

REACHING CLOSE: PROTECTING BANKING'S CORE PAYMENTS BUSINESS

Four decades ago, during the Cuban missile crisis, US presidential advisers worried how they could defend against this new Soviet threat just 60 miles from US shores. "Cuba? We can't fight Cuba," said one, "We don't have anything that'll reach that close!"

Today, that same kind of dismay emanates from our banking clients around the world as the full realisation of their vulnerability in the payment business settles in. While they have been taking the broad view – driving growth far afield or even abroad, setting their sights on new products, forging new alliances – a new threat was unfolding much closer to home in an area long taken for granted: payments. Rather than a full-fledged core business, most banks have viewed payments as simply an inevitable component of their "real" businesses.

A US bank client of ours put it this way: "Revenue from our payment business is being put at risk every day by technical and regulatory change, and whole

customer relationships hang in the balance. In my nearly three decades in banking, I don't know when we've been at a more important crossroads than we are now with payments."

To be sure, the US picture is probably starker, unclouded by cross-border issues, regulatory conflicts, and currency and infrastructure differences. As we

detailed in a recent report on US banks and their payments business, payments

are a huge business, banks have a tenuous hold on about half that business, payments drive as much as 30-40% of the revenue of the larger payments banks, and much of that business is in play due to regulatory, technology, competitive, and market demand changes.

*"A tenuous hold on about
half that business"*

For European banks, the picture is more complex, involving a multiplicity of countries and issues, and generalising can be foolish or dangerous. Nevertheless, our research, coupled with our experience in making payments profitable for banks, indicates that now is a good time for European banks to take a new look at payments – to consider it a business that is core to their long-term revenue growth and, equally important, a business now in serious jeopardy. In our view, it seems evident that the winners and losers in the payments business are being defined right now in the choices banks make and will make over the next three-to-five years.

Among today's indicators are:

1. A growing recognition of the absolute value of the payments business.
2. A more expansive view of insourcing, outsourcing, and interbank cooperation involving payment functions
3. An emerging focus on streamlining and integrating separate payment mechanisms

Just How Valuable Are Payments?

When we instigate conversations on this subject – the current value of payments to banks – in Europe we are accustomed to deprecatory responses along the lines of, “Other than plastic, our payment revenue is nominal, really, in the whole scheme of things. There's a lot we simply can't charge for.”

True as far as it goes. But equally true, we suspect, is the likelihood that payments

value is masked – that the absence of explicit charges is not the same as being uncompensated. Some countries do forbid explicit charges for some payment services, and competitive practice limits other revenues. But a closer look can be revealing.

When we work with banks to forecast the impact of impending payment shifts – particularly the shift of business to enterprising non-bank companies – the results are eye-opening. Like a rock dropped in a still pond, core payments activity ripples outward in waves of precious revenue, relationships, and scale. The inescapable facts are: many basic bank services



J. D. Carreker

Chairman and CEO
Carreker Corporation, DALLAS

require an account relationship, implicit compensation like balances is easily undervalued, margins and revenues from these services are high, and the potential for new information-based services and new market penetration is even higher.

In Global Payments 2002, Boston Consulting Group estimates European payments revenue at more than \$70 billion in 1999. The study forecasts a small decline (uncharacteristic for most of the world) in European payments by 2009, stemming primarily from the

European Commission directive forbidding European banks to charge for more for cross-border

payments than they do for domestic payments. But net, net: the payments revenue at stake for European banks is both significant and increasingly harder to come by.

Insourcing, Outsourcing, and Interbank Cooperation

In our cost management work with banks, we are increasingly focused on which of these applications can be “collapsed” into shared operations, shared services, and shared technology.

In other words, when banks find certain functions commoditised to the point that they offer little margin to individual banks, they need to choose a

new course wisely. They can slash their costs to the bone and hope to be the low-cost provider, potentially diminishing the value of the function itself. They can outsource it to a non-bank provider, pushing off the cost but potentially jeopardising revenue and relationships. Or they can overcome competitive reflexes to recreate the function as a shared service.

Our research and others' indicates that cash is far and away the costliest payment type. A study by UK payments body APACS (Association for Payment Clearing Services) a decade ago found that when it comes to banks' money transmission costs, cash accounts for a weighty 45% – even more than paper at 35%. Moreover, as the study has been refreshed, those rough figures tend to hold firm: Cash volumes are not dropping, contrary to commonly held expectations, and neither is the cost of handling cash. Central banks are exiting the business, driving up the cost banks must shoulder. And where most banks once considered cash-handling an opportunity to differentiate themselves, they now increasingly find it a commodity-like business, ripe for sourcing. Accordingly, three of the largest banks in Australia pooled their cash transportation resources to launch a shared services venture called Cash Services Australia, creating a model for banks all around the world.

In Europe, the business case for selected outsourcing of cash processes is particularly rich. The move to a single currency is promoting economies and will ultimately diminish complexities, as will the European Commission's push for a Single Euro Payments Area (SEPA).

To carry out most payment improvements, banks are obliged to invest in standards and technology that in turn improve customer service and lower costs. Consider the conversion of country-by-country ACH mechanisms to a common ACH infrastructure, and the shift toward economical electronic payments, including "straight-through processing" (STP) without human intervention – good for customers but initially costly for banks. As customers begin gratefully reaping the convenience and cost benefits of these investments, what more opportune time for banks to

seek to improve their revenue streams in recompense? The first banks to seize the right outsourcing/insourcing opportunities can, like the Australian banks, find themselves first to lower their costs, pool their resources, create economies of scale, and then sell the resulting services for new revenue streams. But only rigorous study, case by functional case, can reveal which functions are ripe sourcing candidates. Banks in the US, when they have got it backwards – insourcing commodity functions or outsourcing core functions – have reaped the worst of both worlds.

Blending the Payment Stovepipes

In most banks, the biggest obstacle to wise and timely change in their payments business is not a fundamental disagreement over future outcomes or strategies. It is the tyranny of what has already been built. What banks have built is a series of high-functioning systems designed to make each new payment type, as it emerged as a desirable offering for customers or a useful technology for banks, work as well as possible – efficient, low-cost, low-risk, high-service-quality.

But when bank executives see a drop in payment revenue, or perceive a threat,

their natural response is to urge each payment group individually to address the issue. What this creates is not one crusade but several, all in competition for the same customer base. In the long run, the exercise destroys value for the bank.

These separate groups usually also involve redundant support applications – each with their own version of exceptions, their own reconciliation, their own customer service, their own sales, their own management, and so on. Add to that technology maintenance and enhancements in each area, and the result is a voracious consumer of payment resources that severely suboptimises value to the customer and revenue to the bank. Less obvious, but equally dangerous, is the resulting vulnerability to competitors who can be quick to market by focusing squarely on high potential opportunities that fall through the gaps between banks' stovepipes.

“A new functional organisation alignment”



It is not reasonable to expect the separate payment groups to piece together the complicated customer, economic, and technology trends. Likewise it is not possible for the head of operations or technology to forecast the revenue potential of new infrastructure investments that serve multiple markets and leverage a blend of payment types.

What each bank needs is a single payments strategy, customer-driven, that leverages new technologies across payment groups. That requires a new perspective, and often a new functional organisation alignment with a view toward blended payments technologies. In some cases, it also requires new interbank organisations.

The Tough Questions

As payment matters escalate in importance, the goal should be to answer these basic questions – basic but tough:

1. Are we already maximising revenue on our current payment services? Of the best revenue practices deployed in the banking industry, have we assessed their applicability to our market segments? Often we find banks routinely forego major revenue opportunities because of vague assumptions about detrimental customer impact. Sophisticated models that fine-tune initiatives according to customer expectations can reap extraordinary rewards.

2. Likewise, are we prepared – with the right “blended” payment products and services, the low-cost payment infrastructure, and the insights into customer payment needs – to maximise the profitability of our customer base and our payment investment to date? Are we building payment products that reach across payment stovepipes – that leverage required technologies across a large expense base?

3. Can we take the “enterprise” view of payments – model our anticipated costs and revenues

for the major changes continuing to unfold? Can we get an aggregated view across payment types, across customers, and across the organisation?

In our view, these are the prerequisites for making informed decisions about the major business that payments have become. Only with confidence in answering these questions will banks be able to bring payments, as one UK banker put it, “from the back room to the board room.”

Like the US trying to cope with Soviet missiles in Cuba, the gravest threats sometimes emerge at unexpectedly close range. The considerable value that payments represent is all right there in full reach of the banks who basically invented the business. The challenge is to reach that close, and quickly.

J. D. Carreker
acain@carreker.com