ESSENTIALISING THE BANK

AN OPEN MIND TO PAYMENT UTILITY OPTIONS

Hans Kraus is Senior Partner in the FIS consulting arm Capco and a thought leader in the payments practice. As an ex-banker he has a profound understanding and interest in all the processes behind the scenes that determine to a large decree the performance of financial institutions.

He combines a friendly personal approach with bold and broad thinking – most recently about the role and best operating model for payments in an increasingly complex landscape. In the following 'mental workout' he stretches the executive's mind around the topic of Essentialising the Bank and exploring the opportunity of payment utilities in a way that befits the bank's agenda.

All stakeholders in the global payments value chain will agree on one thing: the volume of non-cash transactions is huge and growing. Today Europe stands at around 100 billion (the last official count in the *World Payments Report of 2014*, which gave a 87.6 billion number for 2012), around 130 billion for North America, 58 billion for Greater Asia, 33 billion for Latin America and around 29 billion for CEMEA.

But, in helping to make sense of how ready these markets might be for market-driven or shared payment utilities, these numbers shed little light. This has to do with two main factors: how far are the individual (large) banks advanced in their utility thinking. Secondly, what is the level of fragmentation in that country/region or how many existing smaller banks and new entrants are part of that particular market? Plus, is payments-as-a-service a culturally acceptable phenomenon?

Coming back on the first issue, Kraus points out: "The readiness to put utility thinking on the agenda has changed immensely over the last two to three years. Where in early 2010 any bank would retort with a firm 'No, payments are essential to us and need to stay inside the bank', there is now more mind space for this topic. Post-2008 most banks were dealing with liquidity and capital issues, quickly followed by a regulatory 'catharsis' that effectively overwhelmed any strategic debate around operations and all thinking was geared to preventing a repetition of the credit crunch. In 2012 and 2013 we saw early signs of banks starting to also look at the operational side of supporting their core business: getting money in and supplying credit. This means that the retail and SME/Corporate business, which heavily rely on an excellent payment service to the customers – got prime focus. The wider part of operations and IT became conceptualised into something that could be done outside the bank and as such the industry provider/utility concept was (re) born. Management talent, capital, skill sets for these functions can be hard to find and maintain inside a bank. This led to broader board discussions and a leading banker has even been quoted as saying: 'There are no sacred cows anymore inside this bank'. This mindset is now prevalent in many institutions and the utility question pops up in most – if not all – strategy payments RFPs we see today".

Repair – engineer – innovate - shape

Although payment transactions are more or less similar across the board, every financial institution defines its very own payment agenda depending on strategy and point in time. Where lifecycle issues dominate the agenda it is often about *repairing* for regulatory maturity or platform efficiency and *engineering* for a new operating platform, improved channel efficiency or sourcing strategy. Others might opt for an *innovation* agenda on the search for competencies in adjacent areas, new digital core services or a totally differentiating value chain in terms of business process or information technology outsourcing. Whereas the previous three steps allow a bank to secure, tune and extend their payments offering, there is also the option to renew their offering by *shaping* a new retail or merchant payments model, or redefine their cash management model and business.

All of the above is taking place in the harsh reality of banking in 2015. "No matter how much passion a payments team pours into their own strategic agenda, they are vying for attention on an overloaded boardroom agenda in nearly any institution: capital adequacy, ongoing regulatory requirements, risk and cost awareness and measures and an innovation agenda driven by the changing behaviour – and options – of all client segments. And these are all challenges that carry heavy impact if not met adequately, ranging from losing market share to losing a license to operate," says Kraus. "Giant leaps are being asked of the board – and made – and therefore preparing the payments strategy agenda, challenge, revisit and rephrase it before taking it to the top table is of vital importance."

> **Utility** *(noun)*: the satisfaction experienced by a consumer of a good or service

Essentialising the bank

The essential bank really consists of core business areas (collecting and lending) and a core value chain. It is not new to think of ways to improve performance on just that axis: outsourcing dates back to at least 1981 and as such is a much overused word for 'lifting and shifting' processes and services with the aim of financial engineering or the creation of economies of scale. "Whereas this has brought its merits in areas, inevitably it got stained with the perception of 'low value, low expertise and low innovation'. What we mean now by utility thinking reaches much further and deeper and as such is really a mental exercise. It puts the key business objectives of transformation, innovation, process governance and assumptions of risk at the heart of the debate", says Kraus.

Industry vision 2020

Getting to a new and modern infrastructure is one thing, staying up to date with the relentless pace of industry and technology innovation quite another. Therefore it is imperative that this continuous innovation should be at the core of utility thinking. "Think of an old Nokia phone versus a new iPhone", says Kraus. "You can change all the parts that make up the Nokia and build the closest match to an iPhone – for a day or maybe a month. In no time new services will be available on the iPhone and finally you realise that buying into the services based idea of an Apple experience will allow you to stay in step. Payment utilities too will evolve from a regulatory perspective, in terms of going instant for many more types of payments, to name but a few examples. Utilities can afford to go further than one bank on its own."

Looking forward to 2020 we could well see a development from payment device software as-a-service (think wallets, ATMs etc.) as we know today to the payment hub as-a-service (a segment in which FIS acquired a main stake with the acquisition of OPF and its many large global implementations) to even payment networks as-a-service,

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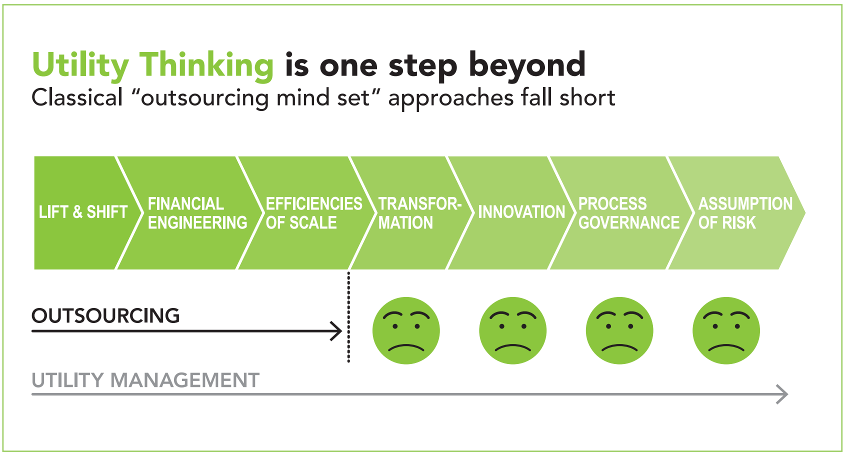

> "THE MENTAL CHALLENGE OF CONSIDERING THE UTILITY ROUTE, OF CONCEPTUALISING A DIFFERENT WAY OF WORKING IS TREMENDOUS."

whereby global network utilities will have replaced large parts of the correspondent banking networks. Although this might seem like a quantum leap, a closer look at the economic rationale makes it worthy of further investigation.

One could conceptualise a payment network as-a-service as a type of global payments overlay. "Obviously, this is both an interesting as a well as a contentious issue at Sibos, where we hope that Swift will reveal more of its long term innovation agenda", concedes Kraus. "But as a company we have an obligation to our customers to have an open mind when it comes to shaping a global payments innovation agenda for the industry at large. A payments overlay could connect local payment utilities and offer an overarching global network for clearing settlement of liquidity. This money stays in the payment overlay to increase interest benefits for the associated parties. Additionally this overlay can provide a myriad of functionality across payment channels and interfaces."

Strategic choices ahead – utility options

One constant factor in the 'sourcing' debate around payments is the confusion of terminology to which Gareth Lodge referred in the 2013 Celent paper 'Thinking the Unthinkable: "a first step to wider use of outsourcing may actually be the dropping of the word outsourcing itself, as it comes with connotations and misconceptions". With this statement, he paved the way for a progressive level of services in a utility environment 'from outsourcing to best-sourcing'.

In-house utilities deliver undeniable benefits like internal integration synergies, cost reduction and a higher level of flexibility and control. A captive utility where the payments environment is also offered as-a-service to other third party clients gives besides higher levels of cost benefits primarily the great advantage of avoiding more systems complexity. At the point where a genuine market utility is offered as-a-service to a variety of different clients with different needs, the cost leader strategy becomes a reality in terms of scale, automation, labour and productivity. Also, for a niche offering like this there is only one success strategy: offer the best that is available in the market (think third party or embedded value add services) for the best price.

How to move from being a payment hub customer to a captive utility or how to build a market utility is determined by the strategic agenda around technology, business model (experience), customer access and capital. Those factors need to be mapped and plotted on a longer term plan and challenged by external and internal expertise.

Mental stamina called for

As in all walks of life, change is never easy. The mental challenge of considering the utility route, of conceptualising a different way of working is tremendous. "At the same time this is exhilarating, every time we meet with a bank we feel a new sense of energy and urgency around the payments paradigm," says Kraus. "Ultimately the bank's strategy on this front determines its future: 'We want to survive'; 'we let regulation determine our path forward' or 'we design our future around payments'. Repair, engineer or innovate are all viable mind sets that can be addressed in the payments utility context."