



Hybridizing the U.S. Payment System and Coming Growth in Remittance Outsourcing

Richard J. Poje
President, R. J. Poje and Company

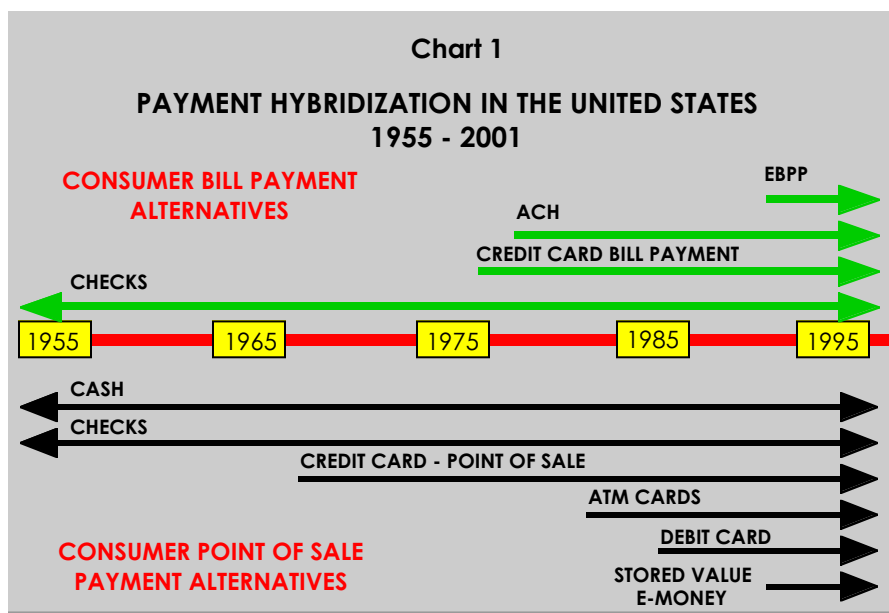
Background

Imagine your employer invested millions in one of those enterprise-wide software systems that promise to walk, talk and spit nickels as it improves operating margins. Then imagine the unimaginable. Your customers, some large number of them anyway, voice disapproval of the new software. They prefer things the way they used to be. Maybe the new system lacks functionality customers valued in the past; maybe the cost of interfacing their software with yours is too high, or maybe, they just don't like your new system. Whatever the reason, you are suddenly faced with Hobson's choice: you can force customers to use the new system, running the risk of losing their business; or in the alternative, you can extend the option of using either new or old software, reducing the return on your employer's investment.

Far fetched? Hardly. It is precisely the problem corporate receivers of consumer payments will confront in the coming decade.

Last year, Americans paid nearly 19 billion bills of a recurring nature. They made 80+% of those payments with

checks (Charts 2, 3 & 4) most of which were processed directly by the companies receiving them. The same companies are now investing millions, billions some may venture, to convert paper



invoices into electronic bill presentments and check payments into ACH debits or other forms of paperless value transfer. Early forecasts projected rapid consumer acceptance of electronic bill presentment and payment (EBPP); however, actual acceptance has been disappointing and recent forecasts increasingly cau-



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tious. American consumers like using checks and consistently demonstrate their intention to continue doing so in the future. Barring unforeseeable events, payment receivers will confront the same uncomfortable choices described in our hypothetical example: they can force consumers into electronic channels, with potentially disastrous consequences, or they can offer billing/payment options that drive up costs and shrink returns.

We hear a lot about the U.S. payment system "evolving," and especially about electronic payments "evolving" from paper, shedding billions in cost as it does so. Such a description is, at best, naively optimistic. There is little historic evidence that payment systems "evolve," completely replacing one way of doing business with another. Payment systems "hybridize," and the difference is more than semantic. Evolution is about survival; hybridization is about co-existence. There is no "survival of the fittest" battle going on between paper and electronics. The two are growing side-by-side, creating broader options and opportunities for consumers and businesses but also creating challenges for businesses that receive and process payments.

Nowhere is this truer than in the arena of consumer-to-business transactions that account for two-thirds of all U.S. payments. Businesses that recognize what is really happening and choose the right strategies for payment processing will reap mighty benefits; those that misread

the tea leaves or jump on the wrong bandwagon will face significantly higher costs and daunting administrative challenges in their payment processing operations.

The paper that follows has five basic premises. First, the U.S. payment system continues hybridizing and growing in complexity, especially as technology creates new channels and methods for transferring value. Second, technology requires capital investments that shift operating costs from variable to fixed categories. Third, modern technology is highly scalable, but scalability seldom works when volumes decline. Doubling transaction volume may increase costs by only 20%; halving it may not decrease costs at all and drives up unit costs. Fourth, consumer payment receivers face greater risks than others because volumes are enormous and even statistically modest volume changes have a major impact at operating levels. Fifth, and finally, the payments community has used outsourcing effectively to manage hybridization for more than fifty years. Broader outsourcing may be the last, great hope for corporations that receive consumer payments and want to balance cost, capacity and capital deployment issues against the need to serve their customers.

A Brief History of Consumer Payments

American consumers were cash transactors before World War II. All but the most affluent purchased necessities like groceries and clothing with cash, and most used cash or money orders for recurring bills. Friday was payday, and Saturdays were for shopping and bill paying. People stood in line at the electric company, the telephone company and other businesses, proffering greenbacks and having bills stamped "PAID" by clerks in cages resembling bank teller windows. The rich had

Chart 2
U.S. CHECK VOLUME
1978 - 2005 (PROJECTED)

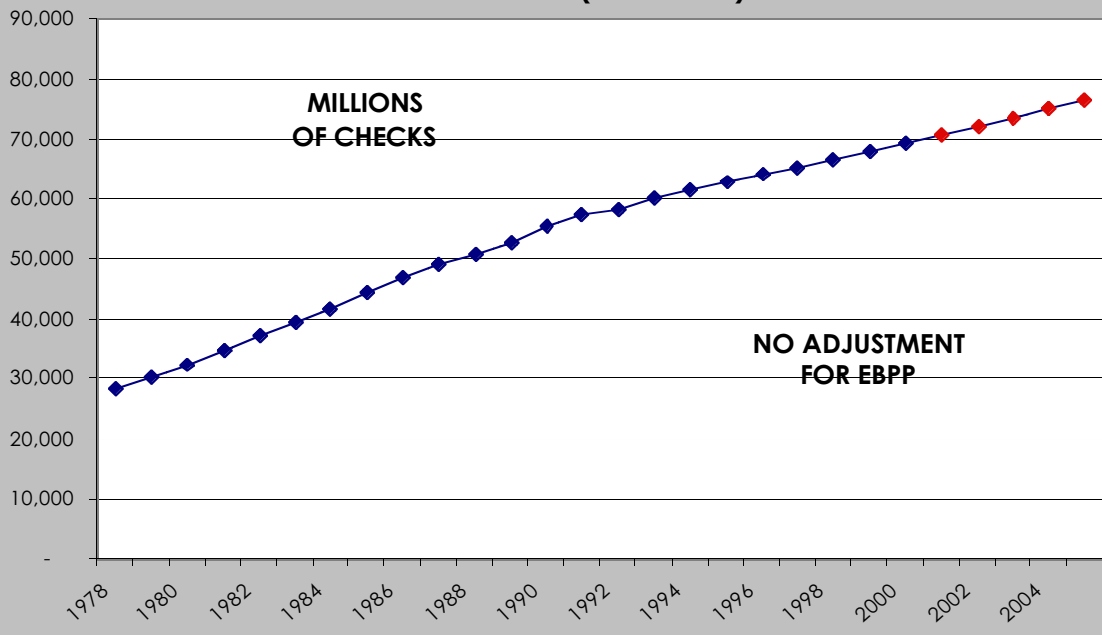
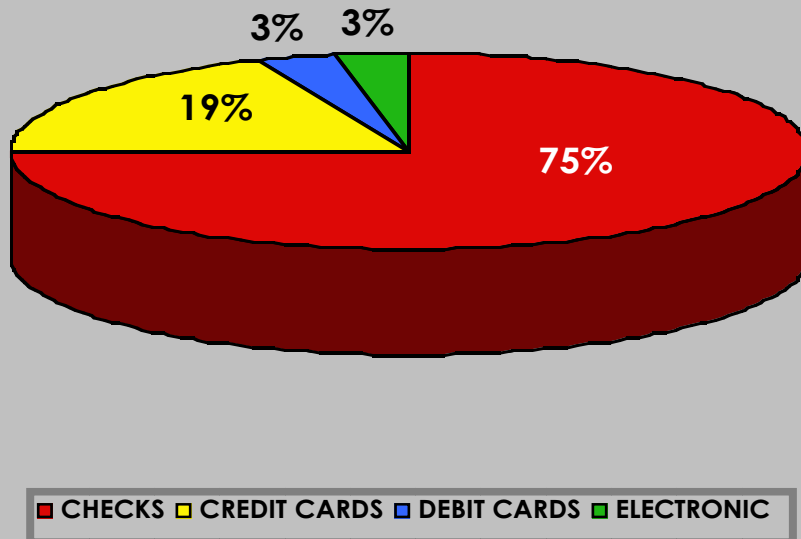
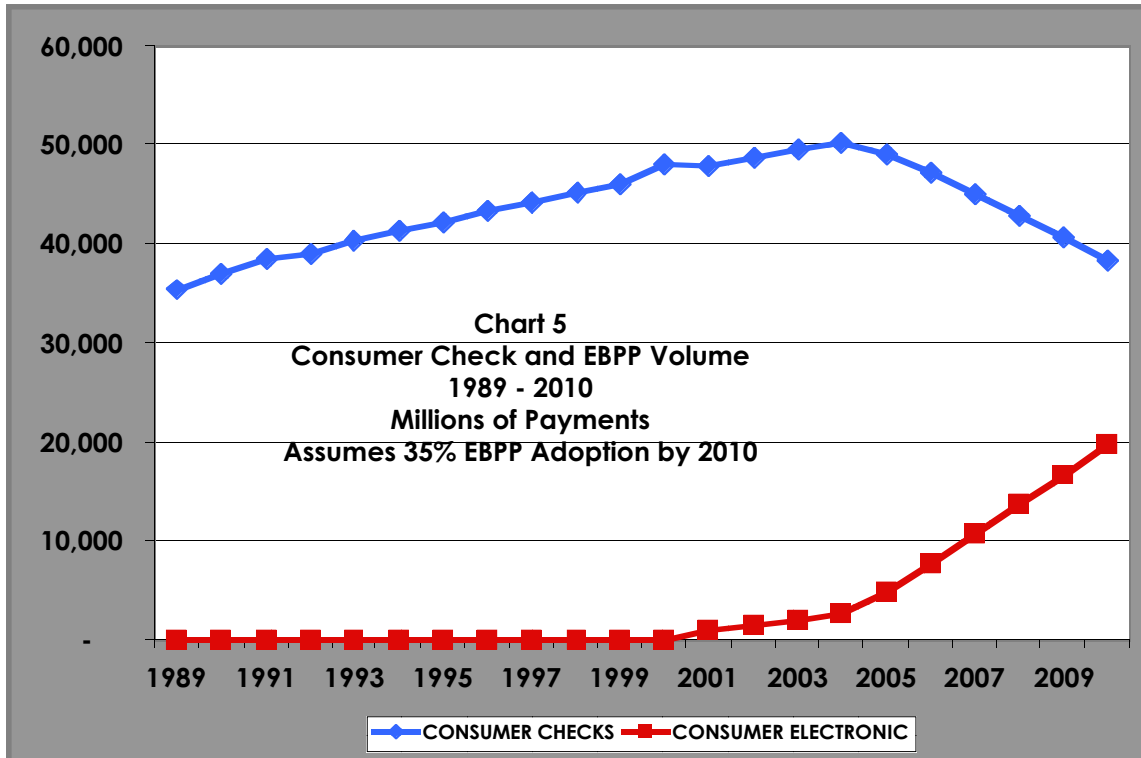
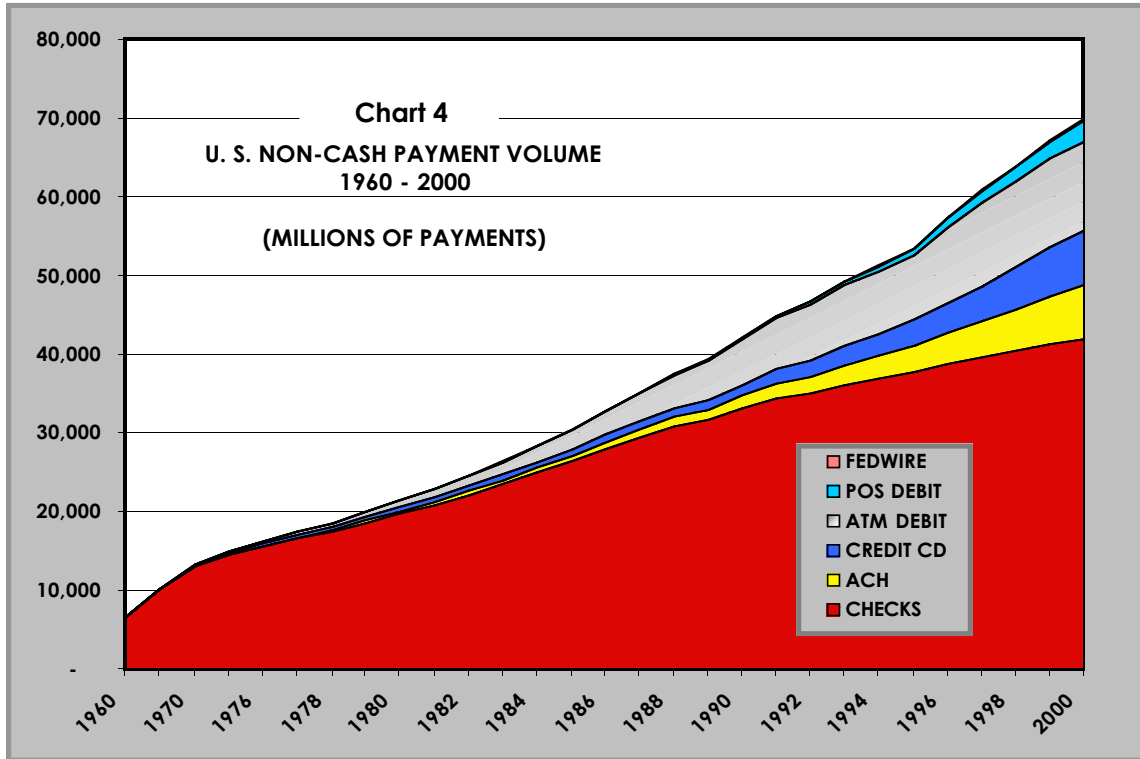


Chart 3
NON-CASH PAYMENT PREFERENCES IN THE U.S.







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options. They had checking accounts and charge accounts, and upscale stores kept blank sight drafts on hand for favored clients, but for most people it was a "cash only" society.

Things changed after 1945. The economy revived, people had greater faith in banks than in mattresses, and MICR technology enabled high-speed, high-volume check processing for the first time. Banks figured out that interest-free consumer deposits were a cheap source of funds and that consumers with money in the bank were decent credit risks. Corporations figured out they could collect payments more efficiently by accepting checks mailed to central processing facilities, and consumers figured out they increased their leisure time, improved their access to credit and kept better records by using checks. They also liked the toasters and waffle irons banks offered as premiums to attract their business. U.S. check volume has grown every year since 1945 and has more than doubled since the Federal Reserve announced the imminent arrival of a "checkless society" in 1978 (Chart 2). Yet, 20% of Americans still pay their bills "over-the-counter," and in cash for the most part. We have become enthusiastic check writers, but we have not forgotten our roots.

Even as check writing became popular, cash remained king at point-of-sale. That began changing in the 1960s when banks moved into the card business. Credit cards

emerged in the post-war period, but usually as single purpose vehicles. Oil companies had cards for purchases at company-owned gas stations, and retailers had cards for use in their own stores. There were a few general-purpose alternatives, called "T&E Convenience Cards" for restaurants, automobile rentals and hotels, but they had limited distribution, no revolving credit, and applicants had to demonstrate substantial creditworthiness. Bankcards gave consumers their first real point-of-sale payment alternative and facilitated the growth of credit, further hybridizing the payment system. Last year, consumers reached for the plastic in their wallets and purses nearly seven billion times. Though no one knows for sure, it is likely they reached for cash ten times more frequently. Those darned roots again.

Automated clearinghouses (ACH's) and automated teller machines (ATM's) entered the market in the 1970s. Neither created the "checkless society," but both have been major agents of change in the payment system. The ACH and ATM's gave consumers powerful new options for making financial transactions and further hybridized the payment system as a whole.

While failing to achieve its initial objective of creating a paperless mechanism for high volume, low value bill payments, the ACH system ultimately changed the way Americans received paychecks and social security stipends. It also changed the way corporations concentrated cash receipts from remote locations. That was certainly a factor in the growth of restaurant and retailing chains and in the consolidation of commercial banks. Companies like Sears, Walmart and McDonalds could not have expanded as rapidly absent a channel like the ACH for gathering funds and providing information about the performance of stores miles distant from



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corporate headquarters. Likewise, commercial banks, finding it was far easier to consolidate brands and balance sheets than internal operations, used the ACH for "on-us" deposit consolidation, creating at least the illusion of true national banking. ACH volume, including B2B, on-us and government transfers, totaled 6.9 billion transactions in 2000, a significant accomplishment over only twenty-five years but modest in comparison to check volume growth over the same period.

ATM's changed the way consumers dealt with cash. As machines proliferated and were linked into regional and national networks, cash became available whenever needed, virtually anywhere, any time. ATM's dramatically reduced consumer requirements for "wallet cash," and, second only to checks, triggered more hybridization than any other post-war innovation. In 2000, Americans made 11 billion trips to cash dispensing machines, 76% of all households had ATM access and ubiquitous ATM plastic was finding a new role for itself at point-of-sale, as a convenient and cost effective alternative to credit cards.

Hybridization accelerated in the 80s and 90s. Credit and ATM cards begot debit cards, point-of-sale checks begot POS debits, and the ACH begot Electronic Data Interchange, or EDI. There were "stored-value" smart cards, plastic with tiny on-board computers, to replace

whatever cash remained in consumer pockets, and something called "e-cash" for buying stuff directly on the Internet. Most found their place, however modest, in the payment system but none came close to replacing what preceded them.

Electronic Bill Presentment and Payment

EBPP, or IBPP, will likely precipitate the next round of hybridization in consumer payments, though there is little consensus about when or to what degree changes will occur. About the only thing certain is that EBPP will challenge the conventional wisdom of payment strategists and alter the economics of consumer billing and payment processing operations. The future would be more predictable if EBPP, as researchers forecast a few years ago, swept tsunami-like through the payment system, replacing paper bills and checks with electronic transactions. It would also be more predictable if EBPP fell flat on its face. Neither is likely, however.

At the height of "dot com" mania, researchers predicted near-universal adoption of EBPP before 2005; the check-less society, making more comebacks than Liza Minelli! As late as 1999 GartnerGroup projected up to half of all recurring payments would be electronic by 2008. "E-payments...will challenge or surpass...paper-based payments," according to its published report. A year later the firm revised its projections downward, forecasting 35% of recurring payments would be electronic by 2010, and "experts" began saying presentment, once the keystone of EBPP, would probably be less acceptable to consumers than electronic payments. A Doculabs executive, speaking recently to the Payments Advisory Group of the Association for Financial Professionals, was more blunt. "...the adoption of business-to-



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consumer (B2C) EBPP is low," he said, "because consumers – other than early adopters - ...(see) no benefit in viewing and paying bills on the web." Fewer than 10% of U.S. households received an electronic invoice in 1999; fewer than 15% received one in 2000. While there is no

consistent data about the number of households using EBPP for all (or a majority) of recurring bills, it is certainly less than 10%. Our theory of hybridization suggests EBPP will grow over time and find its place in

the payment system. But how much growth will we see, when will we see it, and will we ever realize the benefits promised by EBPP gurus?

The economic arguments for EBPP are seductive. One consultant estimates corporate costs for billing and payment processing will decrease on average \$1.57 every time electronics replace paper. That's a 25% savings on simple consumer invoices. Arguments are even more seductive for software developers and service providers. Worldwide EBPP revenues exceeded \$1 billion in 1999, with less than 1% of revenues derived from actual transaction processing. Service revenues (including customer care, exception processing and online archiving/retrieval) are expected to reach \$8 - \$9 billion if half of all consumer payments become electronic. Seduction

can be tricky business, however.

Remember, most corporations process consumer receipts internally, their decision to do so predicated on the belief internal processing

is more cost efficient than outsourcing, internal processing results in fewer errors, and, therefore, fewer customer service problems, and on concerns about making pro-

	2000	2010
Check Volume	12,000,000	10,800,000
Electronic Volume	-	5,400,000
Unit Cost - Checks	\$ 0.100	\$ 0.111
Unit Cost - Electronic (Est)	\$ -	\$ 0.075
Total Cost - Checks	\$ 1,200,000	\$ 1,198,800
Total Cost - Electronic (Est)	\$ -	\$ 405,000
Total Cost	\$ 1,200,000	\$ 1,603,800
Change in Total Volume		35%
Change in Total Cost		34%



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prietary information known outside the organization. Last year internal lock boxes processed fifteen of the nineteen billion recurring payments made by consumers. Almost all lock boxes, certainly those handling larger volumes, are outfitted with sophisticated systems that capture and process payment information at the lowest possible cost. The bad news is that companies have traded flexibility in favor of sophistication and cost minimization; they have done so by shifting costs from variable to fixed categories, and that shift will prove costly in the future.

Let's consider a hypothetical but not atypical lock box operation processing about one million payments monthly at an average cost of \$.10 per transaction. Assuming payment volume continues growing at 3% a year, the shop should average about 1.35 million payments in 2010, and if we assume GartnerGroup's forecast of a 35% EBPP adoption rate is on the money, that means about 900,000 check and 450,000 electronic payments processed monthly. There will be productivity gains as technology improves, but increases for software development and maintenance, and payroll costs in general will likely offset those gains. We saw that phenomenon over the last ten years as processors invested in image platforms, online archiving/retrieval systems, TCP/IP based communications and other techno-paraphernalia. The inevitable result is that **total costs** of pa-

per processing in 2010 will be little different than they are today, except they will be spread over fewer transactions. There will also be new costs for processing electronic transactions, lower, hopefully, than those for paper, but real costs nonetheless. Hybridization strikes again! Payment processors are going to end up running parallel systems for paper and electronics, with neither having sufficient vitality to replace the other or improve the bottom line.

Is There A Solution?

If there is a solution to the hybridization "problem", it is payment outsourcing, just as it has been since 1945.

Hybridization makes the payment system more complex and **total system operations** more costly. Corporations recognized this in the forties as check use began growing. They looked for help and found it in commercial banks, the first outsourcing providers. RCA Corporation approached Bankers Trust Company and First Chicago Bank in 1947, seeking help with B2B payments. Its request gave birth to wholesale lock boxing. The prime rate was 1.75% and treasury bills were yielding about 1%; we can be reasonably certain float costs were not RCA's major concern. The company saw the payment system hybridizing and responded proactively.

Banks also provided "over-the-counter" bill payment facilities when businesses decided it was no longer cost-effective to operate their own payment windows. When they installed computers, banks almost universally broadened outsource offerings to include high volume (consumer) remittance processing, payroll, billing, accounts receivable management and a host of other services. Though they never really succeeded in the



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business except with wholesale lock box, non-bank outsourcers, computer service bureaus mostly, considered them a major threat in the late 1960's and early 1970's. The Association of Data Processing Service Organizations (ADAPSO) initiated an antitrust action in 1969, arguing banks used relationship clout, access to credit and willingness to price at the margin to drive competitors from the market. Banks eventually prevailed, but then abandoned the market to companies like Western Union, ADP and EDS, citing lack of profitability, insufficient economies of scale and other factors in making their exit decisions. What really happened was hybridization, and something analogous to pipeline companies doubling capacity year-after-year while oil companies increased production by only 10%. You end up with half-filled pipelines, none making enough money to cover its costs.

A second, very different, outsourcing wave began in the 1970s when banks became users, as well as providers, of services. Where early outsourcing focused almost exclusively on utilizing excess capacity, the second wave concentrated on functional specialization. Over-the-counter bill payment shifted to grocery stores, pharmacies and currency exchanges; companies like Cashflex and Nationwide Remittance Centers, high-volume lock box specialists, absorbed customers and transactions previously managed by banks, and ADP

gobbled up the payroll market. Later, banks outsourced their card processing to firms like First Data and Total Systems and more recently have surrendered "indigenous" bank services like check processing and mortgage loan origination to outsourcers. The second wave of outsourcing was successful in many ways, but not particularly for remittance processors. Outsource volume grew slowly and profits remained elusive for the majority of providers. However, we digress.

A third and far more powerful wave emerged in the mid-nineties. Where cost reduction had been the value proposition for outsourcing, first by making fuller, if not better, use of resources and later by concentrating analogous work processes, the third and current wave sought to provide clients with "better overall solutions." In *The Discipline of Market Leaders*, authors Michael Treacy and Fred Wiersama use the phrase "customer intimacy" to describe the strategies of third-wave outsourcers. The shift from earlier models is subtle, but it is significant with broad implications concerning hybridization and outsourced payment processing.

Historically, payment outsourcers offered tactical, i.e. cheaper, solutions; they offered them to anyone who came banging at their door, and they generally did whatever it took, however foolish, to bring new business through that door. In the previous decade, two major providers imploded after deciding to focus on serving banks eager to exit the high-volume lock box business. Banks were happy to unload unprofitable lock boxes, but unwilling to lose the high margin depository business associated with that work. The result: with every new bank client, the outsourcers inherited underutilized processing facilities they were forced to run with reduced staffs and controls in order to meet cost targets. They



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failed. A third large outsourcer collapsed when it chased after ultra-high volume corporate work, promising \$.30 worth of service on transactions for which they charged \$.05, hoping to make it up on volume. Another losing proposition.

Third wave remittance outsourcers are taking a different approach to their business, an approach that acknowledges hybridization, growing payment system complexity and the need to mitigate risks.

First, they are more selective in their marketing, seeking clients willing to become partners in problem solving and willing to share both the benefits of partnership, as well as the risks. Service Level Agreements (SLA's) are universal and tough; they penalize providers that fail to meet performance targets, but increasingly, they also reward providers demonstrating superior performance. And service providers have carefully identified customer segments they can serve well. Regulusgroup, largest of the independent remittance outsourcers, targets segments where it has industry expertise and those that can benefit from its integration of bill print/distribution, remittance processing and content management functionality. Remitco, First Data's remittance subsidiary, targets only very high volume payment receivers, and Bank One's specialties are in processing "wholesale" payments requiring key entry and other challenging remittances, like residential mortgage payments.

Second, they are moving away from the narrow silos that have conventionally defined remittance outsourcing deliverables, and in redefining themselves, are addressing hybridization-related needs. They are recognizing, for instance, that bill payment problems begin with poorly designed or inflexible invoicing; they are recognizing, too, that resolving payment problems requires innovative approaches to customer service, and they are recognizing that effective cost management requires more than trimming staff or moving operations to warehouses on the seedy side of town. Mostly, they are recognizing success demands more than just delivering "product" at a lower cost or with acceptable levels of accuracy and timeliness. It demands providing expertise that "drives client performance;" it demands openness to sharing client risks, and it demands meaningful service customization, not useless "bells and whistles." It demands customer intimacy.

Third, leaders in the remittance outsourcing community have recognized the value of "centrality." Years ago, someone asked Willie Sutton why he robbed banks. His answer was simple: "because that's where the money is." We can paraphrase by asking why remittance outsourcers can deal with hybridization, and the answer is just as simple: "because that's where the solution is."

Few corporations can afford, or want to afford, the kind of investment required for interfacing with a hybridizing, mystifyingly complex, and risk-laden payment system. There are better places to invest capital for shareholder return. Today's payment outsourcers have made and continue making investments. They add value by sharing their investment with clients, helping clients balance fixed and variable costs while reducing risks. They are prepared to deal with convergent billing and electronic presentment. They are prepared to accept payments made with checks, ACH or ATM debits, credit



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cards or e-cash; they have advanced technologies to capture billing and payment documents, and to deliver documents over the Internet wherever they need to go. They have the ability to deal with complex and expensive exceptions, and most important, they have flexibility to tailor solutions in ways that really meet individual client needs.

Summary and Conclusions

No one knows exactly where the U.S. payment system is heading. We are not even certain about the number of transactions processed in a year or the value of those transactions. We do know very big numbers are involved, however. We guess at how cash is used, but we have not measured check volume in twenty-five years (though the Federal Reserve has commissioned a study, due for publication later this year). We speculate about credit cards because no one tracks the 25% (or so) of cards not issued by the "majors." We have a better handle on ACH and FedWire volumes but are certain they amount to less than five percent of all value transfers. As far as Internet, EBPP and even e-commerce are concerned, the only things we really know are it hasn't happened yet and American consumers have been slow adopting any electronic payment mechanisms, despite their availability, in one form or another, for nearly thirty years.

One would think the economics of check payment outsourcing, retail lock box, are obvious, yet more than 80% of consumer payment receivers still prefer in-house solutions. That statistic, however, is becoming more apparent than real. Commercial banks, the earliest providers of retail lock boxes, never really had their hearts in the business. They entered the market reluctantly, priced it poorly, and almost never linked the profitability of deposit services to retail lock box until their CEO's demanded market exit. Early non-bank outsourcers only compounded the problem when they perpetuated faulty pricing and traded processing quality for reduced cost, damaging the credibility of all providers.

In fairness, adequate technology for high volume payment processing only became available after (about) 1995, with the introduction of image-based hardware, high throughput software and major innovations like extractor-based image capture. Despite its challenges, consumer payment outsourcing grew, on average, more than 15% a year through the 1990s and growth has accelerated to 20% since 1999, notwithstanding provider changes. Last year, remittance outsourcers processed about 3.5 billion payments, nearly triple the volume of 1990. Today's providers have taken the steps described earlier to shake their "commodity-provider" images even as client CEO's and CFO's became more open to outsourcing, especially after "sticker shock" from hearing the cost for new remittance platforms or EBPP systems. It is likely remittance outsourcing will continue growing in the coming decade, especially as the payment system continues hybridizing.



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About the Author

Dick Poje recently formed his own firm, R. J. Poje and Company 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 more than 30 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 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, and his most recent work, "Paradigm Shifts and Other Consultant-Speak: Six Lessons for Payment Services Providers in the Internet Age," appeared late last year.

Mr. Poje is a graduate of Fordham University and the University of Chicago and is currently on the faculty of the University of Colorado Graduate School of Banking.

**R. J. Poje and Company
312 Ridge Road
Barrington IL 60010**

**847.304.9961
847.304.9976 (fax)
708.764.6768 (cell)
richard@poje.com**



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- We "stick to our knitting." We focus *exclusively* on helping clients de-mystify the complexities that challenge their treasury and payment systems operations. That is our business, our only business.
- We work only for our clients. We create value through consulting and advisory services. We neither promote nor endorse external products or services, and we accept no "third party" compensation for recommending products to our clients.
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- We invest *only* to strengthen our consulting practice. We charge fairly for our services and work to make those services better, not to diversify away from what we know best.

