



BOC's Slow Break from the Gate

Peter Lucas

Retailer adoption of the new back-office conversion code has been slow to gather momentum, but that's the norm for any new e-check code. What are the implications for check-scanning hardware makers and merchant processors?

Slow starts are nothing new for electronic check conversion. Six months after NACHA—The Electronics Payments Association went live with back-office conversion (BOC), merchants are still weighing their options regarding BOC and electronic check conversion in general. And that means, at least temporarily, a state of limbo for makers of check-scanning hardware until merchants get a clearer picture of their options.

The hold-up is due to merchants' general lack of a clear idea about the benefits of BOC while a few early adopters quietly test the technology. With little public information about the efficiencies BOC brings to check processing, most merchants are taking a wait-and-see attitude.

The reluctance of merchants to jump on the BOC bandwagon resem-

bles the slow start of earlier e-checks at the point of sale and at lockboxes, and of the Check Clearing Act for the 21st Century (Check 21), according to industry experts. All grew incrementally for more than a year after their introductions before catching on in a bigger way.

"Check 21 was out in the market for a few years before it began to gain real momentum," recalls Bruce Dragt, senior vice president of product and business development for Greenwood Village, Colo.-based First Data Corp. "As more information about how the process created operating efficiencies came out, decisions about adoption were made."

BOC enables merchants that accept checks at the point of sale to convert them into electronic debits by scanning them in their back offices

for submission into the automated clearing house network. Herndon, Va.-based NACHA, which governs the ACH, sees the new code as a supplement to its older e-check code for retailers, point of purchase (POP). With POP, retailers usually equip every lane with a check scanner, and, unlike BOC, rules require the merchant to get explicit customer authorization for the transaction and to return the voided check.

Despite an estimated dozen or more tests among the top 100 merchants, processors have yet to identify major participants, largely due to non-disclosure agreements. "There have been surprisingly few announcements about BOC pilots," says Dragt. "What the lack of information about pilots suggests is that merchants are in the evaluation phase, which is not uncommon with payments products."

A major contributor to the ongoing evaluation phase is that NACHA did not allow for a beta, or test, period prior to going live with BOC in March, according to Tom Kettel, vice presi-

dent of marketing for RDM Corp., a developer of electronic check-processing applications and hardware based in Waterloo, Ontario. The advantage of a beta period is that it allows merchants and financial institutions to identify best practices that can be shared with the industry prior to rollout. "That's why we are seeing beta tests now," says Kettel.

Pricey Paper

The information logjam is expected to break within a year as merchants and processors gather more results they feel comfortable sharing. "This will be the year of the pilot, and in 2008 the industry will start to see rollouts," predicts Bob Meara, senior analyst in Boston-based Celent LLC's banking group. "Once the rollout commences, we'll see the product move from large merchants to the mid-sized market."

There are about 8,500 chain-store retailers and 171,000 independent retailers, according to Michael Pratt, chief marketing officer for Dayton, Ohio-based Panini North America, which provides applications for document processing and data imaging. "Checks still account for about 14% of retail sales volume in the U.S.," says Pratt. "That's a lot of paper to be left untouched by imaging solutions."

For retailers, the business case centers on operating efficiencies as opposed to consumer demand. "The operational needs are going to be different for each merchant category, so retailers are going to have to fully understand the benefits to their business," he says.

In the meantime, processors and vendors of check-scanning equipment are working to strengthen the business case for BOC by driving down the cost of hardware. The cost of check scanners is down about 30% from a few years ago, according to equipment makers. Merchants can purchase an entry-level scanner that handles about 50 documents per minute for as little as \$600. Prices for higher-volume models start at \$1,000. Software



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to support BOC runs about \$500.

While higher-end scanners for BOC purposes are considered pricey compared to simple terminals that capture a check's magnetic ink character recognition (MICR) bank-routing and account information at the point of sale—some start at less than \$200—the selling point is that merchants need only one or two scanners per store for BOC.

That's in contrast to one for every, or nearly every, lane with POP. For large multi-lane, national, or regional merchants, equipment costs for point-of-sale e-check conversion can indeed be substantial.

"Back-office conversion is a lot more cost-effective, because of the need for fewer scanners and because cashiers don't have to be trained to operate them," explains Paul Ruppel, director of marketing and product development for Digital Check Corp., a Northfield, Ill.-based maker of check scanners. "High-volume, multi-store retailers can handle as much as 5,000 or 6,000 checks a day."

With such a high volume, it does not take long for retailers to recoup their investment in the technology, according to industry experts. Another advantage to be gained is that

once a check's MICR line is captured and the document is electronically imaged (BOC requires merchants to store check images) in the back office and submitted to the merchant's bank for clearing, funds are usually received within 24 hours, compared with often 48 hours or more for paper checks. "Less float is a big incentive for merchants handling large numbers of high-dollar checks," says Ruppel.

Once a check is converted to an ACH debit—or, if it's not a conventional consumer demand-deposit account check, into a Check 21 item—it is easier for the merchant, the merchant's bank and the customer's bank to transfer and handle. Merchants have to batch paper checks at the end of the day, a process that can require several employees and a trip to the bank. With BOC, one or two employees can scan the checks and images can be transmitted several times a day, if necessary.

"Any time a new process can get the paper out of check processing, it is a good thing and it gets merchants thinking more about how they can take advantage of it," says Chris Ward, senior vice president and manager of payables and receivables products for Charlotte, N.C.-based banking giant Wachovia Corp. "BOC is certainly going to get them thinking along those lines."

Indeed, check handling is major expense for merchants. It costs about \$1.20 on average for merchants to handle and process a single check, and the cost is only expected rise as check writing declines and scale economies erode. "Supermarkets still account for 15% to 20% of the check volume at the point of sale, and will continue to handle high volumes for years, but check volume is declining in other retail categories," says Celent's Meara.

'Standing Pat'

Still, questions persist as to whether large merchants will embrace BOC. POP was notoriously slow out of the gate, but now Bentonville, Ark.-based

Wal-Mart Stores Inc., the world's largest retailer, has publicly endorsed POP, as have some regional retailers.

"Wal-Mart is one of the few major retailers to pick up POP, run with it, and stick with it," says Ruppel. "A lot of the other major retailers have looked at it only to back off."

Some industry observers attribute Wal-Mart's success with POP to its training program and the efficiency of its cashiers. With its nearly complete rollout of POP in more than 3,000 U.S. stores, Wal-Mart has given no indication it intends to move on to BOC any time soon.

"POP is a lot easier for the merchant because they aren't capturing an image, they are capturing the account and routing numbers for initiating an ACH debit from the consumer's demand-deposit account," says Gwen Bézard, research director for Bos-



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ton-based Aite Group LLC. "Even though merchants capture an image with BOC, they still have to get the checks into the back office, scan them, and properly dispose of them. With

POP, the check is handed back to the customer in the checkout lane."

Other benefits of POP include the ability to link check-authorization or check-guarantee services to the elec-

tronic conversion process and the fact that many POS terminals are equipped to perform check conversion. "Banks seem to be more excited about BOC than retailers, but then again they are the ones selling it," says Bézard.

Plus, many merchants are struggling with other technology issues, such as improving data sharing across all their sales channels, which is diverting their attention away from BOC. "Even if the business case for BOC is a slam dunk, retailers have other IT implementation issues to consider," says Celent's Meara.

Transaction pricing is also an issue. "Standard processing fees and then some apply in many cases," adds Meara. "As more processors get in the game and broaden the merchant categories they offer the service to, prices will come down, but for now, some banks are pricing BOC as though they are the only one offering it."

Price is certainly going to be an issue with supermarkets, which operate on thin margins and have historically required generous incentives from the payments companies to buy to their

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new products. Further compounding matters is that while many supermarkets are not as technically advanced in the back office as other retailers, they have mastered the efficiencies of handling paper checks and are not necessarily inclined to invest in new technologies when the current system works just fine.

"Merchants do have the option of standing pat, especially if their bank is willing to process paper checks," say Meara. "Some banks may even be willing to continue handling paper checks just to keep a merchant's business."

One selling point of BOC to supermarkets is that it doesn't intrude in the checkout lane. "Supermarkets don't have to change the technical infrastructure of the checkout lane to accommodate BOC," says RDM's Kettel. "The business case for BOC is there for Tier One supermarkets that generate a lot of check volume."

Checks on average account for 17.6% of a chain supermarket's volume, according to Panini's Pratt, citing data from the Food Marketing Institute grocery trade group. Convenience stores are another merchant category ripe for BOC. Checks represent about 11% of c-store volume, he says. "Both merchant categories see checks as an inefficient payment mechanism and have an immediate operational need for BOC," says Pratt.

Outsourcing's Outlook

In sum, the arguments for BOC are not translating into an instant sales bonanza for check-scanning vendors, though they make long-term sense. And industry executives agree that paper checks will not go away any time soon. Digital Check's Ruppel estimates that annual paper check volume in the U.S. will level off at around 20 billion. More than 30 billion checks still are written annually, according to government and industry estimates.

A large portion of the checks written will be to churches, charitable organizations, and health-care providers. While individual merchants in these categories may not generate the volume of large retailers, they can't necessarily justify the cost of a scanner and the supporting software. As paper check volume declines, however, processing fees will rise, putting a squeeze on their operating costs.

One solution will be outsourcing of BOC services. Industry experts predict that third-party processors will arrange with merchants generating low check volumes to have their checks

shipped to them, where they will be scanned and sent to the merchant's bank. "Some merchants are already moving to outsource their check scanning through a central service provider," says First Data's Dragt.

One such firm is Plymouth, Minn.-based Solutran Inc., which is preparing to roll out a BOC product called SPIN, for Solutran POS and Imaging Network. SPIN is being tested with a leading retailer and several other prospects have expressed interest, according to the company.

BOC is even making headway with online merchants. Ruppel says a multi-channel retailer of seeds has installed one of his company's scanners and during a six-week period earlier this year scanned 250,000 checks. "We also have a couple of grocers as clients, so there are legitimate sale opportunities outside the largest merchants," he adds.

Ultimately, the decision to adopt BOC comes down to whether merchants feel it is an economical alternative after weighing the cost savings of paper-reducing e-check services against the capital costs of buying or leasing e-check hardware. "If a merchant wants to do check authorization, it does not take much to add that on to POP," says Wachovia's Ward.

What processors need to understand most about the adoption cycle is that if merchants do not invest in BOC by this month, any implementation will be pushed back well after January 2008, as merchants do not make changes to their infrastructure during the holiday shopping season. "Retailers ramp up to sell during the fourth quarter, not to make changes to their business," says Ward.

Given the lack of information available to merchants about BOC pilots and the short window merchants have to install BOC technology before the 2007 holidays, processors and hardware vendors should not be surprised if adoption rates don't show more signs of life until well into 2008. **DT**