, it is important to understand what checks are eligible for conversion. According to NACHA rules, only consumer checks can be converted. Business checks cannot be converted at the present time. Companies interested in converting consumer checks should visit <http://www.nacha.org> and obtain information on the specific rules that need to be followed for an ARC conversion program. Several key points from these rules are:

- Eligible items are only first party consumer checks. Ineligible checks include commercial/business, money orders, third-party checks, traveler's checks, U.S. and state government checks, convenience or credit card access checks, checks with no check number, cashier's checks, and foreign currency checks.
- Because of checks being classified as source documents under ARC, they are governed by Regulation E, not the Uniform Commercial Code. NACHA rules also pertain.
- The consumer must be given notice prior to the conversion of each payment. While a company may have an opt out process, it is not a requirement at this time.
- Copies of the front and back of converted checks must be retained for at least two years and the original checks destroyed within 14 calendar days of conversion.

Some of these rules are being reviewed and the NACHA website should be reviewed on a regular basis for any changes.

NACHA is having discussions on how business checks could be handled, but rules other than those pertaining to eligibility have not been adopted as of October, 2003. No immediate solution is apparent. The Association for Financial Professionals (AFP) commented on the conversion of business checks and the problems associated with it. <http://www.afponline.org/>

Interestingly, U.S. Treasury rules already permit Agencies of the Federal Government to convert corporate checks at point of purchase, lockbox and drop box locations, and if checks are returned for insufficient funds. On August 21, 2003, the Department of the

Fraud is a major concern if corporate check conversion is permitted

Treasury issued a request for comment for expanding the Federal Government participation in the ACH. Comments were due on October 20, 2003. In essence, the U.S. Treasury wants to expand the definition of a business check to include virtually all varieties of checks. It also wants to change the amount of information needed to inform payers that their checks

will be converted. There are a number of other provisions which can be obtained by going to <http://www.fms.treas.gov/ach>

If these rules are adopted, they will impact any company that pays the Federal Government with a check. Fraud control activities such as positive pay and debit blocks will be impacted along with account reconciliation practices. Another problem is that there will be more variations from NACHA ACH rules. The Federal Government wants to make its own rules to meet its own needs. At the same time that the U.S. Treasury wants to convert all checks, it will not permit its own checks to be converted because of concern about fraud. This is also why businesses don't want their checks converted. A very interesting dichotomy!

For purposes of the following discussion, it is assumed that only consumer checks will be converted. The first area to consider is how a company's customers will react to check conversion. Most people write a check because they want to write a check. If consumer's want to make payments there are methods such as direct debit and bill payment through online banking available.

ACH programs such as direct debit or direct deposit of payroll are opt in programs. This is not the case with ARC. The participant has no choice to opt out. Under ARC rules, proper notification consists of sending a document to the customer informing them that their checks will be converted. See.nacha.org for proper notification requirements.

Consumer protection groups have yet to weigh in on ARC

Currently, there is no opt out process for consumers other than to change their payment method. Consumer protection groups are concerned about the fact that consumers do not have an opt process. It has been reported that some States Attorneys are also looking at the situation. If in fact there is a mandated opt out procedure, the economics of ARC will change radically.

Another factor to keep in mind is that ARC entries will appear differently on consumers' bank statements. They will not appear as checks, but will appear in the fashion that a bank chooses to present ACH entries on its statements. There will be more inquiries by consumers as to what happened to their checks. Even though a consumer's bank will be responsible for answering most of the questions, a company should also be prepared to handle more customer service inquiries particularly in the beginning of the program. Another customer consideration is whether or not a company wants to have its customers' checks clear faster. One of the potential benefits of ARC is improved

availability of funds. Faster clearing of checks may be good for a company, but is it good for its customers as it may mean more overdrafts in consumers' accounts. This may not be an issue or concern for many companies, but some retailers don't like being the company that causes overdrafts. They want customers to come back and prefer to keep them happy customers. At the same time, faster clearing will help in the notification of bad checks. There is both an upside and down side to this situation. Each company will have a different situation and will need to decide what is more important to it.

To date most of the ARC volume comes from the major issuers of credit cards. They have basically taken the tact that the consumer does not care about conversion and will get used to it. There is clearly a getting used to things phase to ARC. A number of banks have reported increases in the number of customer service calls they are getting asking questions about what happened to consumers' checks. For impacts on a company, TAWPI, The Association for Work Process Improvement and the AFP developed an extensive document to aid companies in the ARC evaluation process. <http://www.afponline.org/pdf-non/arccheck.pdf> (\$249 or \$149 with membership).

ARC can be most effective for companies with more than 250,000 scanable monthly payments

A first step is look at the type of payments remitted to lockboxes. Are they strictly consumer payments or are there payments from businesses particularly small businesses intermixed? Can business payments be directed to another lockbox? Do many customers pay with credit union drafts, convenience checks, or similar instruments? How will these payments be handled? If a company has many payments not eligible for conversion, ARC is probably not right for it. Another important consideration is the number of payments received each month. Initial indications are that ARC will be more effective for those companies with more than 250,000-500,000 payments per month. To be effective, the remittance document must be scanable.

Another key question that needs to be answered is whether a company is comfortable with the change to NACHA rules and Regulation E as the governing rules / regulations rather than the Uniform Commercial Code. The responsibilities change and consumers have more rights under Reg E. This should be discussed in depth with a company's lawyers who are well versed in Reg E. Liability issues change significantly when moving from a check to an ACH item. There are more underlying rules to an ARC program and they need to be understood by a company before embarking on it. If a company already has a direct debit program, the liability changes may not be an issue. On the other hand, it could significantly change the way a company deals with payment disputes.

Reg E favors consumers

ARC items must be authorized by consumers prior to conversion. Companies must obtain authorization from consumers. What is a company going to do regarding authorizations and notification that checks will be converted? Will it be buried in some document that appears with the bill or will the process be clearly spelled out with places for consumers to go for answers?

Electronic Check Conversion

ARC	Check 21
Consumer Checks Only	All Checks
Disclosure of intent to convert	No disclosure
Regulation E	UCC
Shifts some liability to depositor	No change in liability

Under NACHA rules the financial institution that originates payments (ODFI) for a company is responsible for insuring that authorizations are valid. What requirements will they place on companies because of the change in liability? The depositing institution for checks does not have this responsibility today. A company needs to make sure that its bank clearly understands the flip in liability for unauthorized payments that occurs with ACH entries as compared with checks. A company should carefully look at the bank agreement to see how this issue is handled and what requirements a bank may place on a company.

Obviously cost considerations are important. From a processing standpoint, the main cost difference is the clearing of checks. Remittances still need to be opened and processed in the same fashion. Payment settlement is what changes. Will the cost of conversion and settling ACH items be cheaper than clearing checks? This may not be as great as many people think. What and how much are startup costs? What are authorization costs? Will there be additional customer services costs?

Improved availability of funds is one of the reasons given for using ARC. With ARC, all funds will be available in one day and possibly some less than one day depending on how the originating bank processes certain items. However, if a company's customer base is mostly local, it may already have availability of less than one day. It needs to determine whether there will actually be an improvement in availability. A nationwide customer base is more likely to generate availability improvements. Once again, a company needs to ask itself whether it actually wants to have checks clear its customers' accounts faster.

Reduced check clearing costs will be partially offset by higher processing costs.

Determining what changes a company will need to make to its own systems is critical. Does a company want to outsource the process? Can everything be outsourced? Will there be any changes required for posting to accounts receivable? A company needs to determine whether or not it will offer an opt out process to conversion. While not currently required, this will be a costly procedure and change the economics considerably if a company feels it is necessary. Staying abreast of developments regarding opt out processing is absolutely critical.

Another area that needs to be considered is how administrative returns will be handled. Administrative returns are those items where the routing transit and account numbers that were captured off the check are not the ones used for processing ACH items. Global Concepts, an Atlanta consulting group, has surveyed potential users of ARC and came to the conclusion that billers are generally bullish about ARC and that administrative returns do not rate highly on billers' list of ARC concerns. Global Concepts has produced a report that may be of interest to companies evaluating ARC. Nevertheless, handling these returns can increase costs and cause customer confusion and anguish if not handled properly.

How processing will be done is the third area of consideration. It is very critical to not be misled by potential processors. Be a skeptic. What

**Privacy of
customer
financial data
retained by
third-party
processor**

capabilities does the processor provide? What can be done to reduce administrative returns? How will credit union drafts or convenience checks be handed? Is a data base maintained to make sure that ACH items are routed correctly? What will be done to make sure that business checks are not converted?. What procedures are followed when business checks are being converted? If a data base is maintained that contains customer information, what controls are being applied to

ensure privacy? A company must establish a clear understanding of liability and responsibilities with its processor. An agreement spelling these items out clearly is needed.

Finally, in evaluating ARC, the impacts of Check 21 need to be considered. The question is whether Check 21 will make ARC irrelevant. A fully implemented Check 21 would provide most of the possible benefits of ARC and at the same time, the paying instrument would remain a check and the downsides of check conversion would not be present. Impacts to all systems at companies and to check writers should be less.

Check 21 is legislation that is designed to facilitate the truncation of checks. Truncation of checks is different from check conversion. When a check is truncated, it remains a check and check law continues to apply. The check is truncated at some point in the clearing cycle and not returned to the issuer. It will continue to appear as a check on a bank statement and the payer will have access to an image of it. All fraud services would continue to be applicable. Legislation authorizing Check 21 has been passed by both the U.S. Senate and the U.S. House of Representatives. It is currently in a conference committee and is expected to become legislation before the end of the year.

**Check 21 will provide
the same benefits
without the downsides
of check conversion**

What exactly does Check 21 do? All it does at this point is to authorize the creation of a substitute check document for those payers or banks that want their checks returned. Instead of the original check, a payer would get the substitute check. The concept of a substitute check is necessary to enable banks to exchange images of checks electronically instead of physically transporting checks for clearing purposes. However, even with

Check 21, individual banks or check processors will need to develop business cases to justify clearing checks electronically. Whether or not this will happen is still an unknown. A company considering ARC should keep abreast of Check 21 developments.

Conclusion: Is ARC a Good Collection Method For My Company? It depends on the answers to the questions posed. While it may be the right collection method for some companies, it will not be the right one for others. There is no simple answer. Considering adopting ARC requires careful consideration and should not be a “snap” decision. It can be more complex than it appears. There are changes in responsibilities and liabilities. It requires a company to rethink its entire process of handling these types of payments. For any benefits gained, can resources be put to better use by encouraging other forms of electronic payments such as direct debit, online banking, or EBPP at a website? Is the added complexity worth it? It depends.

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