Business drivers and technology strategy in retail payments

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Introduction

Retail banks are finding their profit margins in payments increasingly squeezed. Commoditization, competitive pressure, a changing regulatory environment (particularly within the EU), changing dynamics in channel usage and global initiatives to fight fraud are all factors contributing to this. Banks are therefore finding themselves in a situation of having to address a set of seemingly contradictory forces: transaction volumes are increasing, unit costs must decrease, and investment is needed to address the increasing importance of delivering a coherent customer experience. This article explores some of the key drivers contributing to this increasing urgency, and discusses the options faced by banks going forward.

Key industry drivers in payments processing

The external environment: competitive and regulatory pressures are squeezing margins

There are two main factors that are causing considerable pressure on bank's profit margins in the payments context:

- **Intensifying competition.** The increasing level of commoditization of most retail banking products has resulted in a fierce competitive environment, with banks now struggling to differentiate themselves without drastically affecting margins through pricing initiatives. This is particularly the case in Europe, as limited opportunities for mergers and acquisitions mean that the battle for organic growth and market share is hotting up. The possibilities for banks to improve profitability of payment infrastructure (e.g. ATM or plastic card networks) through channel-specific charges are disappearing, as customers are becoming increasingly selective and sensitive to pricing.

- **EU legislation.** As part of the EU's effort to promote market harmonization in payments amongst its member states, recent legislation has forced banks to considerably decrease fees for cross-border payments within the EU. The EU directive on cross-border euro payments demands fees for payments within the EU to be at the same level as for domestic payments. Whilst this currently applies to payments up to €12,800, this limit will be raised to €50,000 from 2006. Even though other European initiatives such as TARGET, EURO1 and STEP1/STEP2 are seeking to provide the simplified clearing and settlement infrastructure to reduce cross-border transaction costs, it will take some time for banks to change their internal systems and fully realize the potential cost savings to match their loss of income due to the regulation.

Both these factors are forcing banks to urgently gain better control of cost in their payments infrastructure. Over the next few years, banks will have to revisit their systems across all payments channels as well as in the back-office in an effort to exploit synergies, increase efficiency and achieve lower unit costs.

Emerging trends in distribution channel strategy: payment channels need better access to customer data

Over the past 1-2 years it has become clear that banks must move away from their singular focus on efficiency of individual distribution channels, and that additional emphasis must be placed on effective and 'smart' integration of various channels. Banks must accept the fact that, in the face of ongoing commoditization of retail financial products, their ability to deliver a coherent experience to the customer is becoming the key differentiator in this business, and that scale alone – although still important – is not enough to remain profitable. Recent trends with regards to branch renewal are possibly the most prominent example of banks aggressively addressing this issue.

In the context of payments, banks should consider these developments along the following lines:

- **Integrate channels to create a coherent customer experience.** As customers become more sophisticated in their choice of payment channels for different activities, they are also becoming more demanding with regards to cross-channel access to transaction information and functionality. Banks will have to considerably improve the real-time integration of payment channels such as ATMs, Internet, Call Centers and branches to deliver a coherent experience to customers.

- **Use real-time customer information to personalize services.** Banks will have to improve front-office access to customer data in order to improve the overall customer experience and personalize the way payment channels respond to individual customers (e.g. for payment authorization). In particular ATM and branch networks are still relatively cut off from customer intelligence held in the enterprise. Considering the value of any customer interaction in an environment where intelligent advice and product-per-customer are becoming increasingly important factors, 'dumb' transaction channels and uninformed front-office staff are a wasted opportunity to deepen customer relationships.

The key implication of these trends is that banks must improve access to real-time transaction data across channels and the enterprise. Considering the product-centric and monolithic nature of many legacy core systems, this will be a considerable challenge and requires fundamental rethinking of banks' entire payment infrastructure.

Fraud prevention: banks need to invest in enterprise-wide view of transaction data

The constant rise of electronic payment usage and growth of Internet shopping are two major factors contributing to the increasing sophistication and spread of payment fraud. The global banking industry is clearly recognizing this and is committing significant investments to improve fraud prevention. This is particularly the case in the area of plastic card fraud, with countries such as the UK being most affected. Consequently, banks are demonstrating significant commitment to improve the security of cards used at the point of sale and otherwise (e.g. the Chip & Pin initiative in the UK and international efforts to support EMV).

However, fraud practices are elusive, and the focus of recent initiatives to improve security at the point of sale (i.e. fraud prevention before the actual transaction occurs) has resulted in a clear trend towards increased cardholder-not-present fraud (CNP). The root cause of payment cards' vulnerability towards CNP fraud is that cards were not originally intended to be used in CNP scenarios (e.g. on the Internet, telephone etc.). Consequently, banks will have to invest in more sophisticated transaction monitoring technology to detect CNP fraud more effectively.

The key challenge in addressing fraud detection is to enable an enterprise-wide view of transaction data. Considering the increasing proliferation of individual customers' payment activity across various channels and financial products, banks will need to move towards a cross-channel and cross-product view of individual customers' transaction history. Narrow, channel-specific fraud prevention methods will become insufficient in detecting suspicious transaction patterns, as they fail to see the full picture of an individual's typical transaction history across channels and accounts.

Technology implications

Cost reduction and new investments as opportunity: the future lies in the middle-tier

Drawing out the technology implications of the industry trends discussed above, it becomes clear that banks are faced by the following two challenges in payments:

- **Lower unit cost.** Given the ever-increasing pressure on margins in payments, banks are forced to achieve the lowest possible unit cost to remain profitable. Banks must therefore ensure the maximum efficiency of their payment infrastructure, reduce manual intervention where possible and be in full control of Total Cost of Ownership.

- **Access to data.** In addition to efficiency measures as described above, banks must also improve the effectiveness of their payments infrastructure by providing better real-time access to data and cross-channel/cross-product integration. This is necessary to enable innovation and revenue-growth initiatives, enable personalized responses to customers as well as achieve an enterprise-wide view of transaction data (e.g. for improved fraud detection). Considering the still limited budgets for new investments in payments, banks will often seek to fund such 'effectiveness initiatives' by first addressing cost/efficiency issues.

At first sight, the two requirements above appear to be somewhat contradictory in nature (i.e. cost reduction and containment on the one hand, investments to improve integration and improve the customer relationship on the other hand). Therefore, banks will increasingly be forced to rethink their overall approach to payments as opposed to relying on quick fixes to address isolated problems. Indeed, some of the current large-scale investments, such as branch renewal or EMV initiatives, could be used as an opportunity to trigger a wider transformation of payments processing across the enterprise:

The current state of fragmentation of payment processing across channels and product silos will make integration hard to achieve at the channel or core systems level. Banks should therefore consider migrating certain shared processing functionality into a middle-tier environment, creating a 'common services' architecture that addresses requirements across several payment channels. Taking this approach would support a gradual transformation of the bank's payments architecture, and offer the following advantages:

- **Eradicate overlap and drive re-use.** The status quo of banks supporting a multitude of payment engines and processing functionality in each individual channel is highly in-efficient. Maintenance, support and addition of functionality are lengthy and expensive processes as they need to be done individually in each channel. Centralizing core payments processes into a middle-tier environment would eradicate this repetition, with a single platform providing several channels with common processing functionality (e.g. for requirements such as EMV processing or fraud detection).

- **Facilitate wider access to data.** Centralizing some payments processing functionality will also enable better access to transaction and customer data held in disparate legacy systems. A central payment engine could increasingly become an enterprise-wide 'data hub' to facilitate a full customer view in various payment channels (including information not usually held in the payments function, such as CRM data and customer profiles). This would move the payments function beyond its singular purpose of transaction processing and enable it to play a central role in any payment related service that would benefit from consolidated customer data.

- **Improve long-term flexibility of payments processing architecture.** Far from being a quick-fix solution, a 'common services' approach would ensure long-term flexibility and agility of a bank's payments architecture. Payments functionality located in a middle-tier environment would form a central platform to efficiently and effectively address future requirements. New functionality requirements could be implemented centrally, and new emerging payment channels could utilize much of the existing processing architecture by 'plugging into' the platform as a shared utility.

Transform, offshore or outsource?

The overall need to reduce unit costs is currently not only felt in retail payments but throughout the financial services industry, particularly in back-office processing functions. Recent years have seen financial services institutions addressing this issue by subscribing to one or more of the following three strategies: **transformation**, **offshoring** or **outsourcing**. The balance and specific approach to combining these three strategies clearly differs across the sector, depending on specific business requirements and types of activity involved. In the context of retail payments, the picture is likely to develop along the following lines going forward:

- **Transformation.** Transformation initiatives typically consist of either 'big-bang' re-engineering and application replacement projects (e.g. as seen in recent core systems replacement efforts) or gradual, step-by-step transformation in areas where a 'big-bang' approach would deliver too slow an ROI or be too risky. Particularly in payments processing, banks are likely to adopt a more gradual approach, disentangling individual functionality from the value chain and attacking business components individually to maximize short-term ROI. This strategy can be driven and facilitated by the approach of centralizing certain processing in a middle-tier environment as outlined above.

- **Offshoring.** Recent years have seen increasing openness amongst banks to move manually intensive work to low-cost countries. So far, this has primarily affected IT development, call center operations and various operations-intensive processing functions (e.g. securities, wholesale payments and trade finance processing). Considering the already high levels of automation in retail payments, the market is likely to use offshoring in this area only to a limited extent. Apart from some cross-border and paper-based payments processing, manual intervention in retail payments is largely concentrated in specialist functions such as fraud checking, which limits the achievable cost savings through offshoring.

- **Outsourcing.** There is a considerable trend across the financial services sector to outsource processing functions to third party BPO providers. Many institutions are keen to concentrate on their core competencies and see outsourcing as a way to reduce cost by benefiting from economies of scale achieved by outsourcers. Outsourcing promises considerable savings and more transparent unit cost if it includes a significant element of manual labour. Again, considering the relatively limited amount of manual intervention in most of retail payments, banks should carefully weigh up the achievable cost savings when considering the option. In order to make outsourcing feasible, banks will need to include more manual intensive elements in the deal (e.g. such as cross-border or paper-based payments processing). Although there have been examples of outsourcing deals recently the challenge of providing a truly scalable multi-bank platform, plus the fact that payments are still very close to the hearts of many institutions mean that it is still questionable whether outsourcing will become a more common practice in retail payments going forward.

Conclusion

Banks are faced with a set of objectives that seem to be hard to reconcile at first sight: addressing the issue of unit cost in the face of ever-increasing volumes and complexity of transactions, whilst investing to improve the customer experience and prevent fraud.

In order to tackle these multiple challenges, banks must move away from a quick-fix approach and start re-thinking their overall payments architecture. Adopting a ‘common services’ model could provide a flexible and ROI-friendly back-bone for such a gradual transformation effort - ‘killing two birds with one stone’ whilst avoiding the need for costly ‘big-bang’ replacement projects or risky outsourcing deals.

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