



White Paper

Primary Payment Systems, Inc.

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Fraud in a 'Check 21' Environment

The Ongoing Value of Receiving an Early Warning® notification

With last year's passage of the *Check Clearing for the 21st Century Act*, or *Check 21*, most financial institutions are examining their internal practices to determine how this legislation will impact their organization, as well as their customers.

Much has been written on the direct and indirect benefits of this legislation. Particular focus has been given to the anticipated cost savings of eliminating physical transportation of items, as well as the reduction to float, especially in those instances where items were not already being delivered on the same day or overnight.

While there are those who have been quick to tout its potential upside, little has been written on how fraud will persist and evolve in this new environment. Apparently many within the industry believe that upon becoming image-enabled, exposure to fraud losses will be greatly reduced or even eliminated. There are many positive aspects to Check 21. However, those who assume there will be a dramatic reduction in fraudulent activity could find themselves highly vulnerable.

Check Processing – Today

In today's processing environment, nearly all checks are physically presented to a paying institution for collection. Transportation of these checks is costly and the float they create can leave financial institutions vulnerable to fraudulent schemes.

However, the true vulnerabilities of this process were fully exposed during the tragic day on 9/11 when the entire financial system was severely impacted. Checks were delayed days, and in many cases weeks, because of stoppages in the courier system.

This event was a major factor that helped motivate the U.S. Congress to adopt legislation to reduce our reliance on physical transportation and improve the overall efficiency of the check processing system.

The Check 21 Act

The purpose of the Act is:

- To facilitate check truncation by creating a new legal instrument known as a substitute check for institutions not able to receive and post electronic images;
- To foster innovation in the check collection system without mandating receipt of checks in electronic form; and
- To improve the overall efficiency of the nation's payments system.

With Check 21, no agreement is required with the recipient to deposit, present or send for collection or return a substitute check.

The long-term benefit of this legislation to financial institutions will undoubtedly be a reduced reliance on the existing courier system resulting in both a general reduction in operational costs and an acceleration in forward presentment, posting and return notification.

On October 28, 2004, Check 21 legislation will go into effect. This new law seeks to help financial institutions increase efficiencies, and accelerate check processing.

The Rate of Adoption

For those institutions that have not begun to implement imaging technology, the investment required is significant, and may be prohibitive for many. These include:

- The ability to capture images and image-survivable security features at the teller window and ATMs. Retention and the retrieval of original items must also be considered;
- The need to redirect imaging to backroom operations in order to achieve next-day posting, returns and exceptions; and
- Significant changes to end-of-day posting sequence logic. Accountholder issues will result if imaged checks are applied to an account before deposits and other debits, which are typically posted first, e.g., ATM and point-of-sale (POS).

The various rates of adoption of this technology by financial institutions will result in numerous presentment, posting and return processing scenarios.

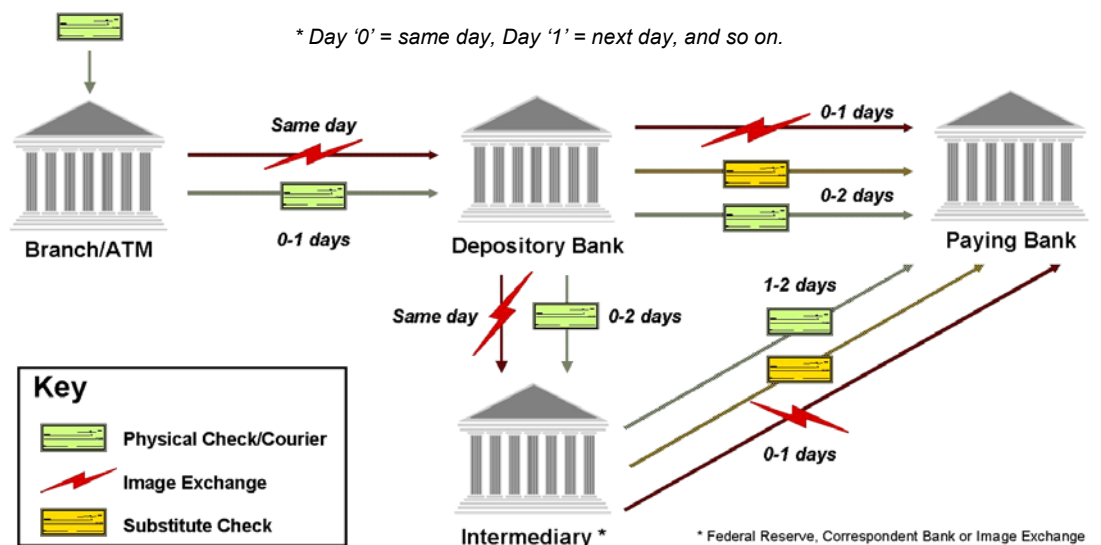
Each of the more than 20,000 U.S. financial institutions will need to evaluate its unique return on investment and determine to what extent (if at all) and in what timeframe adoption will occur. With the absence of any mandate requiring receipt of checks in electronic form, the rate of adoption and the degree to which financial institutions will be willing to change will vary.

Just as reducing float is not synonymous with eliminating or reducing fraud, Check 21 was not created to be a fraud prevention tool.

A Mixed Processing Environment

Those financial institutions capable of exchanging images will experience a reduction in float for those items received on an earlier business day than was the case when exchanging paper. However, until all institutions are image-enabled, the forward collection of the resulting mix of image, substitute check and traditional paper may in some cases expand the processing cycle by one or more business days for those items affected. A challenge for the collecting bank will be to know ahead of time which form the paying institution will accept.

This following diagram illustrates many likely scenarios that will exist during collection and presentment.



The additional following scenarios may expand the processing cycle by one or more processing business days for those items affected.

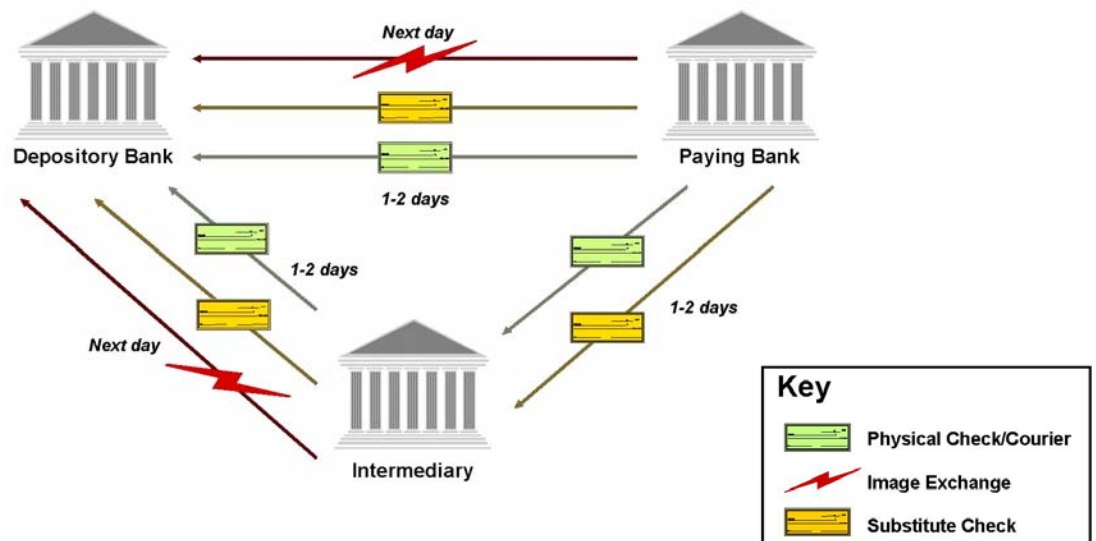
- In all but the largest financial institutions, image capture will likely take place in a centralized location.
- Many institutions will find themselves either partially image enabled, or still reliant on the existing courier system to transport physical checks.
- Others will outsource or utilize an intermediary to exchange images, perform image conversion, and/or create substitute checks.
- For those larger financial institutions that are fully image enabled, direct exchange of non-local items will potentially accelerate presentment and settlement. However, these same institutions may continue to find it more cost effective to physically exchange local checks if they operate in the same geographic market.

Posting and Return Timings

Varied processing capability among paying institutions will subject depository institutions to a wide range of posting times and subsequent return notifications.

There is a natural tendency to conclude that because it will now be possible to send, receive, post, settle and return items on Day '0' (same day) that it will indeed happen. To reach this conclusion one must ignore the numerous obstacles and barriers that must be overcome before incoming checks received for presentment will be posted real-time or ahead of all other debit and credit activity awaiting that day's posting. Thus, paying financial institutions will likely continue to use as much of the allotted time (midnight of the day following posting) to determine which items to return. Thus, an image-enabled depository institution may continue to experience returns as late as midnight on Day '2' from other image-enabled recipients.

For online posting and for many non-POD institutions, deposits at the branch & ATM are often 'memo posted'. These do not actually settle until the paying institution receives the item and makes their acceptance decision.



Regarding exceptions, image retrieval should be faster than physically locating an item. Also, reducing the number of times an item must change hands should result in fewer sorting and read errors. There is, however, a legitimate concern to resolving exception issues brought about by the anomalies created by image processing. Exceptions to both imaged and substitute checks could result in processing delays extending beyond that of traditional paper.

The Impact to Fraud

Fraud is not going away. If history has shown us anything, it is that fraud will evolve as criminals regroup and exploit weaknesses and vulnerabilities of new processes. The battle is not over; it will simply be fought elsewhere and in other ways.

One way in which fraud is likely to evolve will be to exploit the extended float associated with checks drawn on non-image or partial-image enabled institutions. Contributing to these delays will be the continued use of courier transportation for physical items, the lack of image capture at the point-of-deposit, and the need to reconvert images to substitute checks for settlement and returns.

This will impact not only late adopters and those that find the required technology cost prohibitive, but also all depository institutions that receive checks drawn on these paying institutions. Fraud will likely manifest itself in many ways; including check cashing and cash back schemes, as well as various forms of deposit fraud, exploiting the confusion caused by the rate of image adoption.

Some other potential concerns include:

- Since financial institutions may no longer have a paper check to inspect, it seems likely that counterfeiters will exploit the inability of digital images and substitute checks to retain traditional security features, as well as capture certain types of forgeries and alterations.
- The timeframes banks are allowed to place holds on deposited items may be reduced making fraud more difficult to prevent, e.g., possible changes to the Expedited Funds Availability Act (Regulation CC).
- The emergence of faceless transactions and the increased use of electronic checks should cause all institutions to review policies and determine to what extent there exists an increased need to verify that an individual is authorized to transact business on a particular account.

When multiple financial institutions are involved in a kiting scheme (or other professional crime ring activity), every second of risk management analysis counts, because the last financial institution to detect the scheme typically takes the loss.

Summary

1. For those financial institutions adopting imaging, Check 21 helps reduce:
 - a. Time and cost for physically transporting paper items; and
 - b. Float, especially in those instances where items were not already being delivered same day or overnight.
2. Acceptance and rate of adoption will result in a mixed processing environment for some years to come. Regrettably, until all institutions are image-enabled, the forward collection of the resulting mix of image, substitute check and traditional paper will be a new challenge for managing risk.
3. Imaging may reduce the window of opportunity, but contrary to popular myth, imaged items are unlikely to be posted real-time as they are received. Consequently, from the receipt of an imaged item, until it is posted and possibly returned, a window of opportunity continues to exist for the criminal element to exploit.

Primary Payment Systems, Inc. (PPS), a part of the First Data family, offers a suite of Early Warning® solutions that help answer critical questions such as "Should I open an account?" or "Should I give cash back?" as well as "What is the probability that a deposited check will be returned?"

By providing accurate and predictive information on identities, accounts and transactions, these solutions help protect financial institutions as well as the customers they serve against sophisticated fraud schemes.

The Ongoing Value of Early Warning® notifications from PPS

The Early Warning suite of solutions is of greater significance and purpose with the passing of Check 21. These solutions help protect financial institutions against sophisticated fraud schemes by providing accurate and predictive information on people, accounts and transactions thus mitigating fraud on new accounts, deposits and payments at the teller line and in the back office.

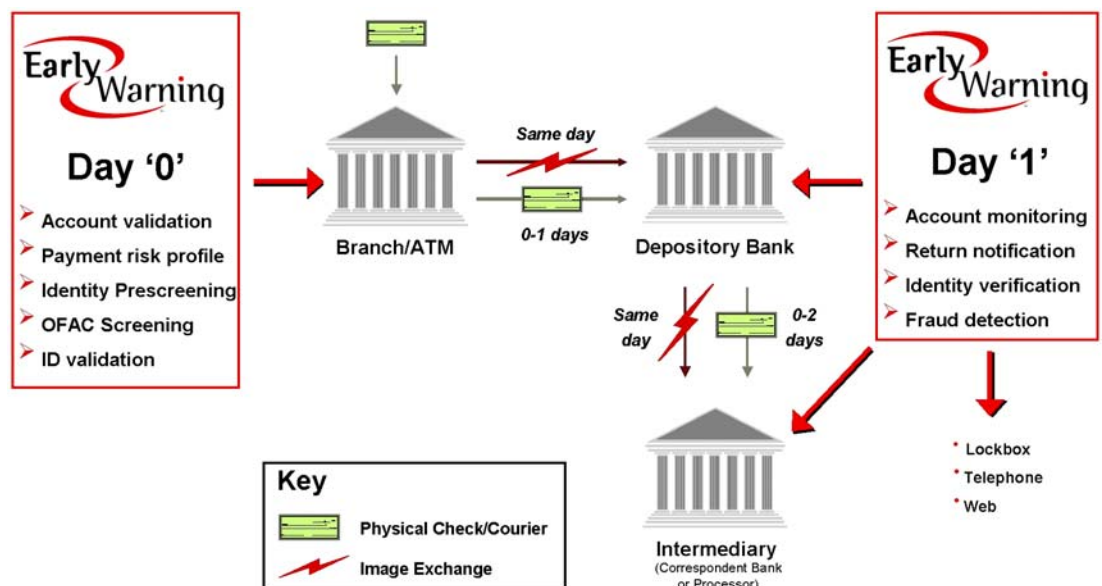
Same Day Notification - DAY '0'

- Those utilizing the DECISION CHEK® service, receive real-time account status notification at the point-of-presentment, helping to protect against check cashing, cash-back and deposit fraud losses before the item is accepted and possibly imaged.
- Conducting up to 60 tests on each identity, the IDENTITY CHEKSM service detects invalid, inconsistent, and unusual identity elements in seconds.
- The IDLogix® service instantly reads and validates encoded information on driver's licenses and other government issued identification.

Next Day Notification - DAY '1'

- Delivering 'hit reports' by 8 a.m., the DEPOSIT CHEK® service provides 'next day' notification on all deposited items drawn on participating financial institutions. Reports indicate whether an account is valid, its status, whether or not a stop payment exists, as well as high-risk status codes, the result of integrating recent check return activity.
- The DEPOSIT CHEK service also delivers electronic return notifications on Day '1', or as soon as a participating paying financial institution makes a no-pay decision. This information is forwarded directly to the applicable liability risk management team.
- Conducting up to 300 tests on each identity, the IDENTITY CHEK service performs positive and logical verification, fraud detection, and OFAC screening.
- Utilizing the Anti-Fraud ExchangeSM service, organizations from multiple industries exchange information on known and attempted frauds on a daily basis.

By not regarding fraud as a competitive issue, hundreds of banks & credit unions participate in what many consider to be the industry's largest collaborative effort to combat deposit and payment losses.



For more information on the PPS suite of Early Warning® solutions, please visit us at www.primarypayments.com, or contact Jennifer Coughenour toll-free at (877) 275-7774.