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Winning in Transaction Banking in Asia

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Winning in Transaction Banking in Asia

Transaction banking has emerged as a priority area for many banks, due to its attractive and stable post-risk returns and traditionally high level of customer loyalty. The sector has been spared the rising capital charges associated with asset-based businesses, and therefore often outperforms those businesses in terms of earnings. A recent McKinsey study found that the operating annual return on risk-weighted assets for a sample of European banks with a declared focus on transaction banking was around 5.3 percent, compared with 2.3 percent for traditional corporate banks.

The largest transaction banking opportunity globally is Asia, which accounted in 2012 for more than half of worldwide transaction banking revenues. As a result, large global banks, Asia-focused regionals and domestic incumbents are converging to enter or expand in the region.

This paper presents McKinsey's perspective on the Asian transaction banking market and a picture of the evolving competitive landscape, before setting out five strategic priorities for institutions seeking to build a strong transaction banking franchise in the region.

To win, banks must take a strategic approach to innovation and develop an organizational structure that fully supports the strategy. Banks must strive for excellence in sales effectiveness and pricing, and make targeted investments in the technology needed to serve transaction banking customers in a differentiated way. The effort required will be significant for most banks, but the reward will be increased share in a growing market.

The Asian transaction banking opportunity

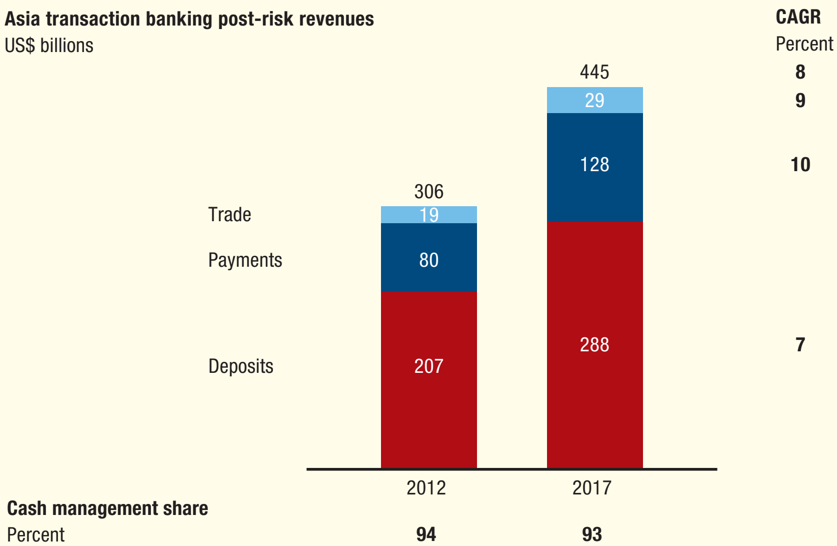
The Asia-Pacific region[1] has emerged as the world's largest transaction banking market, with post-risk revenues estimated at around $323 billion in 2012, or 53 percent of the global opportunity. According to McKinsey's Global Banking Pools data, the market is expected to grow at about 12 percent annually through 2017, when revenues should reach $578 billion (Exhibit 1, page 2).

Growth will be driven primarily by float income, which is projected to rise at a compound annual growth rate of 13 percent, due largely to an expected widening of current account spreads in China as the local regulator tightens liquidity to curtail shadow banking. Payments revenues are projected to rise at a compound annual rate of 10 percent, while trade revenues should grow

[1] Includes China, Taiwan, Hong Kong, India, Korea, Japan, Australia, Singapore, Thailand, Malaysia, Indonesia, Vietnam and the Philippines.

Exhibit 1

Asia transaction banking revenue pools will continue to be driven by cash management



Source: McKinsey Global Banking Pools

at 9 percent. Float income from deposits will continue to account for more than 70 percent of the aggregate opportunity.

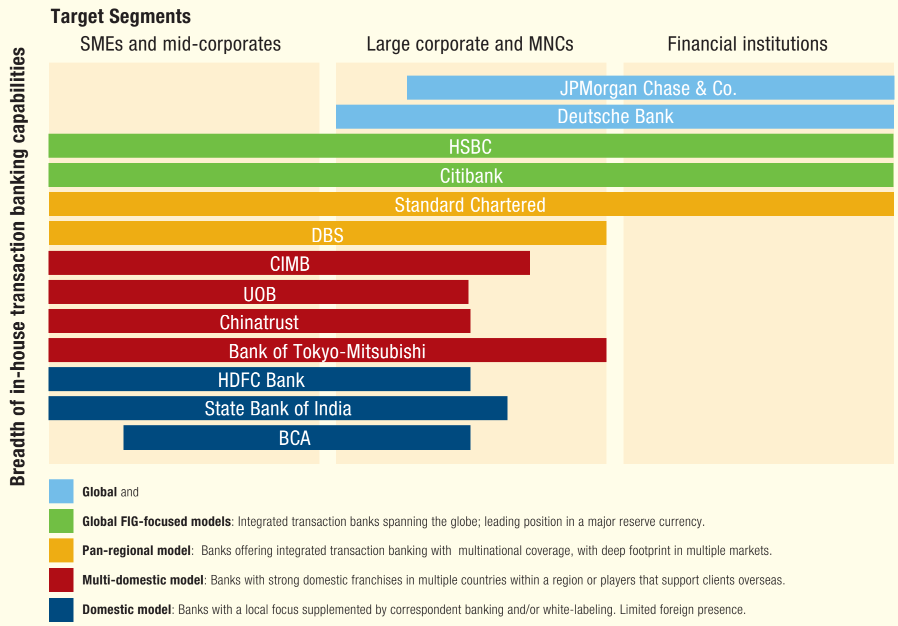
For the purposes of this report, transaction banking includes cash management, domestic and cross-border payments and documentary credits, but excludes security services. About 94 percent of the business comprises deposit and payment fees, suggesting that domestic incumbents enjoy an inherent advantage over global competitors.

From a geographic standpoint, China is likely to account for about three-quarters of Asian transaction banking revenues in 2017, and more than 85 percent of current account float income. These revenues, however, will be difficult for foreign players to access, given the dominance of incumbent players in terms of branch networks and preferential relationships, in particular with state-owned entities. The next-largest opportunity is the ASEAN markets,[2] which are projected to account for 8 percent of total revenues in 2017; Indonesia and Philippines will account for about half of the ASEAN total. Significant

[2] Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

Exhibit 2

The five transaction banking business models in Asia are based on geographic presence and target segments



Source: McKinsey analysis

opportunities will also exist in the developed markets of Japan (4 percent of 2017 revenues), Australia (3 percent) and South Korea (3 percent). India is likely to account for less than 3 percent of revenues, reflecting McKinsey's projection of flattening float income alongside strong competition.

An evolving competitive landscape

There are five primary transaction-banking business models common in Asia, and they may be defined by geographic and target customer parameters (Exhibit 2). Increased overlap in segment focus is leading to more competition. For example, global players are increasingly targeting mid-corporate and even small and medium-size enterprises (SMEs)—the traditional domain of domestic incumbents. HSBC, for example, facilitates international economic connectivity for its global multinational customer base and middle-market and SME firms in Hong Kong, the UK and 20 other growth markets. This focus on cross-border commercial banking is a direct result of the bank's efforts to deleverage in several western markets that have stringent regulatory capital standards.

Local players, meanwhile, are expanding both geographically (away from their domestic markets) and in terms of capabilities. A Greenwich Associates survey[3] shows that local banks now match foreign institutions for domestic cash management in markets including India, Indonesia, Singapore, South Korea and the Philippines. As a result, foreign bank market share in domestic cash management in Asia fell to less than 60 percent in 2012, from 74 percent in 2005.

In trade finance, domestic banks perform well on pricing and service and operational capabilities, while foreign banks are seen to have superior networks, according to Greenwich. Foreign players are also considered to have better sales effectiveness in trade finance, driven at least in part by higher specialist coverage.

Five strategic priorities for improving transaction banking

Asia's growing transaction banking market is also in flux, as global institutions and local banks seek to expand their opportunities. To succeed, players across the spectrum will need to improve capabilities in five areas:

1. Innovate across products and channels to deliver customized solutions to priority segments or customers.
2. Refine organizational structure and coverage models.
3. Improve sales productivity.
4. Reduce pricing leakage.
5. Make targeted IT investments to build cost-efficient operating platforms

1. Innovating across products and channels

Several banks are innovating across transaction banking products and channels to deliver value-added solutions that increase wallet share and customer stickiness. In one recent example, a large regional Asian bank used a consultative approach to supply chain finance that required the bank's relationship managers to shift from a traditional lender mind-set to one that could be described as "client CFOs". RMs were trained in supply chain dynamics and in the drivers of customer business value, giving them a foundation for

[3] "Large Corporate Cash Management Market Trends," Greenwich Associates, 2012

developing creative finance solutions. To drive execution, the bank built a tablet-based solution that gave RMs access to industry benchmarks they could use to build scenarios. Early results at five pilot clients freed up more than $1 billion of working capital, and clients saw 30 to 50 percent reductions in working capital requirements, 20 to 40 percent reductions in days sales outstanding and 20 to 60 percent improvements in days payable outstanding.

Another approach to innovation involves the development of industry-specific solutions across the value chain (Exhibit 3, page 6). This approach requires banks to break down organizational silos, combining lead RMs with product specialists in areas including cash management, trade, structured finance, mobile payments, corporate finance advisory, payroll and treasury. This can be a challenge, as RMs and cash and trade specialists are often housed in wholesale banking, while mobile payments and payroll may be located in retail banking, and vendor financing may be part of a separate SME function. To bring these capabilities together it is important that change is driven from start to finish by senior management.

Another approach to innovation involves the development of industry-specific solutions across the value chain.

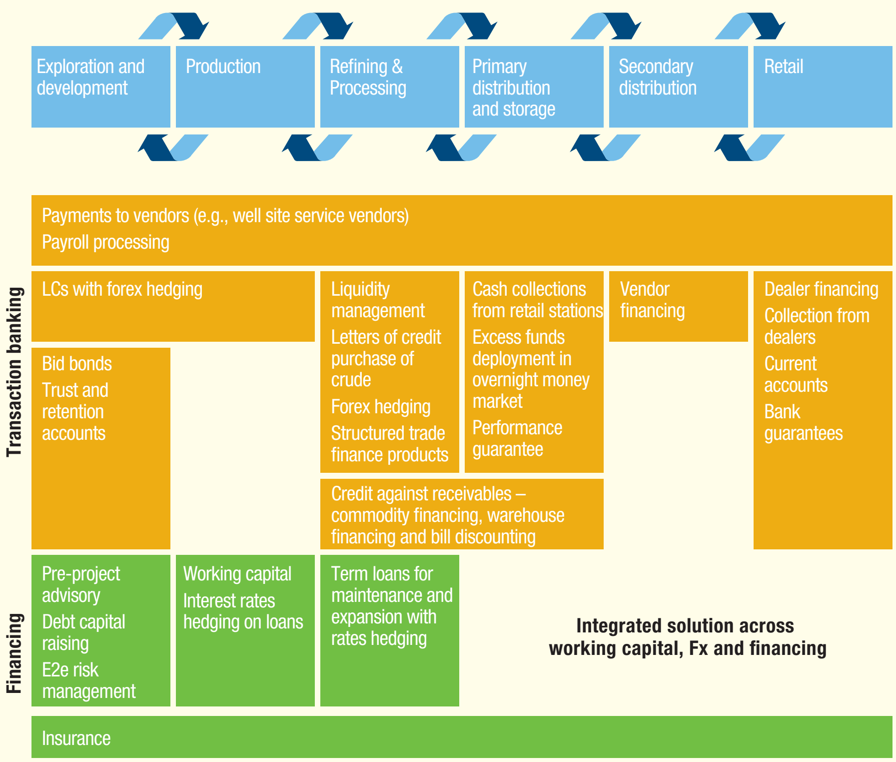
Despite a willingness to innovate, many banks currently lack the necessary capabilities to deliver results. Foreign banks, for example, may be unable to offer corporate distributor financing products or may have insufficient balance sheet resources. Domestic banks may lack the expertise to offer supply chain finance solutions and may find offshore risk difficult to assess. Execution can also be a challenge, as most suppliers and distributors retain existing banking relationships.

In the face of these challenges, banks must strengthen other aspects of their transaction banking approach: for example, identifying sectors and parts of the value chain that are underserved; expanding their network; and developing a specialist sales force and service staff.

Focusing on the value chain, banks must ensure that the incentives of branches required to provide distributor financing are aligned with those of the business unit serving large corporates. Where branches and business units have the same business unit head, this alignment is achievable. But where control is in the hands of different leaders or business units, the large corporate group usually enjoys the float income, while the SME unit takes the credit risk (financing is usually provided without recourse to the anchor corporate). If this is

Exhibit 3

Successful players have designed sector-specific solutions with product offerings across the value chain



Source: McKinsey analysis

the case, branches can be reluctant to finance SME distributors, putting the program at risk. One local Asian bank addressed the issue with a revenue-sharing arrangement between the large corporate and SME business units. Thirty percent of float income from the large corporate account was shared in direct proportion to the extent of distributor financing executed by the branch.

Banks have also turned to technology to ramp up their product offerings. One approach integrates global supply chain finance with Electronic Invoice Presentment and Payment (EIPP) and cross-border supply chain finance. In this case, the focus is primarily on multinational and large corporate customers as buyers and SMEs and mid-corporates as sellers. The solution offers capabilities for purchase order tracking, invoice matching services and e-invoicing, open account payments and end-to-end financing solutions, including reverse factoring. Importantly, banks taking this approach must secure buyer participation before on-boarding suppliers.

Over time, the aim should be to achieve a completely paperless process fully integrated with the cash management platform. A major advantage of the approach is the capital-light nature of supply chain finance (particularly considering Basel II and III treatment of traditional trade finance instruments).

In a subdued economic environment, banks have also begun to invest in innovative value-added services aimed at enhancing supply chain stability. One leading corporate bank offers “business status alerts” that allow corporate clients to review the creditworthiness of their business partners. The service is available at different levels, from single to unlimited inquiries, and customers receive alerts when a business partner’s credit score changes. A related service enables customers to verify the identity of their business partners, while a third is focused on check verification.

From a channel perspective, technology-driven solutions for mid-corporate and SME customers include integrated cash management, working capital and investment management portals, and enterprise resource planning (ERP) integration brought ‘down-market.’ Banks that have executed this successfully include PNC, with its Cash Flow Optimized (CFO) electronic banking offering, and Wells Fargo, with its Commercial Electronic Office (CEO) solution.

Another channel innovation focuses on offering customers access flexibility. A leading European bank in its home market provides corporate customers with a choice of using an Internet- or software-based application. For Internet banking applications, the bank provides a USB stick on which the digital signature of the corporate is stored, offering direct access to the corporate banking portal log-in page without the need for a URL or installed software. The bank has also set up a web trade application for online processing of letters of credit, guarantees and collections. The application has built-in templates and samples and a copy function to avoid duplication of data entry. Automated plausibility checks minimize the chance of errors.

2. Refining the organizational structure and coverage models

Transaction banking divisions are typically organized on the basis of one of three basic operating frameworks: as stand-alone businesses reporting directly to the CEO or to the head of wholesale banking; or as separate cash management, securities finance and trade finance functions reporting to different heads.

As a general rule, global banks tend to operate under the first framework, while local banks use the second or third options. However, recently many local banks are migrating to the global bank model.

The optimal structure depends largely on the maturity of the transaction banking unit and the relative importance of product versus geography. Banks in an early stage of development can benefit from enhanced management focus, suggesting a single unit would work best. A standalone and integrated transaction banking business is likely to provide greater synergies in product development, sales, client servicing, operations and IT.

Organizations with a strong product focus, as opposed to geographic focus, may be better served by a direct reporting line from transaction banking units to regional or global heads. Units with a geographic focus may thrive by reporting into country or corporate banking heads. For nearly all global banks, local transaction banking units have dual reporting to the country head and the regional or global transaction banking head.

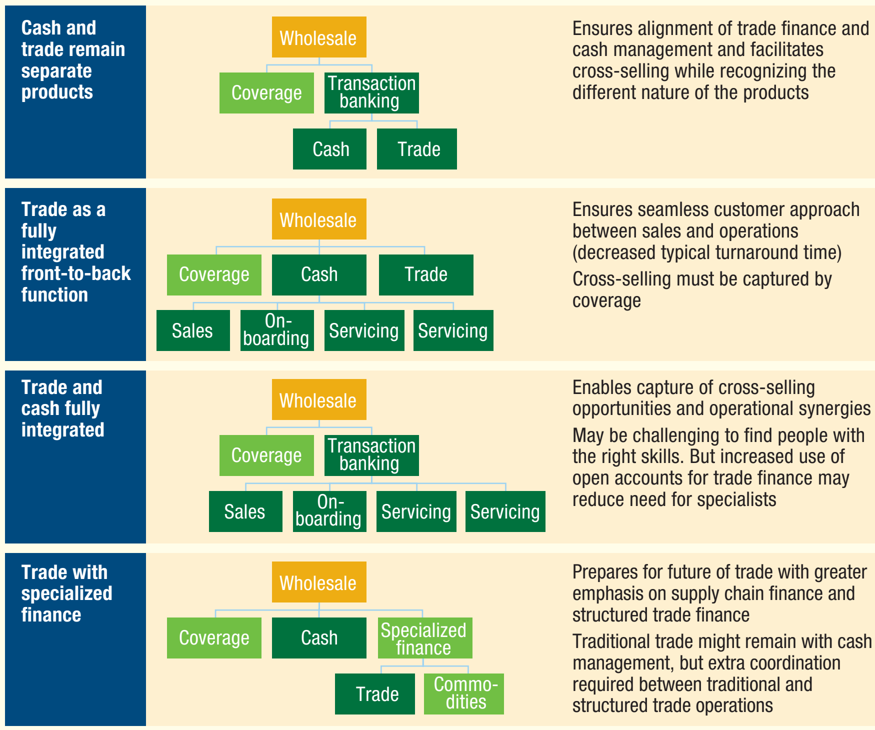
Another organizational consideration is the degree of integration across the three major product groups in transaction banking: cash management, trade finance and securities services. In most cases, securities services are handled by a separate team, which makes sense given the specialized nature of the products and skills required (e.g., fund accounting, regulations) and its focused client base (e.g., financial institutions, real estate, legal). For cash management and trade finance, the ideal degree of integration depends primarily on the amount of convergence between cash and trade, and to a lesser extent on the availability of talent.

When all the factors are considered, there are four models for a product specialist organization (Exhibit 4). One increasingly common approach is integration of cash management and trade finance, reflecting the proliferation of open accounts in Asia. According to the Greenwich survey, open account trade finance accounted for one quarter of trade finance spending in Asia in 2012. An integrated structure reduces coordination issues that may arise with separate cash and trade sales staff liaising with the customer.

Banks can also approach the organizational question by dividing responsibilities between coverage and product specialists. Typically, the RM is the single point of contact for the customer, and he or she provides access to product specialists. However, product specialist capacity is usually allocated based on the relative size of clients and the complexity of their needs. There are three basic approaches to segmentation:

Exhibit 4

Four structures for product specialist organization have emerged



Source: McKinsey analysis

- **Segmentation by size.** In this model, large corporate customers and multinationals are served through a client service team (CST) comprising an RM and dedicated product specialists who tailor products to client needs. While the RM interacts with senior management, transaction banking specialists typically liaise directly with functional managers (e.g., human resources for payroll, procurement for payments, accounts receivable for collections).

  For mid-corporate clients, there is no dedicated product specialist support. The RM leads client discussions and involves transaction banking specialists as they are needed. There may be some limited mass customization. Finally, for SMEs there is practically no product specialist involvement, with RMs trained to offer customers vanilla products with no customization.

- **Segmentation by profitability, wallet size and business potential.** With this more nuanced approach, product specialists focus only on customers with high current wallet or high potential. Large corporate clients with low potential would not receive dedicated specialist support.
- **Segmentation by complexity of needs.** In this model, the bank systematically evaluates clients and only provides RMs for clients that have complex needs such as capital markets transactions. All others are managed by a product specialist who is trained to assess credit risk. Sales specialists are mapped against clients based on primary transaction banking needs. The specialists are provided with training on working capital financing but pull in colleagues to help in the event of more complex demands.

3. Improving sales productivity

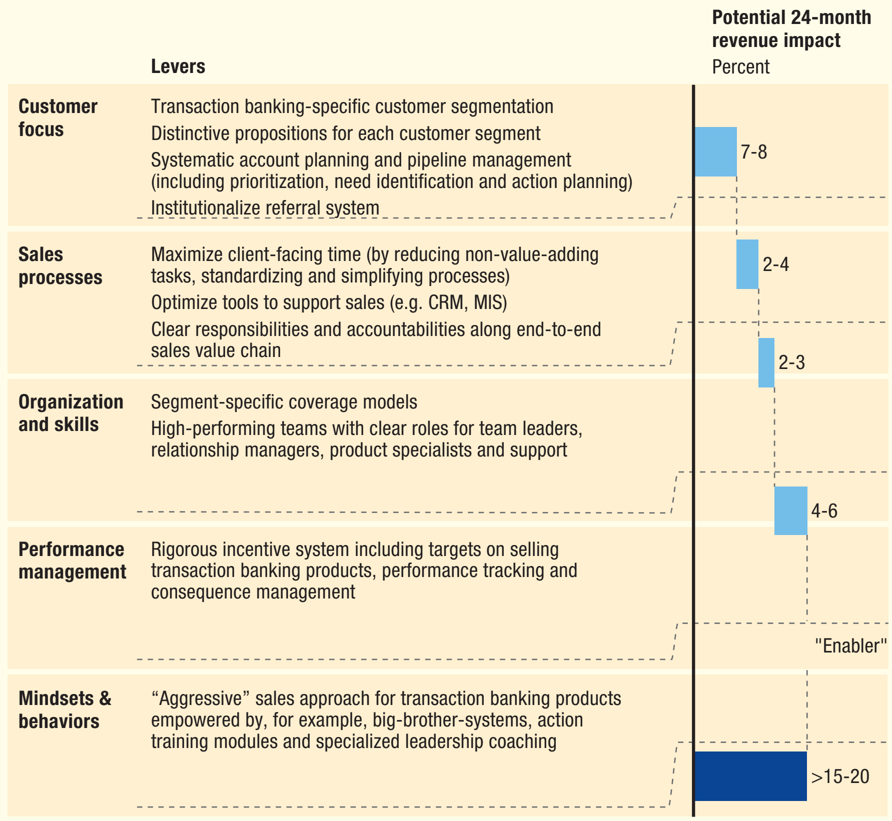
Transaction banking sales productivity can be improved by 15 to 20 percent by applying sales and productivity levers to front-line sales (Exhibit 5). The foundation for increasing productivity is a disciplined account planning process, undertaken at a minimum annually. This effort can be led by the RM but requires active involvement of product specialists from cash, trade and treasury. The outcome of the account-planning process is a prioritization matrix can be used to identify transaction banking market opportunities where the bank is underpenetrated.

A simple approach to prioritization involves measuring transaction banking revenues as a proportion of short-term lending revenues against wallet share of short-term lending. High-potential customers are those for whom the bank has a high share of wallet for short-term lending but a relatively low proportion of transaction banking revenues. Once the prioritization process is complete and clients identified, a product penetration map can be created to identify cross-selling opportunities against client needs. At this stage, the RM should work closely with transaction banking specialists to identify opportunities.

From a process perspective, there are a number of important steps in improving sales productivity. Banks need clearly established sales routines to improve the quality and sales impact of time spent with clients. Standard presentation modules can dramatically improve meeting effectiveness. A streamlined credit process with clearly defined responsibilities and standard service levels, along with daily sales reporting, can also improve productivity. These measures can result in up to a 45 percent increase in client meetings per week.

Exhibit 5

Sales and productivity levers can boost transaction banking revenues by 15 to 20 percent



Source: McKinsey analysis

A common challenge faced by many banks is the cross-sell of foreign exchange (FX) products linked to trade flows. In practice, banks have adopted multiple approaches to addressing this issue (Exhibit 6, page 12). While the best approach will depend on an organization's culture, measures to increase FX cross-sell can yield significant results. One bank introduced hard revenue-sharing arrangements between the trade team and the treasury team that resulted in a 30 to 60 percent increase in FX revenues across multiple markets in Asia.

Another important sales productivity lever is mind-set and capability-building for front-line salespeople. Several banks have had success with a structured field and forum format, in which program participants learn specific skills in

Exhibit 6

A number of approaches can increase cross-sell of foreign exchange products related to trade flows

Hard revenue-sharing between treasury and product team	Develop explicit and pre-defined "hard" revenue-sharing arrangements (50/50 or 60/40) for specific kinds of products, e.g., forex for bill collections
"Sales credit" and bonus pool feeding	Salespeople get a "sales credit," which is a theoretical P&L (e.g., equal to 1/4 of the bid/offer spread at the time when they close the deal) Total sales credit is converted into revenues for the product sales bonus pool after negotiation between heads of business lines
Explicit cross-sell KPI for product teams	Assign a specific cross-sell target on FX revenues generated to members of transaction banking sales team
Profitability metric for relationship manager to drive fee cross sell	Approval for initial limit setting is subject to the account generating a return on risk-weighted assets (RoRWA) of 4%, forcing focus on flow fixed income Relationship manager performance includes a hurdle rate for overall RoRWA from clients managed
Internal customer satisfaction KPI for product units	Develop internal customer satisfaction metrics so that each product group rates the support provided by other product groups. Encourages transaction banking team to inform treasury of potential deals

Source: McKinsey analysis

a series of classroom-type forums, and are then asked to execute on related projects in their home market. A critical enabler of this program is the mentorship provided to program participants during fieldwork. Another is to run the program in a competitive setting with a high degree of senior management visibility.

4. Reducing pricing leakages

Analyses of several bank portfolios reveal a high degree of value leakage due to sub-optimal pricing decisions. A number of factors contribute to these poor decisions: unclear pricing and discount/waiver guidelines, poor account planning, lack of understanding of competitive position and over-optimistic assumptions regarding customer transaction volumes. In addition, performance evaluation and incentives are often based on revenues instead of profitability, motivating RMs to win at any cost. It is not uncommon for banks to offer generous discounts to marginal customers, with little correlation between pricing and customer volume.

Exhibit 7

Six structural levers can help in setting the right price and enforcing its application

Set the right price	1. Price referencing	Basic external/internal benchmarking Risk-based elements and several price list systems Different funding cost-calculation methodologies
	2. Discounting	Commercial discount strategy/policy Discounting rules and responsibilities Technical leakage reduction/elimination
Enforce its application	3. Monitoring	Profitability monitoring Leakage management Responsiveness
	4. Repricing	Repricing targets Repricing execution
Support process with tools and mindsets	5. Supporting tools	Price setting/repricing/discounting tool Profitability/leakage monitoring tools and reports
	6. Organization and mindset	Align organization and power of authority Align incentive system Capability building/performance transformation program Mindset change in the front line

Source: McKinsey analysis

Sub-optimal pricing can be addressed by reviewing the customer portfolio to determine rational prices, and enforcing the resulting pricing guidelines and supporting sales professionals with the tools and mind-set training they need to succeed (Exhibit 7).

5. Making targeted IT investments to build a cost-efficient operating platform

As Asian corporates expand, supply chain payment flows are now a blend of domestic and cross-border, with requirements across cash management, trade and foreign exchange. These emerging business requirements place increasing demands on transaction banking IT systems.

Banks' IT systems must provide clients with a single access point for transaction banking products, while also improving efficiency and reducing the cost of transaction reporting. Further, to support effective client targeting and performance management, banks must adopt advanced pricing and reporting capabilities.

Domestic large corporate and middle-market customers require sophisticated liquidity management, pooling and sweeping solutions, as well as ERP integration. This presents a challenge for local bank providers, who generally have legacy and home-grown systems. One leading bank in South-East Asia is now losing out on corporate payment mandates because its in-house payments platform lacks flexibility. Not surprisingly, banks across the region are investing in new transaction banking platforms and upgrade existing capabilities. While several banks operating in Asia have announced or made investments in excess of a $100 million to build out an integrated cash management platform, others are taking a more targeted approach, focusing investments in three areas: reporting and other value-added services, front-end platforms and processing infrastructure. This has resulted in up to a 25 percent reduction in investment spend and reprioritization of 40 percent of IT investments.

The proliferation of mobile devices and tablets is driving additional change for transaction banks. Deployment of mobile solutions in the commercial arena has increased, although it still lags developments in retail banking. As more corporate clients support a bring-your-own-device approach, demand for tablet- based transaction banking solutions is likely to rise sharply. In this case, the primary client need is for remote access for viewing and authorization, as well as tracking of critical payments. Banks will need to determine appropriate pricing models, that is, whether to make mobile offerings free or fee-based. If the latter, a flat fees, per-transaction fees and increased information service charges must be considered.

* * *

Transaction banking in Asia is a large and increasingly attractive opportunity. Competition has intensified, with global players moving beyond their traditional turf and local players seeking to serve expanding Asian multinationals. Banks across the board must gear up to establish a profitable franchise, which means selectively innovating, establishing the right organizational structure and coverage models, improving frontline sales processes and pricing, and optimizing technology investments.

Successful execution can lead to a more stable and profitable corporate banking franchise and put banks in a position to thrive as the Asian economy expands.

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