



How Global Banks Are Gearing Up to Address Emerging International Payment Processing Needs

Executive Summary

Recent times have seen a significant upturn in the number of international payments made by organizations among players in every business segment – from small and medium-scale companies to multinational corporations. The advent of ever-increasing international trade of course means banks face a surge in cross-border payments.

According to a study by the Boston Consulting Group, cross-border payments are expected to grow at an annual rate of 12%. With increased volumes of international payments and the need to offer cost-effective cross-border payments, banks are continuously evaluating their operational and technological landscapes. Add to this market competition and ongoing changes to the regulatory environment, and banks must redefine their business offerings to ensure an appropriate fit with client needs across segments.

This white paper describes the transformation in the business needs for international payments and illustrates an innovative offering employed by global banks today to address their ever-increasing international payment processing needs.

Situational Analysis of Existing International Payment Processing Solutions

Traditional cross-border payment offerings through wires are not only deemed expensive but do not always fit the purpose of such transactions. Typical wire cross-border payments are expensive because the payer is hit with several additional costs, including foreign exchange (FX) cross-border wire fees, lifting fees and central bank reporting fees. In this type of transaction, no attempt is made to optimize the payment process and several avoidable fees are incurred as a result. As such, wires fail to provide economical payment processing capabilities.

Another approach global clients have used is to maintain multiple in-country domestic accounts and then disburse payments through these accounts. This solution has the merit of avoiding the majority of the fees related to cross-border payments, such as FX and wire charges. The lifting fees are also reduced considerably as the payment is usually a domestic Automated Clearing House (ACH) payment. But this solution offers a different set of challenges to clients: The accounts are at times opened with multiple banks (especially in regions where most global

banks do not have a local presence) and as such payment reconciliation becomes complicated and cumbersome. Different fund clearing timelines and a lack of transparency in the entire payment flow adds to the complexity and makes the solution difficult to sustain.

Over the last decade, many global clients have used shared service centers (SSC), or payment factories, to realize operational efficiencies in cross-border payments. A global approach to shared service centers offers companies significant potential for cost savings and improved service. Cost savings, which can be significant, generally result from the elimination of redundant work and infrastructure.

Shared services implementations often coincide with an ERP implementation/overhaul. For global clients that have not yet moved to ERP or those that have but still maintain legacy feeder systems or have multiple ERP platforms, the implementation of an SSC becomes burdensome. A study¹ by J.P. Morgan confirms that having a single ERP system was critical to the success of implementation of an SSC. The same study contends that approximately 30% of companies surveyed attributed a lack of common systems as the biggest obstacle to the proper functioning of their SSCs.

Emerging Business Needs

Though client demand for innovative and cost-effective cross-border payment solutions remains steady for real-time transactions, banks have discovered various customer segments that desire cost-effective cross-border solutions aimed at non-time-critical international payments. These customers are generally organizations with a global presence and that are heavily involved in high-volume cross-currency payments. Typical categories of such client base include public and private sector administrators, insurance firms, mobile operators and multinational corporations, among others. These clients yearn for a solution to address bulk, non-time-critical payments where payment certainty and simple accounting can be economically achieved.

Trends observed at leading European banks² show that more and more global clients are now willing to treat their banks as payment factories. What this means is that clients would initiate all payments in lots from a single account and banks would then be responsible for segregating different payment categories and taking complete

control of payment processing and reconciliation. Payments would then be executed either as domestic payments or via corresponding bank networks to cost-effectively address client needs.

One possible reason for this tectonic shift is that many organizations are heavily focused on reducing their capital and operational costs; banks, meanwhile, have increasingly tried to cement client relationships in light of increased global market competition.

Bank Alignment with Emerging Needs

This emerging business need creates a variety of new challenges for banks. Also, this development is to the advantage of large banks with worldwide presence. The main challenges banks need to address to align themselves to clients' changing cross-border payment needs include:

- A global branch network and a large base of global clients in need of high-volume international payments.
- Multiple payment processing back-office connectivity in place.
- Strong association with partner banks where back-office connectivity is not in place.
- Ability to process payments across a wide range of currencies cost-effectively.
- Legal and compliance processes in place to ensure all local regulatory and central banking and regulatory requirements are met.
- Existing technological infrastructure that is flexible and scalable.

Banks are now evaluating their technological and operational landscapes to offer "payment factory capabilities." Large global banks are gearing up to this new challenge by streamlining their systems and processes to offer more innovative cross-border payment processing capabilities to global clients. Figure 1 shows the payment processing changes which have emerged as a result of this new offering.

A typical workflow for a payment factory solution is itemized as follows:

- Bank clients submit bulk international payments via existing payment initiation channels. These payments would be initiated from a single client account. Clients would enjoy the flexibility of including multiple payment categories across multiple currencies in a single payment lot.

Cross-border Payment Process Evolution

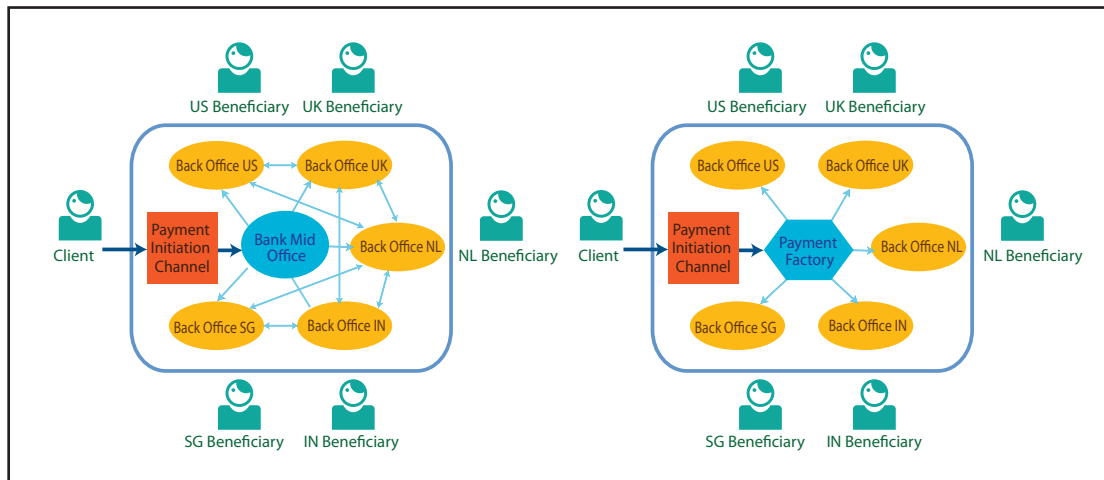


Figure 1

- These payments would then be pooled at the payment factory where all relevant foreign exchange conversions would be performed on the payments. Client accounts would be debited to reflect impending cover payments.
- The payment factory would make use of existing back-office connections to route the payments to their domestic back offices.
- At these domestic back offices, payments would be treated as domestic ACH/wire payments. In locations where banks do not have back-office connectivity, payments would be sent through wires.
- Appropriate management Information would be made available to clients to keep track of all payment information.

New Offering Advantages

The payment factory approach offers a new set of benefits to banks. The key benefits include:

- Centralized control: A payment factory ensures that there is centralized control over all payment routing information. This makes tracking and tracing easy for bank operations and client services users.
- Ease in nostro accounts reconciliation: Reconciliation becomes less cumbersome and easy to control.
- Target new customer segments: A bank can reuse its existing infrastructure and global footprint for new client segments and thereby generate new revenue streams

The “bank as a payment factory” offers a number of advantages to global clients as well:

- Cost effectiveness: Since payments would be routed through domestic back offices as domestic ACH/wire payments, clients would benefit from reduced transaction costs.
- Simplified account maintenance and reconciliation: Maintaining a single client account simplifies the accounting structure and eases reconciliation of payment information.
- Centralized processing, reporting and billing: As all payments are pooled at the payment factory, payment processing, management information and billing becomes simplified and more transparent.
- Improved working capital: Transparency in the entire payments processing workflow and centralized tracking and tracing of payments help improve working capital.

Assessing International Payment Processing Options

The following example provides a cost-benefit analysis on the various international payments processing options in use today. In this example, we assume Global Inc. to be a global multinational (based out of the Netherlands) that banks with Bank XYZ (also based out of the Netherlands). Let's assume that Global Inc. makes salary payments every month to its global workforce through Bank XYZ's direct payment channel offering. Thus, a large number of international

Cost-benefit Analysis of Various International Payment Processing Options

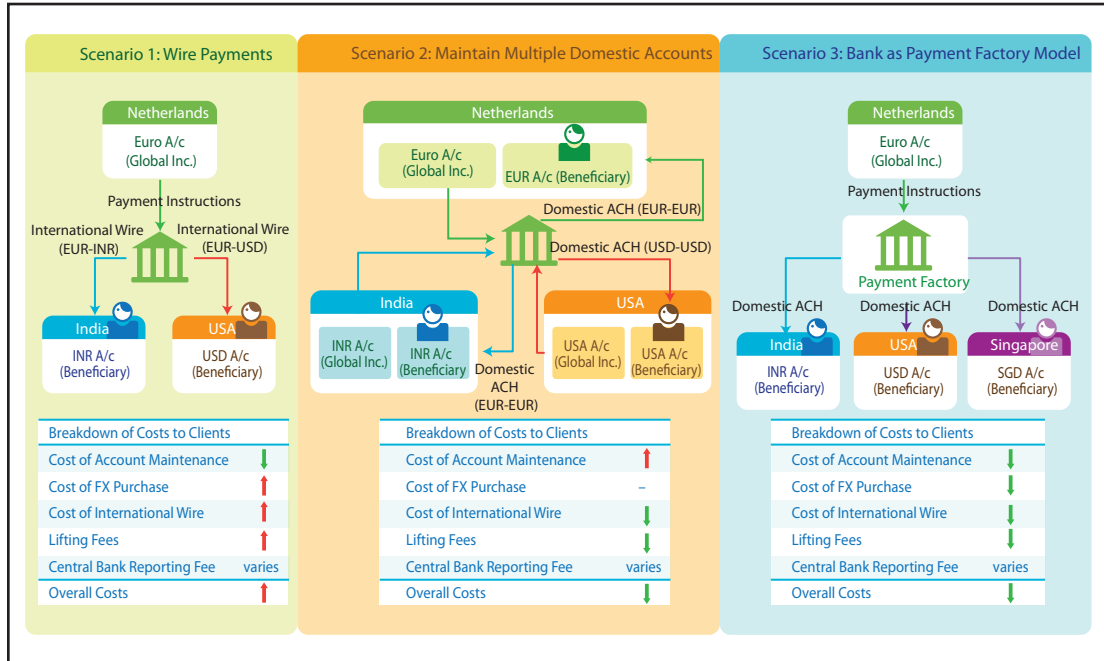


Figure 2

payments are made through Bank XYZ's infrastructure every month. To arrive at a cost-benefit analysis, we have considered three different payment processing scenarios here:

- Wire payments: Here, Global Inc. opens a single account with Bank XYZ in the Netherlands and all salary payments are initiated as international wire payments.
- In-country domestic accounts: Global Inc. opens domestic accounts in every geography of its operation. Payments would be initiated as domestic only and from the accounts local to the geography.
- Bank as payment factory: Global Inc. opens a single domestic account in the Netherlands. All international payments are initiated from this single account and Bank XYZ leverages its infrastructure to route these payments to different back offices as domestic.

Figure 2 illustrates that Global Inc. would benefit from the "bank as payment factory" offering due to lower costs. Maintaining only a single account would mean that the cost of maintaining a relationship would be significantly lower. Global Inc. would also benefit from better FX rates due to netting of currency positions. The biggest advantage, though, would be from the domestic nature of the payments as this would imply a significantly lower lifting and central bank fee.

Costs would be significantly lower for Bank XYZ on the payment factory offering (see Figure 3) as Bank XYZ would benefit due to optimal clearing and routing of payments leading to faster straight-through processing and reduced manual work. The high lifting fee and correspondent bank charges prevalent in wire payments would be significantly reduced as a result of treating international payments as domestic. Banks would also benefit from not opening new nostros for exotic currencies (which generally leads to higher costs for maintaining accounts in exotic locations), since they would likely outsource such payment processing capabilities to a third-party vendor to attain increased operational efficiencies and an enhanced product offering over the long run.

Breakdown of Costs to Banks

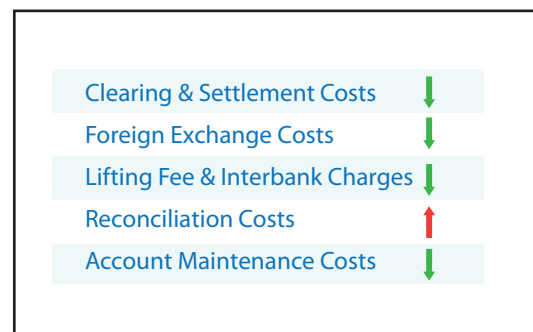


Figure 3

Looking Forward

The evolving landscape for international payments offers new challenges and opportunities to all segments of this industry. To leverage the opportunities provided by new business segments, global banks need to ensure that the challenges are adequately addressed. They must also ensure that new product offerings cover all segments of the population and provide an incentive for organizations to adopt these products. It is anticipated that to meet the increasingly stringent regulatory environment, banks will be required to develop new systems and processes.

The challenge, therefore, before all the stakeholders including global banks and other service providers, is how to introduce such next-generation international payment and settlement models that are needed to keep up with the fast emerging needs of new business segments. In the wake of increased innovation in the international payments arena, a strategy towards offering global banks as payment factories is one important move in this direction.

Footnotes

- ¹ Moving Towards Global Shared Service Centers - J.P. Morgan Treasury Services, 2004.
- ² Information gathered through interviewing personnel at global banks based out of Continental Europe.

About the Author

Anupam Majumdar is a Consultant with Cognizant Business Consulting's Wholesale Banking Practice. He has over five years of professional work experience across product management, business consulting and pre-sales in the wholesale banking domain. His areas of expertise include international payments, payment hubs, e-invoicing, e-receivables and financial messaging. He holds a bachelor's degree in engineering from the Indian Institute of Information Technology Calcutta and a post-graduate diploma in management from the Indian Institute of Management Bangalore. He can be reached at Anupam.Majumdar@cognizant.com.

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