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Technology Insights for the Financial Services Industry

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PAYMENTS



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- Mobile Banking and Payments Security and Usability: What's in Your Mobile Wallet?
- Innovation in Retail Payments • Electronic Invoicing: How to Increase E-Invoicing B2B Transactions

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WHOLESALE PAYMENTS: TRENDS AND TRANSFORMATION

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The evolution of market forces has affected the wholesale payment industry. In this scenario, banks need to provide better value to their clients. They also need to respond to the clients' additional needs of enterprise risk consolidation and synch with the new and changing payment methods across the globe. However, new payment methods imply greater need for compliance with regulations and checks against fraud.

We recommend a consolidated payment infrastructure platform that can enable banks to support vertical application stacks like retail payments, wholesale payments, P2P, etc. This will allow banks to respond to client needs promptly, without having to make large continuing investments.

Introduction

The global payments market is evolving with non-traditional competitive pressures, regulations, new payment alternatives, and rising client expectations. In this environment, banks and technology partners need to skillfully exploit opportunities, while managing threats.

Corporations are looking for efficient payments processing, value-added services - like enterprise level risk consolidation and competitive pricing - from their banking partners. With pressure on margins and the diminishing benefits of existing capabilities (such as low-cost payments processing), banks need to focus on new value-added services. Additionally, banks need to rethink their payments technology spending models because of an increase in associated costs. Technology partners also need to structure their solutions to take advantage of the changing scenario. The major trend toward consolidation, observed in 2007, has continued and now more payment processors and technology vendors are expected to consolidate and improve economies of scale.

To stay ahead of the competition, financial institutions and technology vendors will need to respond to these critical changes in market forces and trends.

This article attempts to highlight the trends in wholesale payments and related transformation initiatives that are being undertaken by market players. These trends have been segregated into the following broad market forces:

A. Increasing competition

1. Commoditization of payments processing

As opposed to the notion of being a value-added service, clients now consider timely, secure, low-cost payments processing as a

hygiene factor. Hence, operational processing efficiency is no longer a competitive advantage for a bank. (Source: Financial Insights, U.S. Payments 2005-2009 IT Spending Forecast and Analysis, Dec 2005).

From the client's view point, given that banks have the expertise and organizational capability to manage large volumes of transactions in a secure environment, outsourcing end-to-end payable and receivables management to banks provides better efficiency, improved liquidity and risk management, and compliance benefits.

Given the increased competition, clients now have the power to bargain and reduce payment pricing. To maintain margins, banks need to increase processing scale or invest in value-added products (such as enhanced reporting and analysis using business intelligence tools, and value-added payment reconciliation or integration into transaction processing) that will add to the competitive value.

Banks are looking to automate back-office operations to cut payment costs, reduce manual activity, and speed up payments processing. Additionally, merged banks have multiple applications, performing similar business functions, which need to be consolidated.

Since payment operations are no longer a specialty, some banks are outsourcing the function to payment processors like Metavante and TSYS, while others are looking at new solutions or reengineering their back offices.

Cost benefit analysis of businesses to outsource or exit will help banks to outsource commodity businesses. Payment processors are providing additional functionalities for SEPA products to bring in more business, which is beneficial for banks. Banks can benefit from the economies of scale through

consolidation of payment processors, currently present in Europe.

2. Changing competition

Non-bank service providers continue to be formidable competitors. This is the case even though mergers are reducing the number of bank competitors. With corporate customers consolidating banking relationships, banks need to find their differentiating factor to be the first choice. While capital and lending are still important differentiators, relationships can also be improved with innovative, value-added products and services, which help attract clients and enable higher margins. Expediting exception management for quicker alert messaging and improving frequency of data updates is an area where banks can differentiate themselves.

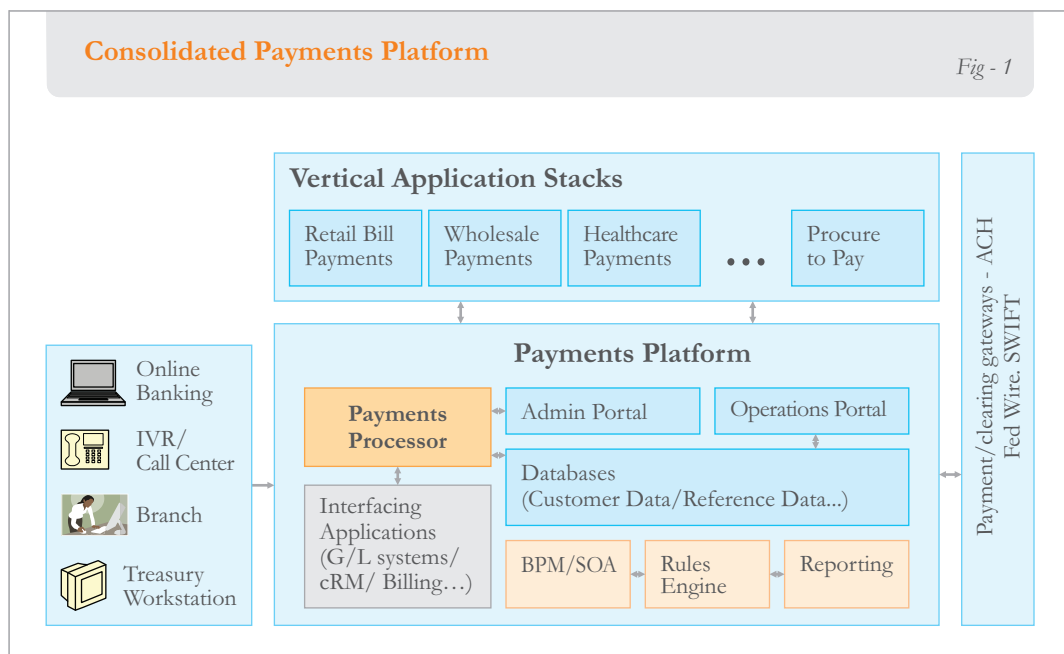
B. New payment alternatives - payments convergence

Traditionally different payment types are now converging, like check data and ACH in US and SEPA products in Europe. Check 21 and the new ACH legislation, ARC and BOC are the

drivers for this convergence in the US. In Europe, the Payments Service Directive (PSD) mandating convergence within SEPA and Faster Payments Initiative in UK are playing a similar role.

The traditional differentiation of payment products, particularly cross-border payments in the Euro Zone is diminishing. This is because banks relied on their network presence to offer unique product and service options by the assimilation of SEPA payment types in Europe.

Banks have invested in image exchange, to improve check clearing efficiency, which will further expedite migration of corporate payments away from checks. The Electronic Payments EPN STP 820 format will promote easier integration with corporate systems, consequently routing payments through ACH. The Federal Reserve and the Clearing House are collaborating to add structured remittance data to wire payments. This collaboration will facilitate integration and reconciliation, and is also designed to encourage migration of some checks to wire payments. Banks need to be prepared to take advantage



of these opportunities. If they don't, they may lose their clients to other competitors with more advanced ACH product capabilities.

The implementation of uniform standards plays a major role in facilitating payments convergence. The SWIFT-driven ISO 20022 XML standard is capable of supporting check data, ACH, and wire payments, which will help develop a technical migration plan for corporate clients. Implementation of enterprise payment architecture, using open payment standards, can support smart-sourcing of payment operations when required, by facilitating interoperability of third-party processors.

A recommended approach for banks is to build a consolidated payments infrastructure platform with BPM, SOA, rules engine, etc. as the underlying foundation. This platform can be used to support vertical application stacks for client payment needs across industries. An indicative diagram to demonstrative this approach is given in Figure 1.

The configurable and modular nature of this approach will enable banks to quickly respond to client needs by leveraging existing infrastructure.

C. Risk & compliance

1. Compliance with regulations

The Payments System Directive (PSD) and SEPA product compliance required in Europe, in 2008, are the main regulations that have far reaching ramifications and require high technological investments.

Compliance requirements will continue to evolve as new payment options, especially those across less regulated markets, are introduced. A centralized OFAC screening for new client relationships across wire, ACH payments, and other payment types, will help banks in minimizing the risk of

violation. The Cross-Border Funds Transfer initiative by FinCEN is intended to consolidate cross-border payments information in a FinCEN database. Given the large volume of data involved, financial institutions will need to deliver all reporting electronically and securely to FinCEN. (Source: GT News, Payment Risk Management: How to Stay Proactive, Jan 2008).

Banks with flexible, centralized AML and fraud reporting systems, enterprise view of payments, SOA, configurable payment screen platforms and technologies with configurable business rules will have a long-term advantage in being able to implement changing compliance requirements. In addition, banks will need to continue spending on business intelligence software to manage the compliance function across the payments enterprise.

2. Shifting fraud and risk trends

Since a more distributed payments technology means a greater separation between the payment initiator and the payment processing network, new payment methods provide an opportunity that could be used for money laundering and terrorism funding.

Payments can be better managed for validation when they are processed. Implementation of SOA, for consolidated payments risk management and solutions that are flexible enough to accommodate emerging payment types, are needed to manage the risk efficiently.

D. Changing needs of clients

1. Faster payments processing

Corporations have to rely on expensive, high-valued payment systems - such as Fedwire in the United States and the Clearing House Automated Payments System (CHAPS) in the United Kingdom - to transfer and settle funds

the same day. Technology service providers, governments and financial institutions are working to develop an inexpensive payment system for instantaneous funds transfer.

The United States federal government-sponsored, Check 21, gained momentum and volume in 2007. As check imaging increases, banks will have to face rising cost issues for paper check processing and clearing. They will need to work on innovative pricing strategies to accommodate these changes.

Real-time updates of payment activity, enhanced monitoring of exceptions and notifications, and increased frequency of remittance files will help in improving client satisfaction and retention.

2. B2B payments - a natural extension for banks

Financial institutions, with their existing infrastructure and network in place, are best equipped to fulfill client needs for paperless and efficient B2B payments processing. Banks are already catering to a part of the financial supply chain through their receivables and disbursement products. By catering to the payables (APO) and receivables outsourcing (ARO) requirement, banks are looking to increase client retention and cross sell opportunities.

A modular solution approach to handle B2B payments will enable banks to cater to companies across industries by enabling automation of all or part of invoicing and settlement processes. Banks are also looking at acquisitions of solution providers, e.g., JP Morgan Chase acquired Xsign and American Express (S2SSM suite) acquired Harbor payments to increase foothold in the area. We expect that there will be renewed competition in this area, as banks seek to garner significant volumes in this space.

3. Globalization

Since SEPA uses the messaging standard ISO 20022, US banks and processors will need to incorporate this new standard if the Fed and Clearing House implement it as well. Financial institutions also need to incorporate the new SEC Code, IAT that has been established by NACHA, for international payments through the ACH network. These need to be complied with by March 2009. Banks with configurable payment platforms will be ahead in the race during the implementation of these recommendations (Source: Towergroup, Top 10 Business Drivers, Strategic Responses, and IT Initiatives in Global Payments, Dec 2007).

In 2008, US banks will need to incorporate more environmental benefits. These environmental benefits include reforestation, discounts or incentives to shop at green retailers, and "carbon offsets" in exchange for utilizing electronic alternatives. Financial institutions will begin to implement eco-friendly standards for all branches, bank buildings and offices. They may also need to consider cost-based pricing of paper-based payments. Bank opportunities for facilitation of carbon trading through payments and liquidity services will evolve as this field matures.

Conclusion

The old field of payments will continue to evolve as traditional payment methods give way to new electronic platforms, driven by changing client needs, regulation and emerging technology.

Banks will need to be proactive and agile to get in a position to exploit new opportunities and build on existing strengths. Banks need to build a flexible organization and architecture so that they are well placed to take advantage of the

changing environment. To respond to increasing client and regulatory pressure for a 'unified view' of enterprise risk, we recommend a consolidated payments

infrastructure platform and a deeper footprint, across capabilities and geographic boundaries through strategic alliances or mergers.



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