



# Mining Profits from Payments: Developing a Strategy for the Future

By J. David Cruikshank

## Introduction

The payments business has been not only a traditional and long-standing source of income for retail and wholesale banks, but in the last two decades it has also provided a source of strong revenue growth. However, a number of concurrent changes – advances in technology, new regulations, the initiation of the Single Euro Payments Area (SEPA), and the recent economic downturn – threaten the continued profitability of payments and have forced banks to reconsider strategies and approaches for maintaining payments as a viable source of income. Further, this occurs at a time of increased service expectations and demands from clients, without a commensurate willingness to pay increased fees.

It is a situation not without its ironies, in that the same changes that make the future difficult to predict and that potentially threaten profitability are also those driving and abetting growth in the payments business, most notably internationally. Decades of mergers and acquisitions have created a banking industry with far fewer – yet much larger – players. These large, global banks are best positioned to take advantage of a changing and growing global economy, but increasingly fierce competition among them threatens potential profits. Product differentiation driven by technological investment is critical, but the rapid pace of change has made banks wary of investing too heavily in short-sighted or inflexible technologies and product choices. Gaining profit in such an environment can be a vexing problem: the margin is there, but how best to extract it?

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### **First Steps: Streamline and Economize**

It should be noted that even in more stable and predictable times, payments processing has never been inexpensive. Developing and maintaining products and infrastructure, acquiring and keeping a customer base, dealing with regulation, bad debt, fraud – all this costs banks billions of dollars a year. In the US, this is compounded by a highly fragmented and inefficient payments infrastructure. There are more systems for clearing and settling in the US than in any other country, requiring banks to maintain numerous, often redundant technology platforms. So there is great incentive for banks to improve their bottom line by achieving greater efficiencies of time and manpower. In addition, the recent flood of mergers and acquisitions has not only heightened competition among the fewer remaining banks, but has also created greater disparity between larger and smaller banks. This widening gap provides larger banks with outsourcing opportunities, while at the same time offers smaller banks a means of staying in the payments business without an investment in research and technology they can ill afford.

As simple as this sounds, it requires banks to change direction away from creating earnings by M&A growth and product sales and to commit to following a broader, future-oriented strategy. Banks will need to assess which of their current products are likely to remain viable in the next decade and beyond and to reallocate resources accordingly. This will involve difficult choices, as some products that are unlikely to show growth in the future will nevertheless remain profitable in the short-term.

### **Corporate Clients Expect More**

While cash management has been a stable and reliable source of profit for banks, it rapidly became less so during the recent economic downturn. Slow growth, dropping interest rates, and the consequent need of corporations to cut back on expenses have taken a swift toll on banks' earnings. Corporate clients have become more demanding of their service providers, both out of need and because increasing competition has made cash management more of a buyers' market. And, as mentioned, there is no appetite for, or expectation of, paying increased fees for more sophisticated services. This is a situation largely of the banks' own devising, particularly banks with retail businesses who were able to extend low-fee services to corporate clients by subsidizing that low cost with profits from consumer checking and credit card accounts, derived from both interest and fees, and from credit card service charges to retailers. But today, many of these fees are being scrutinized by consumers and legislators, and retailers are creating a significant loss of revenue for banks by increasing the use of PIN formats for debit cards – a far less expensive option than transactions requiring signatures.

### **The Increasing Cost of Regulatory Compliances**

The combined effect of increased use of electronic payments and a growing global economy has brought with it heightened potential for fraud and other illegalities within the various payments systems. Response to this has brought more stringent regulatory efforts both by nations and international agencies, OFAC regulations in the US being one example. Further, regulations 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 – layers of complexity and cost.

The creation of the Single Euro Payments Area (SEPA), scheduled to go into effect this year, will create a zone for the euro in which all payments will be considered domestic. By allowing payments to be made through a single bank with a single set of payment instruments, the initiative should standardize and simplify the payments process in the Euro zone, thus making payments more transparent and less susceptible to crime. SEPA is also expected to increase the use of electronic payments and straight-through processing and to reduce the cost of payment transactions. The effect on banks, however, is a huge investment either in making legacy systems SEPA-compliant or implementing entirely new technologies. Loss of revenues from diminished fees could be considerable and reliable estimates of future volume flows are difficult to discern, making it more challenging for banks to set appropriate strategies.

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### **Competition from Non-Bank Providers**

As the payments industry becomes increasingly automated, banks are facing stronger competition from non-bank service providers who, because of their smaller size and less stringent regulatory environment, are often quicker to innovate and to exploit new markets. One notable example is the remittance market – low-value, non-commercial, cross-border payments, typically immigrant workers sending money home. This is a growing, multi-billion dollar market from which banks are all but excluded. Ninety percent of the remittance business is conducted by money transfer companies such as Western Union and MoneyGram. Banks will need not only to find, target, and aggressively pursue such newly opening and growing markets, while taking into account regulatory compliance requirements, but also to ensure that markets they currently control aren't eroded by such smaller, nimbler non-bank entities.

### **Commoditization of Payments**

One regularly hears the argument that the payments business is becoming commoditized and undifferentiated and that, as a result, mining profits from payments will be more difficult for banks. While it will be key for any bank to differentiate its product offering and underscore the added value it can provide in an increasingly competitive environment, one can argue that the payments business has always been an undifferentiated commodity: payments in this view is simply a core business – it's what banks do. It's a view that, until recently, seems to have been held by many banks themselves who, until the economic downturn, were more focused on their investment and asset management businesses and often lacked a clear and consistent management strategy for payments. This view prevailed despite the fact that payments is a lucrative source of income and one that has maintained profitability in both good economies and bad. As recently as 2007, payments amounted to 65% of bank revenues, according to US Banker. The same publication noted, however, that while these robust numbers are, on average, consistent over time, there is considerable variation among individual banks. Percentage of total revenues due to payments varied from 43% to 75% among the top 12 U.S. banks, indicating that there are clearly ways for any one bank to seize a competitive advantage through correct identification of growth markets, state-of-the-art technology, superior customer relations, and efficient internal management.

Banks with a history of technological innovation have an advantage, but this needs to be coupled with a strong, flexible, and consistent global strategy.

The greatest challenge for banks today is the decision of whether to commit to the investment in new technology and infrastructure required to process payments in-house or to develop a collaborative partnership with a larger, global provider.

## The Payments Landscape – Strategies for the Future

The various points discussed above can be addressed as three basic strategies for banks:

- **Streamlining and economizing.** Largely due to growth by merger and acquisition, many banks have numerous redundancies in their systems and platforms. More vigorous analyses of productivity, procedures, location of staff, automation, and reallocation of funds and manpower can lead to a significantly more efficient and less costly infrastructure.
- **Innovation and differentiation.** Where and how to invest and to develop products can be difficult and risky in an environment that is rapidly being changed by technology, globalization, and regulation, yet it is an unavoidable step. Clients are increasingly demanding products that will increase the speed and ease of making payments but will, at the same time, decrease the cost. Banks with a history of technological innovation have an advantage, but this needs to be coupled with a strong, flexible, and consistent global strategy.
- **Regulation and communications.** The payments business is a very expensive one for banks to maintain, yet the complexity of infrastructure and investment is largely unseen by the clients it supports. The fees banks extract to ensure profitability are often seen as aggressive and excessive, not only by consumers but, increasingly, by regulators and governments who, even as they try to rein in fees, may expect that banks will merely pass the cost back onto the consumer through other avenues. Banks could benefit by more consistently leading this dialog rather than responding to it. The payments system is integral to the health of a national economy, but banks are not profiteers living off that system; they created it, maintain it, and continue to drive innovation through significant investments within it. Banks, in this sense, may be seen as stewards, but this stewardship comes at a cost and banks, as for-profit businesses, must keep an eye on the bottom line. It is imperative, then, for banks to take a position of leadership in regulatory reform and not one of defensive reaction.

## Conclusion

In summary, payments will continue to be a viable, growth-oriented business within the banking industry. The greatest challenge for banks today is the decision of whether to commit to the investment in new technology and infrastructure required to process payments in-house or to develop a collaborative partnership with a larger, global provider. This is a matter not just of wagering a complex best guess as to where the business is going; it is foremost a responsibility of a bank's leadership in determining where they want to be in the coming years and what part payments will play in their overall business strategy.

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## About the Author

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