

ACI wholesale payment solutions process more than \$12 trillion each day.

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## Profiting from payment best practices in transaction banking

Transaction banking is now receiving the respect it deserves as a sustainable source of revenue and vital customer touch point. But the business faces great challenges. The global payments landscape comprises a collage of local payment systems and practices that have evolved over time. Legislative initiatives, such as SEPA, seek to promote harmony and competition, but in practice they can increase the cost of doing business. The challenge is to cut costs and increase business agility. Can banks do both simultaneously? We believe so, but success requires a fresh approach.

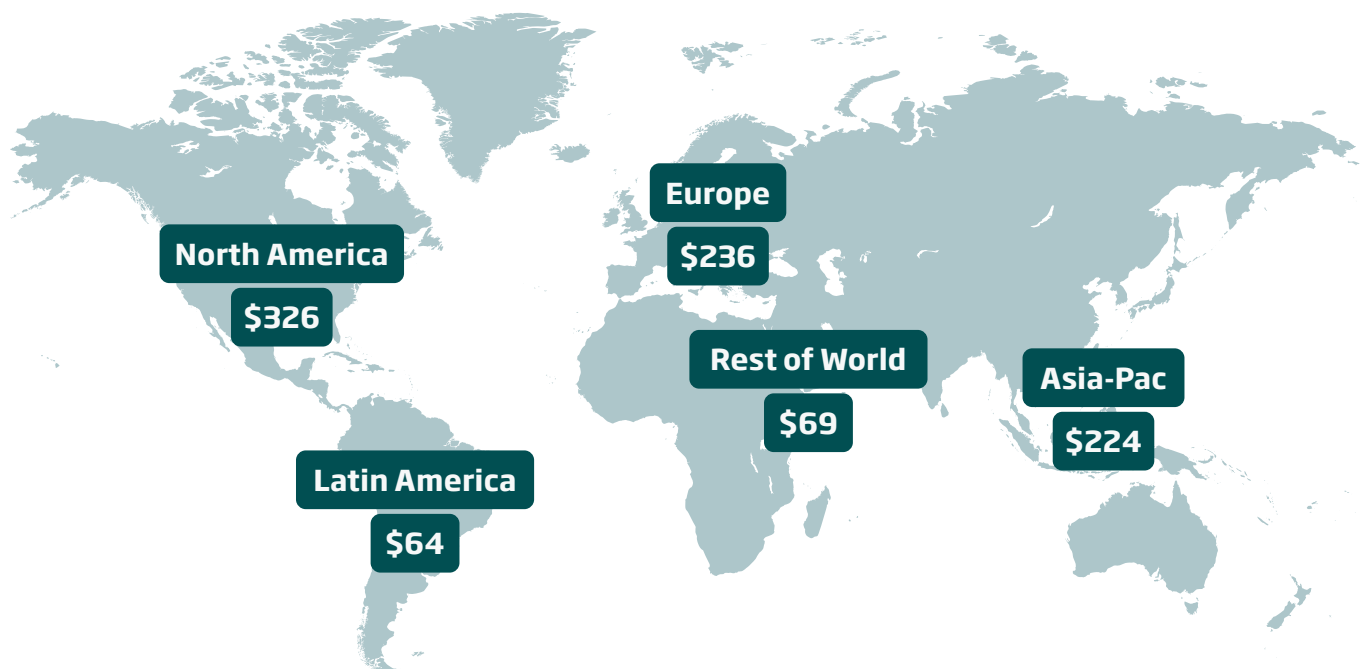
# Trends and challenges

The provision of payments is a fundamental function of banking, practically as old as money itself. Since the introduction of the check more than 350 years ago, the payments landscape has altered continually as a result of changing legislation, technology, customer requirements and competition. However, the industry has tended to follow a linear path of incremental evolution rather than outright revolution. As a result, transaction banking has seldom occupied the limelight and has occasionally suffered from a rather staid image. That image is changing fast. Why?

Tough economic conditions have renewed focus on transaction banking in general and electronic payments in particular. To some extent, this interest reflects the stability and predictability of the business. But, at a macroeconomic level the payment market has enormous potential. The provision of electronic payments is a major global industry that has enjoyed sustained growth since 2001<sup>1</sup>. This trend is likely to endure as overall payment volumes increase and there is an accelerated migration from paper instruments to electronic. Despite the recent slowdown in international trade, the rate of expansion has accelerated faster than global GDP. Global payment revenues were around \$900 billion<sup>2</sup> in 2009 – double that of worldwide airlines<sup>3</sup> in the same period. In some developing economies, such as China and South Africa,

Global payments revenues were roughly \$900 billion in 2009; pre-tax margins expected to be 20-25%

## Global payments revenues \$ billions



Source: Outlook for the Global Payments Industry, October 26, 2010, McKinsey & Company

<sup>1</sup> Estimated at 8.4% per annum, *World Payments Report*, Capgemini 2010

<sup>2</sup> *Outlook for the Global Payments Industry*, McKinsey & Company

<sup>3</sup> Total revenues of \$483 billion in 2009, *The New York Times*, 21 September 2010

payment volumes are growing at over 25 percent per year. The total volume of non-cash payment transactions is expected to reach a total of 299<sup>4</sup> billion items in 2012.

With such encouraging statistics, it is hardly surprising that banks are beginning to identify real strategic value in transaction banking services. Bank stakeholders find transaction banking attractive too, because it is a relatively low-risk business and a highly visible point of brand engagement. But the industry also faces great challenges.

### Dealing with multiple challenges

The frenetic growth in electronic payments creates the need for banks to manage increasing volumes, securely and efficiently. However, an increasingly complex environment means that it can be difficult for some to do so profitably. Whether a bank can profit from payments depends on several factors, including its economies of scale, the efficiency of its processing and the extent to which it can wrap value-added services around core payment propositions.

It can be difficult to ascertain the precise costs of offering payments as they are usually bundled with other services. In practice, most banks are committed to offering payment services and many are prepared to cross-subsidize these in order to gain and retain current accounts and associated liquidity.

An increasingly common response to drive payments efficiency has been the deployment of payment 'hubs', but the diversity of these means there is no single blueprint for what a hub should be or do. To succeed, the objectives should be clearly stated and agreed before embarking on the design and deployment of a hub as a practical solution.

All banks need to understand the detailed composition of their payment activities to ascertain those accounts that are likely to provide liquidity and those likely to consume it. This requires a thorough examination of all business processes and the systems that support them.

ACI Money Transfer System™ is installed at a major European bank that required a new payment processing and settlement hub. The solution positions the bank for SEPA and the flexibility enables the bank to support legacy formats and new SEPA instruments in a single system, facilitating easier migration between the two. Customers are benefiting from a consistent payment experience and are insulated from new legislative changes. As a result, customers' needs are being met through a series of best practice services employed by the Money Transfer System hub.

It is essential that systems are capable of meeting both tactical needs and strategic objectives, though it can be difficult to address both simultaneously. Banks can often benefit from the independent view of a software partner with broad market knowledge gained at the heart of the industry. This can help banks implement holistic solutions that create real value rather than pursuing individual projects in series. The pursuit of tactical gains at the expense of strategic aims will inevitably produce a 'siloed' systems environment, which is already apparent throughout the industry. Such fragmented infrastructures are unlikely to be commercially sustainable in the longer term.

### Margins under pressure

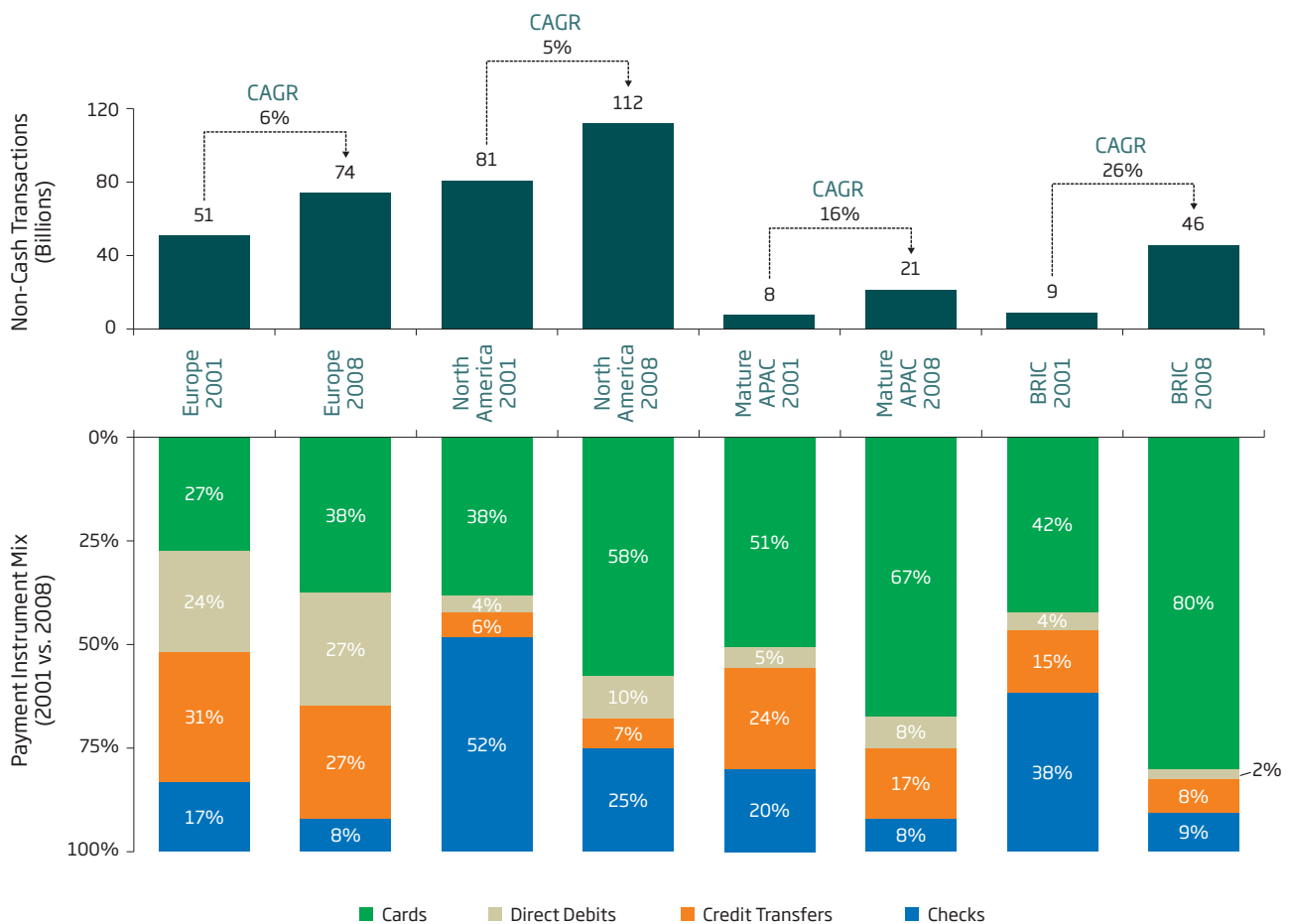
One of the less appealing features of the global payments industry is the pressure on margins due to increasing legislation and competition. A growing body of legislation, including the Single Euro Payments Area (SEPA), the Payment Services Directive (PSD) and Basel III, increases the cost of participating in global markets for banks and their customers. On average, over half of bank IT budgets are consumed by legislative compliance projects and for many banks the figure is considerably higher. In reality, achieving and maintaining legislative compliance is an ongoing process analogous to swimming upstream – if you are not going forwards you are certainly going backwards.

<sup>4</sup> *Global Non-Cash Payment Transaction Volumes*, Tower Group 2010

Banks throughout Europe have invested heavily in SEPA and most European countries have now transposed the PSD into national law. While the standardization that is central to SEPA promises reduced complexity, for some banks SEPA also removes the domestic barriers that have protected margins in local payment markets. Moreover, SEPA imposes a ceiling on how much can be charged for payment and encourages new market entrants. On the face of it, banks

throughout Europe face a dilemma: they must respond to the legislative challenge of SEPA, but none can halt the compression of margins from the revenue side. All banks must work hard to reduce costs and increase efficiency. Success in the new, competitive order calls for rationalization, consolidation and cost reduction. However, banks cannot succeed through cost-cutting alone; a new approach is required.

## Comparison of non-cash transactions by region and change in payments' mix, 2001 vs. 2008



Note: Data not available: for China for checks in 2001, for South Korea for cards in 2001, for Japan and China for direct debits for all years; so the growth rates shown might be somewhat smaller for these regions for those payment instruments

Source: ECB DWH-2008 figures, released Nov. 2009; Bank for International Settlements, Red Book, 2008 figures, released March 2010; IMF database; central bank sources; Capgemini analysis, 2010

Source: World Payments Report 2010 produced by Capgemini, RBS and Efma

# New opportunities and adding value

A legislative initiative, such as SEPA, can also be a great business enabler and an opportunity to do things differently. All banks want to increase productivity, but they also wish to become more agile. Success will not emanate from incremental improvements in processing efficiency or playing catch-up with the regulator. The intuitive appeal of SEPA stems from its innate simplicity, but there is undoubtedly a lot more to it than meets the eye. Banks must be prepared for further changes in legislation and market practice: SEPA is just one project, and there are many other initiatives planned or underway. Significant examples include the Southern African Development Community (SADC) payment system and emerging standards emanating from the co-operative International Payments Framework Association (IPFA). In general, banks need to insulate themselves from such change so they can focus on creating compelling customer propositions. The time is right to introduce best practices throughout the payments industry.

Proven software providers can contribute to the development of these best practices. They can call upon many years of experience in the design and implementation of practical solutions and can help banks streamline processes and add value to core payments processing.

## **Best practices – short-term opportunities**

As the compression of payment margins continues, the payments market will become commoditized, standard pricing will prevail and it is likely that there will be increased market concentration of processors throughout Europe and the rest of the world. In theory, the largest of these will enjoy unlimited returns to scale, and payments processing will remain in the hands of a few large providers.

Banks cannot succeed by simply replicating solutions that have worked for others. In practice, implementing a successful payments solution is as much about applying knowledge and expertise as it is about software. Banks need to turn such expertise into propositions that add value to basic processing in a way that reflects bank strategy and positioning. In this respect, all banks set out from different vantage points. The dissemination of best practices creates a unity of purpose within the global payments community. This allows banks to focus

on the added-value aspects of payments that facilitate service differentiation and are a prime source of competitive advantage.

All banks benefit from improvements in payment market efficiency and experienced software professionals can help the payments community achieve more in less time. This is particularly relevant in complex global markets.

## **Shrinking world, increasing complexity**

The global payments landscape is an amalgamation of domestic systems each with its own unique history and established practices. For most banks, SEPA is part of a bigger, global picture and is only one element of its payments strategy. Moreover, there are similar payments harmonization initiatives underway in different regions, including the Middle East, Africa and Asia. This is beneficial in itself: a harmonized global payments market offers benefits to all as liquidity can be managed more efficiently and processes streamlined. Similarly, increased global harmony is likely to improve the effectiveness of anti-money laundering (AML) and know your customer (KYC) initiatives.

At bank level, a standardized payments framework offers a robust transactions framework on which to hang other services that corporate customers are willing to pay for. The key to success lies in gaining a deep understanding of customers' immediate needs and strategic intentions. A good starting point is to view payments in the context of the bank/customer relationship.

## **Putting payments in context**

From a corporate customer perspective, payments are of little interest in themselves. Payment represents the completion of a transaction, so payments cannot usually be considered in isolation. Processing payments is always part of a bigger picture of corporate liquidity management. Most payment environments have evolved over a long time, often as a result of piecemeal reaction to changes in legislation and market practice. The result can often be a disjointed arrangement of software components that have been built in house and sourced from multiple vendors.

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Payments are often initiated and managed in a fragmented array of processing silos using a diverse range of applications for different transaction types and currencies. Manual intervention can be required, not just for exceptions and repairs but to ensure that payments reach the intended destination. It is generally estimated that 70 percent of European payments are completed without manual intervention. While this is commendable, it still means that 30 percent of payments suffer some degree of deficiency requiring a manual workaround. This increases the cost of processing and can do serious damage to a bank franchise in terms of delay and poor customer service.

### **Interpreting customer needs in the medium term**

The international payments landscape remains some distance away from standardization, but the trend is going in the right direction. SWIFT, in its capacity as registration authority, is helping to establish and implement standards and many banks and schemes are adopting ISO20022. New standards must be implemented, not with just the needs of the bank being considered, but also the needs of customers. If the standards do not convey the message that the customer wants to deliver then they are unlikely to be sustainable. But ISO20022 is a major step forward and does mean that data repositories can start to have a common structure regardless of the payment type.

From a bank perspective, the prime function of IT is to enable profitable business. Technology is eliminating speed and distance as meaningful measures of payment efficiency and source of competitive advantage. Corporate customers of all sizes are demanding more from all of their suppliers, and banks must work harder than ever to maintain their share of the payments wallet. It is crucial for banks to understand how corporate customers use their services, but also to know how these services relate to overall corporate strategy.

The global payments landscape has advanced by supporting local business needs and practices. Much of the terminology used throughout the industry is obscure, market-specific and archaic. Customers do not necessarily think in terms of high-value/low-value payments. These are legacy definitions that offer little guidance for corporate customers. From a customer perspective, there are just payments, with varying degrees of urgency. Technology is already forcing the

pace of convergence between different payment types and channels. For banks with efficient systems, the movement of high- and low-value payments will tend to become homogenous as all messages go through the same processes of identification, validation and authentication.

There is scope to add value in several ways and much of the groundwork is already done and market proven.

### **So how can banks add value to the basic payments proposition?**

#### **Making payments easier to initiate and available at short notice**

In the global economy companies need real-time payment services to support their 24x7 operations. Online has become the universally preferred banking channel for most customers. A secure online portal can also be used to deliver a range of payments data, offering a real-time window on the status of all payments and accounts.

Corporate customers also want flexible integration with in-house IT, either through host-to-host communications or simple integration with existing enterprise systems. Information should flow both ways and customers should have the choice to submit bulk files in a variety of formats for onward routing, according to predetermined rules. Specific payment schemes used for settling the payment should be largely transparent to the corporate customer.

Despite the proliferation of online and self-service banking channels, there is still a need for personal service in the support of payments. Banks can differentiate their payment services by offering first-class proactive support throughout the payment lifecycle. This is particularly important when payments fail or appear likely to fail.

#### **Providing real-time reporting and powerful management information**

Corporate treasurers need ready access to real-time global liquidity positions in the multi-currency environment. Many companies are run along global lines so it makes sense to align liquidity management with overall business strategy. Corporate customers wish to receive more intelligence about payments and need to be able to aggregate accounts to maintain credit levels and liquidity.

Payments information is a critical component of corporate liquidity management, so customers expect real-time status reporting on payments, particularly where there is delay or likelihood of failure. Corporate customers will also appreciate real-time audit trails to track progress and tighten liquidity and risk management. Customers rightly need to know what is really happening to their payments, not just that they are in another bank system.

The provision of summary real-time reporting and management information can be delivered to mobile devices such as Blackberry or iPhone to enable action to be taken earlier. Such mobile channels are an increasingly important customer touch point that offers the opportunity to increase brand engagement.

### **Offer a consistent payment experience worldwide**

Success in international business requires the maintenance of a large number of relationships, many of which have developed over a long time. Banks that have grown through merger or acquisition have inherited complex legacy systems environments, which can make it difficult to offer a consistent global payments experience. Most corporate customers wish to submit payments through a single channel to multiple global destinations without needing to know the underlying formats or processes. On the face of it, this seems a reasonable request, but some banks struggle to offer a consistent customer experience and level of service worldwide. Those that do are likely to be rewarded with increased customer loyalty.

Although straight-through processing is important, there are still large numbers of payments that require manual intervention. All banks need to have efficient processes in place to manage these while offering good customer care in all locations.

### **New business models in the long term**

Increasing legislation and globalization have challenged traditional business models and relationships. Transaction banking is inherently a community affair and banks that compete in certain markets may well be partners in others. New business models are evolving continually and there are many agency arrangements whereby banks offer clearing services to other banks. The disappearance of geographic barriers is also changing payments processing at the country level.

The progress of SEPA means that processing can take place anywhere in Europe as payments traffic passes seamlessly across national borders. Although legislation may be driving the IT strategies of banks, it also creates the opportunity to do things differently. So, what might the future of international payments look like?

### **Partnerships flourish**

The international payments market will continue to benefit from harmonization and banks will be able to choose from a range of processing models that will include an expanding number of outsourcing and agency arrangements. There is already a great deal of interdependency within the payments community. Legislative initiatives, such as SEPA, seek to promote competition, but also require close collaboration to realize their full potential.

The future success of the international payments industry lies in the creation of dynamic value partnerships that enable individual organizations to leverage core competencies. All banks want to increase the contribution of their transaction banking services, but to do so they need to understand which are core, profitable products and which are non-core and unlikely to be profitable. Over time, transaction banks must build flexible operating models that support a consistent global service level across all segments. Few banks can achieve this without assistance, and trusted software partners can help by providing insightful advice based on proven experience.

The burgeoning body of financial legislation creates a perpetual challenge for banks. But it also presents an opportunity to do things differently. Banks can learn a lot from each other and global software partners can also provide a vital conduit through which to develop and implement best payment practices. Software partners must also venture beyond the immediate challenges to deliver solutions that help to mitigate risk and build strategic value. They must empathize with the need to introduce new business processes gradually and without disruption to vital payment processes; generally total replacement is impracticable. Banks are all too aware of the risk and expense involved in systems replacement, so software partners must be able to quantify and demonstrate the sustainable benefits of any proposed investment in technology.

# Conclusion

Transaction banking is undergoing a rebirth due to its inherent stability and market potential. However, its payment practices also face great challenges in the form of increasing legislation, complexity and globalization. Banks must rise to these challenges without interruption to existing business processes. The new environment being created by several global harmonization initiatives calls for cooperation as well as competition. However, it also presents the opportunity to do things differently, to reassess the important role that experienced partners can play in establishing best practices and in helping banks achieve their commercial objectives.

Trusted, proven software partners can play a pivotal role in transforming payments into a profitable business with strategic value for banks. However, success may require banks to engage with their partners at a more strategic level. Choosing the right partner may take time and effort, but banks that choose wisely will be well rewarded.

## **ACI Money Transfer System™**

Money Transfer System helps streamline banking operations, increase efficiency and maximize the use of available liquidity. It provides a set of independent business applications that address the specific

Money Transfer System is installed at a major global bank that provides corporate banking and correspondent banking services. To remain competitive, the bank needs to provide the very best level of service and offer value added services that their customers pay for. The flexible nature of the processing capabilities of Money Transfer System enables the bank to offer new products and charging models faster than its competitors.

processing requirements of wholesale banks. Money Transfer System is a multi-bank product that offers 24x7 multi-currency payments processing and simultaneous reporting. It can operate as an enterprise solution for message switching or a payments hub. Money Transfer System offers a strategic answer to the universal bank quest to create a profitable payments business in the complex international market.

To learn more about ACI and understand why we are trusted globally, please visit [www.aciworldwide.com](http://www.aciworldwide.com). You can also find us on [www.paymentsinsights.com](http://www.paymentsinsights.com) or on Twitter @ACI\_Worldwide.



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ACI Worldwide powers electronic payments for financial institutions, retailers and processors around the world with the broadest, most integrated suite of electronic payment software in the market. More than 90 billion times each year, ACI's solutions process consumer payments. On an average day, ACI software manages more than US\$12 trillion in wholesale payments. And for more than 150 payments organizations worldwide, ACI software ensures people and businesses don't fall victim to financial crime. We are trusted globally based on our unrivaled understanding of payments and related processes. We have a definitive vision of how electronic payment systems will look in the future and we have the knowledge, scale and resources to deliver it. Since 1975, ACI has provided software solutions to the world's innovators. We welcome the opportunity to do the same for you.