

Getting Value Out of Payment Infrastructures: Leveraging SEPA

WHITE PAPER

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"Banks that have implemented payment shared-service centers and built scale stand most to gain from SEPA and payment consolidation in Europe. Smaller institutions need to focus on quality of service and enhanced customer experience" — Rachel Hunt, European research manager, Financial Insights.

The Single Euro Payment Area (SEPA) went live in January this year, with most notably the introduction of SEPA Credit Transfers (SCTs). As we see the start of SEPA fatigue and a growing risk of procrastination, this white paper highlights the risk of resting on our laurels to soon.

In reality, too many banks did as little as possible, as late as possible. While the largest transaction banks are benefiting from new sourcing opportunities and smaller institutions look to outsource their cross-border payments, it is the medium-sized banks that stand to lose most. These now urgently need to review their payment strategy and its impact on the infrastructure.

The winners of SEPA are those institutions that take a holistic view to compliance and can address the following challenges:

- Drive down the average cost of transactions
- Focus on innovation to differentiate in a commodity market
- Increase the customer experience, in particular through greater levels of automation
- Reduce business risk and target new behavioral models for fraud

All of these challenges will involve managing complex data formats and transforming existing business processes, as well as reviewing existing sourcing strategies.

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PART 1: A MARKET IN A STATE OF FLUX

Looking back, it seems that 2007 was the year for payments. Regulatory changes, emerging payment methods, and an accelerating trend towards a cashless society led to many words being written and ideas exchanged. The culmination of this activity was reaching the first milestone for the Single Euro Payment Area (SEPA).

Indeed SEPA ("light") officially went live in January 2008 with the SEPA card framework on January 1 and SEPA Credit Transfers being exchanged since January 28. The EBA Step2 platform recently announced 3 million processed transactions since the launch of its service and with over 4,000 adherents to the scheme it appears that most banks achieved SEPA "compliance." In reality, many banks did as little as possible as late as possible. "Full" SEPA is still a long way off. Most banks will now need to consider their payment strategy going forward and prepare for the next big milestones: the Payment Services Directive (PSD) and SEPA Direct Debits (SDDs) in November 2009.

Managing Change and Creating a Successful Euro Payment Area

SEPA in Unison

"A critical success factor for SEPA will be to get all participants on similar migration plans for SEPA Direct Debits; a clear end-date is required or the banking industry may face a failure of self-regulation" — Jean Francois Denis, global head of electronic payments, Fortis.

Despite the introduction of the euro, payment infrastructures and schemes varied considerably across the European Union, ultimately stymieing the economic development of the region. The vision for SEPA was to create a euro area where "all payments should become domestic and reach a level of safety and efficiency at least on par with the best performing national payment systems today." If creating a unified European monetary system has political and economic ambitions that will benefit the end user, achieving practical and real business benefits for the various stakeholders is a challenging objective.

While an agreement for a legal framework for SDDs is still pending at a country level, many banks still need to analyze the deeper implications of change on their payment infrastructures. Banks need to be able to address the following issues:

- Recoup the loss of cross-border revenues
- Lower payment infrastructure operational costs
- Differentiate and generate new revenue streams

- Protect local markets
- Reduce the cost of compliance by simplifying and normalizing payment processes

In short, banks must be able to drastically reduce the cost of processing payments, while generating new revenues streams to differentiate in a commodity processing business.

Unfortunately, most banks in the region are focusing on how they can protect their local markets by adopting Additional Optional Services (AOS). While these were to enable banks to differentiate and create value-added services to their customers, the danger today is of creating local flavors of SEPA schemes, ultimately annulling the benefits of euro payments harmonization for the end user. This would indeed be a failure of self-regulation for the industry, one that the European Commission is unlikely to allow. The emphasis needs to shift towards the opportunities that SEPA provides: that of a wider addressable market and possible geographic expansion. Reaching an agreement on SDDs and setting targets for migration sooner rather than later will allow the industry to move forward and offer new services to customers.

SEPA Mass Adoption

"Government social payments are key for achieving mass adoption for SEPA payments, but in many countries movement is required towards adopting these at a domestic level. This will lead to a long transition period for banks" — Brenda O'Connell, SEPA program manager, Bank of Ireland

Another key factor for success for SEPA is creating early mass adoption. Stakeholder discussions were slow to include the end users of SEPA — consumers, SMEs, and corporates. More communication of the advantages of SEPA is required at a domestic level, backed by strong political commitment. In particular, government payments are key to achieving mass volumes, which would require a rapid transition from domestic schemes to SEPA schemes. Banks need to articulate strategies that will remove the burden of compliance from the end user if this mass adoption is to be achieved.

An example of the barriers to mass adoption is the requirement for companies to use the correct IBAN and BIC codes for SEPA payments. While for many corporates migrating data formats for cross-border payments has been a manageable task, achieving migration at a domestic level is a laborious and resource-intensive project, with little obvious business value. The same will apply for the many mandate changes that SDDs will require.

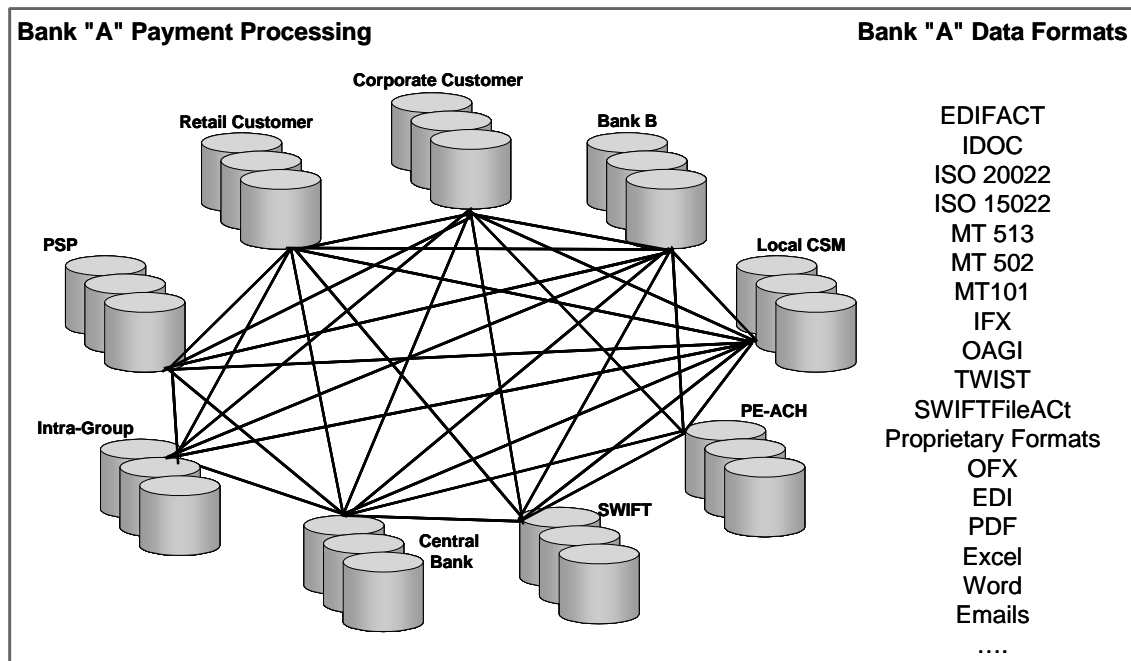
The result is likely to be a long period of transition where domestic and SEPA schemes co-exist. Banks will need to transform between different payment messages, in an environment where a plethora of different formats co-exist. SEPA encourages a move towards open messaging standards with UNIFI ISO 20022. However, this is

mandatory only for inter-bank message transfers for cross-border payments in the eurozone. Proprietary interfaces and local messaging formats are likely to remain unless banks can add value to transactions and encourage their clients to move to UNIFI.

In the short term, the cost of migrating to ISO 20022 for corporate to bank communication is prohibitive for the end user. Banks will need to continue handling multiple data formats from structured open messaging standards such as XML to unstructured data formats like pdf, Word, or Excel files and proprietary interfaces. Figure 1 illustrates a typical bank point-to-point connectivity environment. This is a costly, difficult to maintain, and unscalable architecture. Data is mapped directly from one application to another and processes, routing, and business rules need to be coded to specific message types.

FIGURE 1

Typical Point-to-Point Connection



Source: Financial Insights, 2008

Ultimately, this environment limits client-bank integration, straight-through processing, and visibility into the transaction life cycle. In order to support their customers, create value, and continue to compete successfully, banks will need to review existing payment infrastructures.

A Holistic Approach to Regulation

"Few banks have sufficiently assessed the impact of the PSD, in particular the impact of the reduction of float" — Large tier 1 bank.

While SEPA affects euro payments, the PSD will affect all payments in the European Union. The PSD will drive a further need for cost-effective payment infrastructures and business process reengineering and will result in more competition in the market. The key reasons for this is that the PSD will:

- Determine that domestic and cross-border euro or electronic payments are completed in a maximum of one day after the payment order is given
- Guarantee fair and open access to payment markets by introducing non-bank payment services providers, e.g., "pure" payment institutions or hybrid payment institutions such as telecoms and supermarkets
- Potentially remove certain charges such as value dating

Certainly these are not the full implications of the new legal framework for payments in Europe. Banks now have a small window of opportunity to analyze the impact of both the PSD and SDDs on their payment strategies. The impact of these regulatory changes is much more than a tactical response to yet another level of compliance. It needs to be viewed as a strategy project that will involve long-term decisions.

A transparent and cost-effective financial services industry is viewed as vital for the economic development of the European economy. This drive towards a more harmonized environment should be viewed as a strategic opportunity by banks in the region. Hence, Financial Insights believes that banks need to better integrate compliance as part of their business strategy. A strategic approach will result in compliance being an integral part of the business processes within the bank. Furthermore it will help identify opportunities that will maximize the return on compliance investment.

Most large transaction banks such as Deutsche Bank, CitiGroup, and JP Morgan Chase have already made the investments and changes in their payments infrastructure that will enable them to compete in this new European payment network, while smaller institutions are preparing to outsource most of their cross-border payments. However, it is those banks that fall in the middle of these two groups that stand to lose the most. These are the banks that need to review infrastructures, business rules, sourcing strategies, fraud and anti money laundering capabilities, and product innovation strategies over the next 18 months.

Sub-Prime, Risk, Fraud, and Anti Money Laundering

The financial impact of the sub-prime crisis and its spill-over in Europe, as well as recent fraud cases and rogue-trading allegations, will undoubtedly lead to increased regulatory pressure for financial institutions to tighten up their risk management systems. As payment flows are reconfigured in Europe, some aspects of change are being overlooked, in particular that of the increased risk of fraud and money laundering. As security around card payments increases, fraudsters are migrating to non-card instruments such as direct debits.

As SCTs and SDDs become more mainstream and we move to D+1 for payment settlement, new opportunities for fraud or money laundering will become available. Hence, new models for the prediction of fraudulent behavior need to be developed, but for these to be effective a greater level of integration between cross-border and domestic transactions needs to be achieved. Combining transaction data from multiple systems into a single logical view and simplifying interfaces through a common messaging framework will improve fraud detection by allowing cross-payment system predictive models to be built. Many banks, however, are creating separate SEPA channels to service their customers rather than focusing on upgrading existing payment channels to support multiple message types, SEPA and non-SEPA.

Beyond SEPA

Beyond SEPA credit transfers and direct debits, the European Commission is now working on defining standards for mobile payments as well as a common European Electronic Invoicing (EEI) Framework. These would ideally leverage the SEPA infrastructure and be based on common standards. However, this means that any investments made in payment infrastructures need to be flexible, scalable, adaptable to change, and future proof.

As we will see in part 2, investments made for PSD and SEPA need to focus not just on operational efficiency but also on generating new revenue streams. Without a long-term strategy for the introduction of value-added services to customers, the return on investment on SEPA cannot be achieved.

PART 2: GETTING VALUE OUT OF PAYMENT INFRASTRUCTURES

"Enhancing the capability, scalability, and straight-through processing of existing payment systems will be a challenge for most banks, in particular as structures and processes need to be designed and agreed upon. Meanwhile, corporates demand increased visibility in their transactions, more and more intra-day positions, and higher levels of integration" — Steve Pairman, JP Morgan Chase Treasury Services.

In the wake of SEPA and PSD, European banks are faced with the greatest challenge yet facing modern infrastructures. To remain competitive and to better utilize their existing infrastructures, banks should:

- Combine transaction data from multiple systems into a single logical view
- Simplify interfaces through a common messaging framework
- Centralize transaction monitoring and exception management to eliminate redundant operations and improve performance
- Improve fraud detection by building cross-payment system predictive models
- Reduce the cost of compliance by simplifying and normalizing payment processes, as well as automating the reporting as much as possible
- Eliminate redundant functions and leveraging best practices across the various payment systems
- Reduce the reliance on proprietary technology and increase use of open, standards-based technology such as Java 2 Enterprise Edition (J2EE)
- Provide greater transparency and reliability to corporate and retail customers
- Reduce the time and cost involved in introducing new payment products by facilitating the integration of new technology with the existing infrastructure

This is a long wish-list, which only a few institutions will ever achieve over a long period of investment. However, critical painpoints can be identified that are vital to a bank's payment strategy. Some may need to be reviewed against possible sourcing strategies, while others will justify core reengineering. For example, we see some banks implementing "payment hubs" initially on the front end, to provide corporate clients with more efficient ways of initiating and monitoring payments. Later, the back-end systems are connected to produce real operational efficiencies.

Others are focusing on replacing their back-end systems to achieve scale and flexibility in order to address the challenge of SDDs. This is a driver for many midtier banks looking to capitalize on their strong domestic presence in servicing direct debits on the domestic market, and looking to expand outside of their country remit.

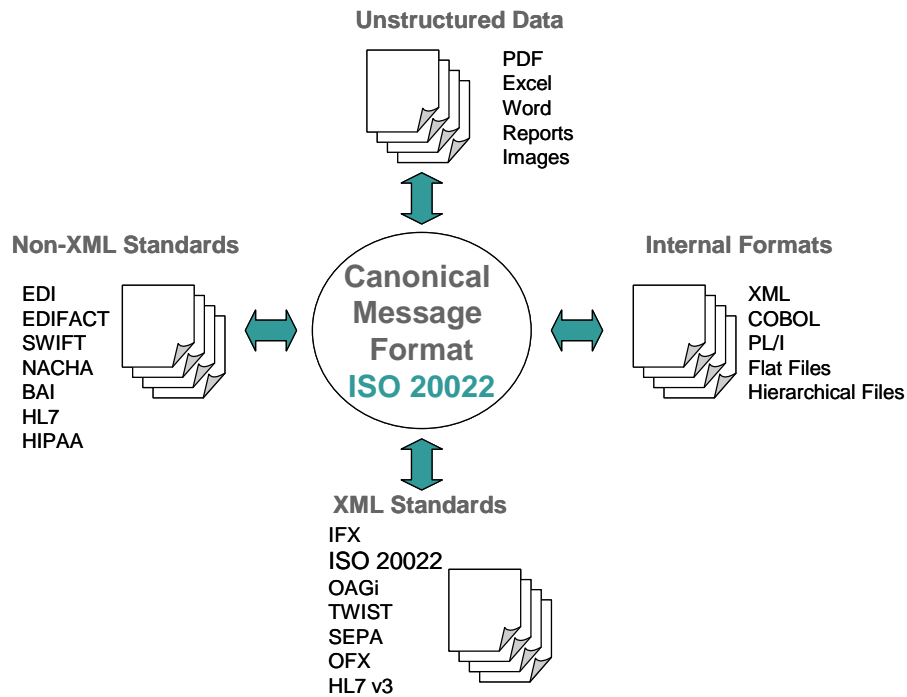
Towards Flexible Payment Infrastructures

As discussed, rather than introducing separate SEPA channels to support their customers, banks need to migrate domestic, SEPA, and non-SEPA channels to achieve greater transparency and cost efficiency. While the European Commission and the European Payments Council would like to have the shortest transition period as possible, all surveys with banks and their customers seem to indicate that a long transition period is more likely. In addition, we cannot consider SEPA in isolation. Despite the efforts to harmonize euro payments, banks also need to support international message types and proprietary formats. Banks have to support a growing number of formats as new open international standards are introduced as an alternative to proprietary formats. U.S. and Asian regional requirements need to be catered for alongside existing or planned SEPA projects.

Adopting a canonical message model based on UNIFI ISO 20022 will allow banks to support this transition period more effectively and cost efficiently, while adding key business benefits.

FIGURE 2

Example of a Canonical Message Model



Source: Financial Insights, Informatica 2008

This type of transformation hub allows the bank to:

- Achieve unified transaction monitoring
- Create shared message services (e.g., a message independent rules engine)
- Achieve faster response to change
- Develop true process integration
- Eliminate and reduce the number of interfaces to manage
- Reduce fraud and money laundering through better visibility of all customer interactions
- Reduce the cost of development and maintenance

It leverages on existing infrastructures and ensures a future-proof architecture as corporates finally migrate to UNIFI. Importantly, it centralizes all types of data sets, whether structured or unstructured formats. This is particularly important to leverage the value of a bank's customer interactions by identifying new service opportunities.

"SEPA is a major investment for uncertain returns without integration into the financial value chain" — Gianfranco Tabasso, chairman, EACT Payment Commission, CAST Coordinator.

Banking in Europe has never been more consumed by the subject of "innovation" as financial institutions seek new ways to differentiate themselves from the competition and better engage with customers. It is partly an acknowledgement of the failure to demonstrate innovation in the past, but also a recognition that other industries have proved more successful at building brands, customer loyalties, and — more importantly — business efficiencies.

Many of these initiatives have been launched hand-in-hand with new "customer-centric" strategies designed to demonstrate that banks can use the information and technologies at their disposal to be more proactive in delivering the products and services customers require.

An important area of future innovation for banks is in supply chain finance. The European Association for Corporate Treasurers (EACT) estimates that the introduction of electronic invoicing has the potential to reduce supply chain costs by up to €243 billion across Europe. This would indeed be a value-creating service for corporates and medium-sized businesses.

There are a number of marketplace innovations in the financial supply chain currently vying for favor in Europe. The business models include central trade information hubs, electronic invoicing projects, and bank-sponsored value-added processing. Infrastructures such as SEPA or SWIFTNet SCORE may create a link to developing new integrated supply chain finance services.

Real innovation in the integrated financial supply chain needs to enable visibility and predictability of cash flows arising from sales covering the order to final settlement. The amalgam of reliable and vetted information flows offers the opportunity to undertake financial intermediation at specific nodes in the financial supply chain (e.g., a supplier receiving a notice of payment can increase the accuracy of liquidity forecasts). This requires banks to support the payment flows of structured data alongside unstructured data carried in invoices (whether electronic or paper based) in a straight-through environment. It does not necessarily mean that the invoice data is carried in the payment message but needs to be presented in a unified way. This type of integration into the customer's supply chain requires both back- and front-office reengineering whereby shared payment services can be created.

Banks need to achieve both process and data visibility in order to identify the high-value customers and introduce the value-added services that will result in a strong and loyal partnership.

WINNERS AND LOSERS

"The SEPA vision is a positive end-state, but we must ensure that we work together towards a common goal that will benefit all stakeholders. There are important opportunities for all institutions and corporates; banks need to work closely with their corporate clients to ensure these are realized" — Anne Boden, head of Europe, Global Transaction Services, RBS.

The winners of SEPA will be the banks that can address the following challenges:

- Drive down the cost of transactions: Legacy applications, fragmented systems, and the rising number of messaging formats that need to be supported increase the cost of transaction while revenues are eroded. Many larger institutions have invested in their transaction engines and will leverage scale to compete on price. Importantly, investments today need to be future proof and leveraged across all payment products and services. Ensuring reusable service development will enable banks to make strategic business decisions.
- Focus on innovation: To balance eroding revenues, banks need to be able to introduce value-added services. Systems often lack the flexibility to be able to introduce new services rapidly and at low cost, while lack of visibility of information transacted limits the ability to recognize new opportunities. As payments become increasingly commoditized, it will be vital to differentiate through services.
- Increase customer satisfaction: Clients' expectations are increasing and in particular corporate clients are looking for greater levels of automation and STP. Crucially they are demanding more visibility into their transaction and positions in real time. Currently clients' experiences remain too fragmented. In addition, banks need to meet customer requirements by modeling business processes to that of the client's, including supporting a variety of messaging formats.
- Reduce business risk and target fraud: Multiple data formats, lack of transparency, and low levels of STP can increase business risk and expose the bank to increased fraud. In particular, anti money laundering compliance needs to be an integral part of SEPA projects. Huge benefits can be achieved by creating messaging integration hubs, for example where transactions can also be checked against AML lists. Increasingly best practices to measure risk and fraud are benchmarked against the capability to identify and predict in real time, which is itself reliant on how the data is acquired.

All of these challenges involve managing complex data formats and transforming existing business processes. It may also lead to institutions having to review their sourcing strategies for payment services. Importantly, midsize banks that do not take action now will stand to lose the most.

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