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McKinsey on Payments

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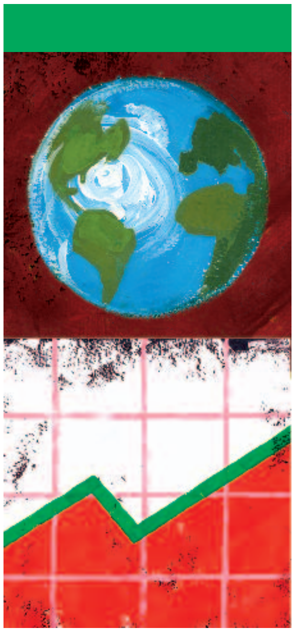

Rethinking correspondent banking

Correspondent banking—in which one financial institution carries out transactions on behalf of another, often because it has no local presence—has been used as the instrument for cross-border payments since the time of the Medicis. The intervening centuries have brought surprisingly little in the way of fundamental change, and banks still generate considerable value from cross-border payments. According to the 2015 McKinsey Global Payments Map, these transactions represent 20 percent of total transaction volumes in the payments industry, yet they generate 50 percent of its transaction-related revenues (Exhibit 1, page 4).

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What's more, revenue margins in cross-border payments have remained healthy over time. As margins for domestic payments were squeezed by regulation and competition in recent decades, banks were forced to pare back costs and improve the efficiency of their systems and products. But cross-border payments have not yet experienced such pressures, so banks have had little incentive to work on their back-end systems and processes or to develop innovative customer offerings.

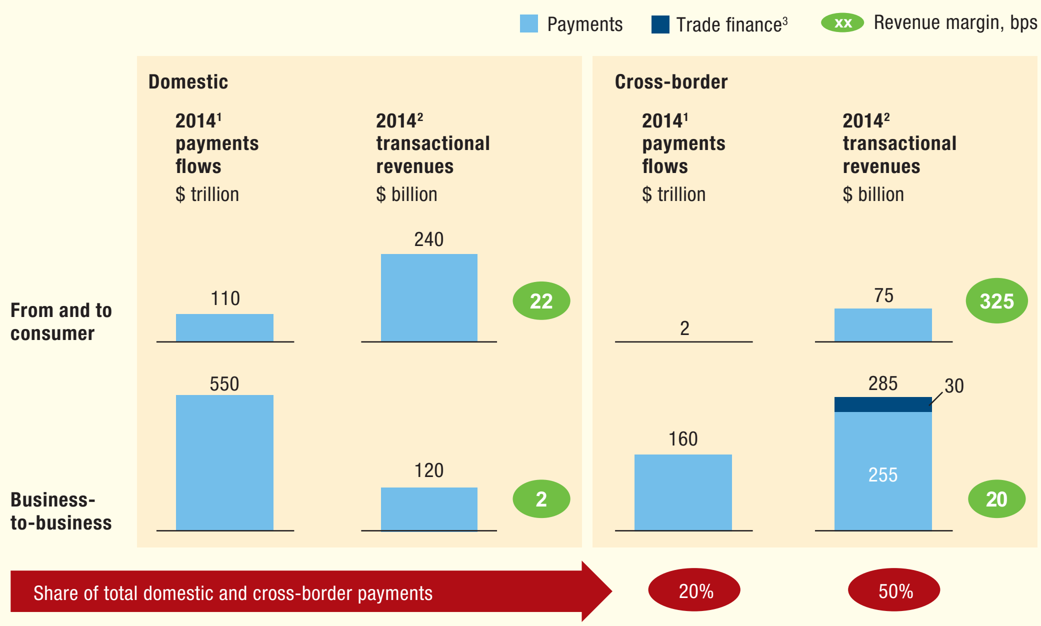
That is now changing. The traditional correspondent banking model for cross-border payments has come under acute pressure from customers, regulators and competitors alike:

- Customer expectations for real-time, digitally enabled cross-border payments are growing as domestic retail payments undergo rapid digitization.
- Regulatory compliance is driving up the cost of cross-border payments systems and forcing banks to review their correspondent relations.
- Digital innovators are attracting customers with new solutions and enhanced value propositions that threaten not only to cut banks out of their correspondent banking relationships but also to loosen banks' ties with end customers, at least where payments-related activities are concerned.

If these growing pressures were to drive cross-border revenue margins down to domestic levels, industry revenues would drop by 70 percent, inflicting losses of $230 billion on banks globally. To avert this stark

Exhibit 1

Cross-border payments represent 20% of global payments flows but 50% of transactional revenues



[1] Excluding flows between banks.

[2] Includes transaction fees, float income and FX fees; excludes revenues not directly linked to individual transactions, mostly maintenance fees, net interest income, and incident fees related to cards.

[3] Includes fee revenue from documentary business but not revenues from trade-related financing.

Source: McKinsey Global Payments Map

scenario, banks need to embrace change and grow the market by delivering new customer solutions through far more efficient operations. This article examines how correspondent banking is changing and proposes options for banks to consider to defend and enhance their position in cross-border payments.

Drivers of change

Three forces are driving change in correspondent banking: the customer imperative, the efficiency squeeze and the nonbank offer.

The customer imperative

As consumers and businesses grow accustomed to the benefits of using technology in their daily lives, their expectations rise. In financial services, digital entrants are offering products and services with thoughtfully designed user interfaces that provide a great experience in terms of transparency, convenience, price and speed. These benefits are gradually becoming table stakes for all participants in the industry. Meanwhile, domestic payments are moving to real-time solutions at marginal cost to the user. Cross-border payments have yet to embrace these developments, and the gap between customers' expectations and their experience is widening.

In fact, cross-border payments continue to be expensive, slow and lacking in transparency on both costs and delivery times. In 2015, a McKinsey survey on consumer cross-border payments found that consumers typically pay a fee of €20 to €60 on top of the prevailing foreign-exchange spread. And this fee does not even guarantee timely delivery: although most cross-border payments could in theory be executed in one to two days, the survey revealed that a typical retail cross-border payment took three to five working days to complete.

More positively, the correspondent banking network still provides distinctive benefits to users. It remains the only solution that is genuinely ubiquitous. It can reach any country or currency and can be used by anyone with a bank account. It is also safe. Banks act as trusted providers of both bank accounts and the elaborate compliance-driven regulatory framework that guarantees necessary security for the cross-border payments that underpin the global economy.

Even leading transaction banks can no longer afford to maintain large international correspondent bank networks, and have been closing down less profitable locations.

The efficiency squeeze

Maintaining an open global network across many different standards and under a strict regulatory framework incurs high costs for banks, making cross-border transactions considerably more expensive than domestic payments. Even leading transaction banks can no longer afford to maintain large international correspondent bank networks, and have been closing down less profitable locations and reducing the extent of their networks. During 2013 and 2014, one leading U.S.-based global bank stated that it had cut ties with 500 network banks, mostly in the Middle East.

The complexity of cross-border transactions brings with it a relatively high failure rate. A 2015 study by Traxpay indicates that about 60 percent of business-to-business (B2B) payments require some kind of manual intervention, each taking at least 15 to 20 minutes. Major variations in account structures, messaging and bank systems generate far more corrections, investigations, returns and stalled payments than are seen in domestic payments or in payments where one party controls the transaction from beginning to end. Over 90 percent of the resulting costs are incurred in banks' efforts to manage counter-party bank relationships in the back office, rather than in the technologies and networks that handle the value transfers between banks. As a result, the cost of handling international payments is counted in dollars, not cents.

The nonbank offer

The high margins and low efficiency of cross-border payments have long attracted the attention of money-transfer operators (MTOs) such as MoneyGram and Western Union. In the past, these companies mostly targeted unbanked or under-banked consumers and differentiated their offerings by speed, convenience and predictability rather than price. They barely competed with banks, as each institution targeted different segments: banked customers and businesses for banks, and unbanked customers using cash-to-cash payments for MTOs. Today MTOs command some 40 percent of global revenues for cross-border consumer-to-consumer (C2C) payments, but less than 5 percent in the business-to-consumer (B2C) and B2B segments.

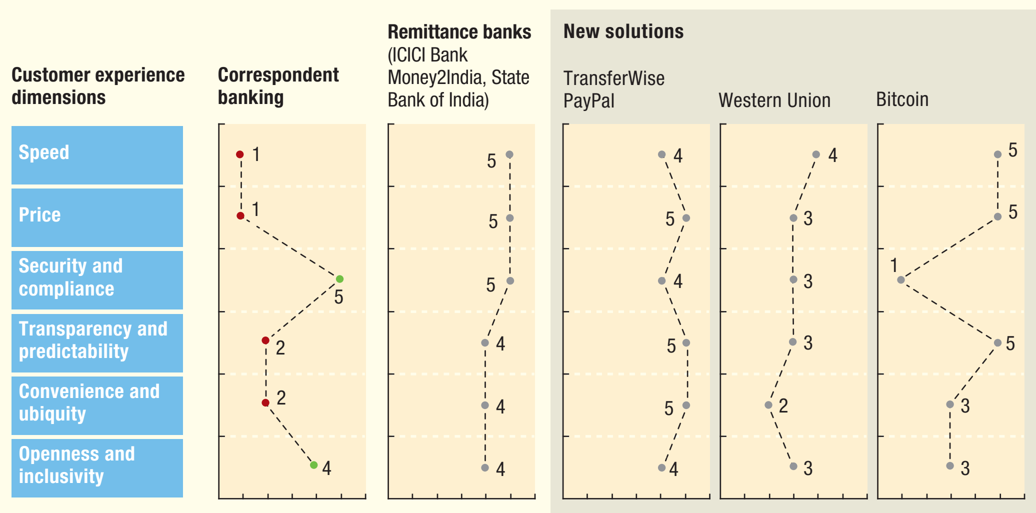
But things are changing. PayPal was the first successful digital player to threaten banks' payments business. More recently,

Exhibit 2

New solutions outperform correspondent banking on most dimensions of customer experience

Customer-to-customer cross-border payments; customer experience ranked 1 to 5 (1 lowest, 5 highest)[1]

Worse than the average for new solutions
Better than the average for new solutions



[1] McKinsey researchers acted as retail customers and transferred €100 or the local currency equivalent back and forth across a set of corridors (routes between the sending and receiving countries, such as UK to India) chosen to be representative of the market conditions encountered by customers across the globe.

Source: McKinsey Global Payments Practice

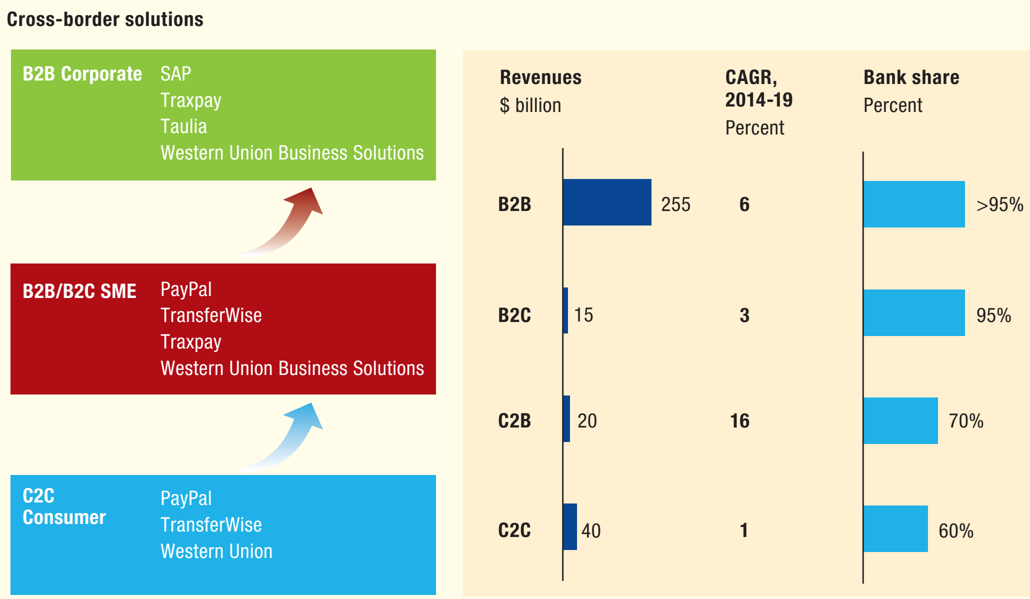
digitally enabled attackers have intensified competition by altering the ways that payments are made. Companies such as TransferWise and Xoom have gained traction with banked as well as unbanked customers by offering superior consumer value propositions for C2C cross-border transfers, outperforming traditional correspondent banking offerings on key dimensions such as price, speed, convenience and transparency (Exhibit 2). For instance, TransferWise provides full upfront transparency on fees, exchange rates and delivery time at a very low cost. Seeing the opportunity, MTOs are rapidly boosting their digital capabilities. Some banks, including India's ICICI, have also started offering customer experiences comparable to those provided by digital attackers, and are bypassing the traditional correspondent banking infrastructure.

This disruption is now moving up at an accelerated pace from C2C to business-driven cross-border payments, starting with small and medium-sized enterprises (SMEs) (Exhibit 3). Companies such as Traxpay and Taulia provide business solutions for financial supply chains that mimic the features of consumer digital offerings, including payments functions. Western Union's wu.com offers an increasing array of business services. Companies such as Earthport deliver cross-border mass payments such as payroll at lower costs using a direct link to local automated clearing houses.

These solutions often include support for integrated accounting software (as PayPal provides with Intuit), supply-chain finance or dynamic discounting (like Taulia). For trade, some solutions redefine the customer need by introducing services such as conditional payments, as Traxpay does, or alternative fi-

Exhibit 3

Disruption is shifting from consumer to SME and corporate, where banks derive most of their transaction revenues



Source: McKinsey Global Payments Map

nancing, like Alipay. All of these innovative offerings weaken banks' relationships with their customers.

Such moves by new players are triggering change in correspondent banking. As Exhibit 3 shows, B2B cross-border payments account for almost 80 percent of all cross-border payments revenues, and this segment is expected to grow rapidly as the economic role of SMEs expands and their supply chains fragment. For banks, maintaining their hefty share of this sector—more than 95 percent—is a battle worth fighting, especially since new rivals increasingly offer links to other services such as alternative sources of financing or fully digital foreign-exchange services.

Overall, the new wave of innovation set in motion by financial technology providers is proving unsettling for many banks, especially those with strong transaction banking franchises that have the most to lose.

Rethinking correspondent banking

Banks are aware they need to act. At Sibos 2015 in Singapore, a session on the need to reinvent correspondent banking attracted the second-largest attendance of the week. Cross-border payments must become cheaper, more transparent and more efficient. Although change will mean forfeiting some revenues in the short term, success will bring substantial rewards in the form of structurally lower costs, higher volumes as SMEs and commerce globalize, and opportunities to cross-sell to satisfied customers.

But banks face a challenge. How can they quickly change while continuing to meet customer expectations, remain compliant and maintain their global reach? Moreover, this is not a time for going it alone: collaboration will be key to ensuring reach and adoption. There are three major initiatives that banks need to pursue in parallel:

1. Redefine core processes and customer value proposition

Change is inevitable in cross-border payments. Smart banks will work to future-proof their products by accelerating operational redesign and rethinking their customer value proposition.

Banks that prepare now will capitalize on the opportunities that emerging interbank capabilities will create, including shorter cycle times, increasing cross-sell opportunities and lower operational costs.

Legacy architecture will need to be overhauled to meet the coming real-time imperative. That means reconstructing core banking platforms so that they can be updated in real time; ensuring that fraud platforms and processes can operate in very near real time; and making clearing systems capable of handling real-time exchange of information, posting of transactions to customers and funds availability. Operational changes will also be needed to move toward 24/7 availability.

Even with today's internal and interbank operational constraints, banks have ample opportunities to revisit their cross-border payments value propositions to bring them more into line with those of attackers, especially where pricing and transparency are concerned.

Banks that start to prepare now will be able to capitalize on the opportunities that emerging interbank capabilities will create, including shorter cycle times, increasing cross-sell opportunities and lower operational costs. Getting ahead of the curve will enable them to benefit from changing customer expectations, while taking advantage of the global footprints that give them a distinct advantage over new attackers.

2. Move to correspondent banking 2.0

Banks can already deliver payments in less than a day, and at cost levels comparable to those of attackers. However, this applies only to clean straight-through-processing (STP) payments between banks that strictly adhere to industry practices. Not all payments follow this pattern, and the exceptions dramatically increase the overall cost to the system. Increasing the share of STP payments or differentiating them from the exceptions would allow banks to bring cross-border payments to market at prices on a par with attackers' offerings, while safeguarding margins. And this could happen in a very short time frame.

To reduce inquiries and corrections and speed up payments times, banks could establish a clear set of enforceable obligations on how to initiate and collect payments, and set maximum limits on response times between banks. This could be achieved with today's technology, but would require strong commitment among participating banks and an enforcement mechanism for any failure to comply with requirements—neither of which is in place yet.

Another major improvement would be for banks to inform payors in advance about the total cost of a transaction and its “crediting” time, as well as confirmation when the beneficiary is credited. The real-time tracking of payment status would be even better. No technical wizardry would be required, but banks would need to share information, handle confirmations diligently and ensure they communicate appropriately with customers. To make this happen, banks could introduce a binding industry rulebook enforcing the sharing of standardized information across the payments journey and defining who charges for the transaction.

These modifications could usher in a new world of cross-border payments where transactions are handled in a real-time flow and delivered on the same day anywhere in the world with full upfront end-to-end pricing transparency and real-time tracking for the customer. Such a value proposition would match or even exceed those of emerging providers hampered by local infrastructure capabilities.

3. Investigate new infrastructure technologies with a mid- to long-term view

In this age of digital innovation, banks are paying a lot of attention to new networking technologies that promise greater efficiency, especially distributed ledger solutions such as blockchain. Such technologies bypass existing infrastructure and connect banks directly across the world, as well as provide alternative sources of settlement, such as the concepts developed by Ripple. (See “Toward an Internet of Value: An interview with Chris Larsen, CEO of Ripple Labs,” *McKinsey on Payments*, Volume 8, Number 21, May 2015.)

However, solutions based on these technologies are still in their infancy. It will take time for them to achieve universal reach in destination and currencies, resolve compliance questions, and equip themselves to handle the high-value, high-volume payments required for international trade. To be valid alternatives they would also need to enable full connectivity across all countries, currencies and bank accounts worldwide—a massive undertaking.

The immediate focus of these new solutions should be on reducing banks’ back-office costs rather than improving infrastructure. Early blockchain initiatives are therefore likely to focus on internal operations first.

Finally, solutions based on distributed ledger technologies still require banks to make correspondent-like agreements to define the rights and obligations of participants in these systems. Technology alone is not a sufficient condition for success. As a result, the investments that banks make in simplifying and tightening their existing correspondent banking relationships are likely to be useful even when new technology-based solutions reach maturity.

* * *

Tomorrow’s cross-border payments will go beyond utility models based on legacy systems and old-school correspondent banking. They will adopt future-proof digital technologies and industry standards that promote cross-country integration and greater transaction efficiency. Such moves can help banks redefine their international networks, reduce the need for manual intervention in investigations and reconciliation, and deliver customer value throughout the transaction cycle.

These changes will mean much lower prices for cross-border payments and lower shares for banks, forcing them to review their commercial and operational set-up. However, a business with improving operational performance, more accessible global commerce solutions and better service to customers can accelerate volume growth, be more profitable, and make corporate and retail customers happier.

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