



## **Truncation vs. Conversion for Industries that Utilize a Payment Receipt Network**

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***Extract: The early years of this decade saw record-setting growth for Accounts Receivable Conversion (ARC) that allowed billers to leverage the massive endpoint participation of the Automated Clearing House (ACH) Network. As the decade begins to wind down, the availability of the ACH Network to convert checks is ever broader but the requirements to process payments in that network are just as restrictive. The growth of image exchange participation has provided a less onerous method of check electrification that can be quite attractive to industries that use networks of collection points to ease customer payment delivery.***

To frame the discussion around check truncation (i.e., Check 21) and check conversion (i.e., ACH) for the distributed payments collection industries, several perspectives must be considered. For insurance companies, for example, additional consideration for the personal nature of the agent network must be included. Face-to-face payments, locally mailed payments, and expedited payments in varied forms can dominate an agent's receipts. This is similar for collection brokers, rental agencies, or property management companies.

Many traditional traits of checks and ACH transactions are still quite pertinent to today's processing. These characteristics paved the way for a strong adoption of ARC in the early years of this decade<sup>2</sup> and set the stage for great anticipation of Back Office Conversion (BOC) in early 2007. Consideration of the classic pros and cons for check and ACH processing highlights the "Pro and Con" lists shown below. These points are intended to be purely factual and objective, respecting the breadth and scope that each payment channel has provided the payment industry.

<b>Check</b>			
<b>Pros</b>		<b>Cons</b>	
+	Understood and widely used	-	Paper handling and transportation requirements
+	Information richness of the instrument	-	Variable funds availability schedules
+	Acceptance by both consumers and businesses	-	Opportunities for fraud from information contained on the check

<b>ACH</b>			
<b>Pros</b>		<b>Cons</b>	
+	Predictable next day settlement for debits	-	Regulations regarding notification and authorization
+	Wide endpoint penetration in a scalable network	-	Strict item eligibility rules <sup>1</sup>
+	Easy to understand technical file and record layout standards	-	ODFI warranties on each Originator

All payments industries strive to maximize their advantage by capitalizing on efficiencies offered to them. Therein lies the debate between check conversion and truncation. Both allow rapid electrification and increased timeliness of returns or rejects. Each, however, has its own set of inherent advantages and challenges. Since no payment mechanism remains stagnant, anticipating the next generation of benefits from each may be just as critical as rationalizing today's comparison. While the characteristics noted above apply to the base nature of the payment mechanism, there are changes (some subtle and developing, others immediate and impactful) to the traditional view of these payment channels that must be considered.

<b>Check 21 / Check Truncation</b>			
<b>Pros</b>		<b>Cons</b>	
+	Elimination of paper as early as possible without the eligibility and notification requirements of ACH	-	Endpoint participation for image exchange (particularly image receive) was not great at the outset of Check 21
+	Exponential growth from outset	-	Individual variations on X9.37 standard and image quality development
+	Opportunities for same day settlement are increasing rapidly	-	Check law requires image storage for seven years

<b>ACH Check Conversion (POP, ARC, BOC)</b>			
<b>Pros</b>		<b>Cons</b>	
+	Low opt-out rates	-	Requirement for opt-out support
+	Leverage ACH Network for transaction volumes that had previously settled through other networks (i.e., check)	-	With respect to the ACH Rules, different requirements exist for each conversion Standard Entry Class
+	Image retention is only two years, as opposed to seven for check	-	Account reconciliation and customer service for a mix of converted and ineligible items may create confusion

Lest one considers the split between the truncation and conversion to be clean on all sides (clearing, processing, reporting), it is critical to note that there are many similarities in the procedures and legislated requirements of the two. When a payment recipient is in an environment that allows for BOC or ARC, several procedural similarities exist to effect either ACH conversion or Check 21 truncation. For example, full check imaging is required for both, so MICR readers alone (such as those found at point of sale stations) are insufficient devices. Both options are expected (though not mandated) to be performed as back office functions, away from the presence of the original check writer. Additionally, both options require the depositing entity to perform check safekeeping for a commercially reasonable period of time. There is a perception by some that implementing back office options of ACH Conversion is a method to avoid some of the check handling requirements. This is not a correct perception.

Aside regarding ACH: It should be duly noted that Point of Purchase (POP) check conversion does eliminate both the full check image and check safekeeping requirements. However, the usage of the POP application is fully dependent on an in-person exchange of the check with the check writer. Furthermore, the POP application is generally applied at each point of sale location, meaning that multi-lane, multi-cashier payment environments will necessitate a scanning device at each station.

Within a distributed payment collection network, there are generally accepted payment practices that cater to payer preferences. Again, using the insurance agent as the example, predictable premiums, agent-policyholder relationships, and the local presence of agent offices create the following payment scenarios that can present challenges to a narrowly defined payment processing structure:

- a) Cash payments are neither convertible via ACH nor eligible for truncation via Check 21
- b) Money order payments are not convertible via ACH but can be included as a truncated item via Check 21; as a related scenario to (a) immediately above, cash payments received by an agent may be exchanged for a money order and deposited via a Check 21 application
- c) Business policyholders may choose to make their checks ineligible for conversion by either utilizing the auxiliary on-us field in the MICR line; additionally, any check payment (whether from a business or consumer account) over \$25,000 is ineligible for conversion via ACH
- d) Agents that receive payments in person, via the mail, and via an unattended dropbox would have to manage multiple ACH applications based on the receipt and related notification methods; this is especially key if a POP application is considered; mailed or dropbox payments are not eligible for POP conversion according to the NACHA Rules; as an ODFI, the financial institution warrants that each of its originators abides by the applicable rules for each payment transaction submitted to the Network

For scenarios (b), (c), and (d) above, check truncation rules allow for seamless acceptance and timely processing of the payment without ineligible exceptions. In an environment where agents

(regardless of the industry they serve) are measured and compensated on the financial results of their operations, timely acceptance, processing, and posting of payment can mean direct positive bottom-line impact. Exception management represents, at minimum, a delay in processing and posting, and, at maximum, a costly payment alternative for the payee. In many cases, these expenses can eventually manifest themselves in higher costs to payers.

It would be naïve and foolish to dismiss two tremendous advantages that ACH clearing has held over check clearing historically. One, the predictive settlement of next day debits made daily financial forecasting easy to achieve with entities that had high volumes of ACH activity. The developing counter-punch from truncation is the ever-increasing participation of endpoints in image exchange receive, thereby creating the real-world opportunity for same day settlement for large volumes of checks. The cost savings to financial institutions indicates that the reduction in float is an acceptable result. The net impact to ACH is that next day settlement, though predictable and stable, may be late as more and more financial institutions are willing to clear items via image exchange. Two, the ACH Network has enjoyed widespread endpoint usage. Until recently, check clearing rails had no comparable tale to tell. However, with the same increased penetration of image exchange endpoints that is challenging the timeliness of next day settlement, sheer numbers of participants in image exchange will also challenge ACH dominance.

In conclusion, the undeniable cost-benefit wins of the traditional ACH model are eroding. Image exchange in-roads into same day settlement present direct financial benefits. Additionally, the overhead associated with ACH eligibility, notification, and authorization is largely eliminated with check truncation and image exchange. Notwithstanding, the implementation and aggressive marketing of direct debit ACH programs (PPD, Pre-Authorized Payment or Deposit) and recurring credit/debit card payments should be continued. Policyholders, especially consumers, are open to these payment methods in such a trusted and loyal relationship as the one forged with a local agent. Furthermore, expedited payment methods such as Internet-Initiated Transactions (ACH WEB) and Telephone-Initiated Transactions (ACH TEL) are also viable and valuable payment techniques that consumers respect and understand. However, when paper is created to facilitate a payment, the most effective, efficient, and straightforward method to process and clear the payment may very well be check truncation and image exchange. Above all, it must be understood by any commercial entity that the payer, not the payee, almost always makes the decision on the payment type to be used. The decisions around processing techniques that drive efficiency then reside with the payee. Great efficiency with minimal overhead should drive decisioning toward check truncation.

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Notes:

<sup>1</sup> The only items defined as ineligible for Check 21 truncation are savings bonds and checks drawn on non-US banks. Check 21 truncation can include the following items, each of which is ineligible for ACH conversion: money orders, bank/teller/certified checks, US Treasury checks, convenience checks, and travelers checks.

<sup>2</sup> For any entity that implemented ARC solutions prior to the industry penetration of image exchange, the financial benefits of ACH settlement have been realized over the past several years. The business case for ARC in the first half of this decade was often compelling, as it was gauged against the availability schedules and transportation burdens of the paper check. No inference should be made here that ARC decisions of the last several years were not appropriate and financially beneficial. It is expected, however, that for the coming years, much of the volume that has historically cleared as an ACH ARC transaction will be cleared via image exchange to capitalize on further expedited settlement.