

Losing Control, Winning Wallet Share

WHITE PAPER

Sponsored by: Unisys

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FINANCIAL INSIGHTS OPINION

Banks are struggling to maintain control of their customer relationships amid a rapidly transforming payments landscape. Non-banks – including payment processors, emerging payment providers, telecommunications operators, and retailers – are simultaneously leveling the playing field and contesting banks for control of their customers. While financial institutions are anxious to maintain control – and the wallet share that goes with it – it is neither possible nor advisable to do so alone. Non-banks can be key partners, but banks must be clear on their role and able to collaborate effectively. Through a global survey of leading banks and non-banks, Financial Insights finds that:

- 86% of banks named protecting revenue as a critical priority, above meeting customer expectations and meeting regulatory requirements.
- All of the banks agreed with the idea that collaboration with non-bank payment providers to speed time to market and achieve scale was a good way to protect revenues and satisfy customer expectations, and 69% were already doing so.
- All of the banks likewise agreed on the need for better business intelligence surrounding their payment operations, and 71% had already made investments in this area.
- Service-oriented architecture (SOA) is a key technology for enabling collaboration with third parties and achieving better business intelligence. There was broad agreement among the banks on this point, although only a third of U.S. banks have actually implemented SOA.
- Non-banks, including telcos, were generally comfortable with the idea of the bank remaining as the primary owner of the customer relationship when it comes to payments.
- Banks, for their part, had complex attitudes toward non-banks; 60% viewed responding to non-bank competitors as a "critical"

priority, yet all the banks agreed that collaborating with non-bank payment providers was at least a good idea. We believe that this represents a "coopetition" strategy, with banks willing to work with non-banks where it benefits them or they have no choice, but preferring to bring functionality in-house whenever they can.

IN THIS WHITE PAPER

In this white paper Financial Insights examines the level of adoption of a collaborative model by banks and non-banks to determine the current status and the future of enterprise payments. We look at and evaluate relationships and approaches banks and non-banks are taking to implement an enterprise payments model.

METHODOLOGY

Surveys were prepared and interviews were conducted with senior level executives responsible for enterprise payments strategies in both banks and non-banks. Targeted regions included:

- Banks in Europe, Middle East and Africa – UK, France, Germany, Benelux
- Banks in Asia/Pacific – Hong Kong, Taiwan
- Banks in North America – U.S.
- Non-banks – telcos and other non-financial institutions that are, or may become influential players in payments.

Due to rounding, not all numbers in the tables and figures add up to 100%.

SITUATION OVERVIEW

Consumers have higher expectations for payment services

Consumers have greater expectations for payments services provided by their banks as technology, and especially mobility, plays a greater role in their daily lives. Non-banks continue to introduce and offer new products and services that are attractive and desirable to consumers. If banks are not able to offer these or similar products and services, the consumers will turn to others for the offerings. With this changing behavior by the consumers, the question arises as to who will have control of the customer relationship in the future.

Competitive environment continues to escalate

The competitive environment continues to escalate with telcos, payment processors, retailers, and alternative payment providers such as Google, Yodlee, and PayPal rapidly introducing new products and services which impact banks' revenue streams. As new products and services are introduced by non-banks, banks must either build competing systems or partner with others to be able to provide these products and services to their customers. Introducing new products and services creates a strain on a bank's implementation and processing abilities, especially when such systems are operated within silos, hence the introduction of an enterprise payments structure to facilitate efficiency and cost optimization.

Key challenges identified

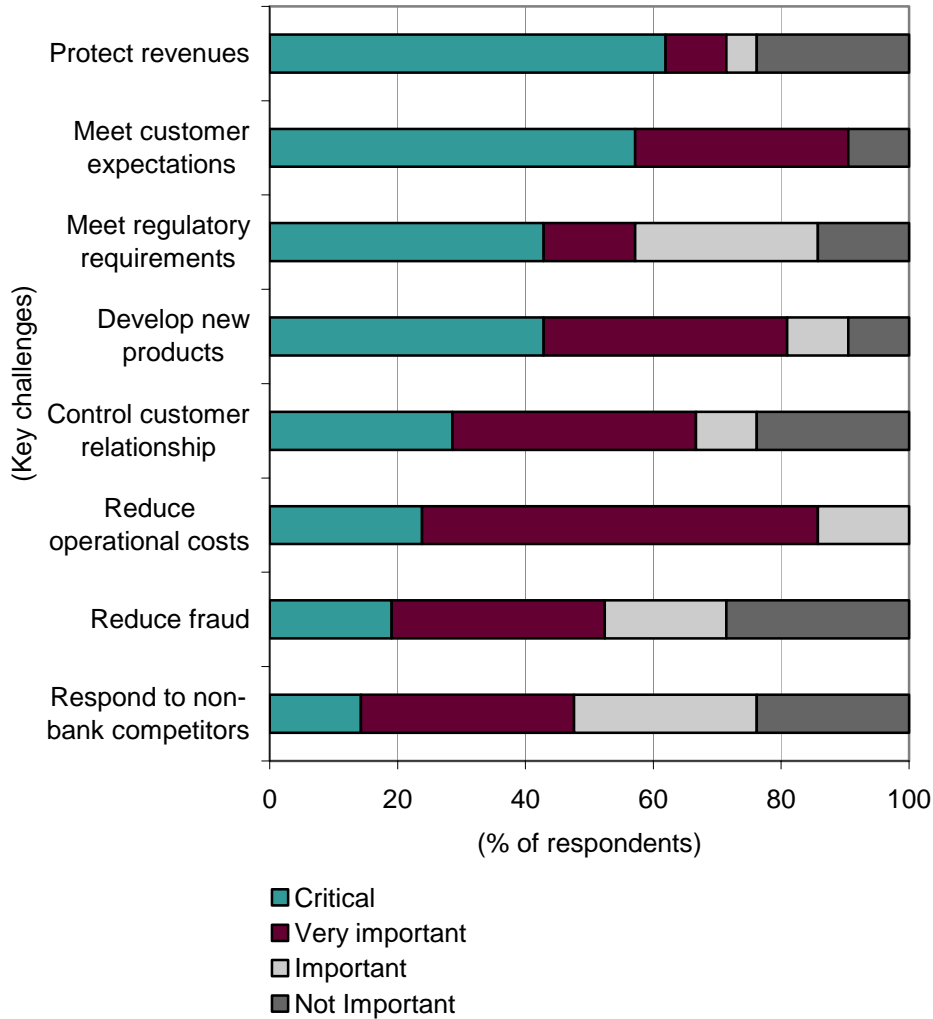
In the area of key challenges, we asked respondents to rate various factors as "important, very important, or critical" (see Figure 1). Our research finds that US banks are universal in their agreement that protecting revenues and meeting customer expectations are the most critical factors. When compared to other key challenges, these two factors obtain the highest rating, while factors such as reducing operating costs and developing new products and/or markets to expand revenue are still very important. That non-banks are considered a primary threat to payment revenues is supported by the fact that 60% of the U.S. bank respondents to our survey considered it critical to respond to non-bank competitors while the other 40% considered it important to do so. Product innovation is also widely seen as a way to protect revenues and meet customer expectations; 54% percent of the respondents consider developing new products as being critical, and the majority of the remainder rated this factor as very important.

By contrast, none of the European banks interviewed considered it even important to respond to non-bank competitors, but 75% did consider it necessary to develop new products and/or markets to expand revenue. European banks are more focused on meeting customer expectations and reducing operational costs; 100% consider it important or very important to reduce costs. All Asian bank respondents also agreed that protecting revenues and reducing costs are critical, as is responding to regulatory requirements.

FIGURE 1

Key challenges

Q1 Please indicate which of the following you consider key challenges for your bank in the payments area, and rank them as important, very important, or critical.



Note: If a respondent did not rank a particular category, it is assigned to "not important".

Source: Financial Insights, 2008; n = 21

For their part, the non-banks were unanimous in agreement that banks should have the primary financial relationship with the customer, and the non-bank relationship would be a secondary one. This is also true of branding, where the non-banks believed the bank should be the predominant brand for the customer. This would come as a surprise to many bankers, but it may be that the non-banks do not see their activities as a real threat to the banks. After all, the banks continue to hold the primary checking accounts and credit card relationships. It may also be the case that the non-banks we spoke to were cautious

about appearing to be interested in entering the banking market, because that would invite unwelcome regulatory scrutiny. If they can rationalize their activities as filling a gap that the banks themselves do not want to address, it helps avoid awkward questions.

Reducing fraud was rated as a very important to critical challenge by over 69% of US bank respondents. While all banks were concerned with fraud and security, only 19% of all banks interviewed expressed this as a critical factor. Seventy-five percent of the European banks did not even mention this as a key challenge. The Asian banks all rated this factor as important to critical. Respondents are primarily from the treasury side of the financial institutions, and some mentioned this category would be rated more highly by others in the retail side of the institution.

Strategies for Responding to the Current Payments Environment

A primary goal of the research was to validate five strategies for coping with the increasingly complex and competitive payment environment:

- Collaborate with non-bank payments providers to achieve scale and innovation
- Invest in payments business intelligence
- Employ Service Oriented Architecture
- Make investments in regulatory compliance
- Consider smart sourcing options

These strategies are described in greater detail in the Unisys white paper, *Big Winners and Big Losers in Payments – Where Is Your Bank Headed?*, available for download from www.unisys.com.

The results of our survey certainly support these findings and are summarized in Table 1.

TABLE 1

Options for dealing with key challenges

Q4. Please consider the following list of options for dealing with the challenges listed in Q1, and indicate how you feel about them.

Key challenges	Already doing	Agree with idea, but not doing yet	Have significant concerns or doubts	Disagree
Collaborate with non-bank payments providers to achieve scale and innovation quickly	67%	29%	0%	0%
Compete directly with non-bank payments providers by building similar products and services in-house	29%	43%	19%	5%
Invest in payments business intelligence, including information about customer profitability and preferences, in order to better match product and service offerings with customer demand	71%	24%	0%	0%
Employ a technical architecture such as service-oriented architecture (SOA) that enables the coexistence of legacy and modernized payment platforms, enabling the transformation of payments systems in cost controlled phases	43%	48%	5%	0%
Use regulatory requirements as a justification to modernize payment system architecture and introduce new payment services	52%	24%	5%	10%
Sourcing payment processing for certain payment types to a third party, in order to focus more tightly on strategic business initiatives	62%	19%	10%	5%

Source: Financial Insights, 2008; n = 21

Banks agree on need to partner with non-banks

One of the hypotheses we set out to validate concerned the need for banks to partner with non-banks to speed time to market and achieve scale. Banks have had limited success addressing new market opportunities like e-commerce, mobile commerce, and worker remittances, creating an opening for non-banks such as PayPal, Google, and telecommunications companies to enter. Rather than attempt to compete with the non-banks, Unisys suggested partnership. The survey results showed stronger-than-expected agreement with this view, with the majority of respondents (66% of US banks, 75% of European banks, and 50% of Asian banks) already collaborating with non-bank payments providers (most often third-party payment processors). Another 27% of US banks, 50% of European banks, and 50% of Asian banks agreed with the idea but were not doing it yet. This does not mean, however, that banks would not change their

strategy if they felt they could outperform the non-banks. Only 23% of the US banks were competing directly with non-bank payments providers by building similar products and services in-house, but 69% agreed with the idea of competition. In Europe there was much less interest in competition, with 75% of respondents having significant doubts about building similar products and services in-house, and 25% disagreeing with the concept altogether. The Asian banks are already competing with non-bank payment providers by building similar products and services in-house. Generally, larger banks are hesitant to outsource and would rather build to compete. However to meet demands and to achieve scale and innovation more quickly, they are beginning to increasingly look to outsourcing and partnering. The difficult economic conditions will also drive many banks to reconsider use of third parties.

Business Intelligence is a Key Priority

Another point made in the Unisys white paper was the importance of business intelligence as a tool for running the payments operations as a business, with its own profit and loss accounting. Since different payment types are best suited to different situations, and use different levels of resources at different times, it is far more effective to view all payment operations through a common reporting system, rather than as distinct products. Our survey found strong support for this concept, with 60% of US respondents already investing in business intelligence and 33% agreeing with the idea, but not yet acting on it. All of the European and Asian respondents are already investing in payments business intelligence.

One key component of a payments business intelligence infrastructure is an enterprise database that provides a consolidated view of multiple payment types. Almost two thirds (60%) of US banks have, are currently building, or plan to build such a database, but not for real-time reporting. The database includes checks, ACH, debit cards, and wires, with plans to include credit/charge cards and mobile payments. Internet payments and credit cards are planned to be added sometime in the future. Fifty three percent of those planning to have an enterprise payments database said they plan to build a customer analytics program; 20% actively use data to target early adoption behavior; and 33% partially leverage data for marketing. This is not a priority item for European banks: 50% have no plans at all for such a database, and only 25% are currently building a database. For the most part, these European databases are now being built only for SEPA. Fifty percent of the Asian banks are currently building a database, but the rest have no plans to do so.

In short, there is broad agreement on the need for business intelligence about payments, particularly in the U.S., but not all banks believe that an enterprise payments database is necessary. One bank we spoke to

had used reporting tools to assemble an single customer view of payments, without building a more versatile database.

Service-Oriented Architecture is Widely Accepted

Unisys argued that service-oriented architecture (SOA), a means of exposing application functionality in terms of standardized components, would:

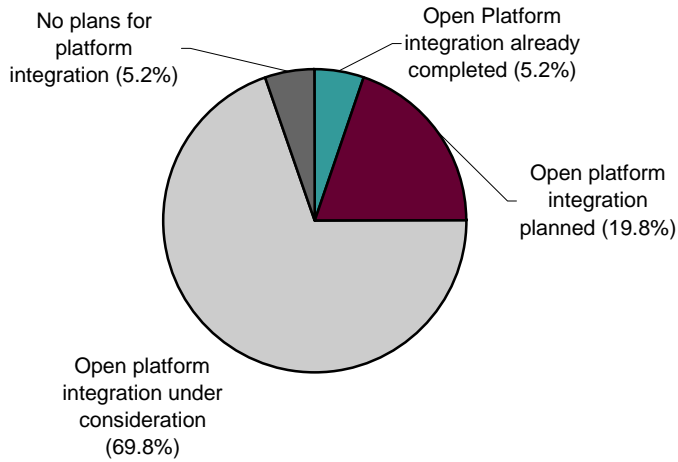
- reduce costs by modernizing legacy systems;
- enable banks to more effectively integrate with third-party service providers; and
- add new capabilities much more quickly.

While our survey found widespread agreement with this concept, actual implementations are still uncommon. In the U.S., about one-third of banks are already doing this, with the majority of the remainder (53%) agreeing with the idea, but not yet doing anything in this area. Only 14% have significant concerns or doubts with this concept. All the large banks consider SOA as a requirement for new solutions, whereas some smaller institutions only consider this as somewhat important a factor. The European institutions all have SOA as a requirement, especially for SEPA, but have not yet rolled it out to all other parts of the institution. None of the Asian banks are employing SOA yet, but they do agree with the idea.

Another key driver of SOA implementations is consolidation of payment platforms. Most banks (81%) surveyed have three or more platforms to process their payments from systems such as checks, ACH, wires, and credit cards. One platform for each system is the most common situation, but all expressed a desire to have a common platform, and all have a platform integration planned or under consideration; only 20% of these institutions has an open platform integration actually planned (Figure 2). Seventy-five percent of the European institutions indicated they have an open platform completed, planned, or under consideration, but the integration so far has been for the SEPA payments. The Asian banks have open platform integration under consideration.

FIGURE 2

Plans for open payment platforms



Source: Financial Insights, 2008; n = 21

Regulatory Compliance Is Limited as a Driver of Payments IT Spending in the US

Unisys pointed out that compliance investments can provide an opportunity to make improvements in payments infrastructure that would otherwise be hard to justify. With Check 21 in the US and SEPA in Europe, government regulations have driven a lot of IT spending in the past several years. However, our survey found that many banks have opted for a more narrow view of compliance spending. When asked whether they were using regulatory requirements as a justification to modernize payment system architecture and introduce new payment services, 47% of US respondents said they were "already doing" that, while 27% agreed with the idea but were not doing it yet, and 20% either disagreed outright or had significant concerns or doubts. European banks are under similar pressure to comply with many regulations, but see the opportunities much more clearly: they all agreed they are using regulatory requirements as a justification to modernize payment system architecture and to introduce new payment services. Asian banks expressed similar sentiments, with 50% of them "already" using regulatory requirements as a justification to modernize.

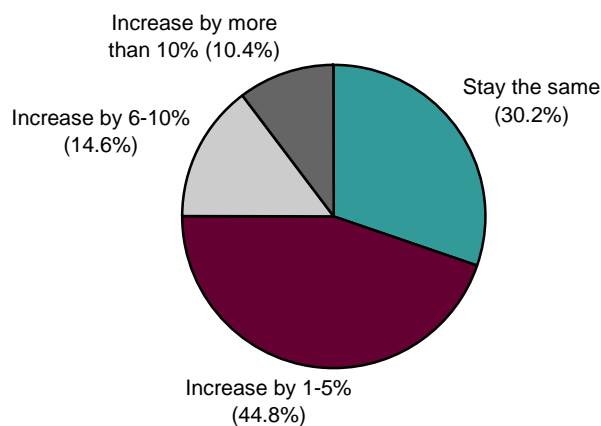
Looked at another way, 73% of US respondents saw the goal of their compliance investments as being limited to proving compliance to regulators, versus delivering improvements in service levels, while 67% of the European and Asian banks also view the goal as limited to proving compliance. Still, all thought that their IT spending on compliance would either rise or stay the same between 2008 and 2009

(see Figure 3), despite the financial turmoil engulfing the financial industry, so clearly compliance is going to have a major impact on payment systems, some of it perhaps unintentional. Depending on how the compliance investments are implemented, they may provide a basis for further, more business-related investments in the future.

FIGURE 3

IT spending on compliance with payment industry regulations

IT spending on compliance with payment industry regulations



Source: Financial Insights, 2008; n = 21

Smart Sourcing is Common

"Smart sourcing," or outsourcing selected payments processes to managed service providers that can leverage economies of scale and best practices, is a strategy that found broad validation among the survey respondents. Sixty percent of U.S. banks are doing so, with 20% agreeing with the idea but not yet doing anything. Having significant concerns or doubts was indicated only 13% of the time. Seventy-five percent of the European banks and 50% of the Asian banks are already outsourcing some payment processing, particularly credit cards, mobile payments, and Internet payments.

Many mid-sized European banks have outsourced their SWIFT operations either to other banks or to service bureaus. Large banks, on the other hand, are increasingly considering bilateral clearing arrangements, bypassing third-party processors to reduce costs. We therefore see contradictory trends in Europe, with outsourcing in

general threatened at the top and gaining traction at the bottom. Outsourcers are facing additional pressure from large banks such as Deutsche Bank, which is offering SEPA processing services for mid-sized banks across Europe.

We asked the banks what the three top criteria would be in evaluating an outsourcing partner. The list and the ranking results are shown in Figure 4.

FIGURE 4

Top criteria to evaluate an outsourcing partner

Q26 If you were to evaluate an outsourcing partner for payment processes, what are the top three criteria that come to mind? [select only three]



Source: Financial Insights, 2008; n = 21

Banks definitely favored strong, stable outsourcers with a lengthy track record over those that had superior technology. In the U.S., banks tended to rate technology more highly than the average, while in Europe, financial stability was even more important. Asian banks emphasized quality and level of support. This means that US banks may be somewhat more willing than European banks to take a risk on

partnering with a high-tech payments provider, while the European banks focus more on large, established payment processors to provide scale efficiencies. The pressures on European banks, most of all SEPA, mean that these banks must be more concerned with basic issues of processing payments efficiently, rather than developing innovative new products.

Banks benefit from Outsourcing

Seventy-nine percent of the U.S. banks (75% of European) perceive lower costs as the key benefit of outsourcing, especially in the short term, or if the outsourcing is a truly collaborative effort. Quicker time to market for new product development and better operational efficiencies were both selected by 62% of the U.S. respondents and 50% of Asian banks, while quicker time to market was selected by 75% of the European banks. Improved customer satisfaction/loyalty, higher revenues, and higher quality service to the bank customer were each selected by 14% of the U.S. banks. Lower exception rates was not considered as key benefit in any of the geographical areas. Only 29% of the banks selected less risk as key benefit from outsourcing, while 43% perceive greater accountability through a well-defined SLA as a key benefit. Banks feel that outsourcing can be beneficial and is especially useful for getting to market with new products developed by others. However, partnerships must be developed carefully, allowing banks to maintain customer control and allowing banks to control the partnership to insure quality customer service.

In terms of specific types of partnerships, the most common were payment processing services. The majority of U.S. banks (60%) are partnering for some payment processing service or services (e.g. mobile banking, bill pay, and lockbox processing), while 100% of the European banks and 50% of the Asian banks are already in partnership with non-banks. The remaining Asian banks (50%) probably will consider partnering for new services. For U.S. banks, another 29% will probably consider such a partnership, whereas 7% probably will not consider any such partnership. Larger banks are more prone to develop in-house systems to meet competitor offerings, whereas smaller institutions are more receptive to outsourcing for specialized products and services.

Certain types of payments were much more likely to be outsourced than others. Traditional banking services such as check processing, branch check capture, legacy check capture, and day 2 check operations are considered a "mainstay" in the banking field. Large banks, both domestic and European, are generally very unwilling – and indeed some say never willing – to rely on an outsourcer to provide the processing of these services. On the other hand, Asian banks are more prone to be somewhat willing to rely on outsourcing these services. Smaller banks, especially newer institutions, are more willing to outsource, and we find that outsourcing these services is becoming

acceptable to the mid-tier banks also. Banks of all sizes are more willing to consider outsourcing newer services such as image exchange and image archiving, mobile payments, and internet payments. The largest banks are very reluctant to outsource credit and debit cards, whereas smaller institutions are already outsourcing these applications. The larger banks are also "already doing" or "somewhat willing" to outsource lockbox services, but are somewhat reluctant to very reluctant to outsource wire transfers, ACH debits and credits, giros, and check fraud management. This is more evidence of the banks' desires to maintain control of the customer relationship, but with a willingness to outsource the critical but non-core processes such as lockbox processing. European banks are even more conservative about outsourcing, and responses from those institutions were mostly would never do to somewhat reluctant (as opposed to "somewhat willing" by Asian banks). Remote check capture, check lockbox, and credit cards are being outsourced by 25% of the banks.

CONCLUSIONS

Banks have traditionally been very protective of their customer relationships and the trust created in the banking system. Going forward, a more flexible, collaborative strategy will be needed to keep pace with market evolution. Rather than insist on complete control of the customer, banks must be willing to lose some of that control in order to win greater wallet share. Working with partners that have their own customer relationships brings new sales opportunities, but banks have to work within those pre-existing relationships. The good news is that none of the non-banks we spoke to want to be banks, preferring to avoid the responsibility for payment management and settlement. The banks we spoke to seemed more comfortable with non-banks now than during past interviews, perhaps because they are receiving the same message from the non-banks with which they are in contact.

Successful banks will use business intelligence, service-oriented architecture, and enterprise payments technologies to adapt their legacy infrastructure to a world in which payments service delivery is distributed across multiple providers, some of which are non-banks. They will leverage necessary compliance investments to construct a more flexible payments infrastructure, conserving future IT budgets. As Table 2 summarizes, many of the largest banks have already adopted these strategies, and more are moving in that direction. The key challenge in the current financial climate will be to preserve strategic payment investments so that when economic growth returns, the bank will be in a strong position to take advantage of it. Several of the banks we spoke to, particularly below the top 25, saw the economic crisis as an opportunity to pick up deposits and take advantage of the distraction of the large banks by mergers, government ownership and ongoing credit losses.

TABLE 2

Bank Support for Key Payments Strategies

Key challenges	Agree and/or Already Doing
Collaborate with non-banks	96%
Invest in payments business intelligence	95%
Employ SOA	91%
Utilize smart sourcing to concentrate on strategic priorities	81%
Leverage necessary compliance spending to upgrade payments infrastructure	76%

Source: Financial Insights, 2008; n = 21

The payments industry is at a crucial juncture. For those with the vision to see and ability to implement a new way of managing payments, there is an opportunity to achieve lasting competitive advantage. Alternatively, there is the risk of pursuing a conservative strategy and allowing faster, nimbler competitors to chip away at your most profitable customer relationships. Which path will you take?

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