



Building on Success in Wholesale Lockbox and Saving the World (Or At Least a Small Part of It)

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Introduction

The Federal Reserve says check use is declining by about 3% a year and plans to test that assumption in 2004. Many in the payments community were surprised when the central bank's 2001 research documented a shift away from check writing, especially by large corporations, government bodies and consumers at point-of-sale. No doubt next year's follow-up will reinforce these findings, encouraging public and private sector initiatives to prepare the nation for a "much less check," if not entirely checkless, world. The CIO of one major bank, speaking at a recent conference, warned, "If there's a 2% decline in check volume over the next four years, that will increase the excess check processing capacity by 59%...and that is going to lead to a disequilibrium." Sounds like we are already there. Things in the check world have been exciting, but they are creating vulnerabilities demanding decisive action by banks that depend on "payments" revenue.

And things have thusfar been very exciting. Even before 2001's check study the Rivlin Commission provided a much needed kick in the pants with its challenge that the Fed provide greater leadership in payment system developments, particularly electronic. With input from the corporate community and others, NACHA defined and tested innovative uses for its network, skillfully introducing ARC, TEL, WEB and RCK into the payments lexicon within just a few years. The New York Clearing House Asso-

ciation became "The Clearing House" and proclaimed its mission to advance "payment solutions worldwide," a promise it has kept with SVPCo, the Universal Payment Identification Code (UPIC) and its central role in creating Continuous Linked Settlement (CLS). The future portends even greater change with passage of Check 21 (the Check Truncation Act) as early as next year and even more ambitious future innovations like same-day ACH and a global standard for low value funds transfers.

What, exactly, should come next? I suggest wholesale lockbox. Wholesale Lockbox makes solid, if not entirely intuitive, sense as a "middleware" step in the evolution of epayments and STP. It provides an alternative for dealing with the information content of payments that does not require massive re-tooling of accounts payable and receivable software. Also, electronic solutions are already emerging that deal with the "back end" of check processing, i.e. transportation and settlement, taking off some of the pressure to solve "front end" remittance and capture problems. The sad fact is that traditional strategies for marketing B2B lockbox, targeting large corporations, with high ticket payments while avoiding more complicated transactions, may now be depriving banks of billions in high-margin revenue and creating pressure massive reinvestment in epayment functionality.





We are not speaking about lockbox from the 1950's or even the 1990's. We are speaking about lockbox that is convergent with new technologies and really bridges the transition away from paper with broader, smarter, more comprehensive use of outsourcing. There are compelling arguments for service providers and payment receivers in using lockbox as a transition tool; we discuss them below. There is an even more compelling cultural argument because approaching electronification from the back end, i.e. the receipt of payments, will facilitate, not impede, epayments and, eventually, STP.

The 800-Pound Gorilla

Lockboxes process checks. Checks remain the 800-pound gorilla of the payment system and that will probably be the case for a long time. Lockbox, by definition, supports the desirable "credit push" payments model without excluding its potential for "debit pull". Lockbox is designed to deliver remittance information with payments and can be adapted with image technology for integration with accounts receivable systems. It is compatible with paper-oriented payables applications and requires no special trading partner agreements. Furthermore, with Check 21, merger of the New York and Chicago clearinghouses, Endpoint and related initiatives coming on stage, electronics will eliminate physical transportation of checks, moving item processing and lockbox squarely

into the epayments world and a giant step closer to STP.

Declining check volume is real and well documented. Though we are writing fewer checks than we thought, even than we were actually writing, our commitment to paper still runs deep. Fewer checks at point-of-sale are no surprise when the alternative is cheaper, safer and more convenient for everyone. Neither should fewer corporate checks come as a surprise in an era obsessed with productivity and cost reduction. Starting with night cycle cash concentration debits in the 1970's and steadily replacing paper with direct deposits in various "income" categories ever since, Treasurers have long appreciated the economics of electronification, adapting it wherever practical. If removing paper from remittance processing had been easy, somebody would have done it already. Technology for moving in that direction is emerging but the idea that digital images are real information, not just pictures of information, is still fighting its way into mainstream payments circles.

The most recent significant driver of declining corporate check use in our opinion *has not* been electronification. It has been process re-engineering: consolidation of accounts payable functions, shared service centers and outsourcing; more invoices paid with each check and only the largest settlements made by ACH and wire, especially in major corporations. Our poor economy has masked consolidation because lockbox and controlled disbursement banks are not observing much increase in the average size of checks passing through their shops. It also masks how deeply we remain wedded to all that paper. Americans are writing fewer checks but they are using more paper, much of it explaining their checks and EDI transactions.



Lockboxes Already Deal With Information

Lockbox deals with payments and information, the great unsolved problem of epayments and STP. If checks are the payment system's 800-pound gorilla, remittance processing is undoubtedly top dog in the check world. At least 11 billion, as many as 17 billion, checks were written to pay bills in 2001 ¹. Bank lockboxes only processed between 750 – 1,000 million B2B remittances, the majority concentrated with fewer than ten organizations. A similar number of providers, banks and non-banks, processed about 4.5 billion C2B remittances. Call it antiquated, a dinosaur or as one EDI guru pronounced, "a vanishing paradigm," lockbox gets to the heart of payment processing's biggest problem. However inelegantly at the current time, they communicate information between payors and payees that facilitates cash application, reconciliation and other payee accounting functions. Canceled checks provide receipt of payment that is often missing in epayment applications, and corporations seldom if ever feel the need for task forces to fret over the security of lockbox operations as they do when money moves across the Web. According to Clearing House research, 86% of B2B pay-

ments are made with checks, making lockbox, despite its modest share-of-market, more popular than all epayment protocols combined ². Could it really be that lockbox works? Or that epayments work less well? Answering that question is fundamental to future payments strategies. A bet on "lockbox works" contemplates four important facts.

First, we know lockbox achieves objectives consumers and corporations consider mission critical. Lockbox is a known commodity, a model with a lot of history and one we understand, accept and trust. We have much less experience with epayments and, admit it; they still scare us a little.

Second, lockbox infrastructure is already in place. Many corporations and financial intermediaries lack the infrastructure to create or process electronically.

Third, B2B lockbox processors are the same organizations that have been in the vanguard of "e-services" developments. They understand the engineering hurdles involved with epayments and STP; they also understand the consequences of success or failure.

And fourth, we know with certainty the B2B market is rich with opportunity for growth, three or four transactions in the wings for every one already lockboxed, assuming banks take the trouble to find them. And revenue potential is similarly huge, assuming banks create and communicate their value propositions. New revenues for banks combined with cost reductions for payment receivers will fund development to complete the "e transformation".

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1. We underestimate precisely the kind of check use geared to generating extra paper: bill payments. Citing the Fed's 2001 study, for instance, Clearing House research reported "3.9 billion business-to-business remittance payments are generated in the United States on an annual basis [and]...According to the same study, there are over 8.5 billion remittance payments from consumers-to-businesses executed annually by paper check." True as far as it goes, though it excludes 26.4% of the entire check sample or more than 11 billion items the study either could not classify or could only classify as "Remit/POS," meaning they fell into one or the other category. Further examination of the data suggests 17+ billion checks were written for bill payment, about 6 billion B2B and 11 billion C2B items.
2. Unpublished. "The Remaining Barriers to ePayments and Straight-through Processing. Research Conducted October 2001 - March 2002 By The Clearing House," The Clearing House:2002, pg. 4.



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B2B and C2B Payments

B2B and C2B payments have different issues. It was easier to address C2B, though one ultimately sheds light on the other. Most consumers use vendor-supplied return envelopes, scannable turnaround documents and payment instruments nearly identical in size and format.

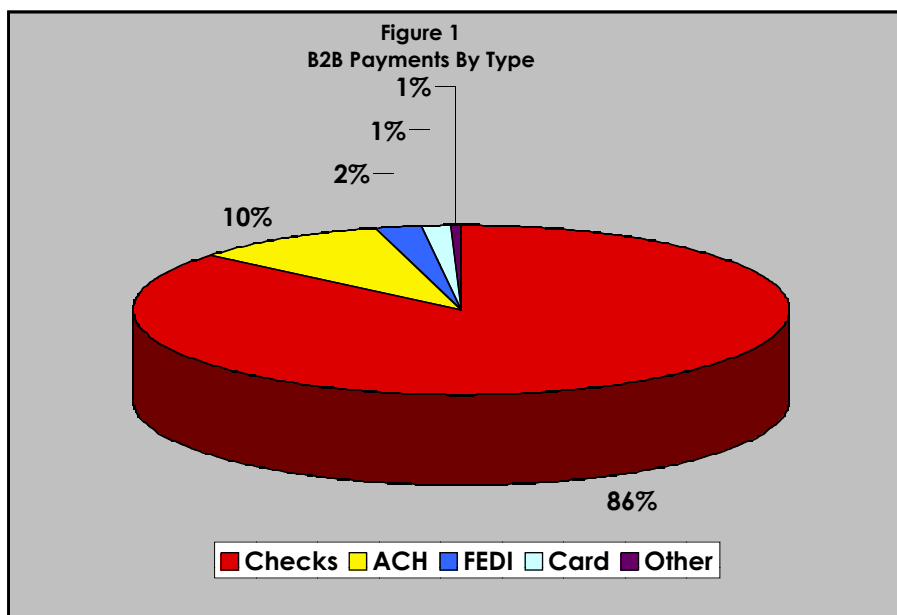
Payment transactions are "complete" in that they contain all the information to satisfy vendors' accounts receivable needs, and consumer "accounts payable" systems,

Quicken, MYOB, or that stack of bills we keep on the kitchen counter near the family checkbook, are straightforward. Consequently, the C2B bill payment process can be simple, slick and highly automated, straight-through to settlement where processors have implemented Accounts Receivable Check (ARC). In addition, processors increasingly use data archives

and Internet retrieval to facilitate customer self-service and CRM applications. Payment exceptions, once an expensive, time consuming problem for accounts receivable clerks, are routinely "autoresolved" with clever software and data extracted from prior transactions. C2B automation preceded B2B and taught us much about image capture/manipulation, handwriting recognition and OCR, workflow management, data storage and secure communications. We are building on that foundation and preparing, in our opinion, to take it to the next level.

B2B payments pose a greater challenge, but developers and processors have, pardon the pun, been pushing the envelope. Payors, not payees, decide the contents of remittance envelopes in most cases; they

pay multiple invoices with single checks, even invoices originating from different payee organizations. They take discounts deserved or not, attaching payment documents that



satisfy their own requirements, not the payee's receivables needs. If B2B lockbox is not a total nightmare, it can be at least a bad dream when workloads are heavy and transit deadlines tight.

The nature of B2B lockbox marketing historically limited benefits to accelerated receipt and deposit of



large checks with basic data capture. Some banks consolidate information about paper and electronic receipts to help with cash application, and some provide invoice matching as an aid in reconciliation, but those processes are logistically difficult and expensive. Payment streams with insufficient float benefit and more complicated payments were never lockboxed. Even when banks prepared and transmitted remittance data, more difficult elements of accounts receivable processing fell back on corporate customers. The rough rule of thumb was that a lockbox had to "collect" at least \$60 million a year, with remittances having certain well-defined characteristics, to justify its use, and that message was imprinted in the minds of bankers and Treasury managers for a quarter century.

Consequently, and despite its visibility in Treasury management circles, lockbox has never exactly dominated B2B payments. Research firms routinely issue press releases about the impressive penetration of lockbox in the corporate world, inevitably making statements about 80% or 90% of their interviewees using the service. Such statements are misleading. Lockboxes process fewer than a billion B2B payments yearly, between 15 – 30% of B2B remittances. The majority of B2B payments, the really difficult ones and payment streams that do not justify lockboxes for their float benefit, stay with payees. Overworked bank calling officers may be unaware these payments even exist, and the people who process them may be unaware

of different or better solutions, or of recent technology advances that radically enhance lockbox' value.

Challenges and Opportunities

No one has more reason to exploit the potential of B2B lockboxes than commercial banks, especially banks invested in advanced technologies and facilities for that purpose. Corporations facing multimillion dollar investments to enable epayments should be encouraging banks, not complaining about higher prices. But banks have two special challenges in this regard.

They are challenged to take their services to places no one has ever gone before: smaller firms, high exception and other applications traditionally considered "unlockboxable," and companies that still believe "we do it better ourselves." They are challenged to deliver the message about a more powerful kind of remittance processing and a practical alternative to epayments and STP. This will require new strategies, like private label services to broaden distribution, marketing intelligence to explore non-traditional segments and applications, plus novel proposal development and service pricing approaches that shatter conventional corporate thinking about price and value. Software prices exploded in the 1990's because developers sold "value." Banks are still selling B2B lockbox for the same \$1.00 - \$1.15 a transaction they charged in 1985. Banks have "value" to sell also, and they have a right to exploit that value.

Not using a lockbox adds between \$6.00 and \$9.00, to the cost of processing a typical B2B check payment, excluding back-end exception processing, reconciliation and storage/retrieval costs, according to experts. We know from the Fed study there are between 4 and 6 billion B2B payments every year, a billion of which are already lockboxed and 14% of which,

sic image capture and ACH with new developments like XML and SOAP that make software smarter. And since processing needs only be straight-through from the clients' perspective, banks will likely also uncover opportunities for manual outsourcing, either as temporary workarounds or as permanent worksteps justified by banks' scalar economies but no longer appealing to FTE-sensitive corporates.

500 – 850 million, are processed electronically. That leaves between 2.5 and 4.2 billion paper checks floating around, costing someone between \$15 billion and \$38 billion *per annum*, plus exceptions etc. Manual retrieval of paper documents adds between \$5.00 and \$30.00 for each occurrence³ and is dramatically reduced with online retrieval. Even a modest penetration of this market can have significant impact on bank revenues that, if rationally priced, produce substantial margins.

Of course, banks are also challenged to deliver on the promises they make. That can happen incrementally and over time, in step with the corporate world's ability to digest change. Technology is and will remain a powerful ally, helping banks apply their collective experience with automation to integrate existing pieces, like ba-

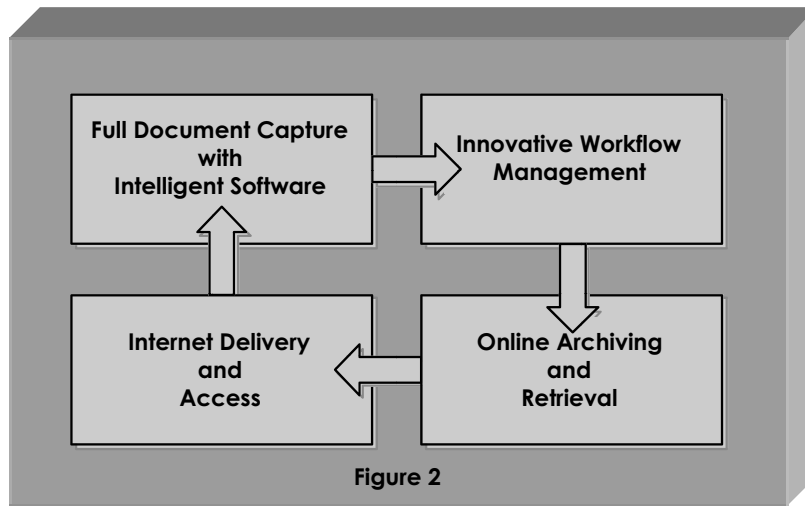
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Are these challenges worth the trouble? You be the judge.

Banks are the payment business's largest stakeholders; they have turf and a big chunk of the business's \$180 billion of annual revenue to defend; they have most to lose if one or more of its elements (origination,

validation, settlement, etc.) get side-swiped or cherry-picked away. Following recent card industry settlements, the *American Banker* reported First Data's CEO "gleefully showed" off a model payment card absent any

bank logo.⁴ Little wonder he was gleeful. Banks desperately need to play their own trump cards. Strengthening the payments supply chain by moving customers a step closer to STP and enhancing the value of an already important product are in the industry's best interest.



3. Assumes 6 - 15 minutes per search, on average, including re-filing
 4. *American Banker*, May 12, 2003, pg. 1.



While banks continue growing, there are signals of future weakness and vulnerability in the payments business. Check volume is clearly declining, so much so the Fed is closing 13 of its 39 check processing facilities. Certain payment-related revenue streams and expenses are being impacted, increasing demand for new income sources. B2B lockbox can generate significant new revenue. Banks are mastering a powerful technology capable of transforming B2B payments without forcing corporations to replace their accounting systems or change their processing “vocabularies.” They have an opportunity to save customers a lot of money and fortify their own franchises while generating those revenues if only they act on it.

Banks have unrivaled relationship strength, brand identities and credibility on which to build. They understand transaction processing and lockbox, along with the reasons why companies use or avoid the service. Banks have the operating capacity and expertise to absorb new B2B lockbox business, quickly if needed. They understand the underlying technologies better than other industries, and more experience, generally, integrating technologies with one another and, particularly the Internet. Banks have a lot they can capitalize on.



“Long-Term” and “Short-Term” Are Relative

“Long-term” and “short-term” are relative things. If check use continues declining by 3% a year, Americans will still write 11 billion checks in 2050. Does that make checks a long or short-term problem? Depends on your perspective, I guess. Similarly, if it takes 25 years to transform the B2B sector for payments and STP (*and note, ACH has been around since 1975 and we still pay 86% of B2B bills by check*) maybe electronics, not checks, have the problem. If we can eliminate half the cost and two-thirds the hassle of paper payments in less than a decade does it matter which is short or long term? Twenty-five years from now we will have different problems to solve and different tools to solve them with anyway. Unless, of course, we are all working for First Data or Walmart.

Our choices are not about the long and short terms. They are about making decisions that may determine our industry’s future. They are about understanding and integrating all we have learned about B2B payments in a generation. EDI started with a “build it and they will come” mindset because it made sense at the time. But we grossly underestimated the implementation challenge and even the attractiveness of that concept for B2B payments. Perhaps we could have learned more from developments in card processing and C2B checks, both of which were banished (by some and for a while) to the financial services hinterlands for want of fatter margins, efficiency ratios pleasing to stock analysts and the heady aroma of “core competency.” And admittedly, technologies facilitating the gradual evolution of B2B payments away from paper were unavailable until very recently. Still, we may have moved more quickly had we looked for answers in what we already understood, i.e. our paper processing system, instead of in what we did not. Either way, we need to be aggressive about executing strategies if they are already defined or cre-



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ating them if they are not. Otherwise, the future may not be pretty for banks that rely on "payments" revenue which, by the way, amounts to about 40% of total revenue at the country's top banks.

It reminds me about taking a walk in the park with my grandfather as a child. I enjoyed his company, and he enjoyed the opportunity to smoke a cigarette without my grandmother's nagging over his health and the smell of tobacco in her upholstery. On one of our walks we met a vagrant who requested a dime for a cup of coffee (it was the fifties, after all). Grandpa gave him the coin. The vagrant then asked for a cigarette, and my grandfather again accommodated, whereupon the man immediately asked to "borrow" a match, which my grandfather gave him with the observation, "Fella, the only thing you've got is a habit." The remark has stuck with me all my life, a reminder I need more than "a habit" if I really want to get anything done. EDI was a good idea in the seventies, but it was also our "habit;" we had no better starting point. With untold billions already invested and 86% of B2B payments still settled with checks, it is still just a "habit." We can wait around for the kindly old gentleman to hand us a cigarette and a dime, or we can do something that starts real change.

Where lockbox is concerned, we have much more than a "habit," and we are not just starting. We have knowledge and experience we lacked a generation ago; we have greater clarity about how we want

things to work; and we have better tools to help get us there. The integration of lockbox technology, especially "full image" lockbox, with Internet delivery and capacity to provide long term document archiving/retrieval creates powerful functionality. Coupled with programming methodologies that make invoices, purchase orders, checks and other documents as reliably content rich and data-accessible as punch cards and "flat files" in earlier times, and visionary people to bring it all together, we have all that is needed to achieve the "next level" of B2B payments and prepare for the future.

About the Author

Dick Poje formed his own firm, R. J. Poje and Company in 2000 to provide consulting services in the areas of strategy development and technology integration. Previously, he had been a Partner and Director of Treasury Strategies, Inc. since 1985. Dick has been active as an entrepreneur and management consultant in the treasury and payment communities for 35 years.

A co-founder of Phoenix-Hecht and its Chief Executive Officer for many years, Mr. Poje brings a unique, entrepreneurial perspective to client engagements. He advises senior managers of client organizations on strategic matters related to cash and treasury management and the payments system. He assists financial services firms in the formation of strategic alliances in various product areas, advises the Federal Reserve on its continuing role in the payment system and works with a number of private and public sector clients in re-engineering treasury and related operations.



Mr. Poje is a frequent contributor to industry publications and a respected commentator on developments in treasury management and the payment system. His article, "Avoiding the Pitfalls of Electronic Commerce," appeared



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in the January 1998 issue of the TMA Journal. In 1997 he co-authored "Electronic Commerce and Financial EDI: An Examination of Innovation in the Electronic Payments Arena". His article, "A Blueprint for Leadership: the Federal Reserve in the U.S. Payment System" was published last year in the American Banker. His most recent work, "The Death and Birth of Wholesale Lockbox" was published this April in AFP Exchange, and his three-part article, "Treasury - IT integration in Plain English" in the AFP Newsletter.

R. J. Poje and Company recently merged with The Collins Group, a consulting firm specializing in treasury management and bank operations, headquartered in Woodbury MN.

Mr. Poje is a graduate of Fordham University and the University of Chicago and is currently writing a book about the roots of treasury innovation.

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