

CHEQUE TRUNCATION

Cost Benefit Analysis / Abridged Report

Executive Summary

1.1 Background and Objectives

In its September 2005 report *Competition in the (Non-Investment) Banking Sector in Ireland* the Competition Authority recommended that the Irish Payments Services Organisation (IPSO) should “analyse new technology for clearing electronic copies of cheques”, and specifically, “prepare a cost/benefit analysis of the various options for the use of truncation technology”.

This recommendation arose from the Competition Authority’s view that truncation is one of the means by which new entrants to the market could obtain easier and less expensive access (in infrastructure terms) to the paper clearing system, which would facilitate competition.

IPSO has also taken into account the view expressed by the Department of Finance that measures required of government (such as legislative changes) and others to facilitate truncation would be dependent on whether the measures would in practice bring improvement in the overall efficiency of the paper clearing system.

Today, Irish paper clearing is conducted directly between Irish Paper Clearing Company (IPCC) members, with each member responsible for managing the exchange of paper with each other member. Bilateral file exchange exists between the largest two members only.

Over the last 18 months, IPCC members have explored alternative models, including a shared utility truncation model for paper clearing. Following the Competition Authority recommendations, IPSO decided to commission a study to identify the outline costs and benefits of potential models for truncation, including:

- A shared processing utility with paying bank truncation, providing IPCC members with a range of clearing services
- Potential other options including truncation at point of entry or at a bank clearing centre.

1.2 Study Contents

In order to meet these objectives the study has considered:

- The current and projected industry costs of paper payments processing in Ireland
- The operating model for the shared utility, including the services offered and how member banks would use it
- The potential supplier configurations for delivering the utility
- The migration approach to the shared utility
- The financial costs and benefits of the proposed model
- The non-financial benefits and implications to the industry of moving to the proposed model, to inform an assessment by IPSO of the impact on access for new entrants and the efficiency of the paper clearing system
- An aggregate conclusion of the overall case.

This Executive Summary covers these contents in the above sequence.

1.3 Current and Forecast Costs of Paper Payments

The study has used 2005 costs from the banks as the last full year's costs available. Clearing processes account for just 36% of this cost, with cheque printing and channel capture accounting for the rest.

The Day 1 transport and processing costs accounting for approximately 46% of unit costs.

A total of 69% of industry clearing costs in 2005 are variable, with 31% fixed. This means that costs fall at a slower rate than volumes, increasing unit costs in the process. By 2018, unit costs are projected to rise by 18%.

The study has created two alternative volume projections to the banks' own projections (which assume that volumes decline to approximately 71% of 2005 levels by 2018). These are the medium decline projection (which assumes volumes decline to approximately 45% of 2005 levels by 2018) and the radical decline projection (which assumes volumes decline to approximately 23% of 2005 levels by 2018).

The impact on unit cost of higher rates of volume decline is acute. In the medium volume projection, clearing unit costs rise by 53%, and in the radical volume projection, they more than double. This means that, whilst banks are currently projecting an ability to keep unit costs reasonably under control, they are exposed to significant risk if volumes were to fall at a higher than expected rate.

1.4 Proposed Operating Model

The model proposed and agreed for costing purposes provides for banks to submit either paper only or paper and codeline into a single clearing facility (the TSU) which is shared by all IPCC members. The TSU performs out-clearing for all members, maintains a code-line and image archive, and performs Day 2/3 payment services on the clearing entries, as required by individual members.

The physical paper is truncated at the TSU – it is not sent out to paying banks. Paying banks access the shared image archive for images of paper as needed for payment processing and information purposes

An "enhanced solution" was also defined in outline during the study, to allow for collecting banks to have the option to send images only to the TSU. This solution is a variant of the initial target model, and supports collecting banks who wish to truncate paper at the point of entry. For these banks, the TSU provides a process to accept code-line data and upload images directly on to the image archive. The bulk of the paper remains within the collecting bank (with exceptions as agreed).

The agreed operating model can be managed in a number of different ways. The costs and benefits have been assessed for three operating scenarios, as follows:

- **Scenario 1: 3rd Party Managed Service**

One supplier is appointed to set up and operate the entire utility for the members. Each member therefore effectively outsources its clearing operations to the supplier. BancTec's response to the IPSO request for supplier information (RFI) was selected as the basis for costing this scenario.

- **Scenario 2: Industry Managed (componentised)**

Multiple suppliers contract with a single utility that is owned by IPCC members. The suppliers provide individual components of the service, for instance clearing equipment or fraud management software. NCR and Vector's responses to the RFI were selected as the basis for costing this scenario.

- **Scenario 3: Industry Managed (lead supplier)**

This scenario was developed from Scenario 2 to test whether there would be any potential advantage to the industry to manage its own utility but by contracting with a single or prime technology provider. The costings assumed this lead supplier would be BancTec, based on their incumbency within the ROI industry.

1.5 Migration Approach

For the purpose of this assessment, the migration approach consists of a period of planning and preparation followed by three phases of implementation, as follows:

- **Planning & Preparation:**

A preparation phase leading to the banks' commitment to developing the TSU model will include agreeing legal and commercial, operational and technical design, business case preparation, supplier selection and creating service level agreements. It also allows the commencement of HR/IR activities and the start of the legal changes that will enable images to replace paper.

Implementation of the legal changes required will be at the discretion of the Department of Finance and will directly affect the decision taken by member banks on whether to proceed with the TSU model identified. If the decision to proceed is taken it will be followed by a three phase programme as follows:

- **Phase 1 – Out-Clearing:**
Migration of banks' out-clearing operations to the TSU
- **Phase 2 – In-Clearing, Settlement & Reconciliation:**
Implementation of posting extract processes – the equivalent of electronic in-clearing based on the codeline database and image archive as required
- **Phase 3 – Day 2/3 Payment Services:**
Migration of Day 2/3 Payment Services to the TSU.

These phases will be reviewed and may be redefined as part of the planning and preparation activity.

1.6 Non-financial Assessment

1.6.1 Regulatory alignment

The new clearing operating model defined for this study aligns strongly to the regulatory drivers of easier access for new entrants, and improved efficiency for the clearing.

All scenarios appear to simplify greatly the technology required by new entrants, and eliminate the need for bi-lateral arrangements with other members. Also, clearing processes are reduced and greatly simplified under all scenarios.

1.6.2 Banking Strategy

The study has focused on strategic themes applicable to all banks rather than complete a full assessment of the proposal against each bank's payments strategy. This would need to be done in the next phase, should the industry decide to proceed.

At an industry level the proposed model is largely positive as, by delivering a single payments utility for ROI, it will:

- Deliver reduced unit costs and a more scalable clearing infrastructure. This reduces the risk of unit costs increasing as volumes decline. (Note that the biggest proportion of unit costs, relating to channel capture, is not reduced)
- As an e-switch for ROI payments, it could strengthen ROI's position to provide a Pan European Automated Clearing House (PE-ACH) capability for the Eurozone.
- Provide an opportunity to expand the scope to include work from other countries, e.g. Northern Ireland. This could include the use of image (the enhanced solution) where appropriate.
- Provide an opportunity to expand to include other bank case-based processing, e.g. regular payments, product applications.
- Drive the commerciality of clearing operations by making clearing costs more transparent.

However all scenarios demand individual banks' management focus and change effort with benefits linked to potentially declining volumes, overall returns depend on how quickly the job can be completed.

1.6.3 Risk

Any change of this nature introduces risk, in particular the proposed model will change the operational risk of clearing and introduce transitional risk during the migration period.

From an operational risks perspective, at an industry level, the proposed model will:

- Introduce a single point of failure for the entire clearing industry. This can be mitigated by the introduction of a managed DR solution into the design and cost, but the risk to the industry is potentially higher than now. This single point of risk also covers the potential impact of industrial action. This remains a risk, although the experience of the ClearCo joint venture in Northern Ireland demonstrates that the risk can be managed
- Increase the supplier risk to service levels through outsourcing. Clearing would become one step removed from other banking operations, with staff at the utility not understanding that they are a

critical element of the bank's end-to-end customer service. Note, however, that experience in the UK shows service levels actually improving over time, driven by expert staff in "centres of excellence" with greater commercial awareness of the financial consequences of non-compliance with agreed SLAs

The transitional risks of a change of this nature are significant but can be managed effectively. The actual risks in this area are dependent on the operational model selected, the suppliers selected, the agreed timescales and the commitment levels of the Regulatory & Competition Authorities, IPSO and the IPSO member banks.

1.7 Conclusions

1.7.1 Industry-wide Truncation through a Shared Utility

Based on current industry volume projections for paper, there are material financial benefits to the industry of migrating to cheque truncation via a shared clearing utility:

- If all members migrate to a single, shared, clearing service, the industry will save 17-25% of clearing costs between 2009 and 2018
- By the end of the period, clearing unit costs will have reduced by 18-39%, compared to an increase of 18% otherwise.

However, these financial benefits are reduced under lower cheque volume projections: under the "radical reduction" projection, savings are only 14-21% of clearing costs. These reduced benefits should be taken in context of nearly trebling unit costs if the banks continue as they are in this volume scenario.

A shared clearing utility would also:

- Provide members with a simpler clearing operation. However, if any members opt out, then the model will be more complex and benefits reduced for existing and new members
- Provide a new processing capability for IPCC members which could strengthen ROI's position for providing a PE-ACH for the Eurozone.

The approach to the migration, and the commercial model adopted, will affect the costs and risks of the initiative. Migration to a third party managed service offers lower transitional risk but a slightly higher cost than "industry managed" alternatives.

1.7.2 Cheque Elimination

The study has not explored the costs to achieve cheque elimination, nor any social or market implications of such a strategy. However, the members have calculated the end-to-end cost of cheques and credits over the study period. This provides a sense of scale for operating cost reductions if cheques were eliminated.

1.7.3 Truncation Alongside a Radical Reduction

Elimination and truncation are not mutually exclusive. By undertaking the truncation strategy, simultaneously with a radical reduction, the industry would be reshaping and resizing its infrastructure to be more scalable as volumes decline.

In addition, the establishment of the TSU does have some non-financial benefits, which could complement moves to reduce cheque volumes.

1.7.4 Overall conclusions

There are identified financial benefits at an industry level if the clearing banks migrate to truncation at a single, shared utility. Such a utility also provides a more scalable operating model, which can better gear the industry to future volume declines. It can also potentially provide additional benefits to the industry, such as the potential to extend to Island-of-Ireland solutions, and PE-ACH capability, to strengthen ROI's position within the Eurozone.

IPSO and the banks need to assess the trade-off between these benefits and the risks involved in establishing and migrating to a truncation model.