Should I Use ARC or Check 21 to Collect Payments?

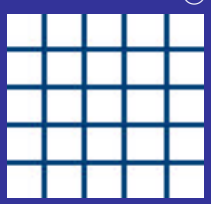
Many billers are trying to answer this question today. In fact, it is an involved analysis with much subtlety, and it is not necessarily even an either/or question! In this paper, we will explore the issues that should be investigated to answer the question for an individual biller.

ARC, Accounts Receivable, is an entry code for an ACH transaction that debits a consumer's account. It is the lockbox (or drop box) "cousin" of the point of sale conversion (POS), in which the consumer, with his consent, is returned a voided check that has been converted to an ACH debit. ARC also involves the *conversion* of a consumer check into an ACH debit against the same account. As part of the conversion, Federal Reserve Regulation E becomes the governing law and provides different protections to the consumer versus check law.

Check 21, using the implied, broad definition that far surpasses the actual legislation, involves truncation of a paper check by imaging and the subsequent clearing of that check either electronically or by an IRD (image replacement document), which is a paper "substitute" of the original check. In this case, the check stays a check and obviously check law applies throughout. Implicit in this process is the belief that truncation will be at least cheaper and perhaps faster than paper processing. We will use the term "truncation" to represent this process in the rest of this paper.

ARC and truncation provide different advantages to a biller. It is crucial to understand the different advantages if one wishes to choose which to use. The first limitation of ARC is that it can only be used on certain consumer payments. It cannot be used to convert business checks (the emerging definition of a business check involves the presence of an auxiliary on-us field in the MICR line). It cannot be used to convert money orders, Treasury checks, convenience checks (such as supplied by a credit card issuer), third-party checks, or demand drafts with no signature. The reason for the exclusions is the requirement of "consent" for an ACH debit. In the excluded cases, the "maker" of the check may not be the biller's customer. Business check exclusion is a bit more convoluted.

The second limitation of ARC is the requirement of "consent" before an ACH debit can be presented against an account. Under ARC, each conversion requires "consent", but the biller is leniently judged to have consent if he notifies the payor (notification equals consent). Thus, each bill presented must have some language to the effect that payment by check gives implicit consent to convert the transaction to an ACH debit. Another rule (effective June 11, 2004) is that the biller must allow the consumer an opt-out process, and must advise the consumer of this process initially and every twelve months thereafter. This requires the biller to keep a file of which customers



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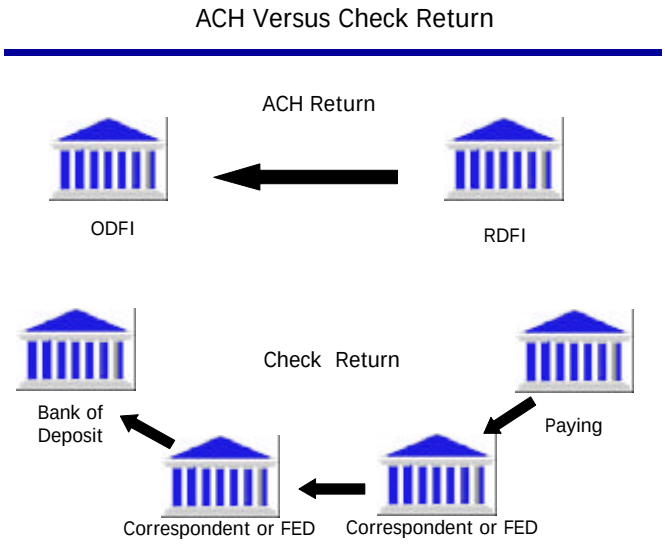
have opted out and cannot have their checks converted. Under ARC, the check is considered to be a "source document." A copy must be retained for two years, but the original must be destroyed within 14 days.

Sample Authorization, Department of Treasury 4/11/02
"By sending your completed, signed check to us, you authorize us to use the account information from your check to make an electronic fund transfer from your account for the same amount as the check. If the electronic fund transfer cannot be process for technical reasons, you authorize us to process the copy of your check."

One last complication of ARC is the capture of the check MICR line. Previously, payment processing simply required the dollar amount to be encoded. Under ARC the entire MICR line must be correct, so the payment processing area will need to do full MICR line repair. Also the accurate capture of the entire MICR line still may not result in a successful ACH debit. Such items are considered to be "administrative" returns, in that the paper check would have cleared, but some alteration (usually to the bank routing transit number) is required to have the ACH debit post successfully. There are, of course, several software solutions available to help reduce administrative returns.

With all the limitations and complications above, ARC must provide some distinct advantages to be enjoying the rising volumes it is. Perhaps the greatest advantage enjoyed under ARC is faster and less frequent returns.



ACH returns are both faster and more predictable than paper check returns in that they must be back to the originating institution two business days after the settlement date. For some billers, such as credit card issuers, faster returns greatly mitigate risk and make ARC compelling. It is also the case that most banks currently post ACH debits before paper debits, so there may be even fewer returns using ARC. It is unclear if this will be a long-term advantage for ARC, but most early adopters have reported declines in the number or return items. And last, the re-presenting of returned items can be "timed" in the ACH system since each transaction carries an effective date. Billers whose

experience indicates that certain days of the month produce fewer returns, such as the 15th or perhaps Fridays, may be able to time re-presentments for greater success.

A second advantage of ARC is the potential for decreased bank fees. Most early adopters of ARC report that in volume, ACH debits are cheaper than paper deposit items plus transit. Interestingly, in the current Phoenix-Hecht Blue Book of Bank Prices™, that comparison is about equal, but early adopters of ARC are finding ACH pricing very

Comparison of Price Paid

Monthly Volume	ACH Debit	Unencoded Check Other Fed
5,000	$0.102	$0.119
10,000	$0.100	$0.116
15,000	$0.098	$0.114
25,000	$0.097	$0.112

Source: Blue Book of Bank Prices 2003™

attractive for higher volume retail lockbox applications. Higher costs for processing a dual payment stream may offset bank fee savings somewhat. If the biller processes in-house, these costs definitely factor in. The majority of early adaptors have reported that processing costs did increase, or that at least initially, processing was more complicated. Retail lockbox providers however have been somewhat mixed in the approach of passing along costs. Some do have an explicit processing surcharge for a converted item.

A common conception is that availability must be better for ACH transactions versus paper deposits. In reality, ARC may or may not provide acceleration. ARC will produce next-day funds for all items, except those items that are on-us to the originating bank (such items should be same-day). So any 2-day or greater paper items find an improvement under ARC.

Retail Total Float Rankings – Nationwide
Postal Survey Assuming 12 Hour Processing

City	Mail Days	Availability	Total Float
Atlanta, GA	3.11	1.22	4.33
Dallas, TX	3.15	1.20	4.35
Kansas City, MO	3.17	1.21	4.38
Houston, TX	3.17	1.24	4.42
Chicago, IL	3.22	1.22	4.44
Saint Louis, MO	3.28	1.19	4.46
Pittsburgh, PA	3.17	1.32	4.49

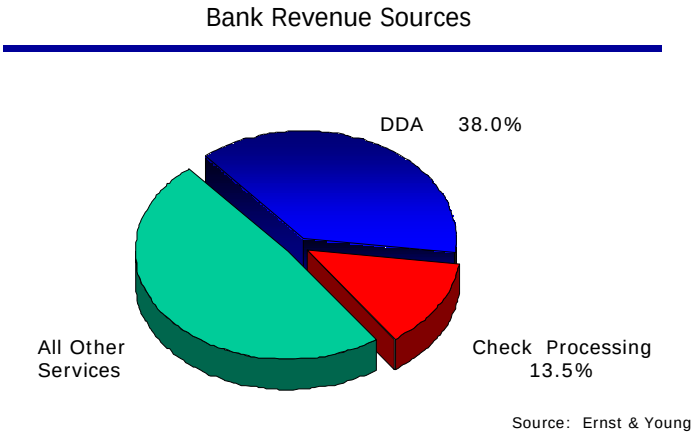
Source: Phoenix-Hecht Retail Collection Model™

However, checks that are not on-us to the depository bank but are still 0-day (local clearinghouse and direct sends) suffer under ARC. Some processors elect to opt-out 0-day paper from conversion, but the Federal Reserve has opined that the notification to the customer concerning conversion creates an "expectation" of rights under Reg E. If taken literally, such opt-outs may be a NACHA rules violation. To date, no processor has been cited for not converting 0-day paper, but the issue remains at least "murky".

One last complication for an ARC transaction is that, under Reg E, the consumer has 60 days to return an item. Granted, the consumer must make a "statement under penalty of perjury" that the transaction was not authorized, and the RDFI (consumer's bank) may still find that there is insufficient cause for a return. Nonetheless, certain industries find the additional exposure problematic.

So what does truncation do for a biller? Actually, the better question is what *will* truncation do for a biller, because truncation is awaiting the effective date of Check 21 legislation (October 28, 2004) and the experience of various pilot projects of image exchange. Today, ARC has the definite advantage of being a reality and having the learning experience of early adopters. The most obvious advantage of truncation is that all checks are eligible. Truncation is an option for items that do not convert to ARC, hence the possibility exists to use both.

That being said, thereafter, advantages become less definite. The expectation is that truncation will produce lower bank fees. There is as yet no evidence in either direction.



The only truncation projects that have been discussed publicly involved no change to pricing by the bank. In truth, until images are widely exchanged, the bank's cost reduction is debatable. Will an imaged item deposited in volume get priced the same as an ACH debit in volume? Very unclear, and most likely, the answer in 2005 will not be the same as in 2007.

Another expectation is that imaging (truncation) will produce faster clearing, better availability, and faster returns. Note that in conversion, the concept of "availability" gets modified. Transactions have an "effective" date; the bank's clearing experience is the customer's "availability" experience. In truncation that is not the case. The bank will

still assign availability, which in theory and historical practice mimics clearing (plus a profit or cost recovery margin). There is no "guarantee" though that a bank would pass clearing improvements on in availability, but there is at least the expectation of competitive pressure. Clearing likely will improve in a predominantly image exchange environment, but the level of improvement is very conditional on how much 0-day clearing actually evolves.

National Average Check Clearing Times

	Calendar Days of Clearing	
Drawee Fed Type	Lockbox Deposits	Over-the-counter Deposits
City	1.36	1.60
RCPC	1.74	2.13
Country	2.03	2.29

Source: Phoenix-Hecht 2003-2 Clearing Study

That is still very much undecided. An imaged item could produce a faster return, but again it is not guaranteed as it is for an ACH item. In fact, the forward presentment may have to occur as an IRD, so the return would likely also be the IRD. Lastly, up to this point there is little indication that banks will post imaged checks with higher priority than paper checks. Thus the benefit of *fewer* returns is unlikely.

In summary, ARC produces measurable benefits for billers but has limitations and complexity. Truncation has almost no limitations but is too much in its infancy to be judged by measurable benefits. Both presuppose that the consumer will become resigned to not receiving all original checks back in bank statements. Both do allow the processing location of payments to be divorced from the entry into the collection system. Eventually, both will also likely be judged superior to pure paper processing. Currently, the most important thing for a biller to realize is that the two programs are not synonymous and produce different benefits. Depending upon the evolution of cost and benefits in truncation, it will be interesting to see if ARC's complexity and limitations impact its eventual adoption rate.