Global Payment Services Sourcing: Key Considerations

Banks looking to keep their payments businesses viable in the face of regulatory pressure, increased competition and reduced margins need to revisit their operating models and identify potential sourcing opportunities to meet their strategic objectives.

Executive Summary

The payments business faces unprecedented changes globally. The advent of regulations impacting core payment processing such as SEPA, Payment Services Directives (PSD) and intraday liquidity requirements under Basel-III, as well as the problem of legacy platforms, operational silos, intensifying market competition and reduced margins in cross-border payments, are putting severe pressure on the global payments businesses.

To keep payments profitable, banks must reexamine their payments business in terms of internal (agility, efficiency and risk) and external (market, products, partners) parameters and devise new payment strategies.

Both big and small banks are adopting innovative models, involving a partner ecosystem, to achieve desirable outcomes on the business/processing fronts.

This white paper examines the various processing models that banks are adopting. It explains how prevailing market conditions warranted a gradual shift in operating models for payments processing and the choices banks have in responding to these changes. It also provides a broad framework for banks to assess their payment processing needs and qualify the parameters that drive decisions to engage processing services partners in the long run. Also discussed is a foundation for evaluating possible sourcing strategies.

Global Payments: Evolution and Strategic Choices

The payments industry has achieved radical improvements in profitability and efficiency since the beginning of the 1990s. This can be attributed to macroeconomic developments as well as the trends within the sector such as the advent of online banking, the growing popularity of online self-service utilities, etc.

Various payment-related functions that were previously considered the preserve of banks are now becoming profitable ventures for non-banking institutions. The evolution of PayPal and Google Wallet are prime examples. This has prompted transaction banks to rethink their operating models.
The payments industry is moving towards consolidation, universal standards, harmonization of payment products across national borders and, most importantly, value chain deconstruction and specialization.

Banks should review their core payments businesses, identify their competitive advantages as well as relative weaknesses and finally focus on the strengths identified. Such a shift should result in focused investments and efforts in certain parts of the payments value chain and procurement of services in other non-strategic parts.

Such an approach will lead to higher efficiency with a greater degree of specialization and better utilization of resources.

Figure 1 illustrates the gradual shift in transaction banks’ payments operating models. The models are classified as:

- **Delivery Model:** This focuses on service offerings.
- **Client Relationship Model:** This focuses on service criteria.
- **Transaction Flow Model:** This focuses on information formats.

While the first two models are more client-focused, the third model is more about internal standardization.

Banks are increasingly identifying business/IT processes in the payments value chain that can be potentially farmed out to third-party service providers. This allows them to concentrate on the in-house activities in which they would like to excel, while extending cooperation with other service providers in the noncore components of the business.

As the global financial market moves towards harmonization and consolidation, with the objective of ensuring that all payment transactions are based on the same standards or interoperable technological standards, the complexities in cross-border transactions are easing.

However, for the banking sector, this new wave of harmonization will pose a new set of challenges and scenarios. SEPA (Single European Payments Area), with the primary objective of bringing down the cost of payments for customers, will also lead to reduced profit margins for banks.

To cope with the new reality, and to remain competitive and profitable in the payments business, banks have to combine a number of cost reduction strategies. These include reducing the number of systems used to process payments, reducing staff costs by eliminating manual processes, consolidation among key players and working with third-party service providers. However, the more business lines a bank offers, the more strategic considerations there are and the more complicated the sourcing options.

**Evolution of Banks’ Payment Operating Models**

![Figure 1](image-url)
Complex regulations, greater pricing transparency and major investments in payments processes and systems are forcing global banks, especially the European banks, to take a hard look at their long-term payment business strategies, and make significant changes to their existing payment models.

A bank with retail, corporate and institutional businesses across the major economies in the Eurozone will face prohibitive costs of expansion unless it can reduce overheads by consolidating or outsourcing elements of the payments process.

Also, a bank’s payments strategy is a function of its market position. Global, regional, national and smaller domestic players will have different views on the strategic importance of specific payment processes and the cost-effectiveness of the people, systems and infrastructure required to process payments in-house.

Keeping in view geographical interests, market share, volume of transactions, upfront investment in infrastructure, technologies and manpower due to complex regulations and the continual struggle to improve profit margins, banks can be placed in three strategic buckets: specialized players, scale players and followers.

This classification can be used by the banks to overcome complexities in identifying their market position, streamline their sourcing options and explore avenues to make their payments business competitive and profitable.

Scale can help large banks in building an internal clearing process, where book transfers replace the need for external execution. Typically, the unit cost of a book transfer is under one-tenth of an externally executed individual payment. Thus for every 1% increase in the proportion of book transfers, a bank could save 0.9% in corresponding costs. By further leveraging fixed infrastructural costs for higher volumes, we estimate that large banks could grow volumes at 10-20% annually at flat operational costs.

The key characteristics of banks falling under the three strategic categories are as follows:

**Scale player:** Its payments business exists as a strategic business line, and innovations are sponsored. It achieves enhanced levels of efficiencies in payment processing. It achieves higher profit margins by offering in-sourcing of back-office payments, and white-label services to specialized and smaller players, taking advantage of its significant economies of scale and its ability to invest in expensive infrastructure and technologies.

### Strategic Positioning of Payment Players

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<table>
<thead>
<tr>
<th>Profitability</th>
<th>Share of wallet/market share</th>
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<tr>
<td>Specialized player</td>
<td>Followers/Small players</td>
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<td>Scale player</td>
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Figure 2
**Specialized player:** It sells a mono product to a niche market and/or multiple products to special segments. It goes in for in-sourcing and white-label services in specialized areas. It has the ability to design and tailor new products to capture new markets.

**Follower/small player:** Banks that cannot sustain the business case on their current business volumes, and do not have the ability to scale up their presence in the payments business, should explore opportunities to outsource part of their payments operations. Followers may have higher levels of dependencies on old legacy systems. Such banks should look to forge alliances with larger banks to meet the regulatory requirements for payment products. Examples in this context could be white-labeling or partner bank agreements. Small players should focus their attention and resources on specializing in value-added services rather than high-volume payment processing.

We note, however, that these three classifications should not be treated as strategic silos. A scale player may operate as a specialized player in a particular geography/market—for example, a large German bank, which would be considered a scale player in the EU, offering forex services for cross-currency payments to its corporate clientele.

A bank’s strategic roadmap will play a role in its choice of sourcing options.

**Key Drivers of Sourcing**

With the exception of a few leading global banks that have made the strategic decision to focus on, invest in and grow their payments business, most banks are likely to find at least some payment processes that cannot be justified by their contribution to the bottom line.

Rising client sophistication and margin pressure will force such banks to focus on the services they excel in and buy other services to deliver value to the client.

For example, a bank that is strong in payment processing but weak in electronic banking could use a white-label customer access tool to offer a top-class, complete solution. Or, a bank strong in euro treasury payments may tie up with a strong bulk-processing bank, organize a SWIFT member-administered closed user group (MA-CUG) using SwiftNet FileAct for access and thereby offer a complete client solution.

The drivers of sourcing will vary from bank to bank, and depend on the bank’s scale, geographical interests and capacity to invest in infrastructure and technology. Also, the sourcing strategy will be a product of overall business strategy, and will be governed by the bank’s decision to focus on establishing itself as either an innovator, a leader in infrastructure services or a follower.

To create a common and flexible framework that different players can use to assess their drivers of sourcing and align their payments sourcing strategy with business strategy, three variables can be considered, namely cost reduction (C1), competency building (C2) and scale (C3).

**Scale player:** Assuming the value for each variable can vary from 0 to 10, a scale player that wants to consolidate its different payments business entities under one unit will tend to invest in infrastructure and technology and focus only on the key competencies that have been identified. Such a player should arrive at the “sourcing plot” (see Figure 3).

As the plot below shows, the opportunities for sourcing in the areas of cost reduction, in-sourcing, outsourcing of payments business activities outside the key competency areas and collaboration with specialized players can be derived more easily.

Such a company’s strategic intent could be as follows:

- Leverage high transaction volumes to reduce per-unit cost of payment processing.

**Sourcing Plot for Scale Player**

![Sourcing Plot for Scale Player](image)
• Use flexible and scalable infrastructure, allowing centralization of core payment processes.
• Increase focus on standardization, volumes, scale and high STP rates.
• Focus on continuous improvement in quality of the internal payments process, partly because it is mandated by service level agreements (SLAs) with partner banks for “on-behalf of” payments.
• Identify areas of key competency, outsource other functions to specialized or other scale players.

These can be mapped as cost, competency, and scale or a mix of them to derive potential drivers for the scale player.

**Specialized player:** On the other hand, for a specialized player that wants to confine its interest to a specialized and strategic part of the payments value chain, the plot may be as shown in Figure 4.

**Sourcing Plot for Specialized Player**

From the plot above, key sourcing strategies aligned with the business strategy can be derived, such as offering white-label services to scale and small players, and outsourcing of noncore and volume-based payment functions.

The strategic intent of a specialized player could be as follows:
• Offer white-label services in specialized offerings that will boost revenue.
• Focus on innovation and development of market-leading products and services, or value-added services.
• Outsource noncore functions to other specialized players or scale players.

**Follower/small player:** In the case of a small player or follower, the focus would be more on cost reduction, both in technology and infrastructure, and less on scale and competency.

**Sourcing Plot for Small Player/Follower**

From the plot above, it becomes evident that the key driver for sourcing in the case of small players is to deliver services at an optimum cost to customers by collaborating with scale and specialized players. Such players must develop high competency levels to deliver value-added services to their customers.

The strategic intent of a small player could be as follows:
• Identify low volumes of payments that require several expensive systems.
• Consider sourcing options to balance increased pressure on margins, high operational costs and profitability.
• Outsource noncore functions to scale and specialized players.
• Focus on value-added services and partnership/collaboration with specialized and scale players.
• Partner with scale and specialized players for greater efficiency in payment processing.
Payment Sourcing: Making the Right Moves

The traditional and current sourcing models, which served the payments business by leveraging technology and the low cost of operations, will lack a value proposition in the new payments era.

Going forward, sourcing models should include strategic sourcing partnerships including outsourcing, in-sourcing, offshoring and white labeling. These sourcing opportunities will play an increasingly important role as the payments industry focuses on refining its operating model.

The new sourcing model must be both cost-efficient and flexible. It should reduce complexity when multiple business and operating models come into play. However, banks have to evaluate their current operating model, future strategies, business drivers and key competencies (see Figure 6) along the payments value chain to position themselves in the right quadrant of the sourcing space. To correctly assess existing operating models, regulatory complexities and sourcing options, a thorough evaluation of a bank's payment value chain becomes critical.

A large proportion of the challenges and issues in the payments value chain are caused by the current payment engines or back-office applications, many of which run on legacy platforms.

Therefore functions such as exception management, billing and real-time reporting and treasury operations become primary factors in identifying the appropriate payment sourcing strategy.

Also, from the technology point of view, core services should be individually identifiable and reusable such that systems development is significantly easier and quicker. Construction and maintenance costs can thus be considerably reduced. The technology used must be future-proofed to accommodate the integration of existing and newer development platforms. This does not have to mean the outright replacement of the core system. Within a bank’s legacy systems reside vital components of the organization’s competitive edge, the mission-critical processes and systems that form the heart of the enterprise. They may require rationalization, documentation and better understanding to enable extracting more value. However, they have proven reliability and value.

Therefore, banks considering the option of payments sourcing must measure their value proposition in terms of the “future” sourcing strategy, but at the same time must continue to leverage the existing benefits derived from the “traditional” and “current” sourcing models. The search for the optimum payments sourcing strategy must be about the right balance between existing sourcing options and new radical options.

Evaluation of Payment Services and Outsourcing Model

![Figure 6](image-url)
Outsourcing Models

Captive-based Outsourcing: Some of the large global banks have hived off the noncore processing part of the payments value chain, which includes most back-office operations and IT processing, to their captive outfits in low-cost locations. This allows the banks to focus more on the core payments business functions. Additionally, setting up the captive in an offshore location offers economies of scale, access to a global talent pool and resourcing flexibility. At the same time, it allows the bank to retain control over the governance and management of these captive units to minimize risk. Captive outsourcing units also provide opportunity for scalability by servicing multiple geographies. They can provide additional revenue streams through in-sourcing and white-label services.

Payment Processor-based Outsourcing: Recent years have seen the advent of independent payment processors in the global payments market. Most of these processors offer specialized payment processing capabilities. Some of these entities have traditionally been clearing and settlement services providers and began offering payment processing capabilities as an extension of that service. For example, Equens in Europe provides specialized SEPA processing capabilities alongside a host of other services. Many of these processors have developed skilled workforces as well as state-of-the-art processing systems by investing in the latest technologies. By offering their services to multiple banks, they benefit from economies of scale. At the same time, they facilitate better market coverage by extending services to their core geographies. By partnering with a payment processor, a bank can avoid investing heavily in developing and supporting processing capabilities especially for region-specific regulatory compliance.

IT Service Provider-based Outsourcing: A majority of banks’ payment processes still operate on legacy technology platforms that are dated or reaching their end of life. There is a need to modernize these systems, which requires significant investment in infrastructure and application software upgrades. Banks have the opportunity to outsource the application development and maintenance activities to IT services providers. They also have the option of replacing legacy applications built in-house with specialized applications provided by payments product vendors. This not only helps reduce cost but also provides access to skilled resources, allowing the bank to focus on its core business functions.

Payment Utility-based Outsourcing: A payments utility focuses on industrialization of payments processing. The payment utility follows a factory-based approach by offering mass payments processing capabilities, with the ability to process the entire range of payment types such as low-value domestic payments, high-value domestic payments and international payments. At the same time, it has the flexibility to offer customer-specific customization and value-added services. It can also help banks expand market coverage by providing access to multiple clearing networks across geographies.

The payment utility can be built and run using different operating models. However, one of the preferred models is where an IT/business process service provider and a payment product vendor partner to service the payment processing needs for the bank. They are able to bring technology/service capabilities, state-of-the-art processing capabilities and business oversight.

Due to the critical nature of payments processing, banks perceive operational control as a very crucial aspect in outsourcing of payments processing – be it technology outsourcing, process outsourcing or both. Operational control comprises control over people, processes and technology. Figure 7 depicts how the control varies across the various outsourcing models with respect to people, processes and technology.

Apart from this, the four outsourcing models can also be compared across a range of other critical parameters such as cost, competency, scalability, risk and control, as depicted in Figure 8.

Payment Sourcing Strategy

How should a bank approach sourcing? Figure 9 attempts to address this question.

The first step is to conduct an internal assessment of the bank’s payments business, wherein the current total cost of operations (TCO) of the payments business is analyzed, current and future business potential is determined and the future spend and margins are arrived at for every product and service offered by the bank. As part of the exercise, the dependencies, restrictions, and challenges in terms of people, processes and technology are identified and their impact on the overall payment strategy is analyzed. This should
lead to an initial direction on sourcing. Key drivers C1 (cost), C2 (competency) and C3 (scale) will be identified, which should be quantified and plotted in the next phase. During the “plan” phase, banks should assess their current payments business using detailed metrics on revenue, costs and margin per payment instrument.

In the next phase – “analyze” – core payment competencies of the bank should be evaluated. By this stage, the bank will have a high-level view on the products and services that are strategic in nature, those that are tactical, those that are profitable and those that are not.

This will help the bank arrive at a decision to either retain or outsource and exit from a payments processing perspective. The key drivers of sourcing, C1 (cost), C2 (competency) and C3 (scale,) identified during the previous phase need to be quantified and plotted using the sourcing plot to arrive at the strategic intent and sourcing options for the bank.

Also during this phase, banks have to explore the possible payments sourcing strategy that is most relevant for them, both in the short as well as the long term.

During the third phase of “partner selection,” appropriate target operating and sourcing models will be defined. During this phase, relevant due diligence has to be performed to evaluate the partners most suitable for the service delivery and sourcing model in line with the strategic intent of the bank. It could be one partner or multiple partners. Partners could range from product platform providers to system integra-
tutors to payment processors to other banks and financial institutions.

The fourth phase is the “implementation” phase during which the plan for implementing the sourcing strategy along with the chosen partners will be drawn up. The benefit measurement and performance measurement metrics will be defined in this phase.

Conclusion

Banks continue to operate in a challenging financial and economic environment and the focus for all banks (as far as the payments business is concerned) is on three underlying parameters—viz. cost, competency and scale. Though many banks across the globe have started addressing these challenges in a tactical manner, the need of the hour for banks is to take a more holistic view of their payments business and formulate the appropriate business, technology and operations strategy. In the past two to three years, many large global transaction banks have devised medium-to-long-term strategies and are working towards operationalizing them. However, most regional and local banks are still struggling to define a new strategy, and incurring losses and losing their customer base to rival banks. These banks will have to quickly determine their target positioning in the payments business after considering their current market positioning, competencies, potential, technological investments and operational challenges, and arrive at a strategy that accrues income to the bank and provides added value to its customers. The mid-tier banks cannot any longer afford to have a “me-too” approach in payments and risk losing their payment income stream as well as their customer base, which could impact related transaction banking income streams.
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