INSIGHT REPORT

INTEGRATED PAYABLES

THE OUTLOOK ON US PAYMENTS: OUTSOURCING PAYMENT EXECUTION

CONTENTS

Introduction

The ability to make payments efficiently and securely is a fundamental commercial activity on which the survival of every business depends. Failures in either efficiency or security can have serious financial, reputational and competitive implications. As a result, every treasurer and chief financial officer is motivated to minimize operational risk and process payments as efficiently and cost-effectively as possible. In the U.S., the widespread use of checks creates a major obstacle in meeting cost, efficiency and control objectives, but the obstacles to migrating to electronic payments have proved too high for many organizations. As this report outlines, this is changing as a new generation of payment solutions emerges with demonstrable value, providing a real alternative to checks without adding to companies' administrative or security burden. This report complements FIS' B2B Payments and Bank Connectivity 2016 Study, in which more than 170 corporations globally participated, of which 51 percent were headquartered in the U.S.

Key Findings

- **Ongoing centralization trend.** Eighty-three percent have achieved some degree of payments centralization, particularly amongst U.S. corporations, even though this can be challenging for businesses growing through acquisition, or with a cultural legacy of decentralization. While M&A can be a barrier to centralization, it is a valuable way to deliver cost and organizational synergies post-acquisition.
- **Payment and connectivity objectives.** Treasurers' and finance managers' motivation for optimizing payments and connectivity can vary considerably, but the most commonly cited aims are to improve controls (59 percent) and reduce fraud (52 percent). Many early centralization projects were motivated primarily by cost reduction, so the increased focus on control and fraud prevention, as opposed to cost alone, is an important and timely development.
- **Obstacles to digital payments.** Although we are seeing a global trend towards the use of efficient, electronic payment methods – particularly ACH payments and wire transfers – the use of checks amongst U.S. corporations remains high, with more than 50 percent of companies using checks for over 20 percent of their payments. Participants indicated that suppliers' preference for checks over electronic methods (41 percent) is the primary reason for using checks, as opposed to benefits to the organization itself. However, 21 percent are planning to reduce their use of checks.
- **Alternative to check.** Increasingly, companies are recognizing that virtual cards enable them to achieve their own cost, efficiency and control objectives, whilst also supporting suppliers' requirements. There is a growing trend towards outsourcing the management of virtual card programs, either to banks or independent providers. However, there are often significant differences in the way that banks or providers handle these programs. For example, in the majority of cases, on-boarding of vendors is a "one-off" process at the start of the engagement, while the company itself then needs to on-board suppliers on an ongoing basis. In contrast, the most successful virtual card (and other electronic payment) programs are those where the provider offers vendor on-boarding on an ongoing basis as well as vendor management, maximizing both adoption and supplier satisfaction.
- **Future trends.** Initiatives such as format standardization and real time payments offer significant potential for the future, but will require considerable industry and payment user consensus which is challenging in the U.S. given the number of participants. Real-time payments are attractive to most survey participants, but 30 percent have some reservations around the legal framework and handling of erroneous or fraudulent payments.

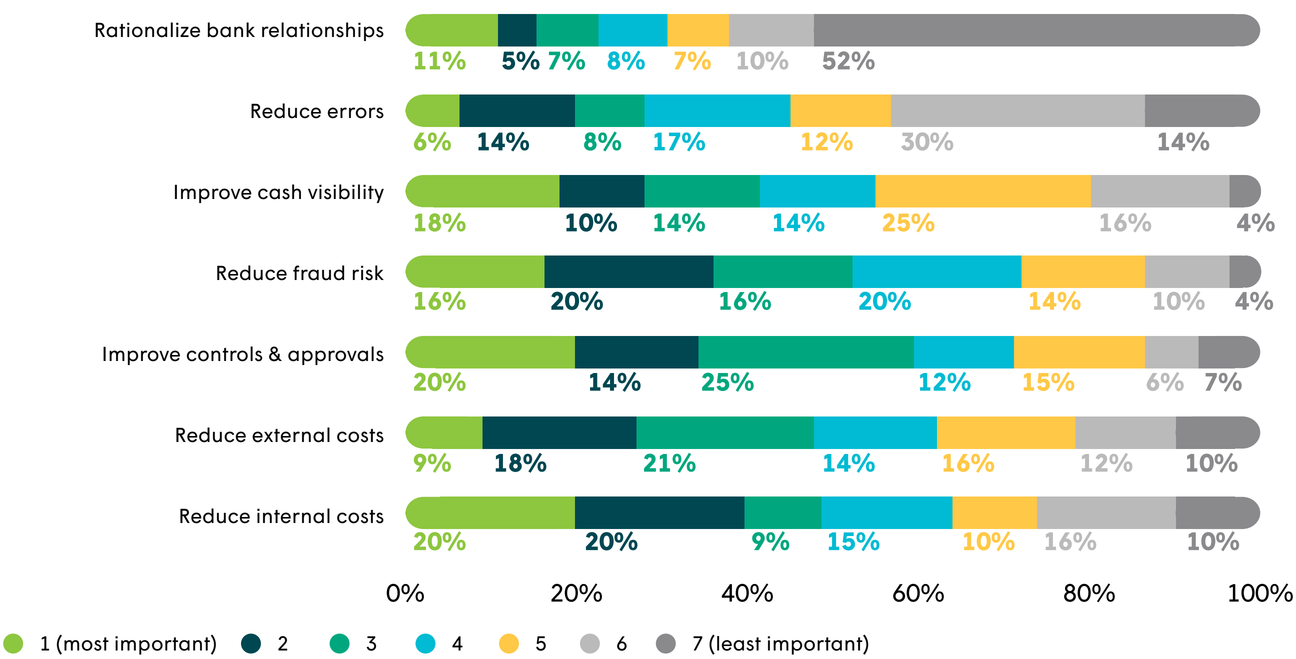
Trends towards centralization

One of the most significant trends we have seen in recent years is centralization and rationalization of cash management, including payments. Eighty-three percent have achieved some degree of centralization, while more than half (53 percent) of participants indicated that they have standardized at least three-quarters of their payments by volume, and for more than three-quarters of their legal entities. This is higher amongst U.S. corporations that operate primarily in their home market, as there are fewer currency, regulatory and organizational obstacles to centralization. Even so, there is still progress to be made in optimizing centralization efforts. One significant barrier – which often is more of a series of hurdles amongst corporations that regularly acquire new businesses – is the need to integrate mergers and acquisitions into centralized structures to deliver cost and organizational synergies. While this is a process that needs ongoing management as the organization evolves, the value of this investment is substantial.

Drivers of centralization

As Figure 1 illustrates, finance managers' motivation for payments centralization can vary considerably. While many early projects were primarily motivated by cost reduction, control and fraud prevention are becoming more important, an important and timely development. Fifty-nine percent of respondents ranked improving controls between one and three in the relative level of importance, followed by reducing fraud (52 percent). These two issues are closely related, as it is essential to have consistent control over payments to minimize the risk of internal and external fraud. Fraud is a growing problem, affecting companies of all sizes, with major financial and reputational implications. It is far easier to prevent fraud in a centralized payments environment, whether by channeling payments through a central payments hub, or setting up a payments factory or shared service center, as companies can standardize and enforce processes and controls, and provide consistent training to staff.

Figure 1. Drivers for payments/connectivity projects



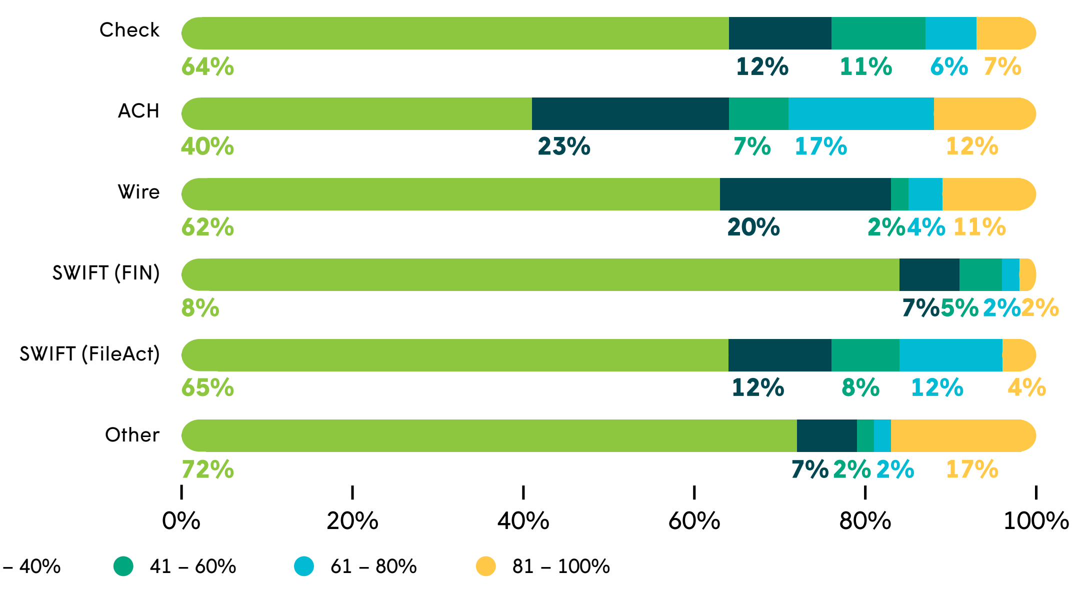
Optimizing payment processes

In general, we are seeing a trend towards organizations migrating from the use of checks to more efficient, electronic payment methods wherever feasible, particularly ACH payments and wire transfers (Figure 2). SWIFT is used by a relatively small number of companies in this study, given that a broad spectrum of company sizes are represented, but SWIFT is widely used amongst the largest multinational corporations with multiple bank relationships.

While the use of checks appears relatively low overall, this is disproportionately weighted towards U.S. respondents, of which more than 50 percent of companies use checks for more than 20 percent of their payments. A fifth of these use checks for the vast majority, or all of their payments. Although 21 percent of those that currently use checks are intending to reduce or discontinue their use, this is not always easy to achieve in practice unless an alternative payment solution meets both payer and payee objectives, as discussed below.

Participants indicated that the primary reason that they use checks is supplier preference (41 percent) as opposed to benefits to the organization itself. In 15 percent of cases, some employees do not have bank accounts, hence using checks, and 11 percent note that they use checks in order to send remittance information to suppliers at the same time.

Figure 2. Payment method by percentage



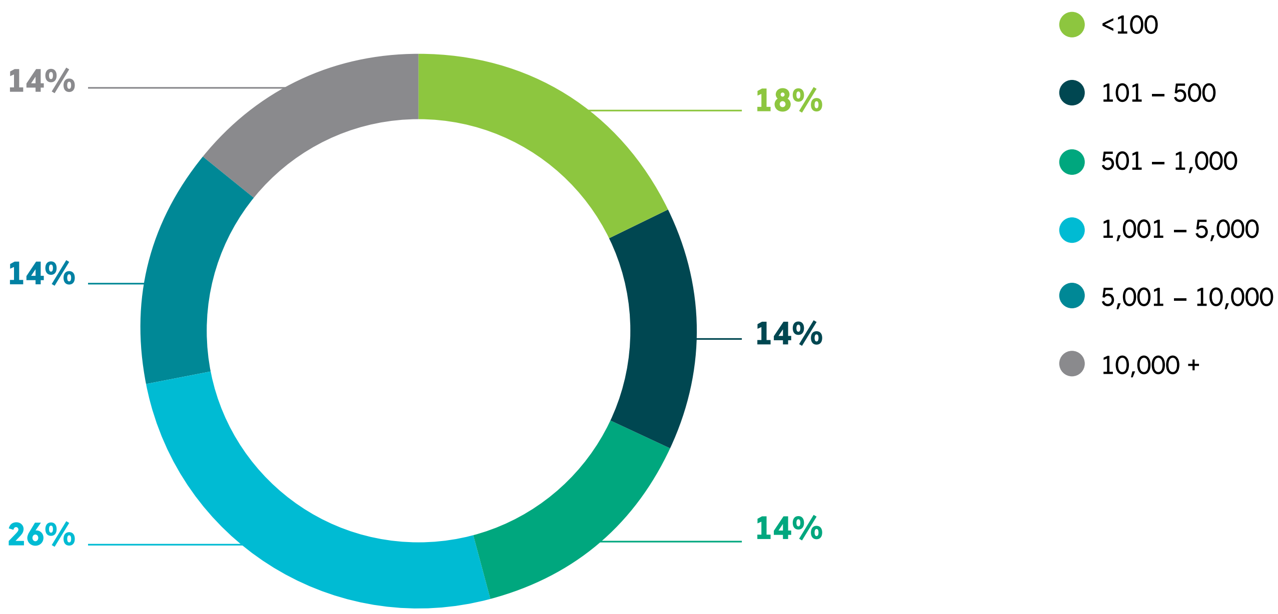
*“OTHER” PAYMENT METHODS IN THE SURVEY INCLUDE DIRECT DEBITS, AND LOCAL PAYMENT INSTRUMENTS IN EUROPE AND ASIA IN PARTICULAR.

In theory, it seems illogical that suppliers prefer checks, given that they have the inconvenience of depositing them, or paying lockbox fees. In addition, there are delays in receiving and crediting incoming payments to their collection account. However, for many companies, a key advantage to receiving checks is that they receive remittance information at the same time (either directly or as a feed from a bank lockbox), making it easier to identify and reconcile payments. Many companies are also uncomfortable with sending bank account information on invoices, a situation they avoid by requesting a check instead.

> Since outsourcing payments processing, productivity among employees has been improved. The time they once used to manually print out checks and stuff envelopes is now freed for more goal-driven activities.
>
> **DAWN LOTHRINGER,**
> TREASURY MANAGER, ZACHRY INDUSTRIAL, INC.,

Companies are increasingly recognizing that alternative payment methods exist that fulfill suppliers' requirements, as well as supporting their own cost, efficiency and control objectives. The value proposition of migrating to these electronic payment methods is compelling. As Figure 3 shows, more than half (54 percent) of participating companies need to pay over 1,000 suppliers, of which half again pay more than 5,000 suppliers, creating significant overheads for check production, processing and mailing. Furthermore, there are control issues in ensuring that supplier payment instructions are maintained accurately and securely, particularly given the increase in "supplier" fraud where fraudsters send credible advices of a change in settlement instructions. Many of these suppliers (more than half for around 30 percent of companies surveyed) are strategic suppliers (i.e., those with which a company has a long term relationship and to which it makes payments regularly), suggesting that there is a relatively high proportion of suppliers with which companies should be able to negotiate the use of efficient, electronic payment methods to replace checks.

Figure 3. Number of active suppliers



Alternatives to check

While alternatives to check have existed for many years (such as ACH payments, prepaid and purchasing cards), it has proved difficult to convince suppliers – and in many cases senior management – of the need to switch from manual to electronic payments. The reasons why a company chooses to use checks are well-documented, but to summarize:

- Ability to enforce signatory process without the need for sophisticated systems infrastructure
- No need to request or store supplier and employee bank account details
- Ability to send remittance information with the check, therefore minimizing supplier queries
- Potential working capital advantage over electronic methods due to "float"
- Familiar to accounts payable departments with established processes
- Potential cost of change in implementing electronic payments and associated systems

However, there are some considerable disadvantages that increasingly outweigh the perceived advantages:

- Significant risk of error or fraud
- Lengthy, resource-intensive process for producing and signing checks
- High production and mailing costs
- Need to allow a working capital "cushion" under escheatment rules to provide sufficient funds to cover uncashed checks. Given that the check cashing date is unknown, this creates a significant working capital overhead that typically negates the potential float advantage.

Although senior management are increasingly recognizing the risk and cost implications of using checks, it is not always easy to identify an alternative that offers compelling benefits to both the company and its suppliers. For example, using ACH or wire transfers can require a change of processes and technology, and companies need to obtain and manage supplier and employee bank account information. Plastic cards can be convenient and offer working capital advantages, but there are security and control considerations, and these are not suitable for all types of payment, particularly employee payments and tax payments.

However, virtual cards have emerged strongly as a viable alternative to electronic payments. Rather than using plastic cards, a virtual card number is generated for each supplier payment, utilizing card attributes to increase security and ease reconciliation. Crucially, each virtual account number has an expiration date, which makes it far easier to manage working capital. Full reporting and integration with internal systems is available, providing intelligence on supplier spend to help inform purchasing policy, and enabling efficient processes. Suppliers receive the remittance information at the same time as the card payment, enabling easy identification and reconciliation, with the benefit of immediate value, unlike checks, where the mailing and float period create delays.

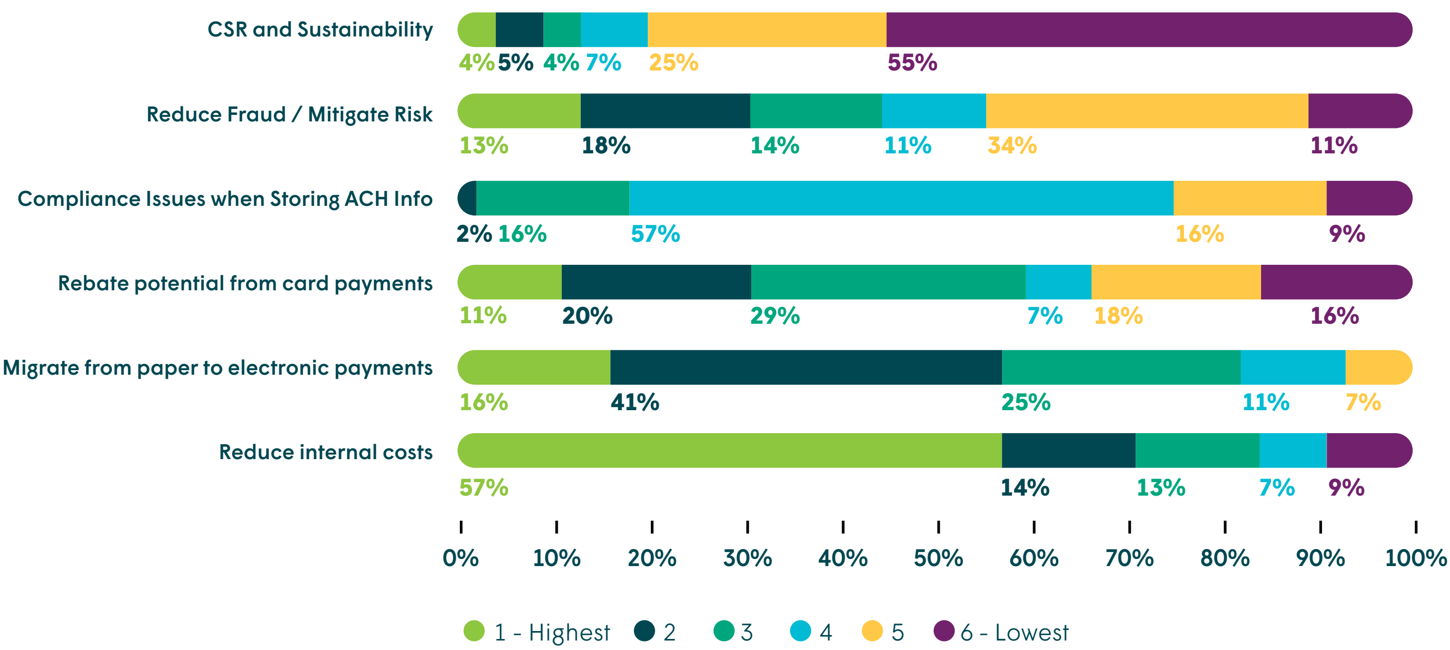
> Virtual Card rebates have more than offset check printing costs and have allowed our AP department to generate revenue that goes directly to our bottom line.

ANDY ABBOTT,
ASST. CONTROLLER, RUSSELL SIGLER INCORPORATED

Virtual card programs can be managed internally or outsourced to a bank or independent vendor, according to each company's preference. In some cases, companies prefer to work with a bank with which they already have a trusted relationship while others that have multiple bank relationships may prefer to appoint a bank-neutral provider. As Figure 4 demonstrates (looking at the two highest categories), reducing internal costs (71 percent) and digitizing payments (57 percent) are the most compelling reasons for outsourcing payment processing. The security and control benefits and the ability to access rebates on card payments, both at 31 percent, are also significant factors, but typically outweighed by cost and efficiency considerations.

While there are theoretical benefits to adopting and outsourcing virtual cards, choosing the right partner is essential to maximizing the success of a virtual card program and avoiding disruption to existing processes and supplier relationships. For example, an average of 3 to 5 percent of card payments are not processed by vendors before the expiration of the virtual card. A comprehensive vendor enrollment program will provide campaigns that contact these vendors on behalf of its customers to ensure that these payments are processed, improving predictability of payment and improving vendor relationships. In contrast, companies do not know when vendors will deposit checks, creating a major working capital burden and additional work due to escheatment laws.

Figure 4. Drivers for outsourcing virtual card payments



Maximizing migration success

Vendor enrollment is the single biggest hurdle for companies seeking to migrate from checks to electronic payments, not only virtual cards, but also ACH. Given that many companies transact business with thousands of vendors, as Figure 3 illustrates, the process of onboarding these vendors must be scalable and structured. Furthermore, as the vendor role changes over time, so vendor onboarding needs to be an ongoing process to maximize use of electronic payments over time. A vendor enrollment program should provide a dedicated team to manage both outbound calls and supplier queries. The campaign should be customized to address specific supplier segments, including email marketing and automation, with trending and analysis to map onboarding progress.

Vendor enrollment is just the beginning. An outsourced payments partner should also manage ongoing vendor relations. The partner should be able to handle inbound calls and servicing and walk suppliers through the process and handle any questions that may arise. This should be handled in a secure PCI-compliant facility.

Payment formats

It is not only the method of payment which is a consideration for treasurers and finance managers, but also the format in which payment information is exchanged with the bank. One of the difficulties experienced by many multi-banked corporations is that banks exchange data in varying formats which their customers must then configure and maintain in their own internal systems. This makes it time and resource-intensive to change or add banks, and complicates system upgrade and integration projects.

There have been a variety of initiatives to standardize the format of payment and account statement information, both domestically – such as NACHA – and internationally – such as the International Standards Organization (ISO). In the U.S., adoption of ISO 20022 emerging remains relatively slow given the large number of formats in use across the banking and vendor community, and the high cost of change. Amongst larger corporations, international payments are generally managed through regional centers, so SWIFT message types and XML ISO 20022 formats are less relevant to U.S. payment functions than to international payment factories or shared service centers.

> Paying vendors via paper check can be a strain on our budget and resources. By moving some of our vendors to the virtual card system, we have improved efficiencies and reduced overhead costs. The solution afforded us with a strategic vendor enrollment program that included an enrollment team and integrated campaigns.

JAMIE DIAL,
DIRECTOR, BUSINESS SERVICE,
KINGS COUNTY OFFICE OF EDUCATION

Accelerating payments

One of the most important recent developments has been the growing interest in real-time or instant payments, with initiatives at different levels of maturity worldwide. In the U.S., the Federal Reserve Faster Payments task force demonstrates the government's commitment to a new payments model, and has been met with widespread support from providers and users of payment services, despite the obstacles of engaging the 12,000 U.S. banking industry participants. Initially, banks will be obliged to adjust their systems and processes to receive instant payments, but not to make them, therefore easing the adoption process for some. The $25,000 limit on transaction size (although none on volumes) means that real-time payments will be most relevant to individuals and small businesses initially, but there are likely to be increasing opportunities for larger corporations in the future. However, 30 percent of survey respondents noted some concerns about real-time payments. In particular, there are considerations around how fraudulent or erroneous payments are handled, the legal framework, and how companies will need to adjust their processes to facilitate "just in time" payments.

Conclusions

The U.S. payments industry has reached a tipping point in the migration to electronic payment methods. Consumers and businesses now have unprecedented choice in the way that they pay and receive that address some of the problems inherent in the use of cash or checks. It is not only the instruments that have developed, such a virtual cards and ACH payments, but also the opportunities to outsource these processes and deploy them successfully. An outsourced integrated payables provider should offer services that are designed to meet the specific needs of different supplier segments, which may have quite different priorities and concerns in the way that they are paid, therefore increasing acceptance of electronic payments.

Payment instruments themselves are also continuing to change. Consumers and businesses' expectations of immediate access to information and services are growing as the use of smartphones increases and e-commerce and mobile commerce become more prevalent.

If people can view bank balances, check train times, track parcels and book grocery pickups at the touch of a screen, then access to instant payment services is just the next step, and a valuable enabler of efficient sales and supply chain models of the future. We may well continue to see a decline in checks as a result, as individuals and businesses increasingly place a greater value on convenience and immediacy. Security remains a vital consideration, but just as innovation is creating new opportunities for speed, access and convenience, there is significant innovation taking place in areas such as fraud detection, prevention and cybersecurity. What these innovations cannot replace, however, is the need for robust policies, processes, and system-enforced controls, which together can reduce fraud and build confidence.

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About FIS

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