



The future of transaction banking

Transaction banking saves the day

All is not lost. This is the message coming from the transaction banking sector. 2008 may have been a year to write off for the banking world but there were some things to write up amid all the write downs.

The transaction banking sector was one such thing according to figures collated by US-based research firm TowerGroup earlier this year. Based on the company reports of selected global banks (taken from a peer group including the likes of Barclays, BBVA, BNP Paribas, Bank of America, Citigroup, HSBC, JP Morgan, Royal Bank of Scotland, Standard Chartered and Deutsche Bank), transaction services was the best performing line of business for these global banks.

While the capital markets business for the first half of 2008 was down by 71.6% on the first half of 2007 and retail banking businesses suffered a 33.4% drop during the same period, transaction services (along with wholesale banking and wealth management) was one of only three lines of business to enjoy a positive net income for the period, recording a 21.9% increase between the first half of 2007 and 2008.

TowerGroup's findings are supported by other research. The 2009 World Payments Report, compiled by Capgemini, Royal Bank of Scotland and the European Financial Management & Marketing Association (Efma), concluded that global transaction services were a stable and profitable source of revenue for banks and, despite the deteriorating market conditions and reduced business volumes in the first half of 2009, these divisions still contributed between 5 and 20% of group revenues.

"Global transaction services remains an attractive business even in light of economic conditions," says Bertrand Lavayssiere, managing director, Capgemini Global Financial Services. "The credit crisis has caused a shift in priorities where clients are seeking to optimise working capital as they face a squeeze in external funding amid tighter credit conditions." Furthermore, transaction services remain a resilient and recurrent source of both revenue and liquidity and have an attractively low cost/income ratio.

It is therefore no surprise that the major banks consider transaction services a key part of their offering. "Global transaction banking is considered one of HSBC's main engines for growth, given that enhanced customer service, global reach and continuous product innovation are central to the bank's strategy," says Andrew Long, global head of Transaction Banking at HSBC. "Cash management continues to be a core component of transaction banking and is an increasingly attractive business for banks due to its low capital usage and high return on equity."

These traits are all the more attractive in a time of recession and go some way to explaining why transaction banking has been such a healthy contributor to banks' revenues in these troubled times. There three main components to the transaction banking industry - trade finance, cash management and asset servicing - facilitate the flow of goods and services, funds and financial assets respectively. And wherever the world is in its economic cycle - at boom or bust or somewhere just above bust - there will always be flows. "Flows on the whole may have reduced

and the participants, geographic mix and purpose may have changed, but they still exist," says Rajesh Mehta, head of Treasury and Trade Solutions for EMEA, Citi. Furthermore, any of the remedial action taken by governments around the world - be it quantitative easing or cash for clunkers - has focused on increasing these flows. "They are all aimed at the transactional side of the business."

And there are commercial opportunities that have arisen out of the recession, says Mehta. "What the financial crisis has shown is that uppermost in corporate treasurers' mind is the desire to get more use out of their working capital. Credit is not as available and they are concerned about risk management in both their supply chain and overall liquidity and cash flow. All of these concerns require a transaction banking solution set."

However, the optimism expressed by the likes of HSBC and Citi is not shared by everyone. For many banks the transaction services business is regarded as a cost centre. These banks have often invested little in their payments infrastructure, seeing more lucrative opportunities in the capital markets or more attractive returns in downstream products than the potential inherent in 'the plumbing'. And the requirements mandated by onerous new initiatives and regulations such as SEPA and the Payment Services Directive have made transaction banking appear less attractive.

On the other hand, if a bank has a steady stream of transactional traffic from its corporate base and is able to service its retail clients from its net margin interest income, then transaction banking is profitable says Mark Hale, director, PricewaterhouseCoopers. "It really depends on the sophistication of a bank's management structure and its accounting information," says Hale. "I think most transaction banking services can be profitable although not all banks see it that way."

In many ways, the economic crisis has been welcome news for transaction bankers. After all, it was the exotic end of the market - the

structured investment vehicles and credit derivatives - that did much of the damage in 2008. Now, in 2009, banks are eager to promote the more stable and traditional side of their business to potential investors, says Hale.

"Treating transaction banking as a utility business can make it hard to unlock investment capital. If you are a utility service provider and taxing the business to meet costs, it can be very hard to communicate underlying value or inherent opportunity. However, if you are a strategic business unit, a profit centre and are pricing for value under normal business rules, then everything works much better."

It is not quite as simple as moving back to the way things were, says Hale. "A lot of financial institutions seemed to have lost the connection to their core banking roots during the boom times. They appeared more focused on the exotic side of the business - the same side that has got them into terrible trouble recently."

But as they look more to their transaction banking services they are now realising the implications of years of under investment. And while some have under invested, others have been busy building up a global capability to the point where there is now a premier league-like elite of banks emerging. Armed with an international reach, substantial resources and restructured processes, they are threatening to break away from the rest of the market.

The widening gulf between the elite and the rest means that the global banks are likely to dominate in years to come, says Hale who cites the cost of compliance as one of the clearest examples of this chasm in capability. "There can sometimes be up to 100 times difference in the relative cost of compliance between banks. That's massive." The cost of compliance depends on the condition of the initial infrastructure and operations. Banks with old and outdated systems, that are characterised by batch based processes and control processes that assume time to address processing problems have a much more difficult task to address the real-time demands of the 2009-2012 regulatory agenda, says Hale.

So is it possible for a bank outside of this premier league to catch up and get back in the transaction banking game? "There is a significant investment lead time to modernising your infrastructure and those bills can be very expensive. While we see other industries willing to spend the required amounts (such as Nissan in its bid to break into the luxury US car market with its Infinity brand), banks are more reluctant to spend that kind of money on their payments business - even if it is something that should be a core competency."

There are three alternatives for businesses that do not fit into the 'global bank' categories. The first of these involves banking clubs where financial institutions look to pool their resources via shared service centres and the like, with mixed results. Banks are not naturally inclined to collaboration and the dreaded prospect of management by committee as the biggest obstacle to progress through this route.

A second alternative is to turn to some of the infrastructure providers - such as Swift and the automated clearing houses - that are offering agnostic platforms for the banks to use. Finally, if a bank is determined to maintain a transaction banking capability, if only for appearances sake, they can turn to the global banks. "We are happy to white label our products and services to partner banks so that their customers can make use of capability not previously available to them," says Mehta.

"I think many banks are realising that so much of the investment in transaction banking is caught up in regulatory change, that there is little left over for business development or innovation. And transaction banking is a scalable business which requires a lot of investment and commitment. We can therefore white label our solutions to such banks so that they have the technology, products and services they need without having to invest in developing or maintaining them on their own."

Outsourcing or acquiring a white-labelled suite of services may seem an obvious decision but, says Hale, the financial crisis has muddied the

waters. "There is a greater reluctance in some quarters to outsource right now. Also the regulators are looking closely at how banks conduct their business and outsourcing might be considered a risky manoeuvre." Plus there is the problem that some banks don't have a sufficient understanding of their cost structures, revenue streams or risk profiles. This means that it is not just hard to invest in the business, it is equally hard to outsource parts of it. "You never want to outsource something that you don't fully understand."

There are some other guidelines to follow when outsourcing a customer-facing activity like transactions banking, particularly when that outsourcing provider may be another bank. This is why Hale believes the market infrastructure providers that are offering such services may see some success. "In this case if the supply chain becomes known by the customer, there won't be the same commercial issues that might arise if it was a competitor bank."

But is the outsourcing or white labelling of transactional banking just an exercise in image management? Will banks merely be paying for a façade that allows them to stay in touch with their customers but will not generate them any profit of their own. Or is it possible to outsource and still make money rather than just saving it? "They can make money directly or through cross-selling. I think there are significant opportunities when you supply the financial engine room to your clients and help them manage their flows," says Mehta.

These views are supported by Hale. "If you outsource well, the customer will never know and the bank will be able to refocus its management team to generate revenue in other ways. In other industries and parts of the bank important activities are outsourced all the time. It is just a case of knowing the risks, managing the process well and selecting the right partner."

Reaping the whirlwind

It has been a tumultuous year, but the resilience and stability of transaction banking has come through and provides a stable basis on which



banks can build competitive businesses - if they find ways to improve efficiency and lower costs. **Martin Wilson**, chief



commercial officer of VocaLink, spoke to **David Bannister** about the issues and the opportunities.

Banking Technology: It's been an eventful year since Sibos in Vienna, but transaction banking seems to have come out of it very well.

Martin Wilson: There is a general recognition in the banking community that transaction banking has been the workhorse of banks for many years and it's proved its resilience in this time of crisis.

BankingTech: At the same time, there is a lot of talk of how to improve margins and how the industry will evolve.

Wilson: Indeed. If you think about the requirements of transaction banking in the past, it is to provide a stable business: certainty and security of payments has been paramount, so therefore there hasn't been that much of a challenge on innovation, agility or margins while banks have been focussed on other, more exotic, areas of business.

However, the crisis has brought those into sharp focus and the resilient and stable business of transaction banking has come through very well. Turning to the forward view, banks will need to

press hard on their cost of operations in transaction banking and press hard on improving their margins in that business area, because challenges are coming thick and fast - through regulation, through other banks and through the broader challenge facing every bank to manage costs more efficiently.

BankingTech: A lot of the sessions in Sibos this year talk about co-operation and achieving common platforms. You're already doing that at VocaLink, aren't you?

Wilson: What we're seeing in the marketplace is a greater willingness of banks to talk about collaboration in their operations. In the past, perhaps, we've seen that payment processing has been a domain of banks' own operations and to a large extent have been sacrosanct. Over the past 18 months a lot of those assumptions have been challenged where banks are looking at changing their operating models to use partners, such as VocaLink, to provide a broader range of services that are typically in the non-competitive areas so that they reduce their costs and are able to focus on delivering new services to customers.

BankingTech: So where are the opportunities within that to shave margins? What sort of savings are we looking at?

Wilson: Clearly it varies from bank to bank, but if I think of some of the exploratory conversations we've had with banks over the last six months, we can build business cases for them to outsource part of their payments processing which would give them a reduction of about 40% in their cost of operation. The reason for this is

that we already operate on a massive scale: we already process 9-10 billion transactions a year. In fact, in one instance, we are developing a proposition with a bank to be their outsourcer of payment services.

BankingTech: Banks also face competition from the non-banks: does the outsourcing model allow them greater agility as well as lower costs?

Wilson: I think it does ... the traditional model in terms of providing payment services to customers is that banks either provide them entirely in-house or they look to other banks to outsource to, but that has caused its own questions in terms of the recent turmoil. So they are looking for outsourcers not so far removed from the payment space that it creates its own risk in terms of their expertise and their resilience and security, but somewhere in between and VocaLink has been in that space for many, many years. Not only, then, does it reduce cost of operation but we can enable them to take new services and products to market very, very quickly and that agility, that responsiveness to market demand and market changes is quite critical when you are building or maintaining a business.

An example of that and very current at the moment is readiness for the Payment Services Directive, and on the back of that being ready for SEPA Direct Debit. We have a solution called SEPA Accelerator that can enable banks to be ready to send SEPA Direct Debits within two weeks - that's the sort of agility, responsiveness and speed to market that a partner such as VocaLink can bring to banks.

BankingTech: The payments world generally has been dominated by European legislation like SEPA. With Sibos in Hong Kong this year, and the new structures and competitors that are coming out of Asia Pacific, there are going to be issues of reach.

Wilson: We've been saying this for some time now: the technological advances that we have seen in the last five years have actually changed the landscape quite dramatically: once-

traditional barriers have been completely eliminated. For example at VocaLink, we don't worry at all about the currency that we process - currency has become a parameter within a look-up table within the core payments engine, it's no longer a significant factor.

What SEPA has provided is a model that other communities and other regions can copy and improve upon through the creation of common standards of interaction. When we addressed the issues around reach for SEPA, what we also developed was a model that could be applied the world over. Currently from a SEPA perspective, VocaLink can reach any account anywhere in Europe, but that same model could be applied so that we could reach any account, anywhere in the world, in any currency if the demand was there.

BankingTech: The other thing you've been involved with has been the development of the UK Faster Payments Service. Presumably as common models get adopted internationally, the real-time aspect will become more and more important?

Wilson: Indeed, and so we come full circle in a way. There is going to be continuous competitive pressure on transaction banking; new markets will look at existing models such as SEPA, but they will look at it and combine it with the emergence of real-time payments. There is every potential therefore that you'll get regions developing a common model for their community but in real-time, which is effectively leapfrogging anything we are developing in Europe right now.

BankingTech: The past year has shone an unwelcome spotlight into some parts of the industry, but it has also exposed areas where there is a great deal of opportunity to improve and build on that resilience?

Wilson: Yes. The key thing here is for banks to break some of the taboos, if you like, look at their traditional assumptions in the provision of payment services and think about how by changing their operating models, by working in

collaboration with payment services providers such as ourselves, they can radically reduce their cost of operation - in some cases by more than 40% - but they can also radically improve their agility, their responsiveness and their time to market in being able to deliver services and products into the market that respond to consumer or corporate needs, or need regulatory requirements in very short order.

A webcast version of this interview can be watched at <http://www.bankingtech.com/bankingtech/mediacentre.do>

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