



Channel integration – why it matters in retail payments

June 2005

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Channel integration – the new old priority in retail banking

The mid 90s saw an awakening in banks' efforts to achieve a multi-channel view of customer profitability. This resulted in the first wave of CRM investments during that period, and a gradual re-orientation from a product-centric to a customer-centric mode of operation across the retail banking sector. However, in many cases this transformation has been a primarily 'philosophical' one, with many banks still struggling to achieve a real 360° view of the customer, and a persistent lack of coordination between various distribution channels and product silos when it comes to interaction with customers. There are a variety of reasons why this transformation has been slower than expected:

- **Reliance on sales automation and CRM applications.** The 'CRM-mania' of the mid to late 90s was characterized by a focus on the implementation of sales force automation and CRM applications, with many banks neglecting the need for more wide-ranging transformation to realize the benefits of CRM. This focus tended to be on efficiency of individual channels (e.g. Call Centers) rather than a more holistic approach to channel integration.
- **Distractions: the Internet.** The Internet bubble in the late 90s has distracted banks from their aim of achieving consistency across all channels. Throughout this period many banks subscribed to the hope that the Internet was going to become the most dominant and cost-effective channel going forward, resulting in a 'hierarchical' view of distribution channels and the neglect of some parts of the distribution landscape (e.g. branches).
- **Retail banks have been 'spoilt' by good market conditions in certain service lines.** More recently, the outstanding financial performance of many retail banks has created a false sense of security, diverting attention from the urgency to achieve better channel integration. The good market conditions in areas such as mortgages and credit cards (particularly in European markets such as Spain, Italy and the UK) have caused a slight regression to a product-centric view in retail banking, as these service lines seemed to perform well on a stand-alone basis, without the need to commit capital to expensive channel integration projects.

Going forward however, Datamonitor expects a swift return to concentrated channel integration efforts across the retail banking industry. The reason for this can be found in the changing competitive landscape banks are faced with:

- **The world is ‘over-banked’ - increasing competition and need for organic growth.** Hand in hand with the good market conditions of recent years (with some exceptions due to the local economic environment, such as Germany), the retail banking landscape has developed into a fiercely competitive environment characterized by price wars, declining margins in some service lines, and ever-faster rates at which product innovations are absorbed by the marketplace. Particularly traditional products such as cheque accounts and payments are experiencing significant commoditization, with retail banks engaging in increasingly aggressive battles for market share as they cannot rely on natural expansion of the market anymore.
- **Focus on sales execution and customer relationship management is returning.** The need to achieve organic growth as described above is forcing banks to return to channel integration as a top priority. Sales practices and customer relationship management are again being recognized as the most powerful differentiators in this increasingly competitive environment. With measures such as ‘share-of-wallet’ and ‘lifetime customer value’ becoming the dominant indicators of success, banks will have to focus on improving their understanding and handling of customers across all channels and product lines. All interactions with the customer – be it automated or in person – need to be coordinated across all channels to make customers feel ‘recognized’ by their institution, and in turn to enable improved cross- and up-selling across the banks’ entire product portfolio.

Why does channel integration matter in payments?

Payments is the ‘problem child’ in retail banking

As retail banking strategy has developed from a product to customer orientation and from a single to multi-channel strategy over the last decade, banks’ payments businesses have often remained isolated from this transformation. Developments around CRM and multi-channel strategy have often focused around customer data integration through operational data stores / customer information files outside core systems, with payments systems remaining in a fragmented and siloed state across various payments channels. Whilst this is valuable for understanding the overall customer relationship and for enabling product origination across channels, this is only part of a multi-channel solution and is operationally inefficient if the customer database is needed to present a real-time / consistent view of transactions across channels.

Simultaneously, from a profitability standpoint the payments business is increasingly becoming a 'problem child' in many banks' product portfolio. This is primarily due to two factors:

- **Commoditization and lack of differentiation.** Retail payments are the prime example of the commoditization that is occurring in some retail banking product lines. Innovation in payments as a stand-alone product is becoming more challenging, and it is increasingly hard for banks to differentiate their payments offering from the competition. For example, ATM networks have reached a level of universal accessibility that has eradicated any potential for revenue generation through simple ATM transactions for banks (e.g. in some western markets, we have seen banks offloading parts of their ATM networks to independent operators, as maintenance costs are starting to outweigh the benefits of owning them).
- **The payments business is becoming a 'scale game'.** The industry's limited view of possibilities to use payments as a differentiator is directly resulting in severe margin pressure in payments, as banks resort to pricing initiatives to compete. As a result, profitability of payments is increasingly starting to rely on economies of scale, creating a clear advantage for large banks that can afford to cut prices for product offerings and services more severely than small players. In Eastern Europe for example, this need to achieve scale continues to drive further merger and acquisition activity.

To a large extent, these two pain points – namely the lack of differentiators and the struggle to protect margins – are the result of payments having been isolated from the efforts to achieve a customer-centric view in retail banking. Therefore, the fact that the payments business is increasingly becoming a mere 'scale game' can be seen as largely 'self-inflicted', with banks having concentrated on achieving maximum efficiency in individual payments channels rather than including payments in the wider multi-channel strategy of the bank.

Many banks are now in a situation where they have to seriously re-evaluate their approach to payments to make sure they can continue providing this service in a profitable way. In Datamonitor's view, banks will have to re-integrate payments as an essential component of their overall customer strategy, and make sure they have a 'vision' of payments as a central part in their product portfolio. The challenge here is to 'un-commoditize' payments as a product whilst ensuring margins are protected. Channel integration will play a central role in this journey.

Differentiation – the role of channel integration

Creating an element of differentiation in payments is a major challenge in retail banking, yet essential for banks to make their payments business sustainable in the long-term. The increasing sense of ‘resignation’ in this respect however is based on a narrow view of payments as a stand-alone product, and fails to recognize its potential in the wider picture of managing a customer’s relationship to the institution.

Banks have to recognize that the majority of customer interactions remain payments-related. Consequently, payments should be seen as the very foundation of the customer relationship across various channels, which can be used for the purpose of competitive differentiation on several levels:

- **Utilize payments infrastructure as a source of up-to-date transactional data and customer information.**
- **Maximize the points of contact at which the customer can be ‘recognized’ as an individual by the institution.**
- **Increase revenue opportunities.**

Some practical examples of opportunities that draw on one or more of these points would be:

- **Push cross- and up-sell messages through payments channels.** Various payments channels allow advertising to be pushed out to customers. This includes ATMs, POS terminals (e.g. commercial messages to be printed on POS receipts), Internet banking and branches. If payments systems are integrated across various channels, such messages can be customized to fit individual customers’ transaction profile and to create more coherent communication across channels (e.g. to avoid the same product being offered to the customer through one channel if he has already rejected it through another).
- **Enable more dynamic authentication to reduce customer frustration whilst improving risk and security.** Increased integration between various payments channels will allow banks to keep closer track of customers’ recent transaction history, and combined with data from central hosts (e.g. cheque accounts core systems) will allow them to move away from the simplistic authentication methods that are still in place across the industry. For example, banks could reduce payment refusals/referrals in cases where customers are known to have sufficient funds in other accounts; or card limits

could be managed more dynamically in case transaction patterns appear temporarily suspicious but not as yet justify a refusal/referral. More dynamic authentication, therefore, creates differentiation on two levels: firstly, it avoids unnecessary frustration of valuable customers, and secondly, increases customers' confidence in banks' risk management/security mechanisms.

- **'Top-up services' to introduce new revenue streams.** Increasingly, banks as well as independent ATM operators are taking advantage of payments channels to offer revenue-generating services. Such possibilities include using payment terminals to top up mobile phones, transport cards or other alternative means of payment.

Margin protection – the role of channel integration

The payments business is experiencing significant pressure on profit margins, causing it to become a 'scale game' that ultimately causes large banks to be in an advantageous competitive position. In order to protect the long-term sustainability of their position in payments, banks will have to work hard to identify any opportunity to protect margins going forward. Channel integration can significantly contribute to this effort, primarily along the following two lines:

- **Consolidate processing across channels to achieve economies of scale.** In many cases, the current systems architecture in payments creates in-efficiencies and duplication in banks' payments processing functions. The historic fragmentation of payments systems across channel silos is a significant barrier to achieving processing synergies across the organization. A multi-channel approach to payments would enable the sharing of resources in areas such as payment repair, fraud detection or AML across all channels, reducing duplication and maintenance cost as well as delivering efficiencies of scale in payments operations.
- **Enable more sophisticated, cross-channel fraud detection.** Fraud remains a significant source of financial loss in payments, in addition to playing a part in customers' level of trust in their banking provider as mentioned above. Whilst most banks do have fairly sophisticated fraud detection systems in place that are designed to detect suspicious activity by comparing transactions to historical customer profiles (using rules engines or neural networks), the effectiveness of these systems is often compromised by the siloed nature of payments channels. This problem is bound to become more severe going forward, as customers' relationships to banks (i.e. the product portfolios they hold) are becoming ever more complex, and fraud

techniques become more sophisticated. Whilst initiatives such as Chip & Pin (primarily in the UK) will be effective at reducing some instances of fraud (e.g. at the POS), they will also cause a migration of fraud activity to other channels. For example, the traditional dominance of card-theft related fraud has in recent years been outgrown by card-not-present and counterfeit fraud. It is therefore necessary for banks to gain an enterprise-wide view of customer interactions to enable more accurate behavioral modeling of customers, which will result in more effective and ultimately more cost-efficient fraud operations (e.g. through reduction of false positives).

How to realize channel integration in payments – focus on standards and architecture

The common theme of all points mentioned above is that channel integration in payments is about creating the possibility to fully recognize customers as individuals every time they conduct a payments transaction, and subsequently act on that understanding. This should be possible across all channels, be it ATMs, POS, the Internet or the branch. In technological terms, this challenge could be summed up along the following two lines:

- **Establish a standardized mechanism to identify customers across all channels.**
- **Make relevant historical data immediately available to all channels.**

In the context of payments, both of the above can be effectively addressed by using plastic cards as the primary means of customer authentication. Whilst cards are already widely used for a variety of purposes – such as drawing out cash at ATMs or electronic payment at POS devices – their potential as drivers of a true multi-channel view of payments is still not fully exploited by most banks.

In the ‘card-not-present’ arena for instance, the emerging chip authentication applications issue a one-time password to authenticate both the customer and card in the context of e-commerce transactions. This provides improved security and counters phishing in online banking. At the same time it promotes greater use of the bank card, motivating customers to ‘keep it at the front of their wallet’ so that it is more likely to be used, than a competitor’s card, for the next payment. New functionality offered by smart cards is also rarely taken advantage of in the branch environment, where many teller and CRM applications still only use account numbers as a means to identify customers in the system.

Enabling full multi-channel capability of payments systems is clearly a potentially challenging project for any bank. For this reason, banks must carefully consider the factors that ultimately determine the cost and returns of such an undertaking. In Datamonitor's view, the two key issues banks should consider in this respect are: *architecture* and *standards*.

Architecture – service-enabling the payments value chain

The first consideration has to be aimed at the fact that banks have to rethink the strategic target architecture of their payments applications to achieve a true multi-channel approach to payments.

At present, banks' payments processing systems are characterized by entirely siloed legacy applications, with hard coded processing logic in each individual payments channel. Considering the sheer cost and risk associated with big-bang replacement projects, there is understandably little appetite amongst banks to realize channel integration through a major business transformation effort. However, with the emergence of standards such as web services and the increasingly realistic proposition of service-oriented architecture (SOA), the option of achieving channel integration in a gradual, step-by-step fashion is rapidly becoming reality.

In Datamonitor's view, banks should approach their payments channel integration by gradually moving certain shared functionality into a middle-tier environment. This approach will allow banks to service-enable individual components with re-usability potential across all channels (e.g. EMV processing/parameter management or fraud detection), and gradually standardize systems and processes across their entire distribution landscape. This approach will deliver several benefits:

- **Increase scale and efficiency of individual components**
- **Reduce maintenance cost and shorten time to market**
- **Utilize existing legacy infrastructure**
- **Concentrate on implementing components that deliver fast ROI**

Standards – increasing the benefits and reducing the pain

There is a range of standards being developed that promote channel integration and at the same time remove some of the historical barriers to achieving a multi-channel approach to payments:

- **EMV – increasing the benefits of channel integration.** The EMV smart card standard that is currently being rolled out globally will be a major driver for increased channel integration. EMV's options for flexible parameter management open up a host of possibilities to manage limits and reduce the risk on individual cards in a much more sophisticated way (e.g. dynamic authentication as discussed above). If banks wish to take full advantage of what EMV offers, they will have to make sure that as many channels as possible establish contact to customers' cards on as many occasions as possible. The early days will see most EMV parameters remain fairly static as banks don't have the relevant systems in place, providing plenty of opportunity for differentiation for the forerunners and technical innovators in this respect.
- **IFX – removing the barriers to channel integration.** Historically, the proprietary messaging standards used by various payment equipment and software vendors have represented a major barrier to achieving channel integration. Even within single channels, such as ATMs, banks had to put proprietary interfaces in place to enable communication between central payment engines and ATMs from various manufacturers. Recent years however have seen increased efforts to establish standards that allow smoother, and less costly, integration between various parts of the payments infrastructure. IFX started as one such initiative initially aimed at standardizing ATM messaging, with plans to expand its scope to other channels going forward. Whilst POS messaging already is fairly standardized (e.g. ISO 8583, Visa II, APACS, SPDH), there is still significant potential for IFX in areas such as branch or Internet communication, as the financial transaction set that is currently available expands further. As these standards get established, the need for proprietary interfaces will be gradually removed, significantly reducing the pain of multi-channel investments.

Conclusion

Over the past decade, payments have largely been left out of channel integration efforts in retail banking. The payments business is now in a position where banks struggle to achieve competitive differentiation, whilst margin pressure is rapidly turning it into a mere 'scale game'. In order to fight this commoditization of payments as a product, banks must embrace them as part of their overall multi-channel strategy and create a 'vision' of their future position in the payments market. Whilst a rip-and-replace approach is an unlikely option for most banks, new emerging standards and modern application architecture allow banks to pursue channel integration in a gradual and less costly fashion.

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