

THE IMPACT OF ITEM ELECTRONIFICATION A BALANCING ACT

A conversation with William H. Gallagher, *A D S Financial Services Solutions* – President and CEO, and Bob Seltzer, *Meta Software Corporation* – President

JANUARY 2006



It's easy to give into the siren song that "outsourcing" is the perfect solution to balance costs and capabilities... make sure that you don't outsource what could become the critical differentiator in the new and competitive payment system – or you are out.

THE IMPACT OF ITEM ELECTRONIFICATION- A BALANCING ACT

There is no question about it, the financial services industry is on the cusp of a major shift as the banking payment landscape evolves from paper-based check processing to a digital imaging environment. Three market drivers are stimulating this change:

- 1) Consumer acceptance of check conversion into electronic payments.
- 2) Regulatory and industry promotion of image presentment and interchange.
- 3) The cost benefits that can be realized through image capture and processing.

As chart 1 (below) indicates, the annual decline rate in check volumes is currently estimated at 8.5%. This decline will accelerate considerably over the next three years; a cumulative projected decline for check volumes is estimated between 40% - 60%. This decline will occur in the context of a total increase in the number of non-cash payments.

As the industry and institutions attempt to position their costs, capabilities, and resources to meet this shift, few have adopted a holistic viewpoint that balances the challenges of cost side rightsizing with reengineering their payment infrastructure. Furthermore, a new competitive environment will evolve from the digital integration of images, spawning new products and services on the revenue side.

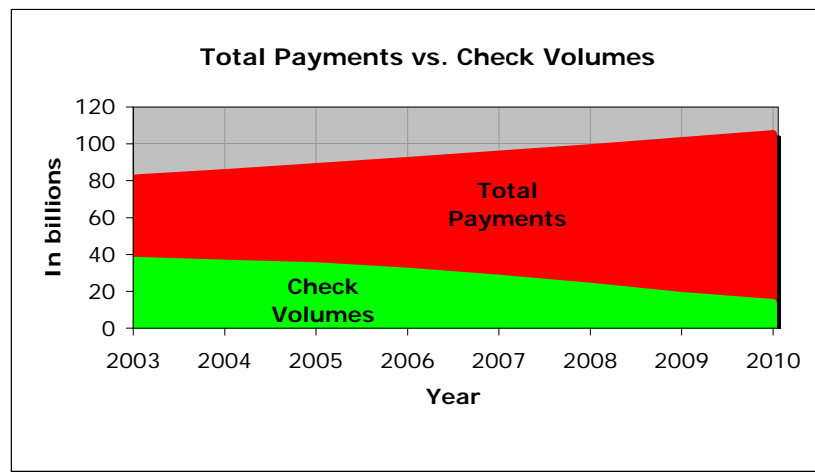


Chart 1

Q: What is the biggest impact of Item Electronification?

A: The obvious reality of this shift is the dramatic impact it will have on back-office operations. Every institution that receives, originates and/or processes paper items is under pressure to balance the costs of: **1)** supporting a large infrastructure that faces a rapidly decreasing check volume, and **2)** supporting the costs of retooling operations to participate in the new image interchange environment.

Balancing these two demands is a rising challenge. Any misstep could dramatically increase per-item processing costs, damage revenue streams, and affect market share.

Q: How do you remain viable?

A: The cautionary advice would be - "don't be short-sighted as you address near-term costs." It would also be foolish to consider the current challenges as a one-time transitional problem. In reality, implementing a successful strategy (cost vs. revenue) will prove to be an ongoing balancing act, requiring discipline and insight as corrections and operational adjustments become necessary.

More importantly, it's easy to give into the siren song that "outsourcing" is the perfect solution to help balance costs. Banks must recognize that outsourcing can impact the opportunity to participate in future revenue sources and diminish the ability to develop competitive products and services. "Make sure that you don't outsource what could become the critical differentiator in the new and competitive payment system – or you are out."

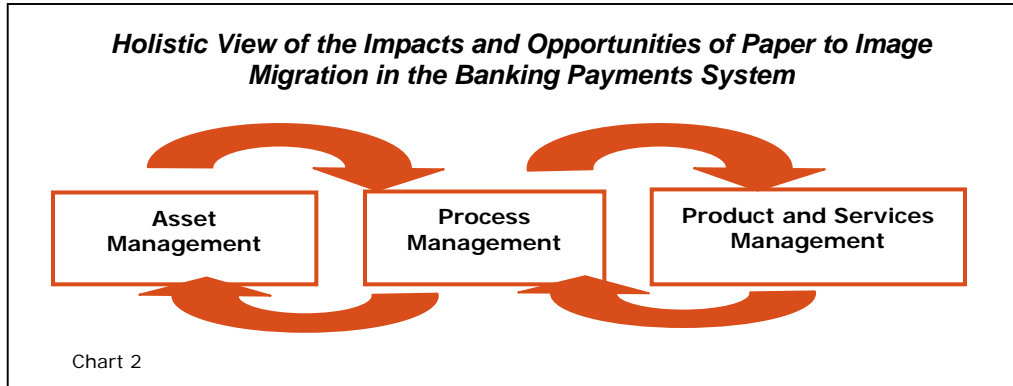
For more information go to www.adsfs.com

An ongoing balancing act:

- Investments versus expense reductions
- Cost containment versus revenue opportunities

Q: So, what's the solution?

A: We believe that a holistic view of how item electrification affects processing operations will allow management teams to make prudent and insightful decisions – aligning the bank's strategy for future and innovative developments.



As the chart above indicates, institutions will have to address the issues relative to the impact of item electrification in three distinct areas: Asset Management, Process Management, and Products and Services Management. Decisions of investments versus reductions, cost containment versus revenue opportunities, and how to position assets and operational processes will require ongoing evaluation. Projects will be identified and initiated in each of these three key areas. As is true with a holistic approach, decisions in one area will create the need for reevaluation in other areas. Dependencies and relationships between Assets, Processes, and Products/Services will require in-depth analysis. However, the resulting solution and action plan stands a greater chance to succeed and positively impact business operations.

It is important to understand what is involved in each of these areas and what type of analysis and initiatives we expect will be encountered.

1) ASSET MANAGEMENT:

Institutions have historically increased operational assets supporting paper items in the areas of: POD, check in-clearing and transit, Day 2 check, and Lockbox processing in response to volume demands. However, for the past several years industry prime pass volumes have declined 3% to 5%, and as a result, banks have developed in-house tools and techniques to measure and match their processing capacity to declining volumes.

Now that paper items are trending downward at double-digit rates, banks must adopt specialized modeling, forecasting, and “what-if” tools to keep capacity (staff, equipment, transportation, and facilities) in line with changing volumes on a monthly or quarterly basis.

Asset Management is a proactive, comprehensive, and ongoing approach to keep unit costs in line with competitors. In a declining check volume environment, competition for volume will intensify and banks will start pricing services at marginal costs to maintain economic scale. In this context, tactical Asset Management is essential to both sides of the cost/revenue equation.

Cost benefits of optimized Asset Management include consolidation of paper processing facilities and equipment, reduction or redeployment of staff, and increased investments in image capture, storage, handling, and presentment technology. The two key factors that will influence the size and location of assets are:

- 1) Adoption trends in the migration of paper to images.
- 2) The changes that will result from new initiatives in the Process Management and Product and Services Management areas.

For more information go to www.adsfs.com

The Digital Integration Era will allow banks to stay on top of the "payment system hierarchy" by owning the statement of record for client payment activities while driving revenue through partner industries.

2) PROCESS MANAGEMENT:

Process Management is the ongoing evaluation of the methods and processes used in handling paper and image items. With the reality of supporting a dual operation, banks have the opportunity to positively affect processes. To do this, banks must **1)** develop new metrics to measure and support decisions impacting operational changes, and **2)** embrace a *unit cost* mentality to ensure they are containing costs effectively while maintaining a competitive pricing structure.

As chart 3 (below) indicates, banks that do not implement ongoing evaluation of their methods and processes risk seeing a dramatic unit cost increase of 80% by 2010. However, banks that successfully adopt a "Best in Class" integrated Asset and Process Management methodology will maintain favorable unit costs over the next five years.

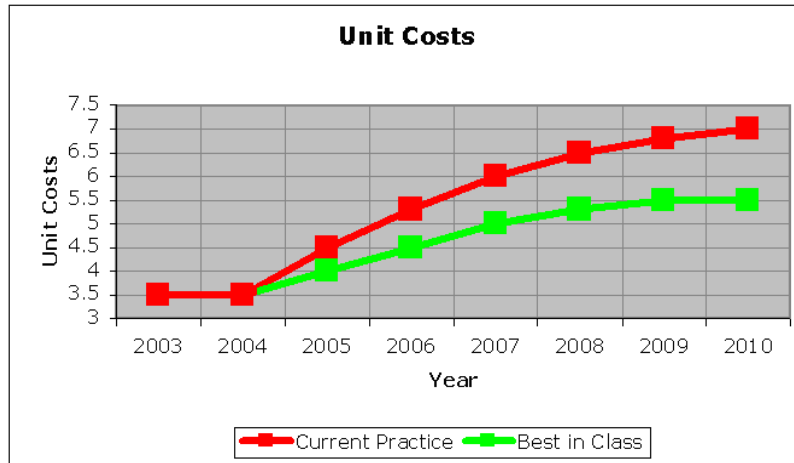


Chart 3

With the growing divergence in unit costs between 'Current' and 'Best in Class' practitioners, the industry will experience major shifts in market share to the low cost providers who are also positioned to acquire volume. The major beneficiaries of this volume consolidation will be those institutions who take a holistic approach to Process Management. These market leaders will reengineer their payment enterprise through key technology investments in conjunction with process changes (to have the greatest impact on unit costs of operations).

What else could Process Management let us do? History has proven that the best businesses are always seeking new ways to improve their capabilities and experimenting with new and innovative methodologies. However, innovation is never just by chance, it is a calculated and planned strategy. For example, adoption of image capture at the earliest point of entry into the system, via branch or customer capture, will create a new workflow for processing and presenting deposits. This new workflow will enable new products and services for corporate clients and, at the same time, the new process will enable a reduction in a fixed infrastructure, thereby improving Asset Management costs.

Once item electronification becomes a mainstream operation in banks, even more creative opportunities will emerge, such as off-shoring image encoding and POD operations. As Process Management matures, Asset Management must continue to monitor and react to the deployment of assets in support of evolving processes.

3) PRODUCT AND SERVICES MANAGEMENT:

The impact of item electronification in banking operations should not be seen as an operational or a cost containment / rightsizing opportunity only. The fully imaged environment will offer banks two main opportunities:

- 1) Revenue growth through creative products and services, and
- 2) New pricing models.

As item electronification becomes more fully imaged enabled, creative concepts will emerge and the true Digital Integration Era will begin.

For more information go to www.adsfs.com

The most important aspect of preparing for the future and for making near-term tactical decisions is to formulate a Holistic View of Image/Payments Strategy.

The Digital Integration Era will be an environment of unfettered innovation and creative product/service development around image integration. In a new environment where items are made up of digital images and customer presentment is based on digital components, a new world of products and services will be achieved. For example, we already have the ability to present statement images through bank web sites, which allows banks to eliminate handling of statements and mailing costs. Furthermore, item electronification could allow banks the capability to brand and construct digital documents creatively before they are presented to clients (this will have great marketing value and appeal i.e. private label statements to college alumni similar to private label credit cards).

The Digital Integration Era will allow banks to stay on top of the “payment system hierarchy” by owning the statement of record for client payment activities while driving revenue through partner industries. To participate in the digital integration mosaic, banks will need to manage both their processes and assets in support of the new dynamic. If the bank has outsourced critical aspects of either their processes or assets, they may have restricted their ability to react to market trends and compete with more agile competitors.

Q: How do banks proceed in the migration to Digital Integration?

A: The most important aspect of preparing for the future and making near-term tactical decisions is to formulate a holistic view of the migration to an imaged environment and a payments strategy. Maintaining a holistic view will ensure that investments, disciplines, activities, and decisions in each of the three areas are made in support of a broad and clear strategy. Exercising “transactional decision making” may lead to short-term gain, but will restrict or prohibit strategic growth opportunities.

Below are a few examples of the type of strategic decisions institutions will have to make to remain competitive in the payment system hierarchy.

Asset Management:

- Deploy an Asset Management solution to continually match staff, equipment, facilities, and transportation capacity to changing volume across multiple operations centers to maintain unit costs and customer service.
- Embrace an operational discipline of continual reevaluation of assets as check/image dynamics and process improvements evolve.

Process Management:

- Create a Unit Cost Model in a paper/digital environment.
- Continually reevaluate internal processes to improve unit costs and support the delivery of new products.
- Extend Image Capture and Document Truncation to the branch.
- Engage with corporate customers and third parties on creative image capture and presentment alternatives.

Product and Services Management:

- Create the capability to support Digital Integration of images and other content.
- Position Digital Statements for Private Labeling.
- Offer cross presentment and marketing opportunities across the institution and to third party partners.

A BOLD NEW WORLD

As the payment landscape evolves, banks have the opportunity to take a leadership role by adopting innovative applications of Asset Management, Process Management, and Products and Services Management. Early adoption not only empowers significant advances and optimizes operational processes, but also produces breakthrough products and services for your institution, bringing value and creating deeper customer relationships.

ABOUT META SOFTWARE CORPORATION

For more than ten years, Meta Software has provided capacity analysis, workforce management, and enterprise modeling solutions to the banking industry. Meta’s solutions leverage a library of field-tested and reusable simulation models that have helped generate a better than 3 to 1 return on investment, giving Meta clients the ongoing capability to conduct site and enterprise capacity analysis.

ABOUT A D S FINANCIAL SERVICES SOLUTIONS

For more than 25 years, ADS has delivered hundreds of complex projects for leading financial institutions nationwide, ranging from operational consulting and systems integration to business alignment services. Every ADS solution takes full advantage of our capabilities and expertise in the financial services industry.

Our team is recognized by our clients for consistently delivering innovative, practical, and effective solutions, on-time and within budget.

For more information go to www.adsfs.com