A RESEARCH PAPER FROM FINEXTRA IN ASSOCIATION WITH FISERV

OCTOBER 2017

PAYMENTS TRANSFORMATION: MODERNISING TO STAY RELEVANT IN THE DIGITAL AGE

fiserv. | Finextra

01
INTRODUCTION

Banks are convinced that payments will be fundamental to their future businesses, and confirm that payments transformation is critical to their digital programmes – but they are less confident in the clarity of their digital and payments transformation strategies.

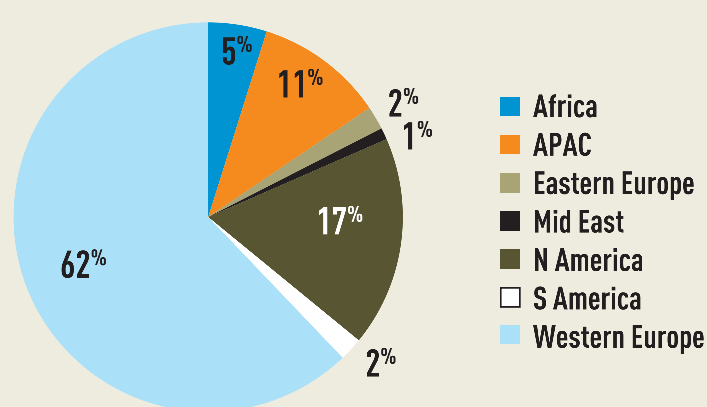
They are excited about new opportunities created by the revised Payment Services Directive (PSD2) and the rise of real-time, but they believe that fintechs have driven more payments innovation than banks during recent years.

And while they are collaborating more with fintechs, the banks still have significant concerns about legacy – with many identifying existing systems as the biggest inhibitor to payments transformation.

These are among the key findings of a recent online survey carried out by Finextra, in association with Fiserv, into banks' views on digital transformation and payments.

TOTAL

104 RESPONSES FROM 32 COUNTRIES



The survey also reveals a strong belief that instant payments will develop into a powerful alternative to cards, both online and at the point of sale, in the coming years.

By contrast, the survey respondents' views on the much-hyped topic of blockchain reveal continued uncertainty about whether – and when – this technology will make an impact on payments processing.

On developments with more imminent impact, the survey suggests that banks are already well set up with funding to invest in real-time payments and open APIs – and the majority are engaged in upgrading their existing payments systems.

This is reassuring given that only a quarter of respondents believe banks are leading when it comes to that other much-hyped concept of 'frictionless' payments.

The survey was completed by more than 100 senior payments practitioners during August and September 2017. The respondents' organisations included banks, corporate treasuries, merchant services, payment processors and industry associations.

The survey findings are presented in detail in the pages that follow, augmented by the opinions of a number of industry experts interviewed by Finextra about the results of the research.

> **"Banks are convinced that payments will be fundamental to their future businesses, and confirm that payments transformation is critical to their digital programmes – but they are less confident in the clarity of their digital and payments transformation strategies."**

02

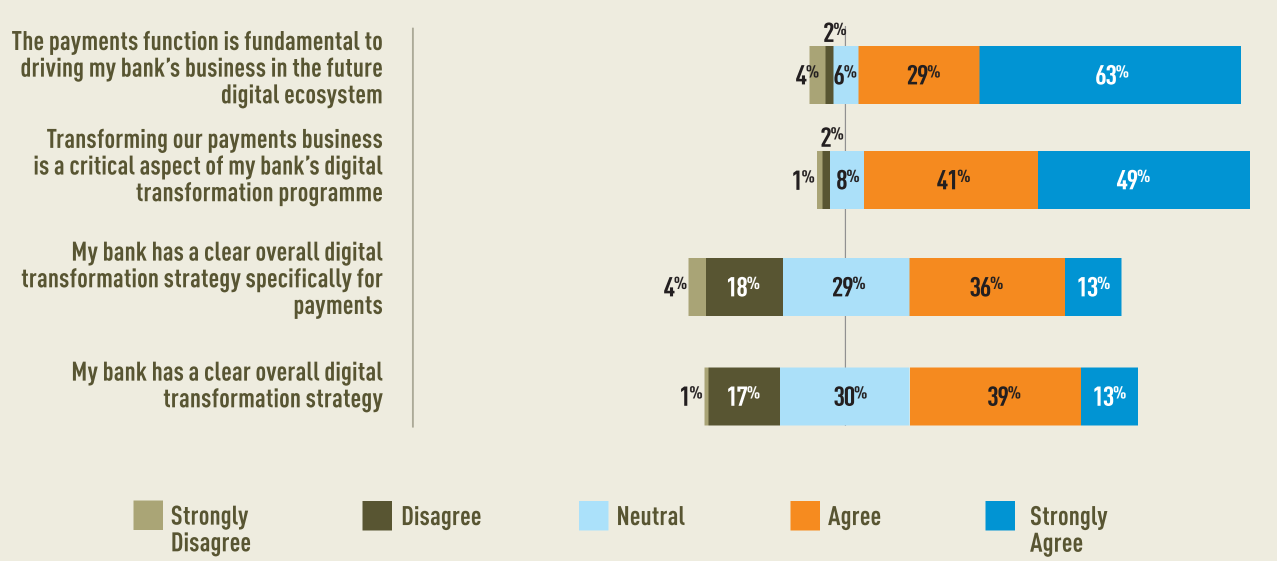
TRANSFORMATION: A DIFFICULT JOURNEY?

As Chart 1 below shows, the survey respondents overwhelmingly agree that payments are critical for their digital futures, and that payments transformation is required.

This is a widely accepted truth, as Daniel Szmukler, Director of the Euro Banking Association, says. "There are huge opportunities to strip out inefficiencies caused by the paper representation of essentially virtual things, but digital is about more than creating internal efficiencies," he explains. "Whole new experiences can be created by combining digital elements that were not possible before, such as the context of the customer at a particular moment.

CHART 1

STRATEGY



"The challenge in payments today is to retool internal operations and upgrade bank offerings in line with growing customer expectations for seamless, omnichannel, secure, real-time, around-the-clock digital services that are perceived as relevant in customers' minds. Different banks will come up with different strategies for how to overcome this challenge,"

On this strategy point, however, the survey findings suggest that banks have less certainty about how to achieve digital and payments transformation in practice. In each case, fewer than half of respondents give a ringing endorsement of the strategies their banks have created (by strongly agreeing or agreeing that clear overall plans are in place).

Only 13% strongly agree this is the case – although it is important to note that the same 13% strongly agree with both statements on strategy. This suggests payments transformation can't exist in isolation, but rather needs to be part of a wider digital strategy, and reinforces the intrinsic connection between the two.

STRATEGIC CONCERNS

There are certainly some challenges for banks in formulating and executing transformation strategies, says Mark Buitenhek, Global Head of Transaction Services, ING. One challenge relates to culture. "It requires a cultural mindset transformation, and this can make it even harder to get organised," he says. "It also needs support and active endorsement from the top of the organisation."

Another strategic challenge in payments is keeping pace with the speed of change, Buitenhek continues. "Payments as we all know is one of the most disrupted areas of banking, and there are so many choices right now," he says. "The world is changing so rapidly, it's hard to predict what the future will look like, and yet banks still have to make choices about where they want to play in that future. They have to make choices that previously they didn't think about – so it's understandable that many find these decisions difficult to make."

Making the right decision about business models to pursue is critical, as Rick Striano, Managing Director, Digital Product Development, GTB Cash Management, Deutsche Bank, points out. "Payment services are already highly commoditised – a trend likely to continue," he says. "Accordingly, financial services providers need to understand what value-added services they can create for their clients, where payment transactions form just one part of a broader and integrated value proposition."

Banks also must grapple with competing priorities, Striano continues. “A solid strategy means balancing these, and mindfully allocating resources in order to manage regulatory imperatives, existing infrastructure improvements as well as new digital developments – disruptive transformation if you like. This third category, disruptive change, is one which does not come naturally to some, as it might require a trade-off, and change of focus from systems that are currently being used by clients and producing value, to solutions being built for the markets of tomorrow (and future revenue streams).”

A further complexity comes from the need for banks to work in tandem with others on transformation. “When we talk about payments and payments networks specifically, it’s about co-operation,” Buitenhek says. “You can think up a lot of things on your own, but in the end, you may also need other parties – banks, providers and others – to move with you, and that makes it difficult to organise a concerted move for all the stakeholders.”

Add in the fact that executing a payments transformation strategy is basically “heart surgery”, says Buitenhek – “at the centre of the bank everything is connected and executing this in isolation based on legacy systems in an already changing world is simply a very difficult task” – and it’s clear that banks on a transformation journey have their work cut out.

> **“The challenge in payments today is to retool internal operations and upgrade bank offerings in line with growing customer expectations for seamless, omnichannel, secure, real-time, around-the-clock digital services that are perceived as relevant in customers’ minds. Different banks will come up with different strategies for how to overcome this challenge.”**
>
> **DANIEL SZMUKLER, DIRECTOR, EBA**

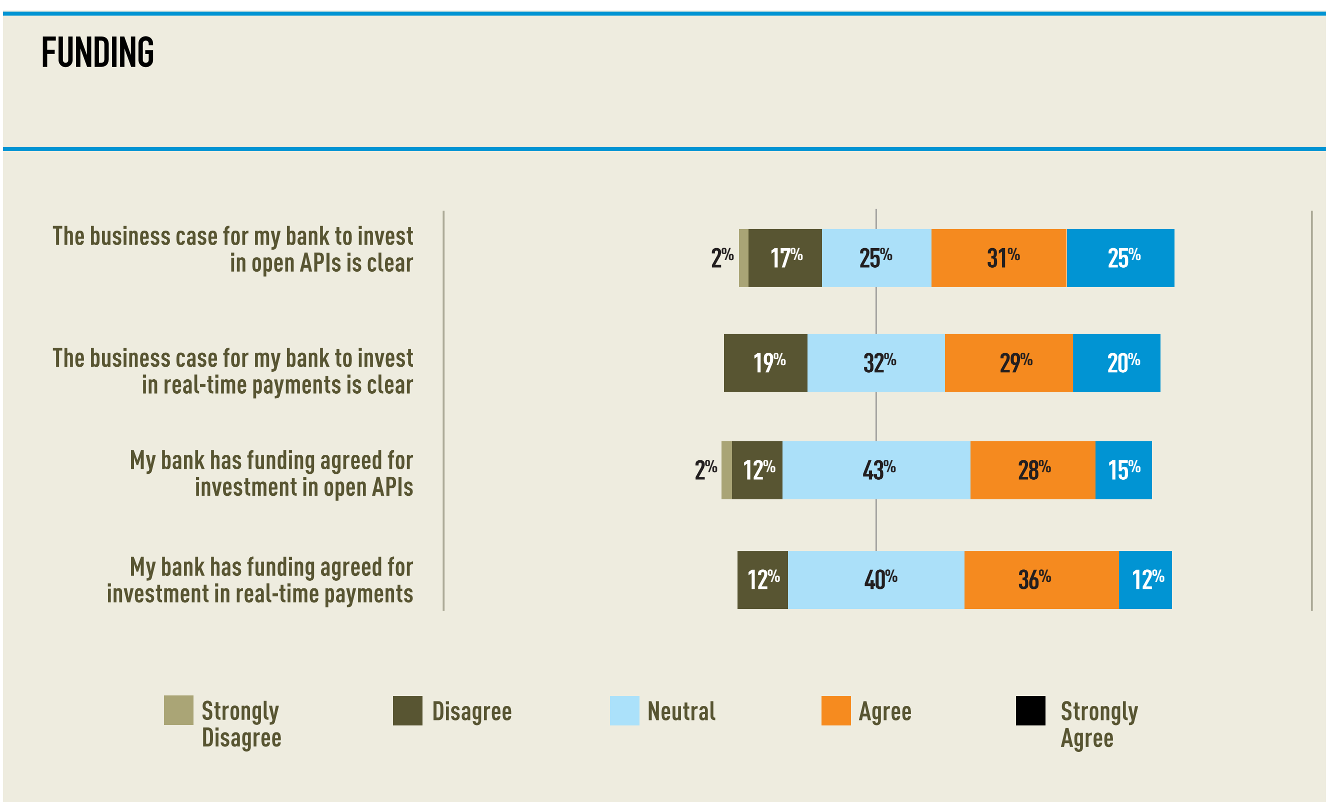
03

REAL-TIME AND OPEN APIS: BUSINESS CASE BATTLES?

Banks on that transformation journey are also dealing with the impact of some imminent change drivers, namely a wider move to real-time payments (as schemes in Europe and the US come on stream) and the advent of open banking underpinned by open APIs.

Good news, then, that the survey shows limited disagreement that funding is in place for investment in both initiatives. As set out in Chart 2 below, while the neutral scores in both cases are quite high, it is encouraging to see 43% and 48% of respondents agreeing they have money in hand to spend on APIs and real-time respectively. The higher score for real-time is likely explained by its longer history as an industry trend, with the first real-time payments schemes having gone live well before open APIs hit the agenda.

CHART 2



In an apparent contradiction, the survey findings suggest that the business case for investment in APIs is slightly clearer than the business case for real-time. However, this is consistent with long-standing questions over the business case for real-time from the perspective of banks, considering they face investing in connecting to new rails that will likely cannibalise existing business.

Respondents also express stronger disagreement with the statements around business case than they do about funding. This suggests building business cases for investment in both APIs and real-time is challenging, though of course since funding is in place, it's a challenge that has ultimately been addressed.

REAL-TIME: A HYGIENE FACTOR

There are some clear revenue and cost benefits in moving to real-time, driven by an enhanced customer proposition. For many banks, however, the strongest driver is retention of existing business, suggests Kevin Brown, Independent Non-Executive Director and Senior Advisor, Global Payments. "The term real-time is also a misnomer, as in many of the implementations it also means instant, 24x7, enhanced data (ISO 20022), request to pay, a whole mix of different elements – and it is these functionalities that deliver value over and above retention," he says. "Banks realise that if they don't do it, they may lose business. They also want to be able to go to market with a complete offering."

There is some evidence to support this thinking, Brown continues. "It is interesting to compare the UK, which has had real-time for nearly 10 years, with the US, where the journey is only just starting, and to note that in the US there are more pure payments disruptors than currently seen in the UK. This points to the need for banks to get behind real-time and all its enhanced functions in order to retain more payments activity within the banking system, rather than giving it up to third parties," he says.

Buitenhek at ING agrees. "For us, real-time isn't about a business case, it's a hygiene factor," he says. "The world is turning into a 24/7/365 economy, our customers are asking for more speed and to be able to transfer money at the weekend, so for us this was 'one plus one is three' and actually we haven't had any large debates about business case. We came to the conclusion that if we don't do this, in the end the market will punish us for it."

FLEXIBILITY BENEFITS

The business case for investment in open APIs is a different one, he contends. “APIs enable us to deliver new, better, easier ways to offer relevant services to connect third parties - it could be fintechs or others that are better in some areas - to both our clients and to ourselves, so in that sense there’s a clear business case for APIs,” he says.

APIs bring other advantages, agrees Brown. “Banks are starting to use APIs in a much more creative way to give flexibility and agility in terms of infrastructure,” he says. “Whether it’s for corporate connectivity, bank to bank connectivity or payments connectivity, APIs enable you to maximise flexibility and connectivity.”

Overall, the ability to monetise payments themselves is just one consideration, suggests the EBA’s Szmukler, because the “value-added services surrounding the payment can be fertile ground for new revenues”. “Real-time cash management services, richer remittance information and faster settlement of funds across accounts and institutions will unlock non-productive balances that have become a permanent by-product of current processes, and revive revenue streams,” he says. “Open APIs will act as a pivot between products and distribution, and will allow banks to move up the value chain and enter new market segments.”

Striano at Deutsche Bank agrees banks need to think of APIs and real-time in a broader context. “Investments in these areas are not only made because of regulatory requirements, but more importantly the increasing client demand we are seeing as the market evolves,” he says. “It is also essential for banks to understand which client segments will likely need these capabilities,” he says. “Identifying early adopters and supporting the development of their business models is key.”

04

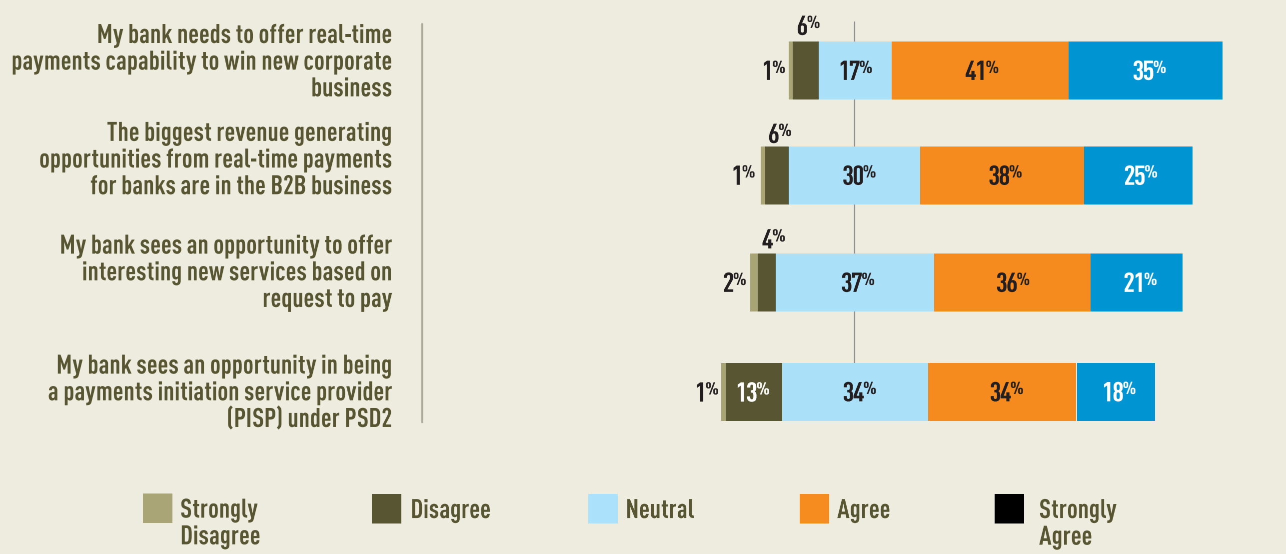
OPPORTUNITIES: EXCITING TIMES?

For Buitenhek, it's clear that "banks are pushing ahead" to leverage the opportunities created by real-time and open APIs. "You feel it, you see it, people talk about it," he says. "We are seeing other parties launch solutions and we're working on both real-time payments and APIs ourselves, so there is definitely real traction in the industry."

The survey findings bear out this view. As Chart 3 below shows, real-time payments are seen as a must-have to win new corporate business, with 76% agreeing or strongly agreeing. Request to pay is also generating some excitement, with 57% seeing opportunities to offer interesting new services off the back of it, and a tiny proportion disagreeing with this statement. There is more disagreement about the opportunity to be a PISP under PSD2, but still more than half see this as a definite opportunity.

CHART 3

NEW OPPORTUNITIES



Interestingly, the results show that there is interest in the PISP model from banks headquartered outside the UK, with a similar rate of agreeing and strongly agreeing seen across all regions.

The majority of respondents – 63% - agree or strongly agree that the biggest revenue generating opportunities from real-time payments for banks are in the B2B business.

This finding rings true, says Brown. “We are starting to see corporates small and large utilising the opportunities of real-time, demanding more real-time reporting and a better flow of information,” he explains. “On the other side, the banks have realised that the revenue opportunities in real-time will likely come from the B2B sector where the value of data and request to pay within real-time are recognised.”

Striano agrees that transaction banks see “monetisable opportunities in the B2B and B2B2C space”.

Echoing the survey respondents’ strong agreement with the statement “My bank needs to offer real-time payments capability to win new corporate business”, Buitenhek emphasises that corporate customers expect this. “They have a clear need,” he says. “They expect us to deliver the same experience that they’re getting from their consumer banking. It’s very strange to see a trader in the morning doing a transaction on his banking app and in the afternoon having to work with very old stuff from 10 years ago, so we clearly see this transformation happening.”

> **“Request to pay is also generating some excitement, with 57% seeing opportunities to offer interesting new services off the back of it, and a tiny proportion disagreeing with this statement. There is more disagreement about the opportunity to be a PISP under PSD2, but still more than half see this as a definite opportunity”**

05

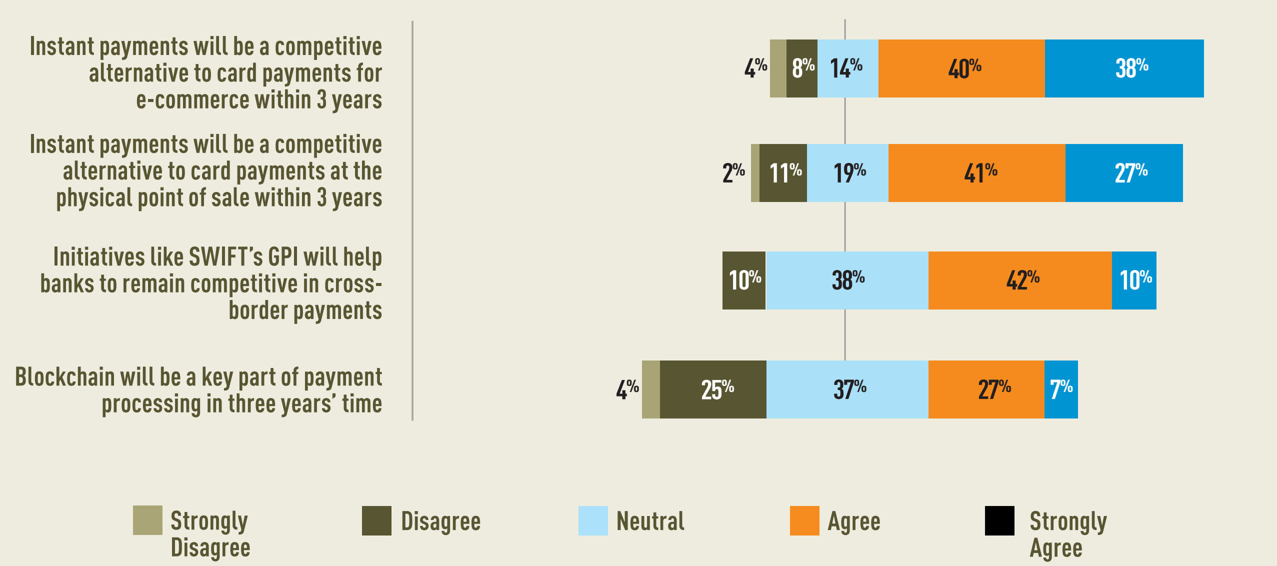
INFRASTRUCTURE IMPLICATIONS: CAN BANKS FLEX THEIR MUSCLES?

The survey findings reveal a strong belief among survey respondents that instant payments will present a serious alternative to card payments going forward. As Chart 4 shows, 78% of respondents say instant payments will be competitive with card payments for e-commerce within three years, and 68% say they will be competitive with cards at the point of sale over the same timeframe.

The impact on banks' own card businesses notwithstanding, if these predictions are well-founded, they reinforce the view that real-time rails represent an opportunity for interbank payments and interbank payments infrastructure to capture greater marketshare.

CHART 4

CAN BANKS LEVERAGE THEIR POSITION?



On the question of whether Swift's Global Payments Innovation (GPI) will also support banks' efforts to remain competitive in the changing payments landscape, there is some fence-sitting from respondents (38% profess themselves neutral on the issue), but nonetheless more than half agree or strongly agree that GPI will deliver its intended value.

Buitenhek at ING emphasises the importance of GPI in the context of important B2B payments revenues. "The GPI programme by Swift was built to improve correspondent banking, and is now able to make international payments within half an hour - and we used to be talking about days," he says. "That is one step, with other steps to follow, and that was specifically targeted at the B2B space. And let's be clear, it's an enormously large segment: when you look at the revenues for transaction banking, that's where the majority come from."

BLOCKCHAIN: A DIVISIVE ISSUE

The survey respondents are, overall, lukewarm in their views on whether blockchain will be a key part of payments processing in three years' time: the agree and disagree votes on this statement are fairly balanced, with only just over a third endorsing the prediction.

The split view can possibly be explained by the fact that blockchain has more immediate potential in some areas of the business than it does in others. "When you talk about blockchain as a core part of payments, then that's the true heart of payments, 300 billion transactions, and three years is too fast," says Buitenhek.

"But if you look at the other areas where blockchain can play a role, like trackers, interbank settlements, internal transactions and parts of correspondent banking, there we do see a future for blockchain in payments. We see this happening in the contracts businesses, like trade and supply chain finance, and that's also where we are focusing our attention through consortia like R3 and Ethereum."

Szmukler agrees. "At the EBA, we have come to the conclusion that currently asset-centric developments are the most interesting crypto-technology related category for transaction banking and the payments domain, because they can operate in an integrated fashion with legacy IT, legal frameworks and existing assets," he says.

"International correspondent banking payments were seen by us as one of the key areas that could benefit from the use of blockchain and distributed ledger technology in the near-term."

Blockchain is not an option for high-value payments any time soon, believes Brown. "I think the central banks looking at refreshing their RTGSs have called it," he says. "Blockchain might have a future in this area, but not for the next five years. The ISO 20022 approaches that most countries are pursuing, with perhaps a single retail payments platform to pump the volumes through, will be sufficient for the near future."

That said, Brown too sees a more immediate role for blockchain in payments in the areas of audit trails and KYC. "There are also opportunities for cross-border payments and other types of activities where the value and complexity are higher," he says.

Longer term, there is little doubt that blockchain "will have a profound effect on almost everything we do", Striano says. "Where blockchain technology can really add value is in the assurance of provenance and transfer of ownership beyond the reconciliation benefit that comes from a shared ledger, where payment is a part of that process flow, like settlement in an exchange," he adds.

"From a pure payment perspective, we see significant potential in leveraging the blockchain to provide a regulated and near-term type of digital cash, combining the digital benefits of crypto-currencies with the preferable characteristics of central bank digital currencies to facilitate payment/settlement validation for institutional financial markets. Broader blockchain use cases for more traditional payment services are likely in the coming years, given the speed with which the blockchain technology is evolving, though there are other solutions available today as viable alternatives to blockchain that solve the major pain points associated with payments."

An immediate imperative for banks must be to understand how blockchain could impact their business models, Striano insists – "understanding and defining the problem that actually needs to be solved, and determining if leveraging blockchain is the most appropriate solution".

"The GPI programme by Swift was built to improve correspondent banking, and is now able to make international payments within half an hour - and we used to be talking about days," he says. "That is one step, with other steps to follow, and that was specifically targeted at the B2B space. And let's be clear, it's an enormously large segment: when you look at the revenues for transaction banking, that's where the majority come from."

MARK BUITENHEK, GLOBAL HEAD OF TRANSACTION SERVICES, ING

06

FINTECHS: FROM COMPETITION TO COLLABORATION?

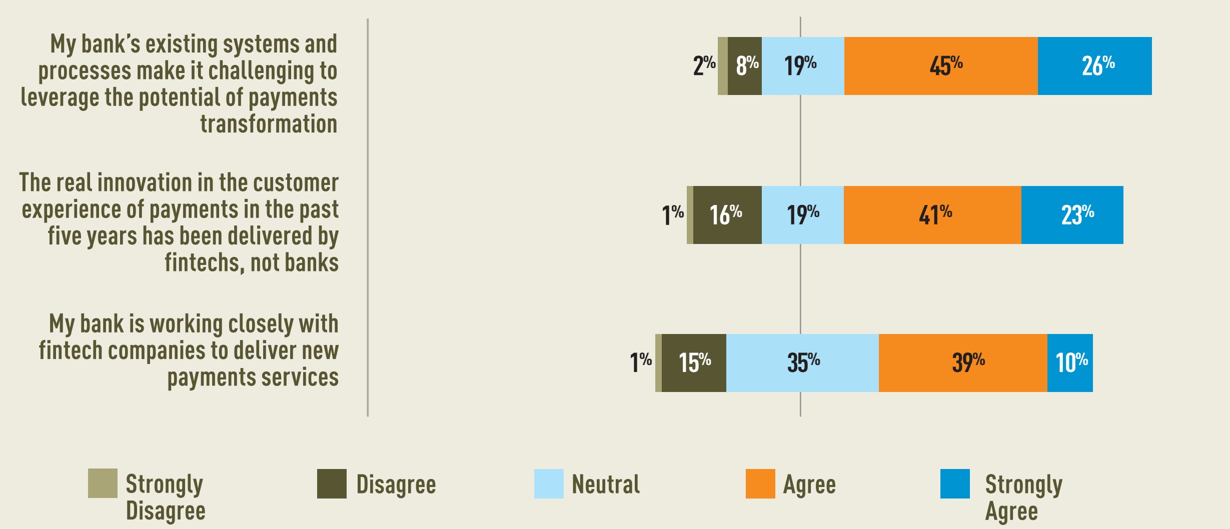
As Chart 5 shows, just under half of the survey respondents agree or strongly agree that their bank is working closely with fintechs to deliver new payment services. Given how recently fintechs were considered the enemy of the banks in the payments world, this level of collaboration is encouraging – and a step in the right direction, observers suggest.

"The strength of fintechs is often associated with their innovation potential in creating relevant customer experiences based on the latest technology and having a short time-to-market for the initial roll-out of new services," says Szmukler. "I believe bank collaboration with fintechs can speed up the modernisation of payments."

This is starting to happen, Brown says. "We are certainly seeing much more collaboration and integration of fintech capabilities by all banks, big and small, to deliver a better customer experience, corporate and retail," he adds. "For

CHART 5

FINTECHs



> **"What has developed is an interesting symbiotic relationship where we may engage with a given fintech in many different ways. Some fintechs for us are at the same time a co-innovation/development partner, a service provider/vendor and a client. I see this trend continuing because it's mutually beneficial not just for us and the fintechs with whom we work, but for our clients as well."**
>
> **RICK STRIANO, MANAGING DIRECTOR, DIGITAL PRODUCT DEVELOPMENT, GTB CASH MANAGEMENT, DEUTSCHE BANK**

corporates, we will see much more around virtual accounts. In a sense it's utilising agile technology outside the bank which previously may have been inside."

Striano at Deutsche Bank confirms that collaboration is a crucial part to a solid digital strategy. "We are very good at what we do today with the systems we have built, but we also recognise the need to accelerate the evolution of our infrastructure, products and services to provide an ever-improving client experience," he says. "This understanding was the impetus that has driven engagement with the fintech segment, exploring areas of opportunity in terms of technology, solutions or even shifts in business model.

"What has developed is an interesting symbiotic relationship where we may engage with a given fintech in many different ways. Some fintechs for us are at the same time a co-innovation/development partner, a service provider/vendor and a client. I see this trend continuing because it's mutually beneficial not just for us and the fintechs with whom we work, but for our clients as well."

ING has taken a similar view, Buitenhek explains. "We truly believe in fintech collaboration. ING has over a hundred fintech partnerships across the world ranging from lending propositions to propositions that have to do with speeding up our internal processes, both on the consumer side and on the business side. So, yes, fintech collaboration can help, and wherever it enhances our capability or makes it better than we have today, we will surely use it."

07

LEGACY: THE BANKS' ACHILLES HEEL?

They may be partnering with fintechs, but the bank survey respondents are also acutely aware that fintechs have done a better job of innovating during recent times. As Chart 5 shows, almost two-thirds (64%) agree that the real innovation in customer experience of payments in the past five years has been delivered by fintechs, not banks.

More worryingly for the future, a significant 71% agree or strongly agree that their banks' existing systems and processes make it challenging to leverage the potential of payments transformation.

Elsewhere in the survey findings there is further evidence of banks' concerns about the impediment their legacy systems present to their future development.

As shown in Chart 6, just a quarter of respondents believe that banks are leaders in frictionless payments, and a concerning 41% disagree that their existing payments platforms would enable them to compete in a frictionless payment environment.

CHART 6

FRICTIONLESS PAYMENTS

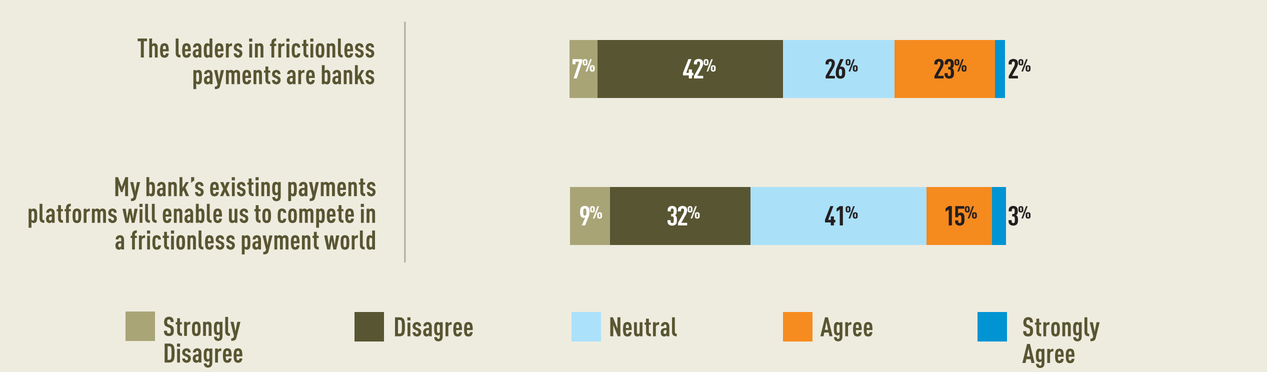
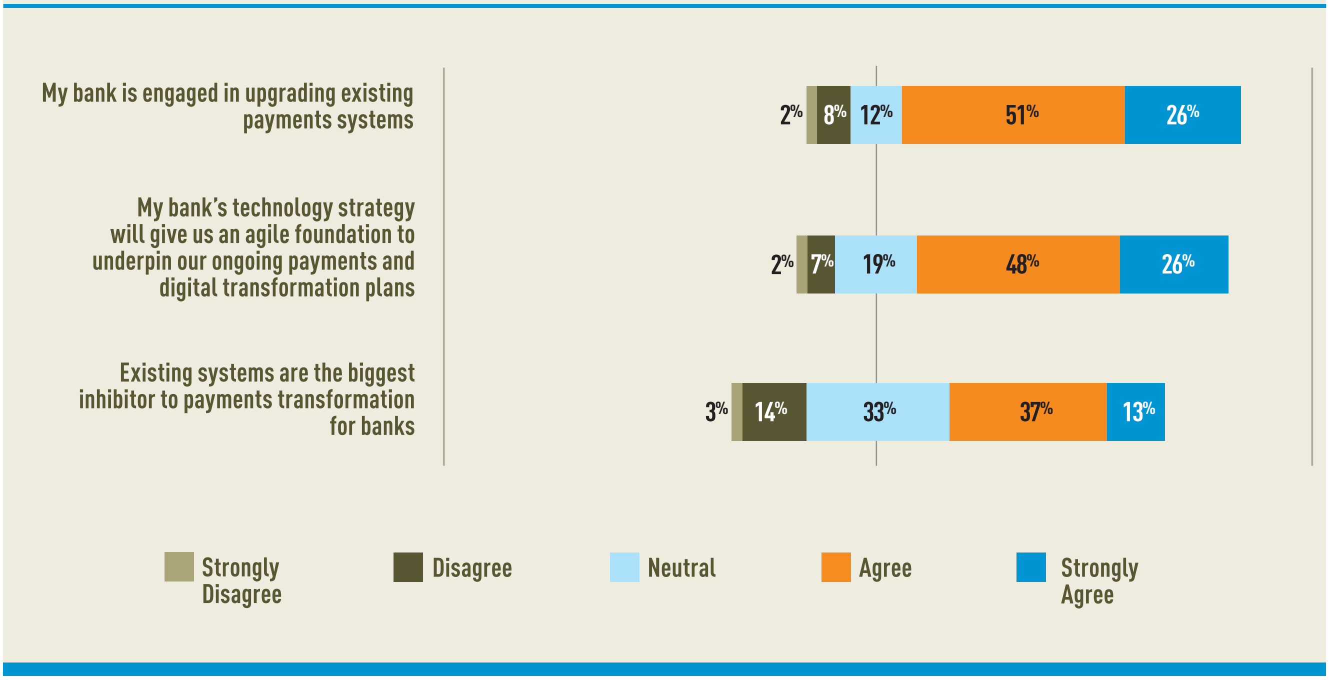


CHART 7

CHALLENGES



Meanwhile, Chart 7 shows that 50% of respondents identify their existing systems as the biggest inhibitor to payments transformation.

One of the reasons for the banks' uncertainty about their digital and payments transformation strategies – as revealed elsewhere in the survey – could be the challenge in reconciling digital development for customer experience at the front end with what has to be done to re-engineer back offices to be smarter and better, suggests Brown.

"They have legacy platforms at the core and they are connecting them with agile new systems at the front end," he says. "They are continually trying to ensure they have a client-winning customer proposition at the front end, while trying to re-engineer their core systems to be more current."

Certainly, collaboration with fintechs is a route to address legacy challenges, Brown adds – and the imperative to do this gets stronger as the real-time payments phenomenon expands. "A challenge that is rapidly becoming the elephant in the room is that, as you move to real-time and there is an expectation of real-time information from customers, this puts continued stress on the legacy platforms that banks have in their core."

Many banks have wrapped their core systems to give the customer the feel of real-time transactions while the back office system actually posts on a batch basis, but this will become unsustainable, Brown predicts. "The problem is that when the banks started down this route, 10% were in the wrapper and 90% in the batch – but now the balance is changing and the question is how much longer can they continue to have a wrapper around their core banking systems to give them the feel of real time."

Striano questions as to why 'legacy' is often a synonym for outdated and inefficient. "Today's new and shiny will be tomorrow's legacy," he says. "When we launched our client access platform Autobahn 10 years ago, it was widely seen as highly innovative and ahead of its time. Ten years later, as a legacy system, it is still an award-winning key digital client access channel to the bank's products and services.

"Existing infrastructures had and have their purpose. They are the foundations for digital and form a part of a solid digital payments strategy, so while the term 'legacy infrastructure' is often associated with a negative connotation, it continues to meet the very demanding needs of the market in terms of stability, safety and security."

Nonetheless, modernisation should be the goal, believes Szmukler at the EBA. "Legacy processes typically involve batch platforms geared towards specific payment channels, instruments and use cases," he says. "Modernised payment infrastructure can help us to advance towards a more cashless economy as new payment solutions built on such infrastructures can address use cases in which paper vehicles still dominate. All industry stakeholders, be they private or public, have a lot to gain from the modernisation of payments."

> **"A challenge that is rapidly becoming the elephant in the room is that, as you move to real-time and there is an expectation of real-time information from the customer, this puts continued stress on the legacy platforms that banks have in their core."**
>
> **KEVIN BROWN, INDEPENDENT NON-EXECUTIVE DIRECTOR AND SENIOR ADVISOR, GLOBAL PAYMENTS**

08

MODERNISATION: KEY TO SUCCESS IN PAYMENTS

The good news from the survey results is that, as Chart 7 shows, a large majority of respondents – 78% - confirm their banks are engaged in upgrading their existing payments systems. The even better news is that confidence that these investments will pay off, and support transformation, is high. Almost three-quarters agree that their bank's technology will give them an agile foundation to underpin their ongoing payments and digital transformation plans.

As Brown points out, many of the initiatives driving change in the payments industry could, while initially creating complexity, ultimately make it easier for banks to transform and leave their legacy behind them. "Building new payments rails that allow easier connectivity can help banks to simplify on their side and change the paradigm," he says. "The new infrastructure being developed will support banks as they move into the new world."

In any event, Buitenhek says, legacy challenges should not hold banks back. "Is legacy a valid concern? No. I think it hampers the 'heart surgery' element, but banks are still able to innovate. There are many examples of banks making progress with innovation in payments – and there will be many more."

09
CONCLUSION: ALL TO PLAY FOR

Overall, the survey results paint a picture of a banking industry caught between great excitement about the future potential of a digitally transformed payments business and great concern about how to realise that potential among other challenges.

The signs are good, however, that banks have overcome business case hurdles to secure funding for investment in two major levers for positive change – real-time payments and open APIs – and are committed to re-engineering the back office payment systems that are holding them back from being leaders in customer experience innovation and frictionless payments.

Focusing on modernisation to tackle the elephant in the room – legacy on the brink of no longer being fit for purpose in a real-time world – will help banks to clarify their digital transformation strategies.

This in turn will enable them to reclaim their historical position of strength in the payments business and to secure their relevance in the space going forward, by delivering the speed and service both retail and corporate customers increasingly demand, underpinned by agile, flexible payment systems fit for the digital age.

10
ABOUT

Finextra

This report is published by Finextra Research.

Finextra Research is the world's leading specialist financial technology (fintech) news and information source. Finextra offers over 100,000 fintech news, features and TV content items to visitors to www.finextra.com.

Founded in 1999, Finextra Research covers all aspects of financial technology innovation and operation involving banks, institutions and vendor organisations within the wholesale and retail banking, payments and cards sectors worldwide.

Finextra's unique global community consists of over 30,000 fintech professionals working inside banks and financial institutions, specialist fintech application and service providers, consulting organisations and mainstream technology providers. The Finextra community actively participate in posting their opinions and comments on the evolution of fintech. In addition, they contribute information and data to Finextra surveys and reports.

For more information:
Visit www.finextra.com, follow @finextra,
contact contact@finextra.com
or call +44 (0)20 3100 3670

Fiserv

Fiserv, Inc. (NASDAQ: FISV) enables clients worldwide to create and deliver financial services experiences that are in step with the way people live and work today. For more than 30 years, Fiserv has been a trusted leader in financial services technology, helping clients achieve best-in-class results by driving quality and innovation in payments, processing services, risk and compliance, customer and channel management, and insights and optimization. Fiserv is a member of the FORTUNE® 500 and has been named among the FORTUNE Magazine World's Most Admired Companies® for five consecutive years.

For more information:
Visit fiserv.com.

Finextra Research Ltd
1 Gresham Street
London
EC2V 7BX
United Kingdom

Telephone
+44 (0)20 3100 3670

Email
contact@finextra.com

Web
www.finextra.com