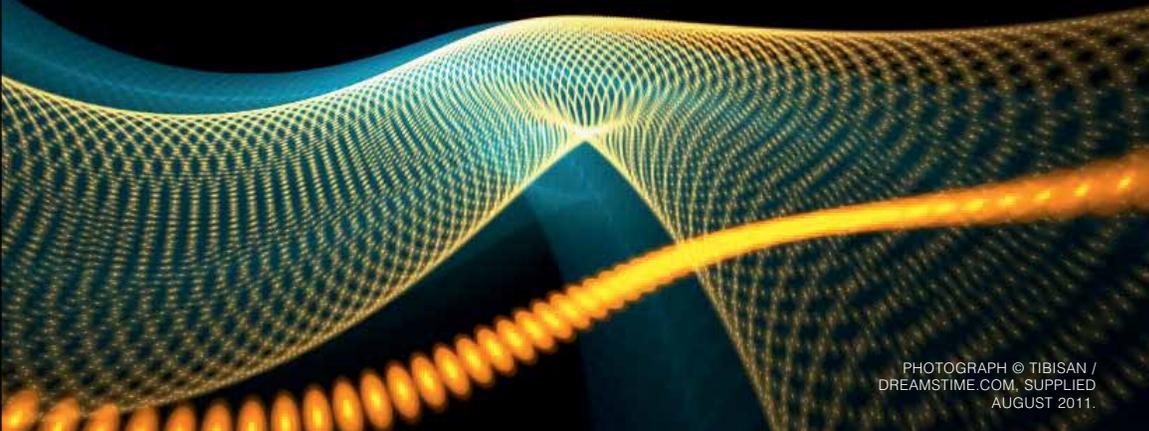




## PAYMENTS

Global Payments is a fundamental business for banks. It is also a business under demand from corporate clients for more and better services, delivered with ever thinner profit margins. In the future, global payment value and revenues will be maximized through smart network management, increased standardisation and payment system rationalisation, and payments to and from what will be the two major reserve currencies, the US dollar and the Chinese renminbi. Drivers of change will be the on-going shifts in trade flow within the global economy, regulatory issues, new technologies, and competition from non-banks. By Jennifer Stanley, vice president, global payments, BNY Mellon.



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## Shifts in trade flows provide opportunities for global payment banks

**I**N CONTRAST TO the recession-ridden economies of the West, the growth and strength of the Asian economies, particularly that of China, have considerably changed the patterns and volumes of international trade. In the past decade, US imports of Chinese goods have increased by more than 350%, resulting in a trade

deficit for the United States of \$273.1bn at the end of 2010. Worldwide, total trade with China has increased from \$509.7bn in 2001 to \$2.9trn in 2010.

According to the US-China Business Council's 2011 figures, the US is China's top trade partner, but six of the other top ten are in Asia, as are five of its top export des- ►►



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tinations and six of its top import suppliers. Indeed, some 60% of all world trade is intra-Asian. These developments are expected only to strengthen, with the likelihood that the US will slip from its top spot, perhaps within a decade, and that these trends become the new realities of global trade.

Trade flows will, as well, move increasingly toward emerging markets, as investment and development mobilise growth in South America, Africa, and the Middle East. Global payments banks will need to increase their presence in these markets; not only through correspondent banking relationships with local banks, but also by establishing a local presence of their own.

Moreover, payments and trade finance are converging, as trade finance becomes as much an issue of money management as it is of risk. Equally, the needs of small and mid-sized exporters in the emerging markets will most often be addressed by local providers, knowledgeable of local language and customs. The opportunity for global payment banks, then, will be two-fold: to provide payment and trade services to local banks *via* outsourcing; and to move processing centres into or near enough to these emerging markets to provide services within local time zones.

### Network management

The growth in emerging markets and changing trade flows will also demand improvement in the management of bank networks. The disruption that crises, both physical and political, can cause, and the speed with which they can occur, was demonstrated in the first half of 2011, with the earthquakes in Japan and the political unrest in the Middle East.

Actually, increased trade into and out of developing countries increases the likeli-

hood and potential frequency of such disruptions. From the viewpoint of the global banks, this will require greater scrutiny and more transparent and time-sensitive knowledge of their correspondent bank partners. Banks in disrupted areas may vary considerably in their preparedness and responsiveness to disruption, but global banks usually cannot maintain or sever correspondent relationships on this basis. However, global banks can, to a degree, mitigate this problem by placing their own branches in emerging economies, but these branches will not entirely remove the need for relationships with local banks, and careful management of correspondent networks will continue to be an imperative. This will compel procedural and technological innovation to ensure that necessary knowledge and data are available in real time, or as near to real time as possible, and that channels exist to move money with minimal delay. Invariably, these will necessitate considerable investment in systems and technology.

Most global banks maintain and manage hundreds of correspondent accounts on a daily basis. These are vast networks of correspondent banking relationships that are necessary to meet multi-currency payments and trade requirements. In most cases, these relationships have developed bilaterally, each with its own reciprocity and pricing agreements as well as service standards, and all with different terms and conditions disclosed in variously formatted documents. These agreements have grown increasingly complex since 2008, newly encumbered with issues of risk, liquidity and credit; increased regulation; issues of trust and confidence; lack of (and new efforts to create) standardisation; and the complex-



ity of technological interfaces. Further, margins have been compressed as the market has grown more competitive.

As will be discussed in more detail later in this article, managing such a network effectively in the future requires standardisation across the firm. This facilitates comparison and negotiation, to create pricing and margin calculation and to validate *nostro* fees. In the best scenario, such uniformity would not be achieved only on a relationship-by-relationship basis, but through some bank-wide standardisation. Better and more consistent management of correspondent relationships would result not just in better-honed adaptability to the changing times, but also greater risk mitigation, improved market intelligence, enhanced service quality, and a move from a fixed to a variable-cost structure.

### **Emergence of an internationalised renminbi**

The emergence of the Chinese currency as an international means of commerce also has important global impacts on business and banks. In mid-January this year, BBC News reported President Hu Jintao as saying that China intends to replace the dollar with the renminbi as the international reserve currency. Hu said this would be a “fairly long process,” but an envisioned time frame is probably one decade, corresponding with China’s goal of making Shanghai a seat of international trade by 2020.

China is now the second-largest economy in the world, large enough to create deep and liquid markets; and the volume of its trade flow and foreign direct investment provides a large base for renminbi-denominated transactions. The purpose for China in internationalising the renminbi is three-fold: for the renminbi to



*Jennifer Stanley, vice president, Global Payments, BNY Mellon. Photograph kindly supplied by BNY Mellon, August 2011.*

serve first as a trade settlement currency, then as an investment currency, and finally as an international reserve currency. To realise any of these goals, a pool of sufficient offshore holdings in the currency must be created. Up until recently, this has been the critical missing piece.

In 2009, HSBC and then other foreign banks were allowed to issue renminbi-denominated bonds in Hong Kong. Later that year, the mainland government issued RMB6.3bn-worth of sovereign bonds, creating a benchmark for future bond issues. Similarly, while Hong Kong banks have been allowed to accept deposits in renminbi on a restricted basis since 2004, in 2010, with the approval of the mainland government, the Hong Kong Monetary Authority (HKMA) loosened its supervision of renminbi-denominated business, allowing virtually any company in the world to open a renminbi-denominated account. ►►



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The importance of the internationalisation of the renminbi both for banks and for nations will be profound and far-reaching. Banks for which US dollar settlement is the primary payments business face the prospect of dramatic shrinkage in profitability as currency settlement increasingly migrates to Asian-based and other renminbi-enabled banks. To remain competitive, banks will need to invest in platforms that can handle more than one currency and, as well, may need to increase their presence in Asia, assuming, in China's case, such an expansion of competition within its borders is tolerated.

**Legislation and regulatory issues**

Since 2008, increased regulation, both within individual nations and worldwide, has made new demands on payment infrastructures. In the US, for example, legislation around anti-Money Laundering (AML), Know Your Client (KYC), and anti-Terrorist Financing (ATF), as well as the increased role of the US Office of Foreign Assets Control (OFAC), has caused banks to institute greater controls around audit, compliance and client security.

Regulations, however, are not uniform from nation to nation or from region to region, so the burden such regulations place on banks requires repeated changes, enhancements, and updates; in other words, layers of complexity and cost. In the short term, this may have stifled innovation, in the longer term, however, it will likely do the opposite, as banks seek and develop new technologies to address these demands. Increased regulation on banks will also change the payments landscape by providing opportunities for non-bank providers that fall outside the reach of these regulations and may also be smaller, more

nimble, and less encumbered by pre-existing legacy systems.

**SEPA & PSD**

The Single European Payment Area (SEPA) and its accompanying governance, the Payment Services Directive (PSD) will create a zone for the euro in which all payments will be considered domestic. This will allow payments within the area to be made through a single bank with a single set of payment instruments. The initiative should standardise and simplify the payments process in the area; make the process more transparent and less susceptible to fraud; increase electronic payments and straight-through processing rates; and reduce the cost of payment transactions. The impact on banks, however, will be substantial. Competition among payment providers and against new, non-bank providers will be intense. Added to this, banks are facing a huge investment either in making legacy systems SEPA/PSD-compliant or investing in entirely new technologies. The loss of revenues from diminished fees could be considerable and reliable estimates of future volume flows are difficult to discern, making it difficult for banks to set appropriate strategies. This, however, assumes a future in which the euro survives. The on-going sovereign debt crisis seems a genuine threat not only to the sustainability of the euro, but to the economic future of the entire European community. As this article went to press, the European Union had agreed to a bailout plan for Greece, but the eurozone still lacks the sort of institutional structure to address such crises on other than a one-off basis. Portugal and Ireland remain troubled and there is much uneasiness around Spain and Italy, whose economies are far larger than that of Greece.



### American dollars to 1 CNY (March - July 2011)



Source: x-rates.com, August 2011.

Nevertheless, it is expected that SEPA will be only the first of many eventually consolidated payment systems. Over time, the individual domestic processing systems of each country should merge or develop fluent interoperability.

#### The impact of consolidation

Growing competition, greater demand for services from clients, and thinner profit margins will force consolidation among payment providers through mergers and acquisition. As well, the emergence of non-bank providers and technology companies into the marketplace will not only increase competition, but also give rise to new partnership models, with banking and delivery segments split between partners. The result will be fewer and less traditional players.

National political interests and pride will likely keep sovereign payment infrastructures, such as CHIPS, BACS, and Fedwire, in place (at least in the near term). Over the longer term, it is difficult to see how the redundancies of multiple payment processors can continue in an increasingly global and competitive market. At the very least, there will likely be considerable con-

solidation within regions, and certainly within a single country. A situation such as that in the US, with numerous systems for wires and automated clearing house (ACH) payments, will come under considerable market pressure to consolidate.

Taking this a step further, one can envision a single real-time system that could process all payments—local and global, high and low-value, retail and wholesale—doing away with clearing houses and the need for correspondent banking. Although such a scenario is unlikely any time soon, that would be consolidation’s end game.

#### Cost pressures and standardisation

In addition to the firm-wide standardisation of network management and the regional standardisation of SEPA and other systems, there are cross-industry standards arising around XML, SWIFT MX, and, in particular, ISO20022. While the success of such initiatives is predicated upon wide adoption, cost pressures, a need to stay at the technological forefront, and the increasing demands of regulations should provide ample incentive for banks to move toward a more standardised world. ▶▶



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ISO20022, or UNIFI, is the standard for financial services messaging. When adopted, it offers the benefits of improved straight-through processing, enabling users to communicate consistently across all of their banks; standardised access to the global payments landscape, including new services such as SEPA; critical remittance information captured along with payment information, creating efficiencies in reconciliation and better identity management for KYC purposes; and intraday payment information, rather than only end-of-day, enabling improved cash positioning.

**Technology: mobile technologies & cloud computing**

That mobile technologies will create changes in payments processing barely qualifies as a prediction. However, most of the focus on mobile banking is with retail payments and, somewhat less, as a way to bring banking services to underdeveloped countries, where mobile phone use far exceeds account banking. For large-sum commercial and wholesale banking, the mobile's role is less clear-cut. Mobiles seem certain to play a role in the provision of information, in managing cash, tracking payments, and minimizing risk, but it is difficult to envision mobile technologies for the purposes of large-scale international payments or currency clearing.

Cloud computing and software as a service (SaaS), however, would seem to have great potential for changing the wholesale payments marketplace, particularly and initially for smaller players, as these technologies have the potential to mitigate the often prohibitive expense of systems development and implementation. The effect would be more competition and lower payment costs. Cloud computing also seems

a technology well suited for the storage and accessibility of payments records.

**Adding it up**

It bears repeating that increased competition and thinning margins press against the problems, trends, and solutions required in responding to the plethora of changes taking place in the global payments landscape. There is a future for players of varying sizes and types, but accurately judging the scale at which a provider chooses to operate will be significant, even decisive, in whether a provider succeeds or fails. Large providers can find economies of scale that are often lacking in smaller providers, allowing them to develop proprietary systems for their own use and for outsourcing to smaller banks. The danger, however, is loss of flexibility and the ability to innovate quickly. Proprietary systems quickly become lodestones when new technologies create new demands and opportunities shift to smaller and nimbler, non-bank providers. This is also the case when a changing economic landscape offers unexpected opportunities.

At the same time, the cost and inconvenience of uprooting entrenched systems and platforms defend large providers against too-rapid innovation, because it is an inconvenience for their correspondent partners as well, particularly if their own systems are insourced. Therefore, although the general trend of the payments business is evolutionary, it will be a fitful and erratic process, with entrenched systems often slowing innovation but, simultaneously, enforcing stability where too much, too fast might bring chaos. What seems certain is a future with fewer players, large and small, altered by the markets they have come to serve, and the changed services they have come to provide. ■