



*Collaborative actions
towards
“experience banking”*

Highlights

- Correspondent banking is an attractive business
- Regulation and new market forces put pressure on profit
- Changing the current model is necessary but not enough
- The industry must evolve towards a customer-centric ‘experience banking’ model
- Collaborative projects are needed to increase efficiency and move toward the new model

Correspondent banking 3.0

The compelling need to evolve towards a customer-centric “experience banking” model

Executive summary

Correspondent banking and payments processing is an attractive business. But profit is under pressure as banks need to comply with more regulation and deal with increased competition, whilst we are bracing ourselves for another global financial crisis and economic slowdown.

So banks need to right-size and cut costs. That’s already happening. Whereas correspondent banking 1.0 in the mid 1970s was about automating the telex with a large network of banks, a different and more efficient 2.0 emerged late 1990s: centralised global transaction processing, fewer but deeper relationships and tighter performance management. That brings more efficiency.

This model is still too bank product-centric, based on inherently inefficient multiple agreements. The world has changed around us. A mobile payment via PayPal is simpler and faster than transferring money from one bank account to another. Corporates too are looking for more integrated solutions.

We thus need to change again, to a new 3.0, customer-centric experience banking model, where customers use a simple banking service, when they need it, as part of their business or personal transaction, and where banks link together the best components to create a consistent and seamless customer experience.

How can banks evolve towards this new model, or better, take the lead? Whilst each bank has to make improvements, collaborative projects are needed as well.

Four such projects of significant benefit – yet achievable – were identified from 35 in-depth interviews held with banks by SWIFT during 2010-2011. The first two make the current model more efficient, the last two are more provocative and radical steps leading towards the new model:

- **Enhanced business intelligence services** to better identify new market opportunities, understand end-customer behaviour, and better monitor liquidity;
- An **interbank EBAM (Electronic Bank Account Management) central utility** to more efficiently manage bank accounts and relationships;
- A **bank-owned global service for person-to-person payments** that is mobile enabled;
- An **international market infrastructure**, to reach many small banks with low volumes, without the need for a correspondent bank relationship and account with each of them.

The purpose of this paper is to start a dialogue in the banking industry on this new model and the projects proposed – and possibly identify other projects – to in the end gain consensus and implement one or two concrete new collaborative services.

Correspondent banking is core to the business of over 3,700 banking groups in 200 countries. Evolving that is not easy, but the new ‘normal’ presents a compelling need to do so, now.

Correspondent banking is an attractive business

We define correspondent banking as the banking services – mainly payments, cash management and trade services - provided by banks to customers via other banks.

This is an attractive business. It is (still) the primary channel to deliver cross-border banking services. Looking at cross-border customer payments on SWIFT in August 2011, those settled bank-to-bank were 67% of total volume. The 'on-us' payments carried out through the bank's own branches over SWIFT remained fairly stable over the last 5 years and account for 13% of the total. Payments settled via cross-border market infrastructures like EBA and Target 2 in Europe increased to 20% of the total. Despite the ramp-up of these market infrastructures, bank-to-bank volume maintained a 7% compound annual growth rate over the period¹.

Secondly, global payments volumes are forecasted to grow at an average compound rate of 9% per year through to 2020².

And thirdly, it's a sizeable business. Provided along with cash management, trade finance, and sometimes foreign exchange or custody services, payments are at the core of the services provided by a bank's transaction processing division and generated USD 590 billion revenues in 2010. Within these, cross-border payments punch well above their weight.

Accounting for 2.5% of global volume in 2010, they generated 10% of the revenue, and by 2020 are forecasted to account for 3.5% of the volume and their revenue contribution to rise to 16% of total³.

This combination of sizeable, predictable and growing revenue, with good profit potential and low capital requirements, makes transaction services an attractive business for banks.

Regulation and new market forces put pressure on profit

Maintaining margin growth in transaction banking will be difficult going forward however. Regulatory and compliance projects are driving up costs. Increased competition will put downward pressure on revenues whilst banks in Asia Pacific and emerging markets will see their market share increase. Funding innovation will be difficult to sustain. Let's look at each of these in turn.

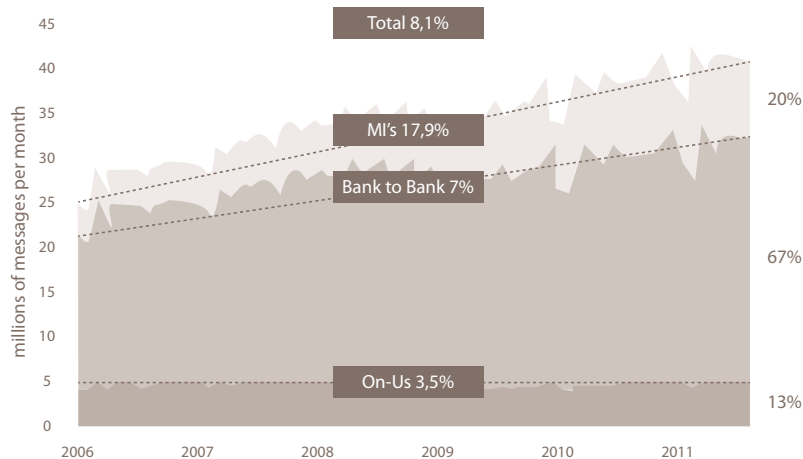
Regulation and compliance drive up costs

The increasing cost of compliance and regulation is on the top of every banker's agenda.

From AML and KYC, Basel III, Dodd Frank, FINCEN and FACTA to SEPA – as one banker stated, "regulation and compliance will dictate what we do in correspondent banking for the next three to four years."

Impact of regulation on banking business: examples

- Compliance with AML will cost the industry over USD 5 billion in 2011, increasing at 7.9% per year⁴;
- Basel III rules on capital and liquidity will make the financial system safer but come at a cost. Balances on nostro accounts will no longer be included on balance sheets, the cost of capital to back up trade finance will increase;
- Dodd Frank Act will mean fundamental changes in US electronic fund transfers and regulation. Combined with compliance costs, this is leading some banks to reconsider their position in retail cross-border services;
- US banks will be required to report all in and outbound cross-border transactions to FINCEN;
- FATCA may oblige non-US banks to make significant changes to their internal reporting systems to report information about financial accounts held by US tax payers to the Inland Revenue Service (IRS);
- The industry cost of implementing SEPA is estimated at EUR 8-10 billion, with a migration end-date set soon⁵.



Ⓐ Correspondent banking is the most important channel for cross-border payments

source: SWIFT Traffic Watch; Customer payments (MT103)

1. SWIFT Traffic Watch
 2. Boston Consulting Group, "Global Payments 2011"
 3. Boston Consulting Group, "Global Payments 2011"
 4. Celent, "Trends in Anti-Money Laundering 2011"
 5. Cap Gemini. "World Payments Report 2007"

The cost of implementing such projects is USD 10 - 300 million per institution⁶, depending on size and complexity.

Competition will intensify

Low growth conditions in mature markets will lead to intensive inter-bank competition for clients and volumes, especially for premium wholesale clients like large and mid-size corporates.

New entrants like PayPal, Google Wallet and also mobile network operators drive expectations in consumer payments, bringing ease of use, immediacy of transfer, transparency of pricing and end-to-end tracing capability. This in contrast to 'traditional' correspondent banking payment services where this level of service still is not achieved. Money transfer operators, which have long been in this business, are now aiming up-market and targeting the small and medium-size corporate segment.

The shift from mature countries to a multi-polar economy with a stronger presence from Asia and developing markets will have a profound impact on the banking business and payments flows. Seventy percent of payments volume growth in this decade will be generated by these regions⁷, whereas payments volumes in North America and Western Europe will grow at 6% and 5% respectively, well below the global average of 9%⁸. Banks in the mature markets will thus need to partner with banks in Asia and developing market or grow their own operations in those countries.

Investment in innovation: difficult to sustain

Whilst banks are investing in front-end channel innovation like mobile, increased regulatory projects and allocation of assets to support balance sheets will put strains on resources for product and process innovation.

Changing the current model is necessary but not enough

These market forces fundamentally changed the traditional 1.0 correspondent banking model of the late 1970s, whereby banks did wire transfers and a long list of correspondents was seen as a sign of importance. Since the late 1990s, banks have significantly improved their efficiency, running payments transactions as a business, and using fewer but deeper and better managed relationships. But is that enough?

A more strategic alignment with the business

Banks increasingly focus on delivering value to their customers, moving the correspondent banking relationship closer to the client-facing divisions. Transaction services are less likely to be discounted as loss-leaders to win credit and investment banking business. Scale is no longer the only objective.

Many banks centralised operations and product management into a "Global Transaction Banking" unit - managed as a business, and moved from product sales to relationship managers assisted by product experts. Product sets with low margins have been weeded out or replaced by a third-party service and the portfolio reconstructed for target client segments. It's about providing the right services to the right clients: large transaction clients that can generate volume, converting credit clients to transaction clients, leveraging higher

margin small to mid-sized corporate and retail segments.

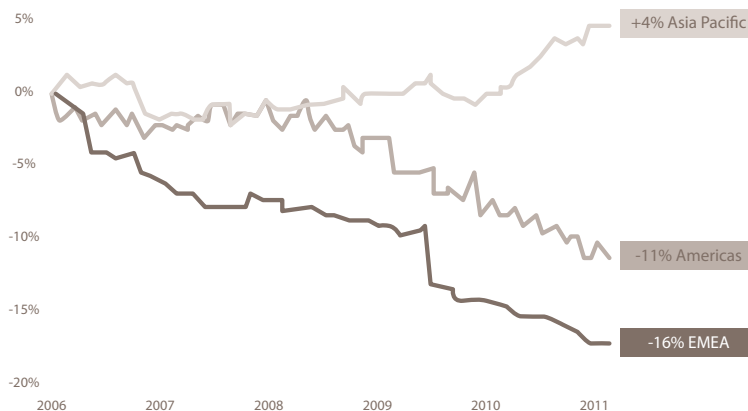
The questions are where can these juicy customers be found, and how to route payments in a cost-efficient way. Significant sums are invested in market and business intelligence to obtain these insights.

Banks are also addressing organizational aspects of managing their network, ranging from a decentralised model to more centralisation – there is no one-size-fits-all solution here. But the common theme is bringing product expertise closer to the local relationship managers and clients.

Fewer but deeper relationships

Managing the correspondent network is no longer an administrative function, but plays a key role in managing compliance and risk. In response to the financial crisis and compliance initiatives, banks are generally reducing their nostros, and relationships with weak balance sheets or high risk are cut. Volumes are concentrated on fewer partners. The concept of "reciprocity" is evolving, from a traditionally "arms-length" relationship to deeper partnerships.

Large banks have rationalised their correspondent banking networks in Europe and North America, whilst building out their payments business in Asia Pacific. A good proxy for nostro accounts is to look at the statements these banks receive via SWIFT. Since 2005, the top 80 payments banks reduced their average



6. Celent, "Getting Smart About Regulation", August 2011

7. Boston Consulting Group, "Global Payments 2011"

8. Boston Consulting Group, "Global Payments 2011"

9. SWIFT Traffic Watch

▲ Top-80 payments banks reduce nostro relationships in EMEA and Americas
source: SWIFT Traffic Watch; Interbank statements (MT950); average number of nostro relationships

number of nostro relationships in Europe and the Americas by 16% and 11% respectively, whilst in Asia Pacific they increased by 4%⁹.

On the “sell-side”, transaction banks want to increase their vostro portfolio. But here, compliance is a barrier to developing the business, as due diligence now extends to a full legal and operational audit of the counterparts’ KYC and AML processes and capabilities, causing delays in contract renewal and on-boarding of new clients.

As result, a three-tier segmentation of the correspondent banking network is becoming apparent:

- Partner banks - based on true synergies, with relationships typically based on geography where the partner bank has a very strong presence in a specific country or region and the ability to transact a high volume of business across a broad range of products;
- Specialist banks - for capabilities on specific product lines – e.g. using strong domestic retail players for distribution of pension payments or consumer remittances;
- Coverage banks - to fill out the geographic footprint of the bank’s capability in areas where it does not have a presence, but its clients need to do business.

More, pro-active performance management

The now smaller correspondent network is under increased scrutiny. Some examples include:

- Proactive monitoring of financial and compliance risks in the network, ensuring that stand-by contingencies are in place in the event of a shock. This requires better access to, and use of external and internal data sources. Collection of information such as account mandates, compliance certificates, audited accounts etc, is more frequent.
- Monitoring of multiple business lines within each relationship requires data gathering from multiple internal systems. This is important in monitoring reciprocal arrangements, which is no longer based on like-for-

like products but looked at on the aggregate business.

- Monitoring performance across correspondents. While products across correspondent relationships are broadly similar, e.g. cross-border payments, service level agreements can be highly inconsistent.
- Ensuring transactions are routed to the correct partners. Even when relationship and network management set clear directions as to where transactions should go to, payments may on an operational level be routed to different (non-partner) banks.

So, a lot of change is already underway. It is positive and essential but only incremental in nature. What is happening today is a prelude to bigger change on the horizon. For that, real step-changes in cost efficiency and customer service capability need to be achieved.

A new vision for 3.0: Experience banking

Whilst necessary, the changes to date are not sufficient to compete and run a successful payments business going forward, because the world around us has changed.

It’s no longer about having a web site that merely projects the bank’s products as offered in a branch and have customers try to navigate their

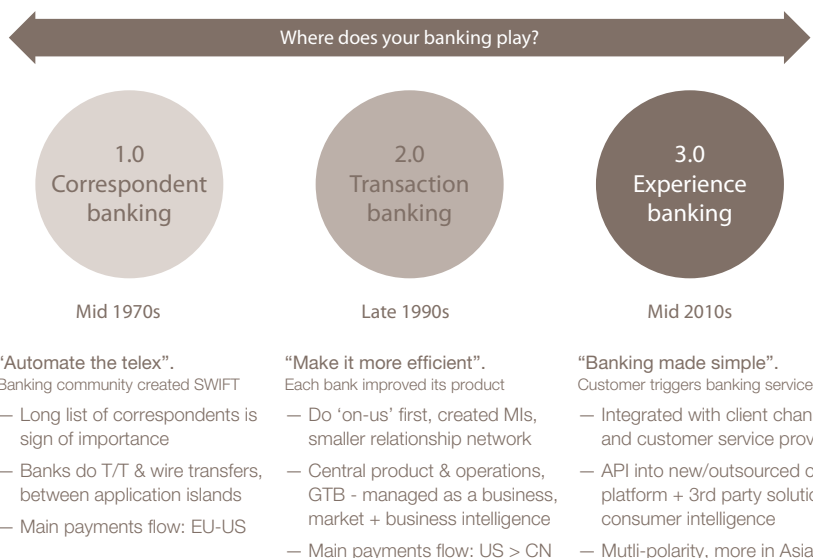
way. Instead, customers now expect a ‘banking service’ as part of their business transactions or lifestyle, at the time they execute that transaction. A corporate treasurer wants a real-time view about the liquidity available across the firm’s multiple banks and accounts on an iPad, or a payment is made from a mobile phone when the family back home calls for cash.

Shift forward: from product transaction to customer experience

The new normal requires a change from the current 2.0 product-oriented “transaction banking” organisation to a customer-centric 3.0 “experience banking” model.

In this model, the bank’s product and relationship management is very closely if not fully integrated with the client channel and the customer service provider (which may or not be another bank). The bank’s service is triggered by an API (published by the bank), and performed on a renewed core banking system or outsourced to a larger bank that can leverage the advantages of scale and offset the cost of compliance or to a 3rd party specialised payment service provider.

Linking all these components together as a seamless experience will allow banks to focus on providing a more innovative experience rather than trying to build out the entire IT product set itself.



⁹ 3.0 = Experience Banking

But how do we evolve towards this new model? The required changes can be complex and costly, and benefits only achieved if a large number of banks move at the same time. The banking ‘system’ comprises over 3,700 banking groups in 200 countries¹⁰. Network inertia is the challenge to collaborative innovation.

Collaborative projects

To evolve towards the new model, banks need to, in addition to improvements within their own shop, start a series of collaborative projects with other banks, to further improve the current model as well as evolve towards the new experience banking model.

From interviews with 35 banks during 2010-2011 by SWIFT, over 20 such projects were suggested.

Filters to focus

Project ideas were filtered against four criteria to develop a short list to focus on:

- **Collaborative** – a project must be for the benefit of more than one bank. E.g. a project to renew a core system is an individual bank’s decision and thus not short-listed here;
- **New** – it must be a new project, not already underway. It is not the intention to re-evaluate a project if already

underway – we may mention some for illustrative reference;

- **Achievable** – a project must produce its benefits with reasonable costs in a reasonable time frame. We assess the technical complexity and costs for a bank to integrate and use the ‘new service’ as well as the network complexity in terms of how many banks it takes for the project to succeed.
- **Significant** – the project must bring significant benefits to banks, improving the existing model or helping evolve towards the new model (as described in the previous chapter), thus filtering out many ‘small’ projects. At this stage, we did not do a full business case or benefits sizing – that will be done once the shortlist is further refined to one or two project proposals.

Project short list

Four projects have been shortlisted. Some are practical, other more provocative and forward looking. We also assessed their technical and network complexity (see diagram below and table overleaf).

The purpose now is to get feedback on the projects proposed, discover other ideas and test them against the same criteria, in order to reach consensus on which projects to take forward.

Conclusion and call for action

Since the late 1990s, correspondent banking has changed from a traditional 1.0 to a 2.0 transaction banking model with fewer but more efficiently managed relationships.

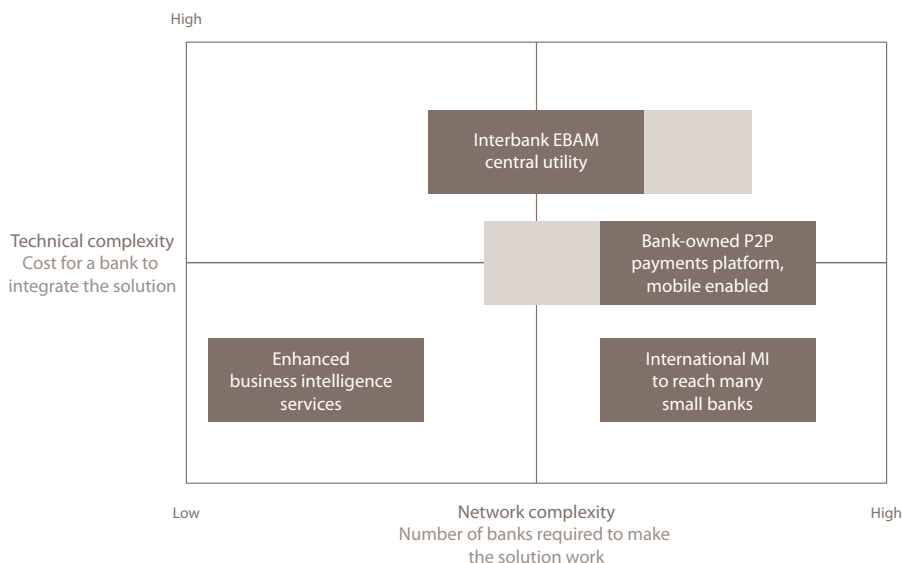
In today’s new normal however, this is not good enough anymore, as we enter an era when banking services need to be designed around customers who trigger them as part of their experience. We call this new vision 3.0 or experience banking.

Banks have the dual challenge to further improve the current model whilst evolving towards the new one. For this, they need projects within their organisation as well as solutions developed and run in collaboration with other banks.

We have identified four such collaborative projects, and look forward to stimulating debate on this new vision and projects proposed. In that process, these projects will evolve and mature, or not find sufficient support and other may emerge. What matters at the end of the day, is the consensus to develop new services that have significant impact, and put them into action.

The world has changed around us. To keep their payments franchise, banks must take charge of their destiny and lead the way.

10. SWIFT Traffic Watch



▲ Collaborative project assessment

Potential project	Description
Enhanced business intelligence services	<ul style="list-style-type: none"> – Issue: To identify new market opportunities, better understand end-customer initiator and beneficiary, counterparty bank performance and liquidity risk, make informed transaction routing decisions, improve interbank invoicing and reconciliation or for example report end-destination country of a specific instructing party, banks need enhanced business intelligence over and above what is available today from their internal systems or via eg SWIFT’s existing set of Watch analytics. – Solution: The proposed solution is to significantly enhance SWIFT’s current business intelligence capability, by for example extracting more fields (e.g. beneficiary end-customer country) provide intra-day timestamps, and combine SWIFT traffic data with external market data (e.g. cross referenced to industry sectors) for opportunity sizing and country risk assessment. – Assessment: The technical integration complexity for a bank is rather low, as data provided only needs to be coupled with in-house business intelligence platforms. The network complexity is low, since no co-operation or multiple banks are required (except e.g. syndicated surveys).
Interbank EBAM (electronic bank account management) central utility	<ul style="list-style-type: none"> – Issue: As part of their correspondent bank relationships, banks need to manage those accounts on an on-going basis (open, modify, close, periodic compliance checks, etc). A large proportion of the information shared is common across relationships but formats and timing are not harmonized leading to manual, time-consuming and expensive processes. – Solution: A solution for EBAM provided by SWIFT is already being used in the corporate-to-bank space. The proposal is to extend this for interbank account management. The solution consists of a set of standards and electronic instructions to open, modify, close and verify accounts, combined with a central hub providing standards validation and a repository to store account opening criteria. As a possible extension, the hub could contain management, KYC and compliance statements of correspondent banks. – Assessment: The technical integration complexity for a bank is rather high, as account management applications are typically not automated systems. The network complexity is medium, as it requires a large number of participants to publish their data but no cooperation between them is required.
Bank-owned global service for P2P (person-to-person) payments, that is mobile enabled	<ul style="list-style-type: none"> – Issue: Retail payments account for 87% of total cross-border volume, and will grow by 13% per year over the next decade to reach nearly 24 billion transactions per year¹¹; worldwide recorded remittance flows are expected to reach nearly USD 536 billion in 2013¹². Whilst banks have a good solution for international ‘on us’ payments and some have proprietary bilateral remittance products, the “international money transfer” based on multiple correspondent banking relationships is losing out to simpler, faster and more transparent alternatives provided by money transfer operators (largest market share), global wallet providers, and mobile network operators (getting into this space with mobile wallets) and they are starting to link to each other. Banks however cannot offer “one” compelling / consistent experience because it depends on the multiple agreements with and capabilities of each of the receiving banks – all different. – Solution: Several banks distribute a money transfer operator’s product or 3rd party’s P2P online or mobile payments service (next to their own). However, banks do not own/control those products, they are not bank branded, and do not allow the bank to further develop the customer relationship since they are not fully integrated with the bank’s operations and customer intelligence. The solution proposed is to create a bank-owned company/product providing a simple yet compelling, international, interbank, person-to-person, mobile-enabled payments service with account as well as cash pay-in/pay out capabilities. It could be built or bought (eg, by buying or enhancing an existing product of a money transfer provider). – Assessment: The technical integration complexity for a bank is medium, via APIs into front-end systems. The network complexity is rather high, since a critical number of banks and/or agent networks need to be connected to the platform.

11. Source: Boston Consulting Group, “Global Payments 2011”

12. Source: The World Bank, “Outlook for Remittance Flows 2011-2013”, May 23 2011

Potential project	Description
International MI (market infrastructure), to reach many small banks	<ul style="list-style-type: none">– Issue: Many banks already rationalized their correspondent network, due to increased cost of compliance versus low transaction volume. Still, they need global reach and exchange transactions with many small banks without holding a correspondent bank account or being required to route transactions via complex serial chains. The problem is with many small banks not with the intense relationship with large bank correspondents.– Solution: The proposed solution is a payments hub to complement existing correspondent banking arrangements. This would comprise a multilateral legal and SLA framework for the clearing and settlement of a limited set of basic payments products. Each participant would accept to receive and process payments from all (or a limited subset of) other participants under a set of business conditions communicated in the framework. Several banks could competitively offer foreign exchange and settlement capabilities to participants within the framework.– Assessment: The technical integration complexity for a bank is rather low, since existing technology could be used (like eg FIN messaging and copy using SWIFT). The network complexity is rather high, since a critical number of smaller banks need participate (but that can be driven by the sending bank).

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