



PHOENIX-HECHT

Fraud and Disbursement Practices

Positive Pay Pays

This Phoenix-Hecht report contains results on fraud and check imaging implications on disbursement practices from the latest *Middle Market and Large Corporate Cash Management Monitors*.

Phoenix-Hecht conducts surveys of the cash management practices, attitudes, behaviors and beliefs of corporate treasury managers. Throughout this report there will be references to two market segments.

	Segment Size (Annual Sales)	Latest Survey Period
Middle Market	\$40 to \$100 Million	Fall 2006
Large Corporate	Over \$100 Million	Fall 2005

Each market segment is surveyed every two years. The segments are weighted to reflect the full U.S.

population of corporations in that market. The margin of error varies slightly from market to market, but is generally in the 3% - 3.5% range at the 95% probability level. Responses to rating type questions are solicited on a scale of 1 to 5, with 5 being high.

© Copyright Phoenix-Hecht 2007
A Division of UAI Technology, Inc.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Fraud In The Middle Market

After decades of slow growth, various forms of corporate electronic payments are gaining some ground. By a substantial margin, checks are still the dominant payment mechanism used for corporate transactions. Industry sources quoted by the Federal Reserve System estimate that check fraud costs businesses in the U.S. between \$10 and \$14 billion a year. The volume of these losses is reported to be growing at a rate of 2.5% to 3% per year. These losses are unevenly absorbed by corporations and banking organizations.

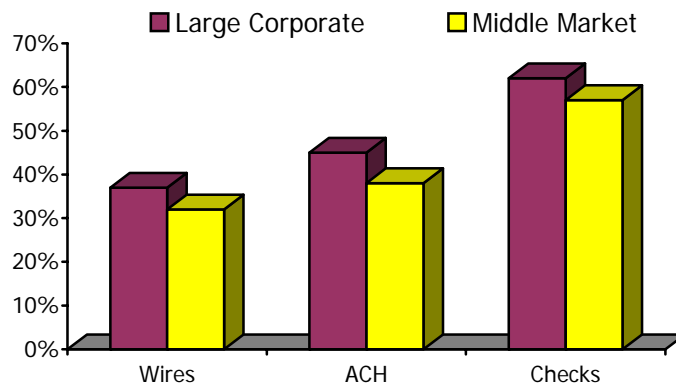
Respondents to the latest survey indicated a much higher level of concern about fraudulent checks and less concerned about unauthorized ACH (Automated Clearing House) transactions or fraudulent wire transfers.

Twenty-two percent of all respondents reported a major fraud issue in the last two years. As expected, the overwhelming majority (88%) of these issues involved fraudulent checks. Less than 1% involved wire transfers. Respondents rated their level of concern as a 5 (on a scale where 5 represented “being most concerned”).

To better understand what constitutes a major fraud issue, the survey asked what *per-item* dollar value represented a significant concern about fraud to the respondents. The response suggests that treasury managers have a low tolerance for fraud.

Payment Transactions Made by Corporations			
Method	Company Size		
	\$40 - \$100 Mil	\$100 - \$500 Mil	Over \$500 Mil
Check	77.2%	72.8%	69.3%
ACH	11.8	13.4	16.1
Wire transfer	6.7	8.5	10.1
Credit/debit card	3.8	4.8	3.6
Other	0.5	0.5	0.9

Most Concerned Responses



Fraud Issues by Dollar Amount

Dollar Amount (per item)	Significant Concern
Under \$1,000	41.6%
\$1,000 - \$10,000	40.1%
\$10,000 - \$100,000	16.9%
\$100,000 - \$1,000,000	1.3%

Results from Phoenix-Hecht's surveys show that middle market corporations have recently become much more aware of both the magnitude and rate of growth of check fraud and are finally catching up to the level of concern shown by larger corporations.

Increase Concern Over Check Fraud		
Last two years (1=Not important, 5=Most important)	Middle Market	Large Corporate
2007	4.31	-
2006	-	4.44
2005	3.52	-
2004	-	3.70
2003	3.29	-
2002		3.54

Fraud Loss Deterrents

To protect against check fraud, corporations historically have adopted procedures such as monitoring check printing, check signing and blank check stock. The increasing sophistication of forgers, availability of technology and changes to the check clearing system allowed by recent legislation will require even more diligence. Many corporations are turning to their cash management banks for services such as positive pay, electronic reporting of checks-paid information and very frequent account reconciliation services to detect and reduce their potential fraud exposure.

A positive pay service should be purchased for every check disbursement account. Use of the service reduces the corporation's liability for losses under UCC. Positive pay requires that when checks are printed, the check generation software creates a transaction file that is transmitted to the disbursing bank. The file contains information such as check number, date, amount, and (in some cases) payee name. When a check is presented to the bank for payment, the bank first refers to the company's positive pay file to see if the check is valid. Only if there is a match of the check details will the check be honored. The bank rejects:

- Checks not on the company's "issued" file
- Checks that exceed the issued dollar amount
- Duplicate checks
- Stale dated checks (this assumes that checks older than one year are removed from issue file)

To prevent alterations to the payee field, many banks are offering systems that will even check the payee name (Payee Verification).

Large corporations are more likely to use a positive pay product than smaller corporations. Corporations who do not use positive pay were asked *why* they're not using it. By a slim margin, they mention cost of the service as the most important reason. Slightly less important reasons for non-use were a perception that there was a low risk of check fraud and the complexity of converting to positive pay. As would be expected, larger corporations were less put off by the

complexity of positive pay. When they chose not to use the service, it was equally likely to be due to the cost and the perceived lack of check fraud. The cost issue may be rather short sighted given the risk exposure. The Phoenix-Hecht BlueBook of Bank Prices™ reports that the actual prices paid for positive pay and controlled disbursement checks are very comparable.

Utilizing a positive pay service will become increasingly more important as the banking industry moves to settle check payments by clearing check images and image replacement documents (IRD's) rather than the original paper checks.

While the vast majority of middle market corporations still reconcile bank statements monthly, a significant minority now reconciles more frequently.

Account Reconciliation Frequency

Monthly Reconciliation	78.6%
Weekly Reconciliation	4.6%
Daily Reconciliation	16.2%

It is important to reconcile your account statement as soon as you receive it and report suspicious activity immediately. Image exchange has the potential to increase certain types of check fraud because the conversion process may destroy the physical evidence of fraud. Many of the fraud prevention measures built into some check stocks will not survive the conversion to an electronic image. Frequent reconciliation is often your last line of defense to prevent fraud.

Electronic imaging makes it possible for a bank to replace paper paid checks with accurate electronic representations. Image delivery systems consist of image-based document processing products used to convert paper documents into digital images that can be stored, retrieved and delivered in a variety of manners. Images generated by the disbursement bank are delivered to customers via the Internet or CD-ROM media for display on a PC.

With regard to check fraud, imaging is used in conjunction with positive pay to allow on-line approval of questionable items. Customers can view an image of both sides of a check and determine appropriate action. Imaging is also used to provide same-day retrieval of recently paid items for research. Both of these uses of imaging have become more important to middle market corporations over the last few years.

Rate Importance of Imaging

Rating Scale (1-5, 5=high)	On-line Approval of Positive Pay Items	Same-day Retrieval of Recently Paid Items
2006	3.82	3.60
2004	3.65	3.56
2002	3.31	3.27
2000	3.20	3.18

New Check Clearing Systems

Check imaging takes on a new meaning for banks and their customers with the passage and implementation of the Check Clearing for the 21st Century Act (Check 21). The legislation provides the legal framework for depositing banks to truncate the physical check. Importantly, no legislation prohibits the voluntary exchange of check images for settlement of payments. Converting the paper check to a clearable image can occur at any point in the check deposit preparation, capture, check clearing or check return process.

Eliminating the physical transportation of the paper checks holds the promise of significant cost savings for depositing banks. The term “check truncation” more accurately indicates actions which “interrupt” the delivery of the original check to the paying bank for settlement. Check truncation differs from check “conversion” (so-called “e-check” ACH transaction codes such as POP, TEL, WEB, ARC, RCK) in that check law continues to be in force (Reg CC versus Reg E). The e-check truncation programs being conducted are all currently focused on checks written by consumers.

The impact of check truncation and image exchange on corporate check disbursements is somewhat mixed, depending on an individual company’s current use of checks and check images. The banking industry derives considerable revenue from providing controlled and other disbursement services and will likely protect corporate customers for as long as possible. To date the warranties and indemnities that a depositing bank makes in converting a check to an image does not seem to deter conversion of high dollar checks even though the depositor is liable for consequential damages arising in a dispute. The following discussion examines how check truncation will impact corporate disbursement practices and services.

Security Features on Check Stock

Most sight review security verifications that occur at the paying bank are badly compromised by image presentment or the presentment of an IRD (Image Replacement Document). This might lead one to conclude that security features on check stock become less important, but actually the reverse may be true. The indemnity provided by the Check 21 legislation against loss “due to the receipt of a substitute check instead of the original check” applies when security verification of the original check likely would have detected a fraud, but was not possible with the IRD. Similar provisions are also likely in the bank agreements that govern full image exchange. Also, it is important to remember that the original check made it partially through the clearing process and was available for fraud detection until being truncated. Thus, for example, a teller at the bank of deposit might still detect a fraudulent item. As truncation moves outward beyond the first handling, fraud detection based on check security features becomes more problematic.

Positive Pay and Payee Verification

Most banks will argue that positive pay can offset any additional exposure to fraud that occurs due to loss of check stock security features. It is conceivable that positive pay will become a mandatory feature for corporate disbursement accounts, even when the bank requires an additional fee for the service. Corporations should consider positive pay a “necessary” feature of corporate disbursement.

Controlled Disbursement Notification

For a time horizon of at least two or three years, the sanctity of the controlled disbursement service will certainly be preserved (i.e., a morning notification of total funding requirements). The IRD is subject to paper processing deadlines (8 a.m. presentment), and banks will mutually protect their controlled disbursement endpoints in all bi- and multi-lateral agreements that govern image exchange. This will also be independent of any change in Reg Q, which currently prohibits the payment of interest on corporate checking account balances.

Disbursement Float

The disbursement clearing float enjoyed by the corporation on an account is impacted by the sum of checks that are cleared by the depositing bank the same day (0-day), next day (1-day) or the second business day (2-day). Actual clearing times for individual checks are based on many factors, including day of week, time of deposit, dollar size, drawee bank and deposit bank. There is little disagreement that check truncation will virtually eliminate 2-day presentments. This will cause some erosion in disbursement float, but probably less than 0.12 days on average. This is because high-dollar group sort and same-day presentment used by many depositing banks (especially lockbox banks) currently eliminate 2-day presentments when the dollars justify higher per-item and special courier costs.

An increase in the level of 0-day clearings is more difficult to determine. A consortium of banks, which clear the majority of controlled disbursement checks, are piloting check image exchange using existing ECP (Electronic Check Presentment) deadlines. Settlement is next day and controlled disbursement endpoints are protected from unfunded postings late in the evening. As long as the ECP model drives image exchanges, large-scale 0-day presentments are unlikely. However, the ECP model will eventually evolve into periodic exchanges of image files to reduce the bandwidth capacity that would be required by all-evening exchanges. Thus it could be possible for a wholesale lockbox to capture controlled disbursement items by an early morning deadline and transmit an ECP file to the paying bank in time for controlled disbursement funding reporting. In this way, 0-day presentments will occur and will deteriorate disbursement float. All in all, predictions of how much 0-day disbursement float will occur are still just guesses.

Check Clearing Times

Deposit Type	Drawee Bank	October 2000	October 2006
Lockbox Deposit			
	City	1.34	1.38
	RCPC	1.83	1.70
	Country	2.15	2.07
Over-The-Counter Deposit			
	City	1.60	1.72
	RCPC	2.22	2.17
	Country	2.53	2.42

Disbursement Fees

We anticipate that the expenses of maintaining a controlled disbursement account will actually increase as the banks charge more for the value of the notification. There also may be higher fees for anti-fraud services (positive pay, payee verification) and the fees associated with maintaining an image archive.

While paid item costs will eventually decrease, for the near term they may actually increase. Banks, after all, will have incentives to recover both increasing paper unit-costs and the investment in image equipment and software.

Longer term, overall paper volume will decrease and there will be winners and

losers among bank participants. Thus, there will be differing cost pressures for the individual providers. We anticipate corporations will see increasing pricing differentials among disbursement banks.

Service Price Summary

2006-2007 Blue Book of Bank Prices

	Average List	Average List Increase	Median Price Paid
Checks Paid	\$0.18	0.4%	\$0.150
Controlled Disbursement Checks Paid	\$0.19	0.7%	\$0.130
Positive Pay Checks Paid	\$0.21	2.3%	\$0.145

Return of Checks with Statement

Perhaps the most immediate impact of the Check 21 legislation was to require banks to formulate and implement a definitive “truncation” strategy for their statement customers. Banks now have huge incentives to eliminate check return with statements to customers. An image presentment to a customer account with full check return now requires the bank to create an IRD just to return paper to the customer. In the corporate marketplace, banks will aggressively push image access over return of an IRD that the bank has to create. The disbursing customer will likely be charged an additional fee for the IRD. Any processes that a corporation performs with physically paid checks needs re-engineering to convert to using images.

Conclusion

Longer term there is real question about the survivability of some disbursement practices. The now stated goal of the Federal Reserve Bank is to evolve a payment system where the legitimacy of any payment is known upon its initial presentment. This goal implies real-time verification at the point of initial presentment, including adequacy of available funds. The goal also subtly implies real-time “posting” against the paying account so that subsequent presentments receive similar assurance.

In the short-term, treasury managers need to take the necessary steps to reduce their exposure to fraud in the payment system. The best solution currently offered by the banking industry for check payments is positive pay. Once exclusively available to large corporations, it is clear that companies of all sizes should be using the service.