

The current mythos of payments outsourcing and its future reality

by Kevin D. Stringer, UBS

Most discussions on payments outsourcing today are built on pure marketing and sales hyperbole. The hypothesis of this article is that true payments outsourcing is at an extremely immature stage in the financial institutions market. Precursors to payments outsourcing do currently exist, but the challenge is to move the industry both psychologically and operationally along the evolutionary path so that payments outsourcing is a viable opportunity for small- to medium-sized banks which choose to focus on their core strengths.

Definition of outsourcing

Outsourcing is perhaps one of the most used, but also misused words in the banker's vocabulary. Having borrowed the term and concept from a number of non-banking commercial enterprises, where it was used to define the placement of IT and logistical functions with outside service providers, the correspondent banking world still does not entirely have a unified and coherent view of what outsourcing actually means for financial institutions. Depending on the audience or viewpoint, the word outsourcing can have extremely negative or extremely positive connotations.

For this article, outsourcing is defined as the act of transferring to another bank an activity that was formerly conducted in-house, and, by extension, the resulting state of not conducting that activity in-house anymore.¹ Therefore, to take a concrete example, the relocation of payment operation centres to India – which is a trend seen among a number of prominent UK and US banks in recent months – is NOT outsourcing. The payment activity stays in-house, but the operations are simply being moved offshore to a lower cost locality.

True payments outsourcing goes beyond nostro consolidation. The customer bank transfers all payment

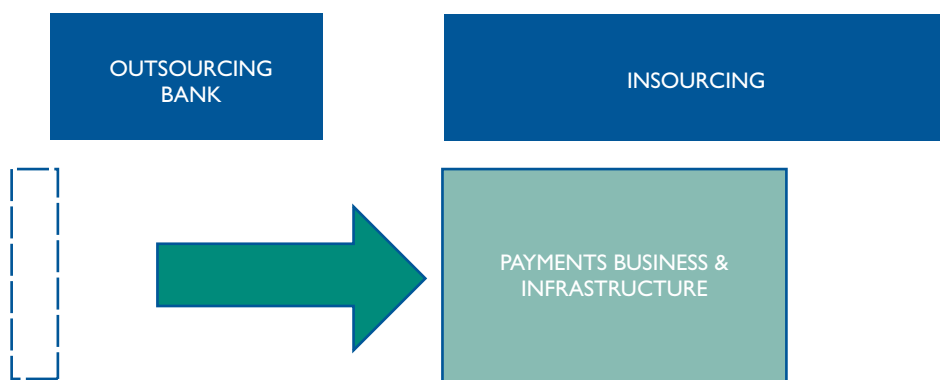
activities and capabilities to a provider bank. In essence, it gives its whole payments infrastructure away. Thus, its retail and institutional customers may believe that they are sending their international and domestic payment instructions to, and receiving their reporting from, their house bank.

In reality, however, the instructions are going directly to the outsourcing provider, who processes the payments and confirms this back to the original customer, probably in a white-labelled format. Customer service and investigations are the same – the customers believe they are contacting their house bank, but in reality, it is the outsourcing provider who is communicating with them.

Market drivers

For years, almost every banker saw the processing and clearing of payments as a core business. This perspective began to change in the 1990s due to three intertwined factors: technology costs, new market and regulatory developments, and the general trend towards a global marketplace in the correspondent banking business where local players were no longer protected from global giants with scale.

Figure 1: Payments outsourcing is a business divestiture



In the technology arena, spiralling investment costs for upgrading or replacing aging legacy payment systems began to place the profitability of less-than-optimised payment businesses at risk. The introduction of the euro, the advent of the Continuous Linked Settlement (CLS) system to reduce foreign exchange settlement risk, the push for a Single Euro Payments Area (SEPA), and increased payment surveillance and customer due-diligence requirements have created the conditions for moving payments from a “core business” to a costly but likely inevitable component of a bank’s real core business.

Furthermore, given the leaps in technology and the aforementioned market changes, global players have attempted to exploit every market to maintain or increase their payment scale. This brings in higher level competition for local players that may have had protected niche or local market currency positions in the payments business. Their position degrades quickly as they cannot generally match the global payment providers in terms of human resources for sales, marketing, product development, and the implementation of best practices, and they lack the financial strength needed for continual infrastructure investment.

In short, payment standardisation across currencies and the economics of scale are key change drivers in the competition between global and small- to medium-sized payment providers. Thus, at some point, each bank has to decide whether it is competitive enough to remain in the clearing and payments business. If not, one of the options available is certainly outsourcing, where the rationale revolves around cost reduction and the focus on core activities.

Current myths

Despite the outsourcing option, however, there are currently several misconceptions floating about the market regarding this. First, outsourcing is not consolidation or the purchase of wholesale cash services. While concentration may be the first step, it is not outsourcing. Some banks, for example, market Continuous Linked Settlement (CLS) Third Party services as payments outsourcing. This author disagrees. Selecting another bank as the CLS Third Party provider is not payments outsourcing, but creates the necessary pre-conditions for a possible full and true payments outsourcing at a later stage. The use of CLS Third Party Services is merely the consolidation of 11 FX trading currencies (€, US\$, C\$, A\$, ¥, £, SFr, DKr, SKr, NKr, S\$) with one provider for payment settlement. Rather than outsourcing, it is a component step in the overall tendency of wholesale payments consolidation that may ultimately lead to payments outsourcing.

The trend to wholesale consolidation began with

the introduction of the euro. This allowed smaller banks to concentrate their previous correspondent relationships across 12 currencies with fewer and fewer providers. In the US dollar world, rising investment and liquidity costs have caused a number of medium-sized foreign banks to give up their proprietary clearing capabilities through their New York branches and place them with one of the top five US dollar clearers. Smaller local banks have followed this inclination and started to give all their cross-border payments to one global bank, as opposed to maintaining their own nostro network.

CLS accelerated this movement with the mentioned 11 FX currencies, and the next step is further consolidation in the multi-currency area. Multi-currency consolidation would entail baskets of currencies - exotic or G15 – as well as both treasury and commercial payments. The next step beyond multi-currency would be payments outsourcing, with the movement of the actual operational activities to a provider.

The second myth is that payments outsourcing is a viable alternative for any small- to medium-sized bank where payment services are not a core business. While consolidation to some point might be a valuable consideration for all small- to medium-sized banks, outsourcing certainly is not. Despite the immature level of outsourcing capability on the market, as well as no clear empirical evidence of a successful commercial payment outsourcing venture to date, payments outsourcing is often touted as the panacea for addressing costs by overzealous salesmen and consultants. It is not yet proven whether payments outsourcing is ideal for all small- to medium-sized banks.

Particularly for the medium-sized bank category, which would be defined by the annual number of payments processed per year, outsourcing may not reduce costs, and could create considerable risk. Substantial cost savings can only really be achieved when the entire payment’s activity, as per this article’s definition, is placed with another bank. This action, though, can create offsetting or greater costs because of the number of interfaces a medium-sized bank will have with its provider. This interface management can be highly resource intensive, since full payments outsourcing from a larger organisation touches on many central infrastructure areas of a bank – customer data administration, complaint management, escalation procedures, etc.

Furthermore, the management of the service level agreement and the greater liaison required with the outsourcing provider at all levels could be a cost increaser. This potential cost growth could expand even more so if the outsourcing provider makes

inroads into the customer or relationship management area through this conduit of payments outsourcing. Also, potential risk is entailed since most outsourcing deals will probably be experimental in the first period given immature provider capabilities today. These risks can be characterised as risk of dependency, risk of failure, and the risk of being unable to return to the old status quo should the outsourcing venture not succeed. Thus, these concerns make a medium sized bank an unlikely beneficiary for the cost savings potential created by a payments outsourcing arrangement.

The final myth is that payments outsourcing is only about information technology (IT) sharing. Banks may share common IT platforms, but this does not mean the payment services have been outsourced. Generally, these remain with the owning bank. Where the decision to outsource is based solely on IT focused goals, rather than considering the organisation's objectives, the full gains of the organisation-wide changes and benefits that outsourcing can afford are not being realised. Payments outsourcing is actually a business divestiture operation to allow resource focus on more critical areas; it is not simply an IT issue.

Existing precursors

There are a few existing precursors in the market for payments outsourcing. These are the development of the so-called transaction banks which focus on the outsourcing of domestic payments. While it may be too early to assess their success or failure, they may highlight the future for all types of payments. The first example is the decision of two major German banks to place their complete domestic payment activities with

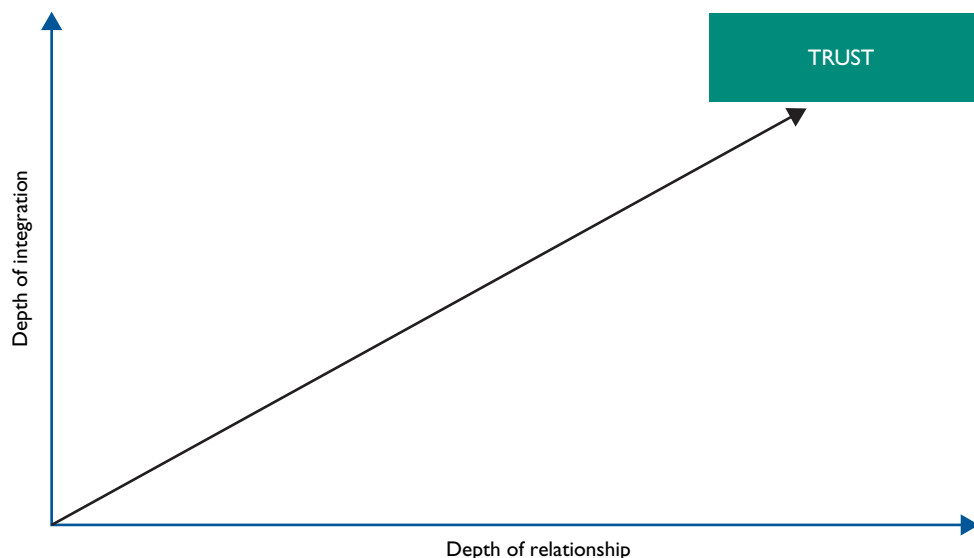
the German Postbank. With this decision, the Postbank gains 5.3 billion domestic payment transactions, and will possess one-third of the entire German market in terms of scale. One outsourcing bank domestically focuses on its core businesses and the other increases its efficiency, and both may save up to a double digit amount in millions of euros. This transaction bank's focus is primarily on domestic payments.

Similarly, the second example is a transaction bank resulting from another two German banks' cooperation. Here the aim is to create synergies for both domestic and international payments. One bank will participate in the other bank's payments institute, which will receive close to five billion transactions yearly. This will move the institute to about 25% market share in Germany. How both these transaction banks will affect international payments remains to be seen, but they can be viewed as vanguards of true payments outsourcing that could ultimately lead to a viable commercial model for appropriate small- to medium-sized banks.

Future approaches

To reach the goal of having true payments outsourcing as a viable alternative for banks, several operational and psychological preconditions must be met. On the provider side, a bank must offer the full range of payment services for consolidation, as this is a stepping stone to outsourcing. The provider must be fully-committed to providing these services, and have the strategy of being a transaction hub. The service provider must have a comprehensive understanding of this product and be able to offer a commercial model that is standard enough for the wholesale market, yet tailorable enough to address the particularities of each customer

Figure 2: Trust is the key element in payments outsourcing



and ease the outsourcing transition for the client bank. For both partners, a transparent negotiation and contract process must be established so that requirements and expectations are clearly spelled out.

For the client, the psychological aspects of relationship and trust play important roles. The road to outsourcing between two parties should proceed rather carefully through incremental steps in order to test provider capabilities and develop trust. As there is a point of no return (outsourcing irreversibility), the client has to have a large enough reserve of trust to placate internal skeptics and address shareholder and stakeholder concerns. In this regard, it might be advantageous to let the outsourcing enterprise participate in the insourcing project in a financial manner. This would help build trust, and could provide financial incentives to overcome the inevitable internal resistance to outsourcing. From this point of view, the precursor group of transaction banks seems to be a good model due to the fact that the outsourcing customer is integrated as a full financial partner in the success of the enterprise.

To conclude, true payments outsourcing is not quite on the market, but rides on the horizon – a galleon bearing treasure for some. To bring this ship to port, providers need to develop a fairly mature, commercialised offering model in order to avoid

“laboratory testing” with the customer. On the demand side, clients need to move to broaden internal mindsets that focus on core capabilities and costs, while developing the necessary level of trust with the chosen banking partner. Once this sufficient level of trust is developed, the evolution from consolidation to outsourcing becomes much smoother.

Note:

¹ This definition is taken from N. Dragonetti, F. Dalsace, and K. Cool, “A Comparative Test of the Efficiency, Focus, and Learning Perspectives of Outsourcing,” INSEAD Working Paper Series, 2003.

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