

Seeds of Surprise in Check Successes

How Check Volume and Value Trends Guide Today's Payments Investment Decisions

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You don't have to be in business very long before you realize that even your unqualified successes can contain the seeds of your next big challenge. And they are often seeds of surprise. This turns out to be true of one of the banking industry's most ambitious goals and emerging successes: ridding the industry of inefficient paper processing, especially the paper check. The surprise in this case? Even while volumes of checks are decreasing, values are climbing.



Since Check 21 was enacted in 2004, bankers, vendors, and regulators have made significant inroads on the paper-based system. The proof is in the Federal Reserve 2007 Payments Study:

1. Checks paid declined from 41.9 billion in 2000 to 30.6 in 2006.
2. Over the same period, electronic payments (credit card, debit card, ACH, and EBT) more than doubled – from 30.6 billion to 62.7 billion.

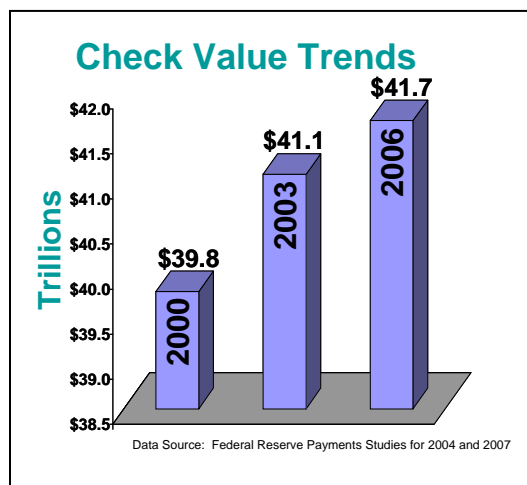
Great. That's what we all wanted, isn't it?

True. But after analyzing the data further, we would like to pose three more true/false propositions:

- 1. True or false? In a system as volume-driven as checks, down-trending volumes demand that we urgently shift our investments away from checks.**

It turns out that volume is one thing, but value is another, and the Fed's value statistics surprised many.

From 2000 to 2006, the value of checks paid actually *increased* from \$39.8 trillion to \$41.7 trillion. Percentage-wise, that is not staggering, but it rose on a volume decrease of 27 percent, and the starting point was already trillions of dollars.



So, even after several years of deliberate, legislated, industry-wide efforts focused on the paper check, the paper check system holds more value than ever – more than all of the other combined instruments included in the study.

As long as the check system remains so valuable (and the trend could take it even higher), we believe banks would be wiser to take the lead of a number of ECCHO members, leveraging their past investments with new image-based enhancements and achieving more efficient payment processes.

Frost Bank's David Rathke, for example, affirms, "The check payment system is transitioning but in ways not anticipated. We must reevaluate our thinking about the future of a system with declining volumes and increasing dollar amounts."

2. True or false? The holdouts who continue to write paper checks are mainly individuals paying individuals, so if they can be incented to use another payment form, we should be able to reverse these trends and safely hasten the reduction of the paper check system.

Let's examine that by moving from total value of the check system to average check size. The surprise: From 2000 to 2006, *the average check size was increasing sharply, from \$950 to \$1,366 – an increase of 43.8 percent --* and this during a period of only mild inflation.

That dollar size seems to indicate that it's just not the homeowner paying the yard man or grandparents buying Girl Scout cookies who are the check-writing holdouts.

Large check writers (think corporations) remain big check users, too, and with good reason. Despite the banking industry's efforts to convert large corporate checks to electronics, the typical organization makes 74 percent of all business to business payments by checks, according to the Association for Financial Professionals.

This suggests that at present corporations have no good substitute instrument for a majority of their checks. The check carries vital information that no other instrument does so conveniently, and companies have already paid for the paper check controls and systems. As long as checks in the system remain high-value, and as long as banks' corporate customers remained heavily invested in using them, any bank that values its corporate business will be prudently investing in new or enhanced digital check services.

3. True or false? Since these volume shifts (down in checks, up in electronics) are clearly happening in parallel, one causes the other.

Actually, only 24 percent of the rise in electronic payments can be attributed to the decline in checks. That means 76 percent came from other sources.

Moreover, the proportion of those “other sources” is growing: From 2003 to 2006, electronics grew from 54 percent to 67 percent of total payments. These numbers indicate that the real trend here is actually multiple simultaneous but independent trends. Many consumers use cash and debit cards exclusively, accounting for a large part of the significant growth in electronic payments, while another set of consumers has shifted many but not all payments away from checks. Another segment of former check users has replaced them with ACH payments. Increased electronic payment volumes from these sources should be celebrated but they are largely unrelated to the trends in check volumes.

The truly notable trend is the transition to image processing. Banks that have invested in image processing are finding image-based services embraced by customers of all types – corporate, middle-market, small business, and consumers. At the same time, image allows banks to reduce or eliminate paper-based inefficiencies while continuing to reap the advantages of the highest-value (non-cash) retail payment system in the country. In effect, image processing separates the check from paper. “Check” no longer means paper, any more than “album” means vinyl.

Many of the largest banks have already made the paper-reducing investments with the goal of dispensing with costly paper-driven equipment and staff. They have been running parallel systems for some time – paper and digital – and are growing impatient to turn off the legacy system. When they do, those banks that still rely on paper systems will face high float costs and find themselves pressured to make major changes fast. Many experts in the industry anticipate that by the end of 2008, 65 percent of all institutions will be receiving images and an even larger percentage collecting checks via images. The Federal Reserve is accelerating its plans to reduce its paper-handling costs. Wait-and-see about image will go from being the safe outlook to the costly one.

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Union Bank of California’s Orlando Mesa, Chairman of the ECCHO Operations Committee said, upon seeing the Fed numbers, “It looks like it’s time to change the way we look at investing in check processing operations. Instead of focusing primarily on our fixed and variable costs, we need to give equal consideration to the value of the payments involved.”

Make no mistake. Nobody wants to perpetuate paper systems. But the Fed’s data make a powerful case for prudent, nuanced improvements that replace the onerous parts of the check system while retaining its advantages.

It is true that the “paper” check was conceived in a different age, and that time and alternatives rendered its handling and transportation requirements outdated. But as long as image processing is resolving that issue, and as long the check continues to serve the needs of companies and consumers, the value of check as a payment instrument is growing, not declining.