How To Maintain An Edge In Wholesale Payments

Sustaining Competitive Advantage

The Path Toward Straight-Thru-Processing

Transforming Payments Into A Customer-Centric Business

Turning Compliance Pain into Operation Gain

Essential Payment Strategies for Surviving — and Outperforming in a Challenging Marketplace

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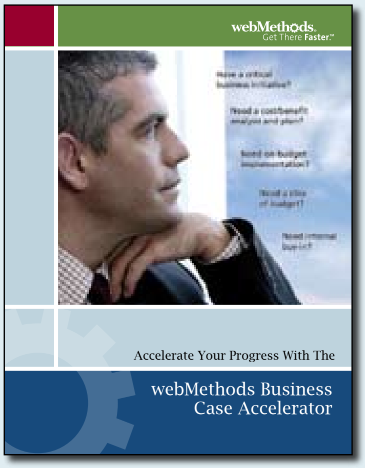

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Maintaining an Edge in the Wholesale Payment Business

By Alenka Grealish, Banking Group Manager, Celent

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Banks are no strangers to the threats of disintermediation, commoditization, and rising costs. Over the past couple of decades, their wholesale businesses have tackled these threats head-on and have, with varying degrees of success, mitigated their impact. Today wholesale banking continues to account for a significant share of net revenues (between 14% to 18% at mid-sized to large banks or around $95 billion with payment-related revenues running between $32 billion and $36 billion). Most wholesale businesses run a tight ship operationally, achieving efficiency ratios at least 10% better than those of retail banking.

None of the businesses under the wholesale banking umbrella can stand still today. All business lines have to ensure that their cost-to-value propositions are in line with their commercial customers' expectations. Moreover, they must achieve efficient and effective processes upstream (e.g., improved time-to-market for new products) and downstream (e.g., superior monitoring and handling of exceptions). Lending must continually improve its underwriting process, refine credit terms, and ultimately strive to meet all the credit needs of its customers from short-term (e.g., accounts payable financing) to long-term. Treasury services must meet companies' heightened expectations of the utility of the Web-based delivery channel, including enhanced cash flow forecasting tools, visibility into foreign exchange and high value transactions, and integration of ERP, treasury, and cash management screens. The cash management business must figure out a means of differentiating itself not only with the basics (e.g., service levels) but also advanced services (e.g., single payment gateway regardless of country of origin or currency; electronic remote deposit services with a least-cost routing mechanism).

Until recently, a minority of banks had the resolve to change their payment strategy and supporting infrastructure. Few have been willing to stick their necks out and participate in standards and open systems development. Fewer still have asked themselves the hard questions around the lack of consolidation of wholesale banking systems and the lack of interoperability across systems as well as the fact that they are unable to reuse components. Leading strategists in treasury services, however, have recognized that the future profitability of their businesses lies in migrating to electronic payments and in adding value as an information provider whether the information is related to the payment (e.g., detailed remittance information) or the process (e.g., alerts regarding processing glitches). Winning banks will not only provide advanced services but also will outperform on delivering these services.

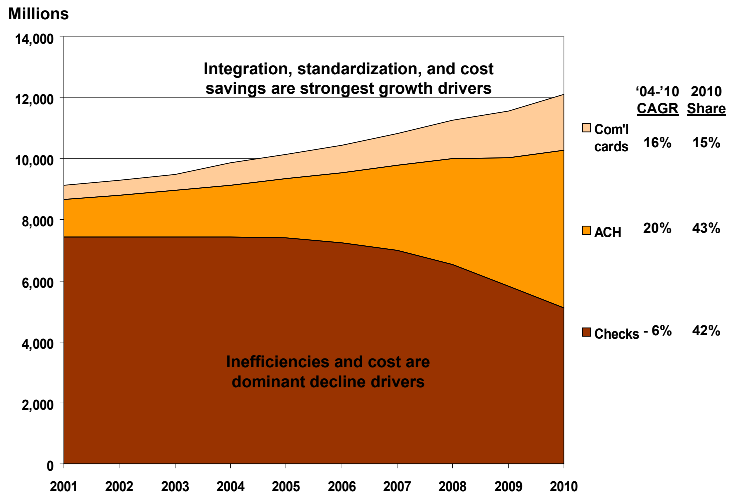
Pain points

Both the top line and bottom line of wholesale banking businesses have been under pressure driven by shifts in the competitive playing field, customer needs, and technology. Lending has suffered from disintermediation as commercial paper has become a popular substitute for other short-term credit products (e.g., lines of credit) at many large companies. Treasury services are challenged by rising cost-to-serve and pressure on fees. For example, to remain competitive and meet customer expectations, banks have had to boost their annual investment in Web-based cash management applications 4.8% on average between 2003 and 2005, up from 2.8% between 2001 and 2003. Technology has proven to be both boon and bane. It has allowed banks to vastly improve processes and delivery (e.g., Web-based channel) but has also resulted in a patchwork of expensive proprietary systems.

Exacerbating long-run pressures, the current low interest rate environment has also wreaked havoc. Cash management fees are under pressure because the portion of fees paid through compensating balances has fallen. Most banks report that as companies increasingly have to pay these fees directly, they are scrutinizing these charges, reducing their use of cash management services, and are lobbying to renegotiate contracts. (The money at stake can easily run into the millions of dollars for a major cash management customer). Pressure on fees in turn puts pressure on banks to generate new revenue streams through product and service innovations.

Unlike interest rate trends, which are cyclical, the adoption of electronic payments will only increase over time and hence is a trend requiring banks to reformulate their long-run strategic plans. Forty-three percent of business-to-business payments, which have been the most resistant to moving away from paper, will migrate to electronic payment vehicles by 2008 (Figure 1). Underlying this shift is the gradual automation of the financial supply chain. Suppliers implementing an electronic invoice presentment and payment solution have seen as much as a 56-percentage-point jump in the use of e-payments by buyers receiving electronic invoices. Buyers, in turn, have been able to increase their own use of e-payments by implementing an order-to-pay solution and participating in a payments network, which allow them to pay 100 percent of their suppliers who join the respective network via ACH. The gradual adoption of e-payments is shifting banks' payment revenue mix away from check-related fees to ACH fees, wire transfer fees, and information-related services (Ernst & Young's annual cash management surveys found that check revenue's share of the total declined from 12% in 2001 to 11% in 2003). On the one hand, the shift is alarming because check services are a leading revenue engine (typically in the top four at most banks) as is the interest earned on float. On the other hand, the shift opens up new opportunities in e-payment services, including providing critical payment-related information. Given the concentration of ACH originations in the top 5 banks (55% of the volume in 2004), these banks will be in a strong position to take advantage of the shift.

Figure 1: Growing use of e-payments in business-to-business transactions



Imperative to change

Although the trend in interest rates will reverse, the pressure on cash management fees will not, given the competitive environment. Unless banks build strong customer relationships by adding value beyond transaction processing, they will be relegated to the low-margin payment clearing and settlement business while others win in high-margin, information-related businesses (e.g., workflow automation, dispute adjudication, and electronic delivery of rich remittance). Only by forging strategies to add value through information automation, system integration, and electronic payments can banks stem the erosion of revenues and margins in their traditional paper-based services. Only by revamping their product-centric infrastructure to be process-centric will they enhance their payment-related processes. Process efficiency, however, stems not only from reconfiguring and automating the workflows but also through real-time monitoring and management. Banks, which excel on these fronts, will achieve operational excellence, raise the bar on guaranteed delivery of customer service level agreements, and ultimately gain market share.

Although banks have historically built their organizations around products, their wholesale business is founded in multi-product relationships. Most banks cross-sell treasury services, primarily cash management-related, to their credit customers. Cash management-related balances are a critical source of relatively low-cost funds that fuel commercial credit businesses, funding about 45% of a large bank's commercial loans. Conversely, when selecting a bank for cash management services, commercial customers typically take into consideration the bank's ability to offer them credit-related services. Not surprisingly, nearly all the top tier banks include line of credit initiation as a feature of their Web-based cash management service.

Until recently, banks' product-focused organizational structures and IT infrastructures were able to generate cross-sales in an ad-hoc manner and adapt to changes in the competitive landscape and customer preferences. But no longer. Banks have to add value through superior performance across the entire payment handling process and beyond, regardless of the type of payment. For several reasons, banks can no longer view their payment processes as distinct to each product or as isolated from the rest of the financial supply chain. First, the payment systems, which support the various products and have historically been a differentiator, are becoming an unsustainable modus operandi, particularly at top tier banks. The system morass has also impeded banks' ability to monitor their payment process flows. Traditional revenue streams are increasingly unable to cover the cost of banks' patchwork of legacy, proprietary systems, and middleware. Second, payment types and clearing mechanisms are changing (e.g., checks can be truncated or converted into an ACH payment).

Moreover, commercial customers are increasingly demanding more visibility into the payment process, particularly those with international operations. They want real-time monitoring of high- value transactions. They want real-time alerts when there is a potentially fraudulent or non-compliant payment initiated or when a deposit becomes an exception item. Banks, in turn, stand to realize notable performance improvements from greater visibility into their processes.

Beacons of the next generation

Several farsighted banks have recognized that if they want a future in wholesale payments, they must revamp their payment infrastructure. In reaction, they are examining the different payment processes and determining how to build a single payment infrastructure and leverage technology across the different payment types (e.g., an all transaction archive; common OFAC and fraud tools). By improving process efficiency, reducing the number of formats, and eliminating proprietary networks, these banks are not only reducing their operating costs (top tier banks have reported cost savings up to 35% on select phases of the payment process, e.g., dispute resolution) but also gaining new revenue streams (e.g., providing integrated reconciliation).

Despite the Herculean effort required to chart a new payment course, there are several beacons shedding light. One European global treasury bank has been at the forefront of standards development and client integration. It recognized early on that its valuable and scarce resources should be directed toward building the value-added component of its offering and not toward supporting a proprietary infrastructure. Consequently, it is striving to compete by providing superior information reporting, data quality and consistency, and service levels (e.g., cutoff times). In the process, it has been reducing the number of formats that are used to exchange information. In addition, the bank is being extremely proactive in developing standard formats and open networks in order to integrate its payment systems with its corporate customers' ERP systems. Not satisfied with waiting for ERP vendors to take the initiative, it went to the leading ERP and treasury workstation vendors with messaging standards to integrate into future releases. As a result of its efforts, the bank has lowered its processing costs while raising its straight-through processing rates for account reconciliation (above the 20% average for global accounts receivable operations) and improving information consistency. Lower costs have allowed the bank to serve mid-sized companies that other large banks have tended to ignore, thereby allowing it to expand its market share.

Another frontrunner is a U.S.-based universal bank that spent over four years consolidating its multiple payment systems into a single global funds transfer and payment platform. It recognized early on that if it wanted to maintain its leadership position in global treasury, it had to replace its quagmire of proprietary and packaged applications that existed across countries and product silos. Only through a global platform could it effectively lower its long-run costs while expanding its service and product offering and delivering real-time information across nearly one hundred offices. At the same time, it consolidated its electronic banking platforms into a single Web-based interface (with 40 languages), simplified its middle layer that connects the customer-facing system with back-end systems, and added a robust alert system that spans the spectrum from payment details to trade-related notifications. Never standing still, this bank recently took the lead in launching an integrated treasury system, combining cash flow, investments, and debt-related dashboards. Despite the upfront costs of these massive projects, the bank is already realizing significant costs savings, particularly on maintenance. On the revenue side, its initiatives have paid off in terms of its growing share of business from Global 100 corporations. In addition, it has profited from its top ranking for treasury and cash management services in well-regarded trade publications.

A European-based global bank became concerned in 2002 that its legacy payment systems were placing them at a competitive disadvantage vis-à-vis competitors that were building a common global payment platform and offering transaction monitoring and attendant alerts. The bank felt that it was falling behind on meeting the rising delivery expectations of its corporate customers, which were partly driven by their use of competing banks' Web-based systems. Facing a critical juncture of invest or divest, the bank decided to retain its stake in the global wholesale payment business and embarked on a four year, multi-million dollar project to consolidate its multiple payment system across the world. To date, the bank is meeting its goals of not only simplifying the myriad of payment processes but also of shortening processing times and improving its ability to troubleshoot. Already the bank has raised the bar on the service levels it promises customers initiating cross-border payments, and its customers have reported improved cash flow forecasting.

Over the next five years, market forces will compel banks to ask and answer the hard questions about their Byzantine payment system. Any bank that wants to stay in the wholesale payments game will eventually adopt standards, embrace open systems, consolidate its payment infrastructure, redefine its value propositions along process-related performance metrics and deliver unfailing customer service.

For more insights, visit www.webMethods.com/payments.

Extending Beyond the Payment Business: Sustainable Competitive Advantage

By Alenka Grealish, Banking Group Manager, Celent

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For commercial bankers, payment-related revenues are a big deal, generating between $32 billion and $36 billion annually overall, accounting for over a third of wholesale banking revenues. Bankers are increasingly realizing, however, that payment revenues are not the only deal to be had. Upstream of the payment process lies ripe territory to apply best practices from payments and add value. Most companies have—at best—automated only fragments of the financial supply chain and only the largest corporations have established buyer-supplier connectivity via electronic data interchange. Consequently, companies are saddled with excess working capital generating low or no return (e.g., Fortune 500 companies have upwards of a billion dollars each in working capital). Moreover, the interests of suppliers and buyers are at odds: suppliers want to shrink days sales outstanding (DSO) while buyers want to extend days payables outstanding (DPO). Enter the banks in a classic intermediary role, allowing buyers and suppliers to select a payment date by providing various funding options and earning a fee. A classic role, yes, but with an electronic twist. Until recently, banks were hindered by a protracted, manual financial supply chain process and convoluted payment systems. Automation, however, is increasingly possible thanks to straight-through processing systems for payments and electronic invoice presentment and payment applications.

Pain Points

Treasury bankers are finding themselves caught in a vise: rising commoditization of their payment businesses, fee erosion, and increasing infrastructure costs. Fee pressure is felt by most banks and across a majority of their wholesale payment-related products. Companies ranked reduction in bank fees as a relatively high priority in a Federal Reserve Bank of New York survey. As a result, they are increasingly scrutinizing their bank fees, demanding greater discounts. According to data collected by Phoenix-Hecht, the frequency of discounts offered on cash management services has risen steeply from 35% in 1999 to 43% in 2004 (Celent notes that relatively new products, such as remote check image capture, are not spared discounting and are vulnerable to their prices being cut by a third within the first year). Compounding bankers' situation is the cost albatross of their payment infrastructure. Most banks grapple with multiple payment systems, many of which are proprietary and use different formats (e.g., one for each payment vehicle, one for high-value and one for low-value, several for cross-border). Consequently, payment processing tends to consume a greater proportion of operating costs (up to a third more at some banks) than its share of revenues, resulting in below average margins.

These pressures have led numerous banks to examine their payment-related businesses and take a defensive posture, rationalizing those that generate low or no profits and/or are subscale. For example, many banks have chosen to exit certain businesses completely (e.g., retail lockbox and trade finance) and offer them through a white label provider. Leading treasury banks have also taken an offensive posture, undertaking massive IT restructuring projects (e.g., building a single payment platform) and exploring new business opportunities along the financial supply chain.

Imperative to change

Banks have traditionally not explored opportunities along the financial supply chain beyond the payment piece. Today, with the advent of Web-based protocols, service-oriented architecture, and integration and communication possibilities, they can extend their reach and add significant value. Figure 1 covers the financing to payment phases, which hold the most lucrative opportunities. Overall, banks can contribute to automating processes along the chain and integrating disparate systems (e.g., accounting and cash management). Although from a technological standpoint, banks do not have a comparative advantage in automation, they do have a strong understanding of the workflows involved, which is a prerequisite to automation. Banks can easily overcome the technological hurdle by teaming with a third party.

At the end of the supply chain, banks can add value through payment-related credit products. Although banks—as well as their arch rivals, commercial finance companies—have historically played a role in financing business-to-business transactions, few have latched onto the opportunity to provide working capital management in the form of discount management services. (These services reconcile the competing demands for lower DSO on the supplier side and higher DPO on the buyer side.) This oversight is due not to ignorance but primarily to paper-based and manual processes that make it nearly impossible to process and pay an invoice within the typical 10-day discount window. This no longer need be the case. Banks can expedite invoice processing by offering accounts payable services and leveraging technology most already have in-house (e.g., imaging, system integration, and business process management) or implementing new e-payables technology. Moreover, they can enable their commercial customers to pay electronically instead of by check.

Figure 1: Bank Opportunities Along the Financial Supply Chain

Role		Financing and Payment Assurance	Invoice Presentment & Dispute Resolution	Payment, Remittance, & Reconciliation
Trading Partner	Both	• Provide F/X and/or hedging services	• Match items (limited) - Reconcile PO with invoice	• Match items (limited) - Reconcile payment with invoice • Limited e-payment functionality
	Buyer	• Provide financing or leasing services	• Consolidate invoices	• Consolidate payments • Initiate check payments electronically
	Seller	• Provide assurance • Provide A/R financing		
Potential	Both	• Provide payment-related financing (see last column)	• Provide collaboration tools to resolve disputes • Provide transaction transparency	• Offer discount management services
	Buyer		• Capture invoice • Validate invoice • Route for review and approval	• Provide payables discounting • Initiate e-remittance and e-payments online
	Seller		• Enable e-invoicing	• Expedite payment by paying on behalf of the buyer • Provide advanced items matching and reconciliation

That bankers can add value with the appropriate resources and products/services is evident. But should they? The answer for any bank that wants to be a leader in treasury services is a resounding yes. The rationale is manifold: comparative advantage, economic and competitive imperatives, attractive revenue and profit potential, and green field opportunity.

First, given their skill set, banks are well positioned to play leadership roles in enabling an electronic financial supply chain. They already have expertise in remittance processing, disbursement, reconciliation, information management, and dispute resolution, to name several critical areas. In addition, select banks have recently crossed the threshold to straight-through processing of payments and are able to leverage their technological investment in streamlining their payment workflow. Moreover, they can apply their credit skills and develop discount management services that optimize the use of working capital. For example, a bank can offer dynamic supplier discount management: the buyer earmarks invoices she is willing to pay early in order to earn a discount along with the discount amount, and the supplier indicates which ones he accepts. Alternatively, the bank could fund early payment directly either via a payables discounting service (in which the buyer borrows funds from the bank in order to maintain or extend his DPO) or via a purchase card.

Second, banks are vulnerable to being relegated to the low-margin payment clearing and settlement business while non-banks win in high-margin, information-related businesses (e.g., workflow automation, dispute adjudication, and rich remittance). Only by forging strategies to add value through information automation, integration, and electronic payment can banks stem the eventual erosion of revenues and margins in their traditional check-based services. Through the integration of disparate systems, banks will improve their payment processing capabilities and be able to offer advanced services such as real-time monitoring and rich payment information.

Third, many large banks (assets >$100 billion) cite electronic payment and remittance as one of their strongest growth areas in cash management. The profit potential shows promise. First, because the cost structure of these electronic services is dominated by fixed costs, banks should be able to improve their profit margins as scale grows. Second, revenues will likely be attractive. Early-adopter companies have shown that they are willing to pay a relatively high price (e.g., $0.75 to $1.00 per transaction) to lower their accounts payable costs, which can run as high as $10 per transaction. Electronic payment is a linchpin in the process because it is a prerequisite to an end-to-end electronic financial supply chain and can shave one to five days off clearing and settlement time, which encourages suppliers to participate.

Fourth, the market is in a nascent stage with demand just beginning to increase. The green field opportunity is vast, but it's not forever. In ten years, this green market will be mature; most companies will use e-invoices and e-payments. Banks must act soon to establish a long-run position because early movers will likely sustain an advantage based on their track records. Implementations beget implementations.

Banks paving the new path

As demand for automation and integration from businesses grows, the vast green field of opportunity will be for banks to win or lose. While many mid-size and large banks have already been building up their ACH-related services, most currently are not yet able to offer advanced services and most have little presence or revenues in the automation of the rest of the financial supply chain. Fewer than a dozen have planted a flag by offering some form of electronic invoice presentment and payment (EIPP) or e-payables solution. A third of the top 20 treasury services banks risk being also-rans. The few that have forged ahead have the raised the bar on payment processing standards (e.g., offering real-time monitoring of payments) and stand to reap rich rewards.

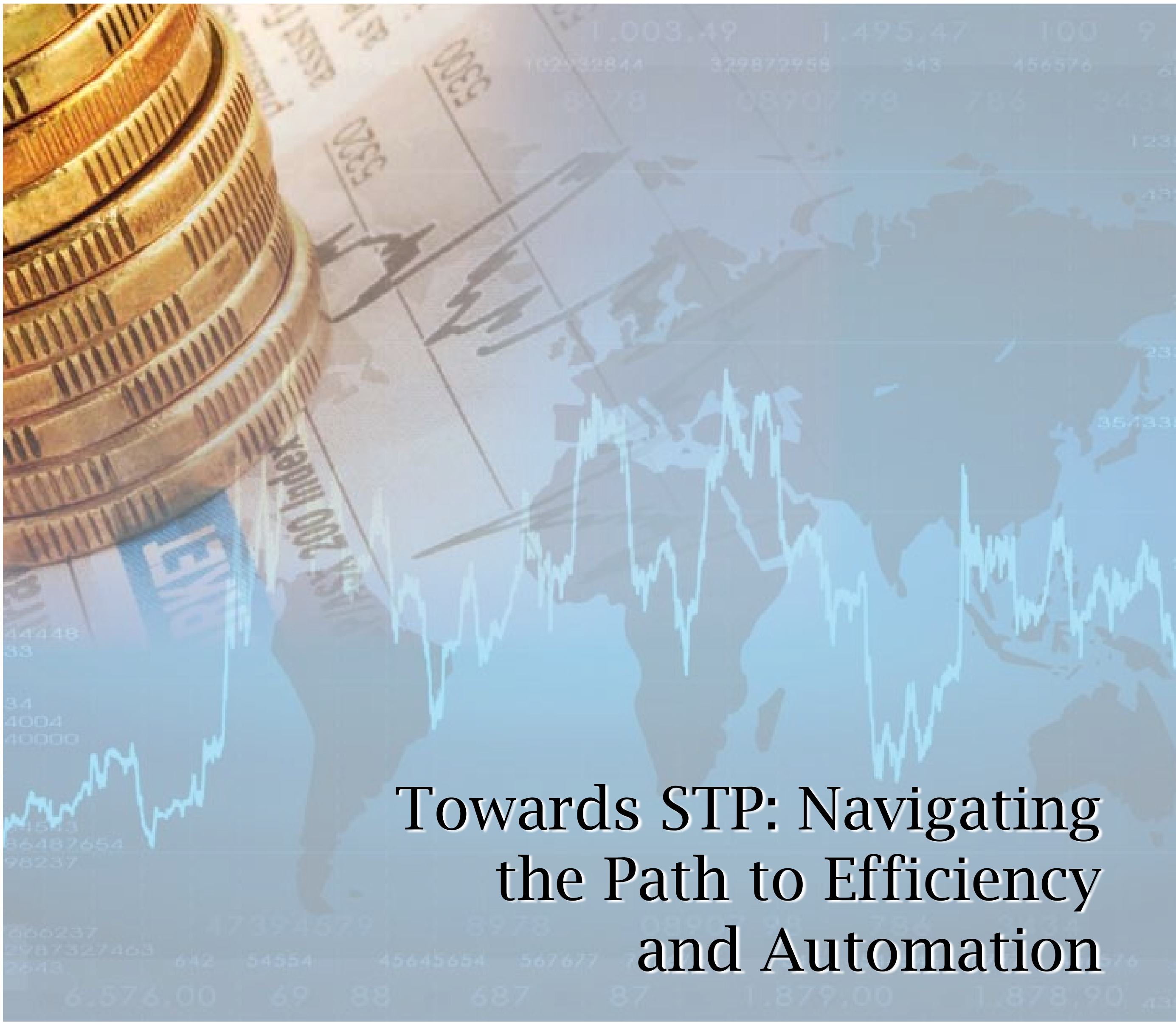
Among those banks already reaping reward is a top tier U.S. bank that began its venture in 1997 with a then unprecedented vision: automation of the entire financial supply chain. The bank was striving to position itself as an enabler across the board, not just a player at disjointed stages along the chain. Its ambition was to yield not only operating efficiency but also financial efficiency by offering six components: data exchange, compliance audit, transaction management, accounting, settlement, and business intelligence. It developed an e-payment solution capable of interfacing with the numerous business systems linked to a business-to-business transaction. In other words, the bank reaches out to the businesses rather than requiring them to reach out to itself. It brings both buyer and seller to the table by extracting data from their relevant systems into a single data repository with secure access. The transaction is expedited via sophisticated electronic workflow and collaborative tools. Over the past five years, the bank has not only generated a new revenue stream but one with an attractive profit margin as well.

Another early mover is a leading wholesale bank that chose to build its own seller-oriented EIPP solution in the late 1990s. The bank viewed EIPP as a natural extension of its accounts receivables business and as a vital component of its strategy to aggressively expand its cash management business. Overall, EIPP exemplified the bank's broader strategy to remain on the cutting edge of payment systems advances and to forge multiple links with its business customers, thereby building strong bonds and customer retention. The bank has found that its EIPP offering gives it a competitive leg up in attracting new clients and has been a good launch pad for cross-selling other cash management-related products.

More recently, a leading global treasury services bank decided to extend beyond payment to credit, specifically supplier financing. It spied an opportunity to offer supplier financing in the form of innovative discount management services that eradicate the inefficiencies inherent in traditional discounting and working capital management. Instead of investing resources and time in developing the prerequisite electronic invoice processing engine, the bank chose to team with a third-party e-payables provider (process automation is required to reduce the invoice processing window to 10 days or less). By formulating three offerings to optimize the use of discounting and leverage the bank's, the supplier's, or the buyer's balance sheet, the bank has generated a win for both sides: DPO management for the buyer and DSO reduction for the supplier. Moreover there is an opportunity not only to increase the discounts captured but also to reduce the unearned discounts paid. The bank wins by funding early payment either through net interest income or an interchange-type transaction fee.

The success of these banks suggests that banks can and will play a critical role in the eventual automation of the financial supply chain. Automation is certain. Most companies will not be pushing around paper invoices or checks in ten years. To the degree banks invest in enhancing their payment systems, the greater the opportunity for them to play a vital role. Given the current climate of rising DSO and DPO and financial pressures, banks are almost certain to stir up demand for their financial supply chain offerings. On the heels of success, however, competition looms. For example, commercial finance giants will surely be in hot pursuit of a share of this market. Fortunately, the market is in a nascent stage and the green field opportunity is vast.

For more insights, visit www.webMethods.com/payments.



Towards STP: Navigating the Path to Efficiency and Automation

By Jacob Jegher, Senior Analyst, Celent

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There are numerous inefficiencies and challenges in the payments process that need to be cleaned up and streamlined. These challenges span from payment request all the way to clearing and settlement. Banks need to work on achieving straight-through processing (STP) – managing, automating, optimizing, and integrating the various steps in the process in order to streamline electronic transaction flow and remove manual intervention. The potential benefits of achieving true STP have brought this fundamental concept into the limelight, yet these benefits are often overshadowed by challenges and pain points encountered along the road. This business and technical-oriented conundrum is further intensified by advances in technology, the creation of new standards, as well as promises of new-found levels of efficiency and automation.

Banks and corporations around the world are striving for true STP in payments. The paths that they take to get there however are often convoluted, riddled with cultural decision-making, and impeded by the siloed nature of banking organizations. Instead of merely contemplating the concept, financial institutions need to embrace and streamline STP by systematically attacking organizational challenges, understanding and implementing solutions that are in-line with client needs, and focusing on adopting and utilizing standards and best practices. That several leading wholesale banks are forging ahead is auspicious.

Pain Points

Banks across the globe are aiming to remedy pain points and work around potential problem areas in an effort to improve STP. Many of these pain points are true hindrances to optimization and simplification, and they are not easily combated. Challenges range from the impact of bank mergers, to organizational priorities and approaches, as well as the lack of recognized industry standards.

The popularity of bank mergers can have an adverse impact on priorities and evolution. Given the competitive nature of the banking industry and the popularity of bank mergers, bank priorities are truly scattered. The competitive nature of the banking industry has generated a climate of merger mania with banks constantly scouring for potential fits and business opportunities. While improving and working on STP can certainly provide efficiencies, it can get lost in the shuffle of higher-level priorities and limited IT budgets. Banks are all too often caught up in merger activity or other IT projects that have taken on a strong role within the organization. Although STP and the improvement and automation of the financial supply chain are clearly important subjects to tackle, they often end up in the dust due to the diversion of focus and funds.

Payment systems are numerous and fragmented – efficiency and automation are suffering. The banking industry still has some heights to scale before reaching the STP pinnacle. Many banks are still riddled with numerous fragmented legacy systems that may get the job done, but at a cost. These systems are expensive to maintain and run, and they contribute to a lack of automation, integration with processes, and optimization of the financial supply chain. Additionally, these inefficiencies hinder the ability to respond to the requirements of increasingly demanding corporate clients.

Inefficiencies in the financial and physical supply chains need to be optimized and resolved as STP is about much more than back-office automation. Numerous opportunities exist for automation along the financial supply chain. From order to payment, inefficiencies exist along this supply chain – banks have a lot of work to do in cleaning up their payments shop and pushing towards STP. When a bank achieves STP it enables the organization to get to the next level – integrating into treasury workstations and ERP systems. In order for the adoption of electronic payments to increase and for the achievement of true STP, an additional step is also required. Banks and technology providers need to band together to examine potential opportunities. Additionally, corporations are exerting influence over e-payments development like never before. These large corporations are not sitting back and allowing financial service providers to control all the cards in the deck.

The progression of standards development has great potential, yet it is confusing, competitive, and disconnected. Established standards and the organizations responsible for developing them are not new to the market. In addition to these long-standing players, new entities are attempting to reshape the development of standards. Leading torchbearers for next-generation, XML-based standards for payment-related transactions include TWIST and SWIFT. For example, SWIFT and the European Payments Council (EPC) recently signed a memorandum of understanding regarding their collaboration on messaging standards for the Single Euro Payments Area (SEPA). The goal of this agreement is to provide banks and corporations with access to standards that take advantage of existing products and infrastructure as well as build a foundation for the future.

In the realm of remittance-related standards and transport protocols, RosettaNet stands out as a pioneer. TWIST, RosettaNet, and others have proven to be effective and nimble, successfully bringing together representatives of all interested parties—from financial institutions to corporations and technology providers—and leading the charge to fulfill their member corporations' needs.

Imperative to change

The challenge to banks ready to forge ahead is building the business case. Because projects inevitably compete for resources, next-generation treasury-related projects must show a relatively strong return in a relatively short time. Until recently, it was hard for open system based projects to compete because the payback was greater than a year and the list of potential customers was short. As more competitors, corporations, and software behemoths sit at the same table to hammer out standards, the more motivation global treasury banks will have to set aside resources. Moreover, the revenue opportunities are becoming clearer to bankers. For example, if they can help a company reduce reconciliation time from five–seven days to one–two days through the use of standards (e.g., the correct data in the right portion of the payment file and in the right place for the clearing system), they stand to win not only new business but also generate new revenue streams. A three-day reduction in reconciliation time would free up millions of dollars in working capital for a large corporation. To the degree that a bank is instrumental in the reduction, it could easily monetize its investment and charge for its services.

Companies have everything to gain. Driven by the desire to centralize their treasury operations and achieve straight-through processing of payments, major global corporations are exerting more influence than ever over e-payment developments. They are already generating a demand pull that banks, which want to retain their business, are hard pressed to ignore. In addition to facing the ultra competitiveness of the payments business, banks are being pushed to excel at providing optimized and efficient payment offerings to their client base. In addition to working on improving and replacing payments architecture and infrastructure, banks need to apply resources to a variety of areas in order to push forward along the road to STP.

Standards development has an important role to play in expediting STP. It is important to note that "development of standards" is a bit of an oxymoron. "Standards" should mean established and accepted practices that are well entrenched and used. However, standards development efforts are part of recognizing and accepting that the environment is evolving. This evolution has to be taken in context as well – standards development needs to be globally focused as we are and will continue to be in a world without physical borders.

Payment system standards need to provide a net benefit to all parties involved— corporations, banks, standards organizations, technology providers, and others. For these solutions to evolve and provide tangible benefits, a long-term vision and spirit of collaboration is required. Banks and corporations need to understand that collaborative standards development will be key to reaching the next level of payment systems automation and STP. Those that focus on harmonization and collaboration will end up in the winners circle.

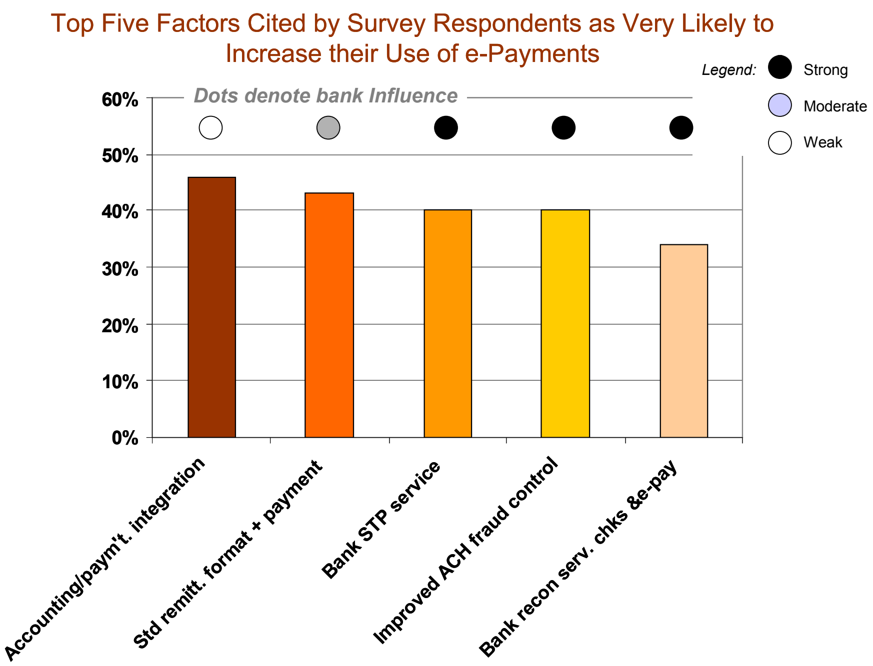
Bank STP services play a critical role in driving the adoption of electronic payments. Adoption of electronic payments is on the rise in most regions of the world. Although certain regions have certainly made more progress than others, there is still plenty of work to do and improvements that can be made. Optimizing the use of electronic payments and STP is on the minds of many companies and they are looking to financial institutions for answers. The 2004 AFP survey (Celent acted as the sole advisor to the AFP for the survey) ranked bank reconciliation services and

STP services close to development standards and system integration in terms of being likely to increase corporate use of e-payments (Figure 1).

Architecting an optimized and collaborative STP environment

Financial institutions certainly have a lot on their plates when it comes to finding ways of automating and improving e-payments. Many banks today are exploring and starting to move forward with a service-oriented architecture (SOA). The target IT state for numerous banks would be to reach a point where everything becomes a service. Banks are looking toward using standard re-usable components in a shared environment. This type of environment could provide banks with speed and agility that would assist in getting that much closer to true STP. In addition to providing a robust architecture, SOA could help banks realize significant cost savings as well as deal with compliance and regulatory requirements.

Figure 1: Bank STP Services Are Crucial in Driving e-Payments Adoption



Source: AFP Survey 2004, Celent

Moving to SOA, however, will not be an overnight process, especially given the siloed nature of banks and the protracted process of developing and adopting standards. There will be cultural hurdles to overcome in terms of getting everyone on the same page and spurring collaboration. SOA is a work in progress – it will need to be clearly defined and standardized in order for banks to jump on the bandwagon. Currently, SOA components are in an early development phase and hence its adoption is still in a rudimentary stage. As SOA matures, more and more functionality will migrate from custom-coded solutions to become part of the purchased SOA infrastructure and, later, part of an open standard. For example, with rudimentary SOA, security could happen endpoint to endpoint. With more advanced SOA, this security layer could migrate to the middle layer and allow for single sign on. With still more time, a standard such as WSS could commoditize such services and help drive them to be a bundled feature in SOA offerings.

Banks that are willing to explore the arena of open systems will enjoy the benefits of lower costs and improved collaboration and efficiency. SOA can be particularly powerful in the context of payments. Banks are dealing with a huge legacy quagmire and a patchwork of systems. Additionally, payments are siloed by type, size, and geography (domestic versus cross-border). The issue, however, is that banks will simply not rip and replace existing systems unless they are faced with system failure or breakdown. SOA can improve efficiencies in the payment process while still maintaining legacy systems.

Although this transformation may not happen overnight, there are good examples of banks that are taking steps forward in an effort to improve STP and overall efficiency. After a detailed analysis of its payment processing system, a large bank in the Midwest decided that it was time for a change. The bank decided to move away from its legacy payment system toward a more open

real-time environment that would be able to handle its growing payment volumes. The bank implemented a new payment processing solution based on SOA and customized it to provide new reporting processes and customized messaging. Improved STP rates are already apparent as the system is well suited to handle the bank's growing payment volume. The very same bank is also pushing the envelope in its ability to handle multiple payment types through a single file. This service provides bank clients with a flexible solution that interfaces with ERP and accounting systems. Additionally, this single file can contain numerous payment types, specify multiple currencies, and be routed to destinations around the globe.

Cost-cutting, simplicity, efficiency, and automation are corporations' buzzwords. Competitiveness, growing and nurturing client relationships, and fee maximization are on the minds of most banks. In the longer term, true collaborative efforts among banks and corporations will yield a win-win. A migration to SOA will give rise to improved automation and efficiency using newly defined standards.

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Transforming Payments Into a Relationship and Information-based Business

By Jacob Jegher, Senior Analyst, Celent

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The payments business is evolving and there are numerous factors that banks need to address in order to make sure that they retain their piece of the pie. Historically, banks have approached the payments arena with a narrow field of vision – as the dominant players and with a focus on the transactional component of the business. This field of vision must widen to panoramic proportions, given the evolution taking place in the payments industry. Corporations are exerting influence and placing pressure on banks for specific services and pricing levels, and an array of players is vying for a share of the market. As margins and revenues erode, banks are beginning to realize that a shift in philosophy and business model is required. The shift that financial institutions need to undertake is complex and requires distinct emphasis on specific factors that will help gain insight, vision, and understanding. Banks need to rise above their strictly transactional mind frame and work on mapping out payment processes, as well as making use of business process management and workflow to manage their siloed organizations.

A dominant theme needs to resound in the banking industry – customer-centricity. While the vast majority of banks will claim that this matter is clearly on their radar, there are still much to be done. The customer needs to become the center of focus for banks, and the payments component of the business is no exception to this cardinal rule. In order to approach this level, banks need to dive into a core understanding of their payments offerings and work on transforming their business to improve efficiency and focus on client needs.

Pain points

Given the evolving nature of the payments business, banks today face a variety of challenges. Challenges range from inefficiencies in the payments process, to a poor understanding of customer needs and the ability to build and grow product offerings and relationships. These shifts are making it difficult for banks to compete, resulting in a struggle to understand how to uphold a position that is slowly slipping away from them.

Inefficiencies in the payments process and lack of integration are hindering banks from providing optimal products and services. Banks are facing a variety of challenges with their payment systems and processes and are often confused as to the steps they need to take. From integration to optimization, inefficiencies and opportunities need to be tackled that would allow banks to gain a better understanding of their payments process. This in-depth view would provide banks with much needed visibility into their processes and would allow them to add value well beyond the transactional component of the business. This additional value can be derived from a variety of sources, including taking on the role of a trusted information provider as well as integrating accounting/ERP systems with payment systems.

Banks often enter the payments process with blurred vision. Given the challenges and complexities associated with payments, banks need to open their eyes to the vast payments landscape that lies before them. Limited understanding and insight into processes and sub-processes has banks jumping into the payments world unable to manage their siloed organizations and with a strict transactional focus. Bottlenecks and redundancies exist throughout the entire payments process and banks are not taking the appropriate actions required to eliminate them. A focus on efficiently making use of business process management and workflow are necessary steps in understanding dependencies, offering relationship products, and in attacking payments with clear vision.

Banks do not place enough emphasis on customer needs. Over the years, North American business culture has proven time and again that the customer is king. Customers have become accustomed to owning, directing, and controlling the relationships they forge with suppliers. Successful businesses in all industries have grown to understand that their top priority is the customer. Failure to recognize this priority is a grave mistake that could lead to imminent demise. The payments business is no exception to this cardinal rule. In fact, given the competitive nature and complexity of the industry and its operations, prioritizing the customer must be a top concern. Building, enhancing, and nurturing relationships is very much in the best interest of banks—satisfied customers are loyal customers. Loyal customers drive future payments revenues and can be excellent sources of opportunity down the road. This simple-sounding shift from a transactional to a relationship-based focus is difficult to achieve, and one that many banks struggle with daily. In order to satisfy customers, banks need to understand and meet customer expectations with regard to payments. Customers are looking for their payments provider to also be an information provider. Additionally, they are looking for value-added offerings that will integrate bank systems with their own ERP/accounting systems. Banks need to grow and nurture client relationships and must therefore enhance their understanding of the interdependencies of steps and organizations to deliver these relationship products.

Imperative to change

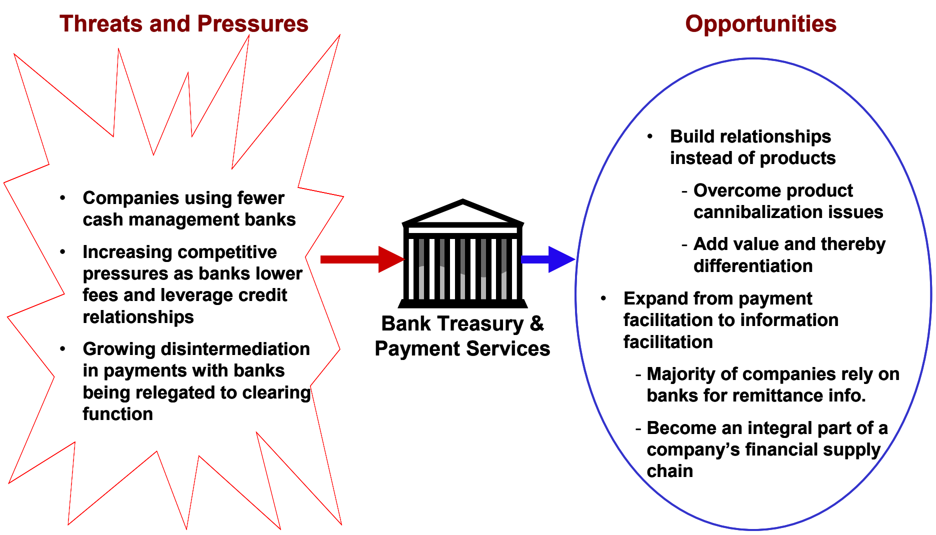
There are multiple reasons for banks to remedy their pain points and map and optimize payment processes, breaking down silos and working on building and growing relationship products. Demonstrated organizational and system coordination can help drive forward banks' payments businesses and can improve adoption of e-payments. As banks forge relationships and work toward automating the financial supply chain, they will need to take on the role of a trusted information provider, as well as facilitate integrating payment systems with ERP/accounting systems.

The role of technology and, consequently, third-party providers in the e-payments process is profound. Until the activities that precede payment are automated, e-payment is unlikely. As confirmed by several surveys, the prerequisite for the migration to e-payments is automation of the financial supply chain, in particular electronification of rich remittance data (i.e., detail comparable to what EDI formats provide). Forty-three percent of respondents to the AFP survey indicated that a standard format for remittance information would help push them forward, while 46 percent cited a ready means to integrate accounting and ERP systems with payment systems.

Currently, electronic payments suffer from a major problem: Either the payment and data are separated, or the data is insufficient for posting and reconciliation purposes or in a format incompatible with the recipient's ERP/accounting system. The logic that paying by check is inefficient and relatively expensive is insufficient to mobilize businesses to adopt e-payments. Businesses know that ACH is cheaper than checks and lockbox processing. Most, however, do not know whether the restructuring required to adopt e-payments is worth it. As the restructuring process is facilitated by third-party vendors and banks, companies will increasingly warm up to the idea of changing their payment process.

Banks have a critical role to play in pushing e-payments forward and in improving and optimizing processes. Many of these financial institutions need to rethink how they view treasury and payment offerings. Only by shedding completely their traditional product focus and embracing a relationship management model can they adopt to changes in the competitive landscape. The hardest part of adapting to change involves some cannibalization of legacy businesses, primarily check-related services (e.g., controlled disbursement and paper-based lockbox). Adaptation requires the fortitude to invest in new businesses based on assumptions about the future rather than the

Figure 1: Threats to and Opportunities for Banks' Treasury and Payment Services



Source: Celent

facts of the past. Banks have an important role to play in moving the market towards electronic payments. Much of the value that they can provide stems from adding value to the process by acting as a trusted information provider. Additionally, they can further add value by integrating their systems into their clients' ERP/accounting systems, building a critical electronic bridge over a manual abyss.

Why should banks move beyond their base camp in payments and credit to the next level – the automation of the e-financial supply chain? A simple yet accurate answer is because they have not only a comparative advantage in payment/information processing and credit underwriting, but also a notable revenue stake in these areas. Mid-size to large banks derive up to 14% of their non-interest income from cash management-related services, and many cite electronic payment and remittance as one of the strongest growth areas. This stake, however, is increasingly under fire. A variety of players are attempting to grab a share of the payments business by jumping in as information providers. This is placing banks in a difficult position as they are seeing their margins dwindle in the good old clearing and settlement business. Banks cannot stand idly by as the pressures on their treasury services business mount. They must apply a version of Newton's third law: for every threat, they should find an equal and opposite opportunity (figure 1).

Multiple levels of transformation will position banks for the future

A key opportunity for banks is to move towards building and growing relationships. Banks have long been known for the rigid and defined structures and divisions that have been built up across the organization. In addition, as banks grow, their organizational structure becomes more complex, thereby creating a breeding ground for silos—the larger the bank, the larger the silo. Achieving customer-centricity in a siloed environment is a paradox—banks need to approach customers with a unified front in order to grow and nurture relationships and provide the customer with a targeted perspective of payments products and services. In order for banks to successfully become customer-centric, they must draw up and execute a plan that takes into account processes and the technology that will be used to manage them. Banks need to determine the processes they want to work on as well as those that will be affected as a consequence of embarking on an analysis of payment processes. In addition, they have to be set up to manage this transformation and ensure that it stays within pre-determined parameters. By becoming an integral part of their business customers' financial supply chain, and providing customers with increased information and control over payments, banks strengthen their ability to boost customer retention. Retaining customers is increasingly critical in the face of ever fiercer competition in treasury and payment services. Moreover, once a bank has a full understanding of the entire financial supply chain of its business clients and maps out customer relationships, the cross-selling opportunities multiply.

Banks have an important role to play in automating processes as well as integrating accounting/ERP systems with payment systems. An important first step would be for banks to get a more in-depth view and analysis of their payment processes. This mapping would allow banks to identify dependencies and eliminate bottlenecks and redundancies. Once this mapping is complete, the processes can be orchestrated as well as managed during exceptions in order to achieve optimal efficiency and effectiveness. Given the strong understanding that banks have of workflows, they are well positioned to push towards increased automation. Additionally, they can band together with a third-party vendor to more effectively attack the technological portion of the automation process.

This automation process is key to improving efficiency and solidifying the relationship between the financial institution and its clients. Banks need to ensure that information is well received, positioned, and utilized in order to be able to meet service level agreements (SLA) and provide relationship products. Integration is of the utmost importance as financial institutions must provide their corporate clients with detailed payment status and summary information. This information should come directly from the corporation's ERP system and is critical to providing a high-level overview of payments made between the corporation and its suppliers. Corporations will have an in-depth view of payments and related information, while banks will be able to process payments based on defined business rules, meet SLAs, and ensure overall client satisfaction.

Banks are in a strong position when it comes to integration. A large number of companies rely on banks to provide or receive remittance information. (According to the 2004 AFP survey, 78 percent of buyers relay remittance advice via a bank, while 85 percent of sellers receive remittance advice via a bank; these buyers and sellers send and receive via other processes as well.) While today banks make more money on the transaction piece—either directly or indirectly—than the information piece (e.g., remittance handling and reporting, positive pay), the importance of these revenues streams will flip over the next decade.

There are good examples of proactive banks that are taking the steps required to enhance payment transaction performance. One large U.S. bank had already decided in the late 1990s that it would invest in what it takes to be a global treasury bank in the 21st century. It realized early on that integration, automation, and information are where its future lies in treasury services. Over the past five years, the bank has invested heavily in building bridges, making the bet that its value proposition would resonate. The results have borne this out. Among its accomplishments is building a global trade portal as well as an online cash management service, which includes cross-border STP. Equally important to its financial supply chain infrastructure are the electronic bridges that it has been building between its systems and its customers' vital organs, including treasury management and ERP systems, thereby successfully increasing STP rates. The bank will soon complete integration with the SAP ERP system. In addition, it has adopted messaging standards to facilitate transactions and lower costs.

In order for banks to smoothly transition into the shifts taking place in the payments business, a variety of elements must move forward. Banks must take a deeper look into their payments business in order to gain a better understanding of the e-payments process. By taking advantage of this mapping and striving towards improved automation, banks will be well positioned to approach the next level – focusing on growing and nurturing customer relationships as well as providing rich information and integration options to a host of clients.

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Turning Compliance Pain into Operational Gain

By Neil Katkov, Manager, Asia Research Group
Cubillas Ding, Senior Analyst , Celent

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Financial institutions are suffering from compliance fatigue. The past several years have seen a seemingly never-ending stream of laws and regulations that require major organizational and technical response, at significant expense. Now, smarter institutions are working toward rationalizing their compliance programs in order to reduce duplicated effort, increase compliance efficacy, and, hopefully, derive operational and even business benefits from an area that is currently seen as a pure cost center. Consolidated data management and activity reporting technology is key to this effort.

U.S. financial institutions are now faced with two particularly strenuous compliance regimes: anti-money laundering (AML), mandated by the USA Patriot Act (October 2001) and other regulation, and financial transparency, governed by the Sarbanes-Oxley Act (SOX, July 2002). The Patriot Act essentially extended existing AML measures for banks, embodied in the Bank Secrecy Act, to a wide range of financial institutions and other businesses. Key provisions require financial institutions to implement an effective AML program (Section 352) and customer identification program (CIP) (Section 326), and to respond to government requests for information on customers and transactions (Section 314). In practice, these requirements translate into the following procedures: screening accounts and transactions against the OFAC watch list of blocked entities; monitoring and analyzing accounts and transactions to uncover potential money laundering or terrorist financing; and rapidly providing information on suspect accounts and transactions to government regulators. In addition, a financial institution must establish an independent audit function to test the effectiveness of its AML efforts.

While many financial institutions have purchased specialized AML software, other firms are leveraging existing technology investments in their Patriot Act compliance efforts. These include auditing software, business intelligence tools, and business process management and business activity management technologies.

Sarbanes-Oxley, passed in the wake of the high-profile bankruptcies of Enron and WorldCom, is aimed at ensuring transparent financial reporting in order “to protect investors by improving the accuracy and reliability of corporate disclosures.” The law requires that a corporation assesses, on an annual basis, the effectiveness of its internal controls for financial reporting and that this assessment be verified by an independent auditor (Section 404). SOX also requires corporations to disclose, within 48 hours, any material changes in its financial condition or operations (Section 409).

Companies have responded to these compliance requirements by making major upfront investments in organizational and process restructuring and supporting IT. Some firms have leveraged existing investments in risk management, data management and other areas for SOX compliance. Some existing tools that can help fast-track SOX compliance include application inventories (thanks to Y2K), regulatory filings, risk and control self-assessments by business units, and existing technology policies and methodologies. This list highlights the fact that first-generation SOX compliance has been a largely manual process. As a result, increasingly, institutions are looking to achieve greater efficiency in ongoing compliance activities. This means achieving a state where compliance activities are “business as usual,” in operational rather than project mode, and by automating processes and the verification of controls as much as possible.

Towards a More Efficient IT Infrastructure

In order to build a more efficient and cost-effective IT infrastructure, more and more institutions are looking for ways to increase flexibility and integrate exchange of data between multiple applications. In the context of spiraling compliance overheads and uncertainty around ongoing regulatory developments, there is a substantial increase in institutions looking to integrate multiple internal views across product, geographical, and channel applications, as well as externally between organizations. This is another symptom of the increasing burden from regulatory requirements, where cost efficiency in ongoing operations is a growing emphasis and compressed compliance deadlines are forcing institutions to respond more quickly.

As a result of these pressures, systems need to be more flexible to change and integrate. The concept of a single view of the customer is no longer relevant just in the context of front-office channels, but increasingly in the middle and back-office as well. Previously, the concept of a single view of the customer was often just discussed in the context of CRM and front-office channels. However, regulatory compliance requirements are now driving the need for institutions to extend the concept of a 360º view of the customer into the middle office. Regulations like Basel II mandate banks to take an enterprise view of their credit risks and require financial institutions to set aside appropriate safety capital. The implication from a technology perspective is the need to adopt a view of the customer across lines of business, which is often the single biggest challenge of financial institutions.

For instance, if a business customer does its banking with a particular financial institution in multiple regions or countries, or across business lines, it is likely that this customer will exist in multiple core banking systems and credit risk management applications as separate and distinct entities. This poses a risk to institutions in terms of understanding overall risk exposures, as well as increasing complexity in complying with regulatory reporting requirements.

The situation is similar in the case of addressing AML requirements. Customers may do business with different business lines, or in different geographies, within the same institution, making it difficult to get a full, real-time picture of their transactions and holdings. Money launderers actively exploit such disjunctions, exposing institutions to risk. Moreover, disjointed payment applications result in a fragmented view of the source of transactions at various stages within the payments cycle—from initiation, to routing, exceptions, case management, and clearing and settlement. This increases the complexity of creating efficient payments operations, as well as of fulfilling AML and know your customer (KYC) requirements.

To adequately deal with these challenges, financial institutions must manage and integrate data from siloed applications, across geographies, business lines, and system functions, and feed them into centralized monitoring and management systems to provide executive management with a bird's eye view of risk facing the institution.

Regulatory Convergence

Multiple regulatory mandates mean that large financial institutions are organizing themselves to address the bigger picture of governance and risk, not merely compliance. SOX and AML are two aspects of this order, which also includes risk management and the requirements of Basel II. While it is still early days as far as looking to optimize their regulatory initiatives, there are more forward-looking institutions who are putting in place regulatory convergence projects to institute a consistent approach tackling these multiple strands of regulation.

For example, a large U.S. credit card issuer of a top five U.S. bank mandated to comply with Basel II, while already completing its first round certifications for SOX, has begun to re-define its Sarbanes-Oxley (SOX) efforts in the context of Basel II's operational risk framework—adopting a risk-based approach to some of the SOX elements associated with risk, control matrices, and test scenarios, making it consistent with the overall operational risk framework used within the organization and using common technologies. These technologies include operational risk toolkits associated with risk/control self-assessments, loss data capture, key risk indicator design, reporting tools, workflow support, and business process monitoring, among others.

In the area of AML, many larger banks and brokerages have established separate compliance departments for each major business line—retail and corporate banking, for example. Typically, each business line's compliance department is headed by its own compliance officer and makes independent decisions regarding technology and procedures. There is, however, a trend at some firms to consolidate AML efforts into one department and to adopt technology to fight money laundering enterprise-wide.

In addition, some firms, particularly in Europe, are beginning to consolidate their various financial crime efforts into one department. This means combining the departments that work on AML, fraud, ID theft, employee fraud, broker market abuse, and, in some cases, security into one consolidated crime-busting unit. In the near term, some financial institutions will consolidate AML with both external and internal fraud teams into one division targeted at financial crime. Eventually, they may merge all compliance efforts—both organizational and technology aspects—into a truly enterprise-wide risk framework.

Currently, then, regulatory convergence is organizing itself along two major strands: the SOX - Basel II - risk management continuum, and the AML - fraud - security continuum. Ultimately, though, these two strands may fuse, creating centralized management of all the compliance requirements and risk exposure faced by an institution.

This is already starting to happen. Some firms are implementing compliance dashboards that deliver data from various business units and channels to one electronic portal, which can be customized for different stakeholders. Achieving this involves integrating enterprise-wide data and managing it effectively, as well as monitoring the data for relevant events and generating alerts based on this analysis. Such compliance dashboards are, essentially, business activity monitoring systems, with business intelligence and behavior detection technologies used in those areas that require complex analysis to uncover fraud, money laundering, or, in the area of SOX, improper financial structures and activities.

Turning Compliance Pain into Operational Gain

Fulfilling the growing spectrum of compliance requirements is a major cost center, as well as headache, for financial institutions. Increasingly, however, firms are seeking to leverage their technology investments in compliance to produce operational and business benefits. The technical requirements for fulfilling compliance include data quality, data management and integration, record retention and accessibility, and security. These requirements are consistent with those needed to address some of a financial institution's key operational and business goals: improving operational efficiency, reducing risk, increasing cross-selling, and providing products and customer service through multiple delivery channels. Moreover, integrating the technical infrastructure for compliance and business requirements in this way can reduce IT costs significantly—by up to 25 percent according to Celent estimates.

In the operational environment, access to accurate data and the ability to manage it in real time can speed processing of transactions, reduce the time needed to resolve exceptions, and streamline reconciliations. Further, integrating and centrally managing data from across the enterprise can speed both internal and external reporting and audit procedures, as well as enable a firm to concentrate its back-office processes to realize further efficiencies.

In terms of leveraging compliance investments for direct business benefits, several banking institutions have adapted account monitoring systems originally developed to combat fraud or money laundering into, for example, CRM tools that analyze customer data and activities to find cross-sell opportunities. Although a financial institution must be sensitive to consumer privacy issues in pursuing such a strategy, it suggests one area in which compliance investments can be leveraged to produce business benefits.

Smarter financial institutions, in short, are working to put the best face on a growing compliance burden, by aiming for a consistent, unified approach to data management, integration and activity monitoring and analysis that can provide operational and business benefits at the same time as they help fulfill a firm's regulatory and compliance responsibilities.

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