

Outsourcing Lockbox Processing: Making the Right Choice

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BNY MELLON

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EXECUTIVE SUMMARY

Outsourcing Lockbox Processing: Making the Right Choice, commissioned by BNY Mellon and produced by Aite Group, provides insight about particular lockbox processing capabilities' importance in banks' determination to use an external lockbox provider to process their items and the criteria for choosing that partner. Aite Group's views are expressed in this paper, and are not necessarily representative of BNY Mellon's viewpoint.

Key takeaways from the study include the following:

- High percentages of banks at least partially outsource their lockbox processing to other providers: 70% of retail lockbox banks, 74% of wholesale lockbox banks, and 69% of whole-tail lockbox banks do so.
- Lockbox products contribute to banks' profitability as lead products to entice new clients, raise client retention rates, and raise client market shares.
- Reasons banks cite for outsourcing lockbox processing range from declining check volume, mail delivery delays, economic pressure to reduce operational costs to strategic objectives, such as avoiding investments in emerging technologies, expanding geographic coverage, and gaining competitive offerings not currently available.
- When banks choose to outsource their lockbox processing, they must strategically consider whether they want the processing to appear to be done by them (white-labeled processing) or if it is acceptable for their clients to know that another bank is providing the service on their behalf.
- Fundamental table stakes for lockbox outsourcing processors include highly to critically important determinants such as data security, processing accuracy, and core product capabilities. Other important factors include site locations, provider commitment to the product, white-labeled (private-labeled) solutions, and vendor management.

INTRODUCTION

As the number of check payments businesses receive declines, fixed costs force the per-item costs of processing to increase for companies' own accounts receivables and for banks providing lockbox services. Aite Group predicts a compound average growth rate (CAGR) of 1.5% from actual 2009 to estimated 2016 for overall lockbox volume, broken into CAGR of 0.4% for retail lockbox, 2.9% for wholesale lockbox, and 1.9% for wholetail lockbox.¹ The small CAGR portends fewer lockbox providers, but banks of many sizes still consider lockbox solutions valuable for enticing new clients, retaining existing clients, and increasing market share. One way for the industry to respond is to consolidate providers and outsource some or all processing to those providers. Those banks that provide outsourced lockbox services to other banks can increase their volume and lower their per-item costs.

This white paper looks at a range of factors that contribute to a bank's decision to use another lockbox provider. It considers the experience of banks that have already outsourced part or all of their lockbox processing as well as that of banks thinking of doing so in the next two years. Aite Group posits a number of rationales for choosing to outsource and determines the importance of each to the banks facing such decisions. The findings reported in this white paper identify important capabilities that banks offering outsourced lockbox services to other banks must ensure they are providing. It will also help banks trying to decide whether to continue processing in house by presenting factors they should consider. Bank receivables and lockbox product managers and technology vendors that provide capabilities for outsourcers will find this paper informative.

METHODOLOGY

Aite Group conducted an online survey of bank lockbox providers' senior managers from April to August 2014. Thirty-eight banks responded to the survey. Given the size of the research sample, the data provide a good directional indication of conditions in the market.

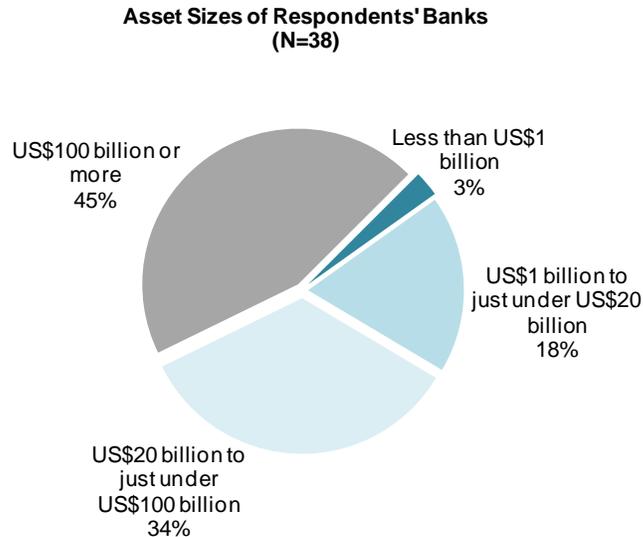
The information in this report reflects the responses received in this survey. Further, it incorporates Aite Group's extensive experience in the industry and observations about the industry based on the survey data. Some charts may not add to 100% due to rounding.

1. See Aite Group's report *Lockbox in North America: The Facts and Figures of an Exaggerated Demise*, August 2014.

RESPONDENT ATTRIBUTES

Aite Group estimates that between 2,500 and 3,000 North American banks offer lockbox solutions, and the number slants toward banks with larger asset bases. Seventy-nine percent of the Aite Group survey respondents represent banks with US\$20 billion or more in assets, with 45% at banks that have US\$100 billion or more (Figure 1).

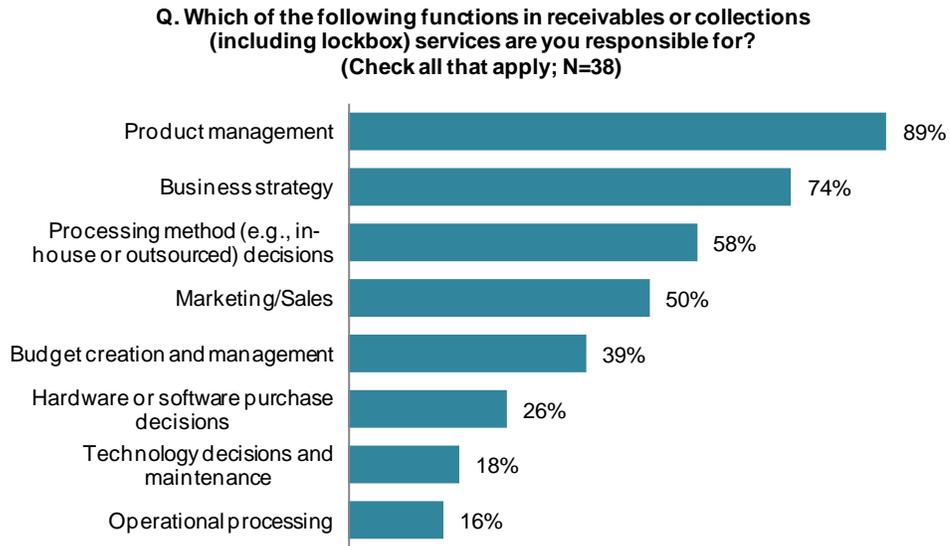
Figure 1: Asset Sizes of Bank Lockbox Provider Respondents



Source: Aite Group's survey of 38 senior North American bank lockbox managers, April to August 2014

Aite Group's survey covered a wide range of lockbox issues, so respondents are well-versed on strategy, technology, day-to-day operations, and alternative processing models such as outsourcing. Figure 2 shows the functional responsibilities of the respondents.

Figure 2: Responsibilities of Bank Lockbox Respondents



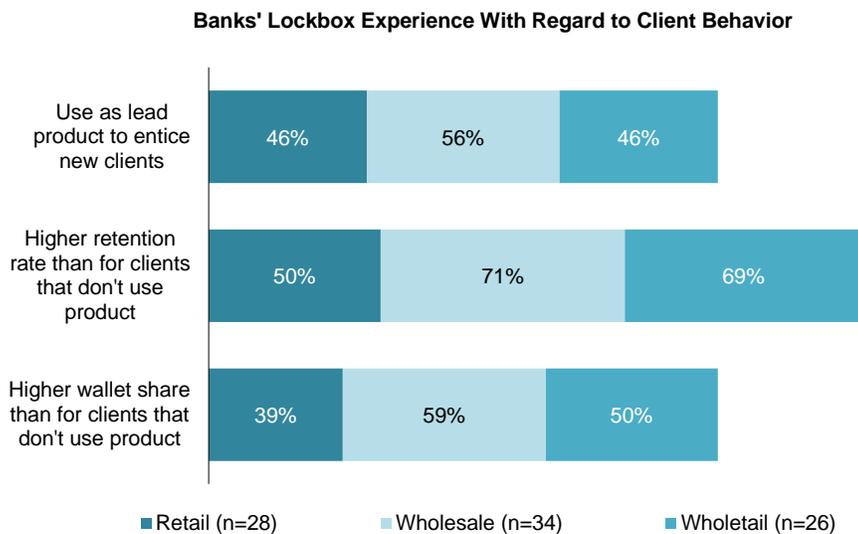
Source: Aite Group's survey of 38 senior North American bank lockbox managers, April to August 2014

LOCKBOX IMPACT ON NEW AND EXISTING CLIENT RELATIONSHIPS

The bank products that are often the first product a client buys are considered “lead” products because they introduce the bank and client relationship and encourage cross-selling and up-selling of other products. Wholesale lockbox is used as a lead product by the highest percentage of banks (56%), with 46% of respondents using retail or wholetail lockbox as lead products. Wholesale lockbox processes complex payments such as business-to-business and business-to-government (and vice versa). Wholesale lockbox solutions offer the most customized approaches and value-added services compared to the other lockbox categories; they address companies’ major challenges with regard to their receivables processes such as payments not matching invoices.

Key measures of client relationships’ strength include retention rates and wallet share. Use of any one or more of the three types of lockbox leads to higher client retention rates than for those clients that do not use any type of lockbox. Roughly 70% of banks indicate that users of wholesale or wholetail lockbox have higher retention rates than those of clients that do not use those products, while half of banks say that retail lockbox users have higher retention rates than do those that do not use retail lockbox. Clearly, lockbox products benefit the banks that offer it in more ways than direct processing revenue (Figure 3).

Figure 3: Benefits of Lockbox to Bank Profitability



Source: Aite Group survey of 38 North American bank lockbox providers, April to August 2014

OUTSOURCING BY LOCKBOX TYPE

The decision to outsource lockbox processing is made by type of lockbox. Some banks may outsource all three types of lockbox: retail, wholesale, and wholetail, which is a combination of wholesale and retail lockbox transactions processed on a single platform. Others may only outsource one or two types of lockbox.

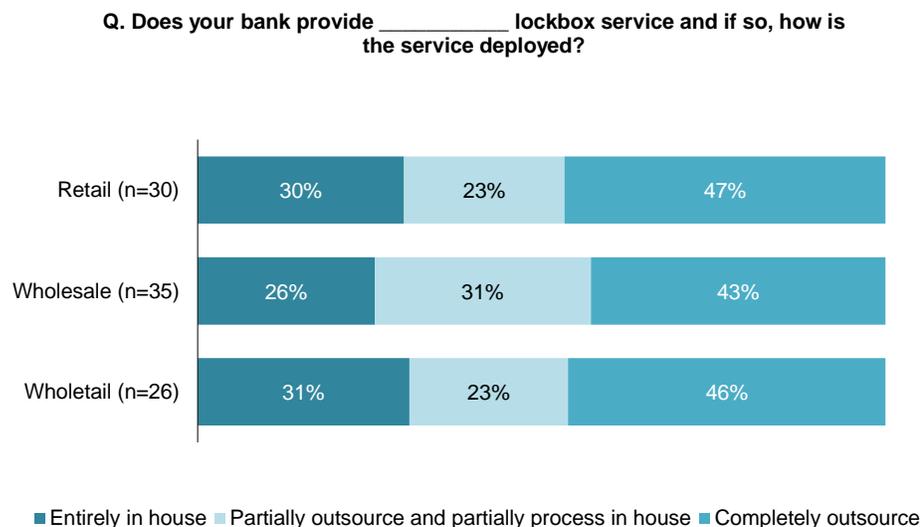
Another distinguishing factor is whether the outsourcer provides the service under its own brand or white labels (private labels) it. When banks choose to outsource their lockbox processing, they need to decide whether they want the processing to appear to be done by them or if it is acceptable for their clients to know that another bank is providing the service on their behalf.

LOCKBOX PROCESSING METHODS DEPLOYED

Typically, smaller financial institutions outsource services to offer capabilities comparable to those of larger financial institutions. In recent years, banks of all sizes increasingly outsourced retail lockbox because of declining margins. Of the bank respondents, 70% at least partially outsource, with nearly half completely outsourcing their retail lockbox.

Wholesale lockbox per-item pricing maintains better margins than retail lockbox, which is highly automated, because of the rules-driven processing involved in business-to-business payments. Nonetheless, roughly the same percentage of banks (74%) partially or completely outsource wholesale lockbox. The third and final form of lockbox processing is wholetail. Sixty-nine percent of respondents at least partially outsource wholetail lockbox (Figure 4).

Figure 4: Lockbox Processing Methods



Source: Aite Group survey of 38 North American bank lockbox providers, April to August 2014

DECIDING TO OUTSOURCE LOCKBOX

A number of factors and economic conditions contribute to banks' decisions to outsource their lockbox services.

Each of the factors tested in the online survey received "high" to "critical" importance ratings in terms of the bank's decision to outsource some or all of its retail lockbox:

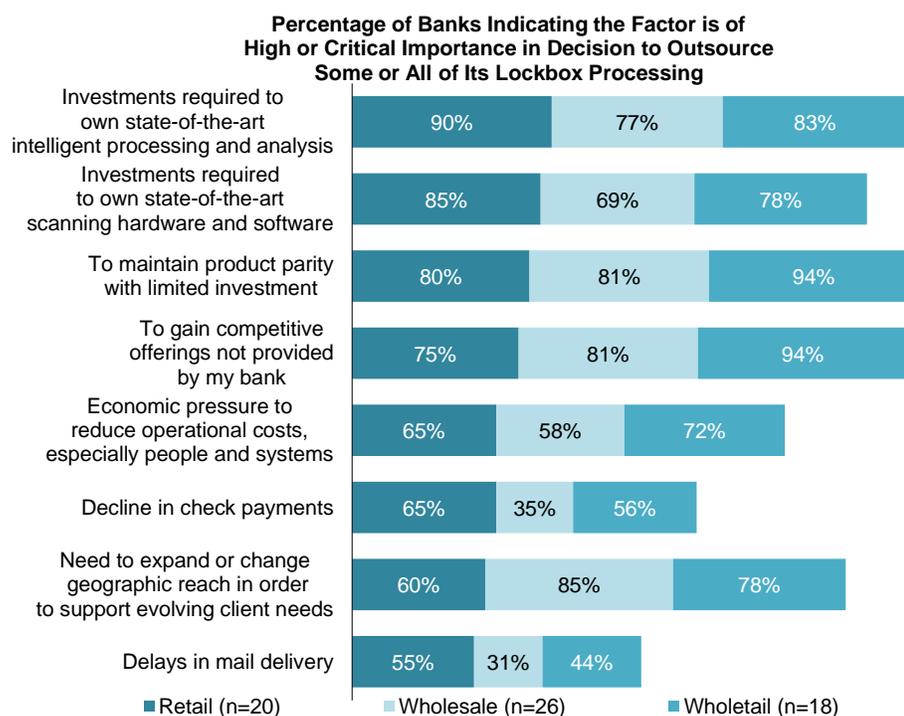
- Investments required to own state-of-the-art intelligent processing and analysis (90%)
- Investments required to own state-of-the-art scanning hardware and software (85%)
- To maintain product parity with limited investment (80%)
- To gain competitive offerings not provided by my bank (75%)
- Economic pressure to reduce operational costs, especially people and systems (65%)
- Decline in check payments (65%)
- Need to expand or change geographic reach in order to support evolving client needs (60%)
- Delays in mail delivery (55%)

More than half of respondents perceive almost all of the proposed factors to be of high to critical importance in their banks' decisions to outsource wholesale lockbox:

- Need to expand or change geographic reach to support evolving client needs (85%)
- To maintain product parity with limited investment (81%)
- To gain competitive offerings not provided by my bank (81%)
- Investments required to own state-of-the-art intelligent processing and analysis (77%)
- Investments required to own state-of-the-art scanning hardware and software (69%)
- Economic pressure to reduce operational costs, especially people and systems (58%)

Only "decline in check payments" and "delays in mail delivery" received less than 40% of high to critical importance ratings from participating banks, indicating that traditional drivers of lockbox services have less impact on the decision to outsource wholesale lockbox than do more strategic considerations.

Every factor potentially impacting a respondent bank's decision to outsource some or all of its wholetail lockbox is deemed to be of high to critical importance by more than 70% of respondents except a decline in check payments (56%) and delays in mail delivery (44%), as shown in Figure 5.

Figure 5: Factors Affecting Respondent Banks' Decisions to Outsource Lockbox

Source: Aite Group survey of 38 North American bank lockbox providers, April to August 2014

CHOOSING YOUR BANK'S OUTSOURCE PROVIDER

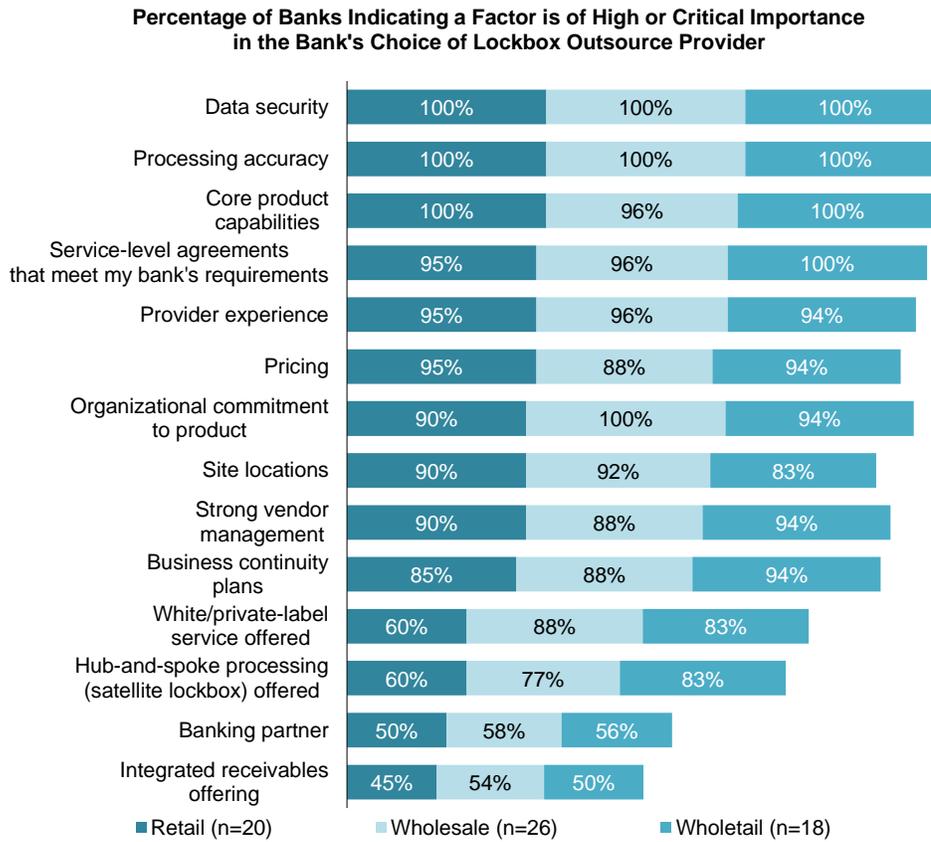
When choosing a retail lockbox outsourcing provider, banks consider many highly to critically important factors. Every factor but “integrated receivables offering” is designated of “high importance” or “critical importance” by at least half of the respondents. Offering integrated receivables is deemed highly to critically important by 45% of respondents.

When respondent banks choose an outsourcer to provide wholesale lockbox, more than half deem all of the factors provided of high to critical importance. Both data security and processing accuracy are considered highly to critically important to choosing wholesale lockbox provider by 100% of the respondents.

Mirroring the important factors for respondent banks' selection of wholesale lockbox providers, all factors are of high to critical importance to half or more of banks choosing wholetail lockbox outsourcing providers. Four factors are of high to critical importance for 100% of respondents: data security, processing accuracy, core processing capabilities, and service-level agreements that meet the bank's requirements.

Figure 6 shows the high to critical importance of each factor with regard to choosing retail, wholesale, and wholetail lockbox outsource providers.

Figure 6: Importance of Factors in Choice of Lockbox Outsourcing Provider



Source: Aite Group survey of 38 North American bank lockbox providers, April to August 2014

CONCLUSION

While receiving companies' check payments decline, companies continue to value outsourcing to bank and third-party lockbox service providers for reducing per-item costs, speeding funds collection, and providing value-added services such as integrating receivables processing. Bank lockbox providers can achieve advantages of scale by either providing outsourced services to other banks (building volume) or contracting to outsource lockbox services to banks or third-party lockbox providers. To achieve the advantages of outsourced lockbox services, the following are important factors to include:

- Banks without scale should consider finding an outsourced provider to handle their processing on a pay-as-you-go basis and avoid significant software and hardware investments.
- Fundamental table stakes for lockbox processors are data security, processing accuracy, and core product capabilities, which are highly to critically important to a bank's choice of outsourcing provider.
- In addition to the decline in check payments, banks that choose to outsource lockbox processing are driven by the investments required to own state-of-the-art scanning hardware and software; the investments required to own state-of-the-art intelligent processing and analysis; a desire to gain competitive offerings not provided by their bank; economic pressure to reduce operational costs, especially people and systems; the desire to maintain product parity with limited investment; and the need to expand or change geographic reach to support evolving client needs. Outsourcers must commit to investing in state-of-the-art intelligent processing and analysis and scanning hardware and software to ensure they will address such requirements.
- Other highly to critically important attributes considered by outsourcing banks are business continuity plans, accuracy, organizational commitment to product, strong vendor management, and provider excellence. Outsourcers must make a strong commitment to lockbox services over an extended period of years to fulfill the multiyear contracts they sign to provide services to other banks.

ABOUT AITE GROUP

Aite Group is an independent research and advisory firm focused on business, technology, and regulatory issues and their impact on the financial services industry. With expertise in banking, payments, securities & investments, and insurance, Aite Group's analysts deliver comprehensive, actionable advice to key market participants in financial services. Headquartered in Boston with a presence in Chicago, New York, San Francisco, London, and Milan, Aite Group works with its clients as a partner, advisor, and catalyst, challenging their basic assumptions and ensuring they remain at the forefront of industry trends.

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ABOUT BNY MELLON

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Leveraging the product, client support, and technology strengths of BNY Mellon's Treasury Services business, BNY Mellon's Private Label Solutions enable clients to provide their customers with a sophisticated array of treasury and cash management solutions while minimizing the costs and operational complexities associated with product development, platform upgrades, and system enhancements. Solutions encompass an extensive array of cash and liquidity management and multicurrency payment solutions, and these are provided in a variety of forms, ranging from private-label processing to full operations outsourcing.

Our flexible Private Label Solutions are designed to meet each client's unique requirements and include a staff of dedicated experts in client service, onboarding, product management, and relationship support. In recognition of the quality of our service, Global Finance magazine for the eighth consecutive year named BNY Mellon its Best White Label System Provider in its 2015 Best Treasury and Cash Management survey.

BNY MELLON PRIVATE LABEL LOCKBOX SOLUTIONS

BNY Mellon has been a leader in remittance processing for more than 50 years and has provided private-label solutions for over 25 years, an ongoing commitment demonstrated by continued investments in these areas of the business. The Private Label business is a key component of the overall Treasury Services strategy. The wholesale, retail, and whole-tail lockbox services are strategically located to optimize mail collection, minimizing float and maximizing funds availability for clients. Uniform operating procedures and standard processing hardware and software across the network provide consistent, high-quality service at all sites and make it possible for the sites to act as backup processing locations and ensure business continuity.