

# Transaction Matters

Issue three – Summer 2009



## Introduction

Welcome to the summer issue of Transaction Matters. As we all know, our industry is under intense scrutiny and unprecedented pressure at present. Banks and other financial institutions must cut costs as well as comply with a great deal of complex legislation. Meeting both of these objectives necessitates finding new ways of working that increase productivity and mitigate risk simultaneously. The VocaLink Service Bureau offers a cost-effective, turnkey solution to the connectivity challenge for both domestic and international payments. Moreover we have great plans for the new service. In our market overview, Andy Hunter, Head of Transaction Banking at VocaLink explains how the new service works and why this business model benefits all.

In November the PSD becomes law. This marks the beginning of SEPA for real as a failure to comply will have serious consequences. However, the enactment of the PSD is also grounds for celebration as it marks the culmination of immense concerted effort by all within the payments industry. In this issue we review what the PSD means in practice and remind ourselves of the advantages of the new payments order.

Continuing the theme of celebration, May 27 marked the first anniversary of the Faster Payments Service in the UK. Naturally, we are delighted that our infrastructure has proved robust, exceeding service levels every month, and that the new service has achieved sufficient reach to make Faster Payments available to virtually all those wishing access. We believe it heralds a new epoch in payment history with benefits to all market participants. Read the expert opinions of Paul Smee, Chief Executive of the Payments Council and Richard Martin, Head of Payments & Cash Management, Global Commercial Product, Barclays Bank.

With the summer solstice now behind us, the time is right to start thinking seriously about Sibos in Hong Kong. VocaLink will be there – and we would be delighted to meet you at our stand (number 3E05) – the next issue of Transaction Matters will have a distinctly Sibos theme. In the meantime, we include an independent preview of Sibos 2009 by David Bannister, editor of Banking Technology Magazine.

Enjoy the issue.

### **Martin Wilson, Chief Commercial Officer**

PS You may be aware that in April an external telecoms incident disrupted internet connectivity for several thousand users. This included clients submitting to the Bacs service using the VocaLink Bacstel-IP channel. However, clients using the VocaLink connectivity managed service Fixed Extranet were insulated from the disruption. More than 39,000 corporate clients still submit to Bacs via the internet and all are susceptible to these types of issues. This incident demonstrates the value of the VocaLink managed connectivity service in facilitating business continuity. Please contact us if you feel you could benefit from the Fixed Extranet service.

## Market overview

**Success in transaction processing needs scale. But interoperability is vital too. Andy Hunter, Head of Transaction Banking at VocaLink discusses the need for processors to be well connected and the merits of the VocaLink Service Bureau.**



### Payments processing – a scale business

Payments processing is a scale business. Although all banks must offer payment services, building and maintaining a robust infrastructure requires massive investment and specialist know how. However, once established, a well-designed payments system offers substantial returns. As transaction volumes increase, average processing costs decline and continue to do so until capacity is reached and further investment is necessary. The benefits of scale are one of the well-established reasons for specialist payment processors to exist in the first place. However, with the right business model, banks of all sizes can benefit. How?

Aggregation of payments traffic makes the market more efficient. Banks of all sizes can realise the benefits of scale while continuing to compete on the strengths of their individual service offerings. The bigger market created by the Euro, PSD and SEPA will magnify this effect such that banks will increasingly be dependent on aggregators to compete and prosper in the new competitive order. But success in this market requires banks to improve the scope of their services in a world of increasing complexity – so successful payment processors can and must help banks and their corporate customers achieve more with less.

### Interoperability – big name, simple concept

Banking is intrinsically a community affair. Throughout the world, banks operate not only as individual entities but also in communities with multiple relationships. International payments are made through a host of bilateral and multilateral arrangements, many of which have evolved over a very long time. This was originally supported by significant customer revenues, and so the focus of banks was on serving the customer in order to retain the relationship. With increased pressure on revenues through regulation and competition, focus on costs takes centre stage.

Additionally, payments flow not only between banks, but between banks and their corporate customers. The trouble is that many of these relationships are based on different messaging formats that are proprietary, arcane and expensive to maintain.

VocaLink simplifies all that. First, by offering multiple options, customers can connect in whatever way suits them best. This includes using SWIFT, managed VPN, secure FTP and Secure IP services. A single connection to the payments world spares banks and their corporate customers the expense, risk and inconvenience of managing multiple systems and suppliers. In this way we can help banks cut costs and improve efficiency simultaneously. But a single connection can do much more.

### One connection, many benefits

In a world of growing complexity, banks often find themselves needing to manage an increasing number of data formats. For example, SEPA formats are an additional burden until

local standards are phased out. Furthermore, corporates increasingly expect banks to translate from ERP formats such as EDIFACT and IDoc rather than do the job themselves.

VocaLink can help in two ways. First, our extensive translation library enables us to move data between payment formats easily and cheaply. For example, we are currently working with a bank that is exploiting SEPA to enter new territories but still needing to deliver into national systems for the time being. VocaLink takes its output in ISO 20022, strips out the payments requiring local delivery, formats these and delivers them into the local clearing.

Secondly, we can break a file of payments into its respective components and deliver them to different destinations both nationally and internationally. For example, we are currently working with a bank which will send all its outbound payments to us in a single format and to a single gateway. On receipt, VocaLink will perform a series of translations before delivering the several outbound payment types to clearing gateways both nationally and internationally.

These examples translate into improved business agility for banks and their corporate customers, which can delegate as much of the transformation and routing activities to VocaLink as they wish. It's a managed service that provides total flexibility and choice.

## **Now is the time**

The time is right for banks and their corporate customers to find ways to simplify their data flows. VocaLink has a deep understanding of message formats in multiple geographies and our connectivity solutions can be implemented to augment or replace existing arrangements. In many ways this is an extension of services we have provided domestically for some time. So why should we be talking about this now?

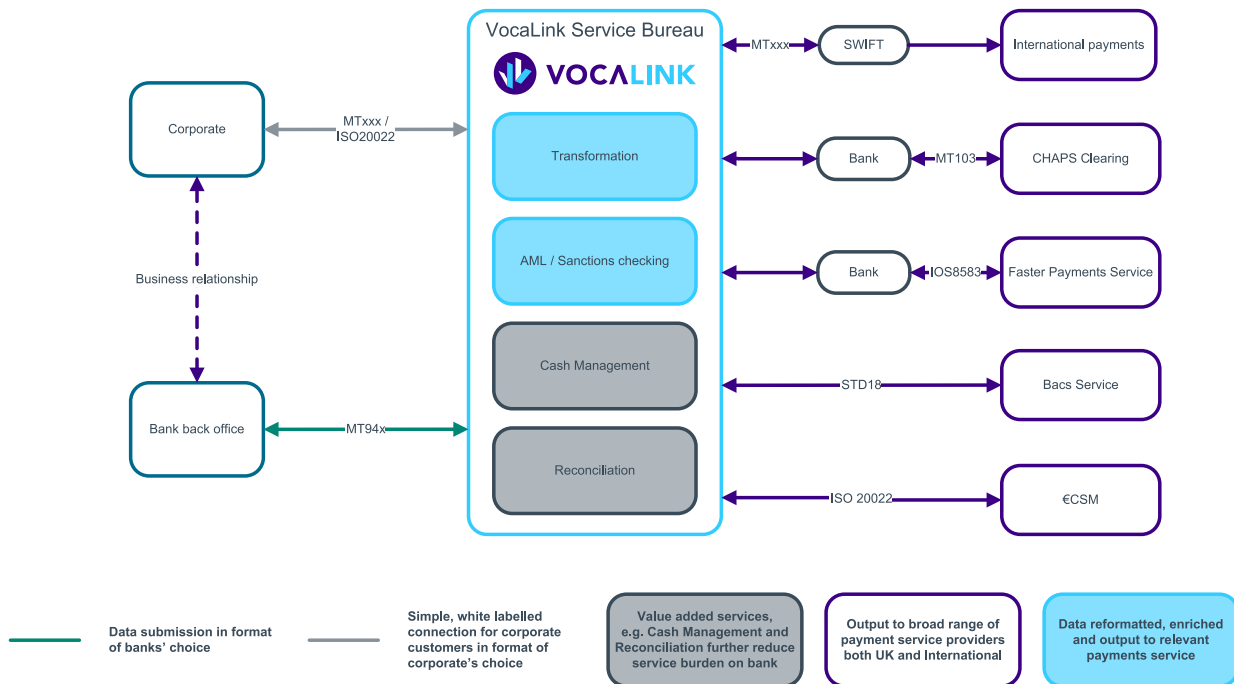
The success for banks in payments depends as much on cooperation as it does on competition. An integrated payments market, by definition, requires banks, payment providers and their corporate customers to adopt common standards for message formats. With increased pressure on costs, there is also a need to increase automation and STP levels. Working with a specialist provider offers a cost-effective, painless transformation to all formats in a way that also mitigates risk.

## **Well connected**

VocaLink offers a turnkey connectivity solution for domestic and international payments. As markets increase in size and complexity, we are receiving increasing interest from banks wishing to outsource more non-core functions including transaction routing, reformatting and transformation, as well as core processing. The VocaLink Service Bureau is a direct response to the market need for banks and corporates to communicate with multiple transaction infrastructures through a single connection.

Figure 1 shows a typical implementation for a bank and its corporate customers. This illustrates the breadth and depth of scope of the VocaLink infrastructure. But it also demonstrates our potential to offer a strategic connectivity solution to meet evolving customer needs and changing legislative requirements. The VocaLink Service Bureau can be used in conjunction with other managed services, such as ATM and POS managed, or gateway, services.

Figure 1



The VocaLink Service Bureau offers a 'one stop shop' for all electronic payment types. We can receive through a broad range of input channels, transform between most common formats, and route to multiple destinations across Europe. And the economies of scale we secure mean all this at a cost typically well below those a bank could achieve in its own right.

We have ambitious plans for the VocaLink Service Bureau. The service is already available, rich in functionality with the potential to reduce the complexity and cost of connectivity for all. We hope you are encouraged to find out more. Please contact either your VocaLink relationship manager or me directly. I look forward to hearing from you.

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## Getting to grips with the Payment Services Directive

After a long wait and a great deal of consultation, the Payment Services Directive (PSD) becomes reality on 1 November 2009 in 31 countries. These include the 27 countries which are members of the EU as well as 3 EEA countries (Norway, Iceland and Liechtenstein). Switzerland will also become PSD-compliant. Dr Edith Rigler, Senior Director Business Development, VocaLink talks to Transaction Matters



The PSD is a European Directive which means that all Member States will have to implement PSD rules into their national legislation, a process called transposition, by the deadline of 1 November 2009. We should resist the temptation to regard this as merely one more step on the road towards European payments integration. The adoption of the PSD marks the beginning of SEPA for real, because a failure to comply with it is tantamount to breaking national law.

The benefits of the PSD will be seen by consumers and businesses making everyday payments such as deposits and withdrawals, credit transfers, direct debits, credit and debit card payments, money remittance payments and other digital payment services. It affects domestic payments made in sterling, in euro and other non-euro EU currencies, as well as cross-border EU payments from sterling and other non-euro EU currencies into Euro. With that in mind, it is perhaps a good time to remind ourselves of the specific objectives of the PSD and some of its practical implications for banks and other financial institutions.

In essence, the PSD has five objectives:

- Establishing a single payments market in the EU, for euro as well as non-euro
- Providing the regulatory framework for a single payments market
- Creating a level playing field and enhancing competition
- Ensuring consistent customer protection and improving transparency
- Creating the potential for increased efficiency in EU payment systems.

### **Promoting efficiency, transparency and competition**

These objectives will combine to produce a harmonised payment environment across 31 countries that offer customers improved protection, transparency of information and clarity around charges. The PSD is absolutely clear on the obligations of payment service providers in relation to their customers. It specifies the information that must be made available to customers and establishes new, shortened execution times for payments. There are new obligations placed on customers too, including a requirement to notify the providing bank without undue delay on becoming aware of the loss or theft of a payment instrument, such as a card.

The PSD also provides clear rules for a new category of lightly regulated entities called payment institutions, allowing non-banks to handle payments and join payment schemes and associations. The new payment institutions are likely to include money remitters, non-bank credit card issuers, non-bank merchant acquirers, and mobile phone operators offering payment services. Therefore the PSD will change the competitive landscape of the financial services industry significantly.

Although the PSD creates a lot of work and a need for substantial investment on the part of banks and other payment providers, there are real benefits too. A uniform legal framework creates a level playing field and supports all aspects of the new SEPA payment instruments, particularly the SEPA Direct Debit. This removes barriers to entry into new markets within the EU/EEA.

Although the PSD is a maximum harmonisation Directive meaning that EU Member States cannot diverge from its provisions, there is a degree of regulatory flexibility in its implementation. Each Member State must decide whether and how it will implement the

so-called “Member State Options”; each must also decide which regulatory authorities will be responsible for monitoring compliance with the PSD. In the UK, the competent authority is primarily the FSA, though HM Revenue and Customs and the Office of Fair Trading also have roles to play.

For banks, the PSD represents a significant challenge. They must comply with the PSD in terms of both geographical scope and currencies, as both euro and non-euro currencies of the EU and EEA are included. As the PSD mandates faster execution times (D+1, unless otherwise agreed with banks’ customers), systems and platforms need to be adjusted. The PSD will affect banks’ revenues because it mandates that a payment’s full amount must be transferred, without deduction. This reduces banks’ float income, will increase customer information disclosure requirements and the need to provide information free of charge. With all this in mind it is easy to lose sight of the longer-term opportunities for banks...

## **The benefits of standardisation scale**

The PSD gives banks the opportunity to standardise their service portfolios and customer terms and conditions. Standardisation of product offerings means that business processes and IT systems can also be standardised. Banks should consider to which degree legacy systems can be retired, manual processes be abolished and new systems and automated processes be established. Many banks are embracing this climate of change as an opportunity to explore new ways of working. We believe that payment partners will play a bigger role. Why?

The standardisation of instruments means that operational scale becomes even more important in the new environment. At VocaLink, we have already made sure that our Euro Clearing Service is PSD-compliant. We are keen to ensure that all of our customers benefit from both the scope and scale of our processing infrastructure. We have invested regularly and heavily over many years in the right technology to handle vast payment volumes and the demands of complex legislation. In practice, this means that customers achieve instant and ongoing legislative compliance, reduced processing costs and mitigated operational risk. Banks throughout SEPA can then compete on the basis of their customer propositions rather than their processing capability. And that of course is what SEPA and the PSD are all about.

## **The Faster Payments Service – a major achievement with great potential**

**The Faster Payments Service went live in May 2008. It is arguably the most ambitious project undertaken by the UK payments industry since the introduction of electronic payments. VocaLink designed, built and implemented the technology infrastructure that powers the service. The Payments Council is responsible for scheme governance. After a year of live running, is the Faster Payments Service a success? Transaction Matters spoke with Paul Smees, Chief Executive of the Payments Council.**



The UK Faster Payments Service has its origins in the Cruickshank Report of 2000. The report highlighted the need for fast, low-cost payments throughout the UK. At that time, UK payments lagged behind some other major economies in terms of payment options and clearing times. The faster payments initiative sought to rectify this and was originally intended to be a same-day or late/early service. In reality a combination of factors drove the industry to adopt

real-time technology. Now the UK has a real-time payments backbone and is in the vanguard of advanced payment providers.

## **Faster payments in practice**

The Payments Council worked closely with VocaLink to deliver a cutting-edge infrastructure, which was to become widely available. The deployment has been a great success: over 90% of people now have access to the Faster Payments Service. The concept of near real-time payments has exceeded all expectations and the industry can take pride in having delivered a world-class infrastructure in only two-and-a-half years. From a technological perspective that is a huge triumph and the system has proved to be exceptionally stable since inception. So, what about volume uptake?

Faster Payment volumes have been high but perhaps not as high as we would have liked. The new service was launched on 27 May 2008 and during the remainder of the calendar year over 86 million payments were processed with a value of £33 billion. That's about 0.04% of total clearing values, against a backdrop of dreadful economic conditions and the banking crisis. The UK banking industry must now find proactive ways of incorporating Faster Payments into appealing customer propositions. There is huge potential for both commercial and personal banking. Faster Payments make sense from several customer perspectives: immediacy, certainty and convenience. And from a banking point of view, the cost of processing is far lower than cheques and the risk of fraud is greatly reduced.

Uptake of the new service has been quicker in some sectors than others. The personal finance sector has been quick to realise that Faster Payments are the ideal payment instrument for buying stocks and shares, topping up ISAs or moving money between different savings institutions. Individuals are now better informed than ever and are far more active in the management of their money. Faster Payments make switching funds far easier and many people originate payments from internet bank accounts. Over time it seems likely that there will be an increase in mobile Faster Payments but we cannot predict the direction of the service with certainty. Applications need to meet customer needs and be commercially viable for the banks. The important thing is that the UK now has a suite of payment services to meet most business and personal needs. However the real benefits to the banking industry have yet to come...

## **Real time has real potential**

The Faster Payments Service offers a strategic payments platform that can remove payment 'silos' from the banking industry. The current payments landscape is a reflection of various payment initiatives throughout the life of the industry. Every instrument has its own administration and processing requirements, which means maintaining multiple processing systems and platforms. This increases the overall cost of processing payments to our industry. Moving to real-time technology gives us the opportunity to streamline and standardise business processes and systems. Over time, banks will be able to support multiple instruments from a single platform using standard formats, such as ISO 20022 in real time. Potential benefits are available at every stage of the payment value chain.

Consider the case of retail customers. Real-time payments offer all the benefits of cash with none of the downside. This improves financial control and facilitates the development of new self-service banking services. Corporate banking customers benefit too: with real-time

payments, the status of each payment is known, so the cost of investigating and repairing failed payments is reduced significantly.

The potential benefits of real-time payments are intuitively appealing and the Faster Payments Service marks the first milestone along that journey. However, the successful deployment of the Faster Payments Service is itself a major achievement that required the concerted effort of 13 major financial institutions. The industry still has lot to do but we also have a lot to be proud of.

## The Faster Payments Service – the evolution of the payments industry

**The Faster Payments Service recently celebrated its first anniversary. It is the first new payments service to be introduced to the UK market in over 20 years. The rationale for the service was to allow individuals and businesses to make single immediate payments easily, cheaply and irrevocably. Faster Payments can be effected by branch, telephone or internet. From a consumer perspective, there are obvious benefits in terms of convenience and certainty of payment. The benefits to business are perhaps less obvious. Barclays Commercial Bank believes the Faster Payments Service is of real benefit to its corporate customers. VocaLink is working with Barclays to incorporate the Faster Payments Service into its direct corporate access service. Why? Transaction Matters spoke to Richard Martin, Head of Payments & Cash Management, Global Commercial Products at Barclays Commercial Bank.**



### Customer preference

Barclays regards the Faster Payments Service as being a matter of customer preference and empowerment. The unique characteristics of the service are the speed and certainty of payment. Both of these can translate into tangible business benefits, depending on the type of commercial activity being undertaken. There are no hard-and-fast rules that define the appeal of Faster Payments but, from a marketing perspective, the service sits comfortably between Bacs and CHAPS. The Faster Payments Service allows transactions to be completed more quickly than Bacs but it is cheaper and more suitable for smaller payments than CHAPS. Companies engaged in buying and selling activities can release goods more quickly, and cash positions managed more easily and accurately. Just as importantly, the cost of repairing failed transactions is greatly reduced: in most cases the payer can repair a failed payment almost immediately so business is uninterrupted.

Although speed of payment is intuitively appealing, in reality, many business payments and collections are predictable and scheduled well in advance. Salaries, rent and utility payments are examples of the scheduled payments where there is no compelling commercial reason to substitute Faster Payments. For many payments and collections, the traditional Bacs service offers a reliable, cost-effective solution. So when are Faster Payments appropriate?

## A matter of time

Faster Payments are of greatest benefit when there is uncertainty regarding the timing or exact amount of payments. Barclays has many business customers in the service sector and it is here that the Faster Payments Service scores highly. Consider the case of an employment agency that employs many weekly paid contract staff. Although the pay-day may be fixed, the amounts paid will vary from week to week and employees are paid in arrears. The exact sums payable will be unknown until the work is done. Faster Payments offer a modern alternative to cash as a way of paying the weekly payroll for temporary or contract staff. Employees can be paid securely, on time and with certainty. The essence of the Faster Payments Service is this ability to 'push' money into defined bank accounts on the same day. Barclays is keen to give its customers this facility through existing payment connection and without disrupting workflow. The natural choice was to include Faster Payments within the current direct corporate access service.

Many smaller financial institutions, including agency banks, will also be able to offer new services based on Faster Payments, particularly those offering on-line banking services and short-term credit and loan facilities, which almost always require same-day payments.

## Online on time

Another market segment that will benefit from the Faster Payments Service is online business-to-business trading. Many companies are now trading with others over the internet and Faster Payments offers business an alternative payment method that suits both parties. Business will also welcome the ability to receive confirmation in near real time that their payments have been successfully executed and received enabling the release of goods and speeding up the working capital cycle.

Barclays is continually working with its business customers to help them improve cash flow and reduce the amount of time spent chasing payments. The Faster Payments Service has the potential to offer overall step-change in operational efficiency and introduce 'just in time' management to the financial supply chain.

## Evolution not revolution

In practical terms, Barclays is offering Faster Payments as an additional payment mechanism through Secure-IP, an addition to the familiar Bacstel-IP payments channel. This gives business and corporate banking customers the option to select Faster Payments in addition to existing payment services. Over time, the availability of real-time payments processing may define a new era in payment processing, but the pace of the journey must be dictated by customer needs and working practices. In practice we are experiencing an evolution rather than a revolution.

## An independent view

**Sibos 2009: Now, where were we....?**

**David Bannister, Editor of Banking Technology Magazine**

The first day of Sibos 2008 in Vienna was marked by the departure of a number of delegates, heading back to their offices to deal with the rapidly



unfolding crisis that followed the collapse of Lehman Brothers that morning.

The rest of the week had a somewhat surreal atmosphere, as rumours flew and grew. Bank of America's show stand became an impromptu video conferencing centre as its shotgun acquisition of Merrill Lynch was announced.

Some people, oddly, seemed to think that it was right and fitting that the implosion of the financial services sector should coincide with the first day of Sibos – is it not the most important date of the calendar for senior bankers and those charged with maintaining the flow through the world's financial plumbing system?

That plumbing system coped pretty well, as it happened, according to a Bank of England report.

No doubt there will be some people at this year's Sibos in Hong Kong who will see this as a reason for self-congratulation; let's hope that they are not in the majority, or in any way setting the agenda for the dialogue.

Sibos is an important event, but it is an event for back-office and operations people, and for a long time it has been dominated by the payments side of the industry – and the European view of the payments industry at that. Meanwhile, the pressures that led to the crisis were building up elsewhere – in the investment banking side, dominated by the US securities industry, which was happily making gold out of the base metal of the US sub prime mortgage market.

Using advanced mathematical risk techniques and high-frequency algorithmic trading models they managed to create a huge backlog in the clearing pipeline that effectively scuppered the whole thing.

There were initiatives from the likes of International Securities Dealers Association and the Depository Trust & Clearing Corp (the US clearing and settlement body for securities) to reduce that backlog – in fact it could be argued that they were getting close when Merrill collapsed – that put them in a good position to contribute to the urgent debate that is happening on clearing and settlement of derivatives products, even if they are partisan approaches. (Continuous Linked Settlement will also be able to point to its success, but let's not forget how long it took to get going).

Should there be a global approach? What about the regulatory framework? These questions are dominating the debate at conferences around the world, and will no doubt be raised at Sibos. It will need more than that, however, if the role of Swift and Sibos is not to be sidelined. Taking the Eurocentric payments view, the debates have been dominated by the Single Euro Payments Area, SEPA Direct Debits and the Payment Service Directive.

Meanwhile the world has moved on – corporates and non-banks are picking up the baton of innovation there, and even the regulators seem to be bored by the industry's dilatoriness (and the politicians see that as part of the cause of the crisis).

Participants in Sibos 2009 have an opportunity to be part of a global debate on the future direction of the industry, but they are going to have to take a bigger view than they have previously shown themselves willing to.