



The Gnomes of Chargeback

by Bill McFarland
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Fee income continues to be a significant factor in bank earnings. When it comes to fee income, though, all banks are not created equal. Using 2006 FDIC source data, the national average for “service charges as a % of transaction account deposits” is just over 2%. The country’s largest banks (those with total assets greater than \$25 billion) achieve an earnings level of over 7% of service charges as a % of transaction account deposits, while banks with assets between \$500 million and \$25 billion only earn about half that, at 3.65%.

What’s different? Why do the “big boys” generate twice as much fee revenue on deposits as their smaller competitors? The reasons are numerous, but a change in viewpoint probably comes first: bankers sometimes overlook profit-making opportunities hidden deep in the bowels of their own bank—commonplace functions that have never before been considered “a profit center.”

One of the *most* unglamorous of these locations is home to the gnomes who process returned deposit items, a.k.a. RDIs or “chargebacks.” In their simplest form RDIs are checks, typically deposited by merchants in payment of services, which are later returned NSF by the bank they were drawn on.

Although some bankers remain a bit uncomfortable with overdraft protection programs, most banks have overcome those qualms and are now generating significant fee income from ODP programs. Chargebacks are the “other side” of the ODP equation, if you will, where a pizza shop owner who has deposited the check used to purchase a pizza then receives the check back “Drawn on NSF.” The pizza buyer’s bank didn’t pay the NSF, though you can bet it collected an NSF fee! Now, the pizza shop must collect the check from the inadequately-funded pizza buyer. Just as with ATM surcharges (another key source of fee income from *other banks’ customers*), there is additional revenue to be obtained from this NSF transaction. The source of the incremental fee income is not the bank’s customer base, the additional income is from the pizza buyer—who is probably NOT a bank customer.

Expanded chargeback automation and collection is a natural outgrowth of a bank’s item handling capability. Though not a traditional “cash management” service, it is valued—most merchants appreciate the assistance and would prefer to deal with their banks rather than the commercial check collection services that are generally not bankers. In the largest banks, entire departments specialize in this service. Remember that statistic? *The biggest banks have earnings levels of over 7% of service charges as a % of transaction account deposits, while banks with assets between \$500 million and \$25 billion only earn about half that, at 3.65%.*

Chargebacks can be a meaningful source of fee income. Not only is there a chargeback fee assessed to the merchant for handling each returned deposited item, there is also the opportunity to assist

merchants with collection of these items. In particular, ACH collection of RDIs for bank business customers is a service rapidly growing in popularity that can improve new commercial account acquisition. It can be a tie-breaker in a competitive situation, and it further deepens existing commercial relationships with the bank.

ACH collection works for both paper and electronic returned items. The reasons for this growth in popularity are several:

1. It dramatically improves collection of bad checks for business customers, typically at no charge to them (the check-writer pays). Nationally, bad check collection averages run about 45%. With improved processes and automation, business customers can collect 70% to 80% of their bad items. This is because items can be re-presented twice more as ACH items (vs. once more as paper items) and the re-presentation can be timed to occur on Fridays and paydays, when there are more likely to be funds in the account. *This is a significant benefit to the bank’s commercial account-holders.*
2. It creates recurring fee income for the bank.
3. Up-front staffing and capital investments are typically minimal, depending on whether the bank uses in-house procedures or outsources the entire process to a specialist in the field.

With ODP, many banks prefer to handle overdraft courtesy pay using internal staff and institution-specific procedures. Other institutions look to specialists in the field who offer services which increase a bank’s collection ratio using proprietary methods and procedures—but these service providers also extract a fee from the bank’s potential revenue stream. The same options exist with respect to chargeback processing—banks can increase fee revenue from this source using procedures developed in-house, and there are specialists in the field who can provide the service for those who prefer to outsource specialized functions.

Chargeback processing services are provided by commercial service providers and some larger correspondent banks. Key considerations that differentiate products in this arena include the following:

1. Are services NACHA compliant? ACH fee collections require a consumer authorization signature for each item, so that it is preferable to issue paper drafts to collect the bounced check fee.
2. Does the service provider provide call center support, so the bank does not have to answer questions or deal with support issues from its business customers?
3. Is the program designed for and marketed to banks and their customers? Some service providers primarily sell directly to banks’ customers, and continue to draw the bulk of their revenue as a competitor to banks.
4. Does the service provider collect on all returned items from a bank’s business customer, not just the ACH-eligible items? Some service providers supplement RCK collection with IRDs, letters and phone calls.



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5. When collected, are merchants paid at 100% of face value? Most merchants do not receive 100% of face value on secondary collections from non-bank servicers.
6. Handling all returns in a single location simplifies processing, since the bank does not have to sort the various types of returns before forwarding to the service provider.
7. Some service providers and correspondent banks share a percentage of the gross collected fee with their client banks.
8. Are there provisions for an opt-out of selected merchant depositors? If so, what is the opt-out ratio? If a service provider has an opt-out ratio of 40% or 50%, the bank will receive income off of only about half the items it handles.
9. Service providers who process returned electronic items allow the bank to capitalize on the growth of ARC, POS, BOC, PPD, TEL and WEB.
10. Some service providers provide operational simplicity by allowing both the merchant and the bank to access RDI status information over the Web.

It doesn't matter whether the source of the expertise is in-house or externally acquired, but it *does* matter that many banks have overlooked this excellent source of customer goodwill and incremental fee revenue. As readers of medieval literature know, gnomes often guard hoards of gold, hidden deep in forest caves. What treasures do your Gnomes of Chargeback have hidden away? -gb

For banks that decide to make chargeback collections a profit center, what are some of the operational considerations?

Chargeback collections can be applied to more than just returned paper checks, including ACH check conversions and other transactions originated as an ACH item – transactions such as TEL (payments made by telephone), WEB (payments made online) and PPD (pre-authorized payment debits). Following are the transaction possibilities and chargeback options:

1. Paper Check Payments (customer writes out a check and submits to merchant)

- **Option A – Merchant endorses check and physically deposits at his bank.** The electronic recovery of traditional NSF paper checks is attempted via an ACH transaction known as an RCK. Most bankers know by now how that works. When handling paper checks, it is also worthwhile to attempt "secondary collection" (phone calls and letters) recovery of paper checks NOT eligible for RCK. These include personal checks over \$2,500; checks returned due to "Closed Account," "Return to Maker," etc., and business checks and several other categories of transactions that can't be collected via RCK.
- **Option B – Merchant scans check at point of purchase, creates an IRD (image replacement document) either locally or remotely and transmits it to the bank for deposit.** Many remote deposit capture systems work this way. They DO NOT convert the check into an ACH, but duplicate it as an IRD, which is treated as a paper check after it arrives at the bank. This means that if an IRD is returned, the bank can send a paper copy of the IRD for collection via RCK, just as with a traditional paper check. Just because a check is scanned at the point of purchase, that scanning does not necessarily mean that this is a check conversion transaction.

2. ACH Check Conversions (customer writes out a check and submits to merchant)

- **Option A – Merchant immediately converts check to a POP (point of purchase) ACH item and electronically transmits check to bank for deposit.** This is how the more sophisticated Remote Deposit Capture systems work—converting the check into an ACH POP at point of purchase via use of an approved scanner. The actual check is handed back to the check writer. Once converted, the item is maintained as a POP through the clearing process. Each POP item is placed within a NACHA batch file that accumulates until it is transmitted by the merchant to the bank for deposit. If a POP is returned, the bank can extract the eligible POP item from the NACHA returned batch file and process it for re-submission. Only NSF returns of POPs are eligible for re-submission, and secondary collection for ACH check conversions is not allowed.
- **Option B – Merchant (or merchant's agent) receives check in a lockbox system, immediately converts check to an ARC (account receivable conversion) ACH item and electronically transmits check to bank for deposit.** This is typically what happens with utility payments made by check: converting the check into an ACH ARC at point of receipt via use of an approved scanner. The actual check is destroyed soon after conversion. Once converted, the item is maintained as an ARC through the clearing process. Each ARC item is placed within a NACHA batch file that accumulates until it is transmitted by the lockbox agent to the bank for deposit, usually at least once a day. If an ARC is returned, the bank will extract the eligible ARC item from the NACHA returned batch file and send it for re-submission. Only NSF returns of ARCs are eligible for re-submission; "secondary collection" attempts are not allowed.
- **Option C – Merchant receives check at point of sale, but delays conversion of the check to a BOC (back office conversion) ACH item until later in the business office, where all checks will be scanned, converted and electronically transmitted to bank for deposit.** This is a typical use of remote deposit capture, converting a check into an ACH BOC in the more normal business environment of "the back office." As with lockbox, the actual check is destroyed soon after conversion. Once converted, the item will be maintained as a BOC through the clearing process. Each BOC item is placed within a NACHA batch file that accumulates until it is transmitted by the merchant to the bank for deposit, usually at night. If a BOC is returned, the bank will extract the eligible BOC item from the NACHA returned batch file and send it for re-submission. Only NSF returns of BOCs are eligible for re-submission; "secondary collection" attempts are not allowed.

3. Other ACH Originations (customer uses the telephone, Internet or other means to make payment)

- **Option A – Merchant receives payment via telephone call, immediately originates a TEL ACH item, and electronically transmits item to bank for deposit.**
- **Option B – Merchant receives payment via Internet transaction, immediately originates a WEB ACH item, and electronically transmits item to bank for deposit.**
- **Option C – Merchant is pre-authorized to debit the customer's account on a certain date, originates a PPD ACH item, and electronically transmits item to bank for deposit.**

With any of these, the item is maintained as a TEL, WEB or PPD through the clearing process. If an item is returned, the bank will extract any NSF returned item from the NACHA returned batch file and send it for re-submission. Only NSF returns of these items are eligible for re-submission; the information contained in the NACHA file is limited and prevents any "secondary collection" attempt.