Breaking down the boundaries: Time for a rethink on international low-value payments

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ABSTRACT
Movements in populations and business changes have transformed low-value international payments from niche to segment. Traditional cross-border payments schemes are an increasingly poor fit, and the segment is poorly served. Banks are struggling to respond quickly enough to a fast-growth market, for a range of economic and architectural reasons. Is an alternative approach possible that secures the banking industry’s position in the profitable elements of the value chain? And is there an opportunity to grow market share, and to retain the liquidity, customer and brand of their global payments services?

Keywords: international low-value payments, international retail payments, corporate cross-border payments, global trade payments, global ACH, alternative correspondent banking, alternative cross-border payments

INTRODUCTION
The unit cost of intermediation [in financial services] has increased since the mid-1970s and is now significantly higher than it was at the turn of the twentieth century. In other words, the finance industry that sustained the expansion of railroads, steel and chemical industries, and later the electricity and automobile revolutions seems to have been more efficient than the current finance industry.¹

Though some areas of financial services have seen dramatic change in recent years, such as commodity and derivative trading (in which low-latency systems is state of the art), payments services lag far behind. Is a generational change due?

The world has certainly changed. People are becoming more mobile, choosing to work and live abroad in ever greater numbers. At the same time, commerce is more global, with the internet and mobile devices making it easier to shop and do
business beyond national borders. But while global economic conditions, combined with contemporary culture and modern technology, encourage this flow of people and commerce, one of the key elements of the infrastructure to support it has not kept up.

An efficient — and safe — system for facilitating financial transactions is essential to any thriving modern economy. However, many existing payment systems were designed for a more static world: one in which retail and lower-value transactions were overwhelmingly domestic, while cross-border facilities tended to be designed for higher-value, predominantly corporate, transactions. Things are no longer that simple. Demographic and technological shifts mean there is now a soaring demand for a type of transaction that does not fit this model — international low-value payments.

INTERNATIONAL LOW VALUE PAYMENTS IS A SEGMENT, NOT A NICHE

Cross-border payments are small by comparison with domestic payments, at 2.5 per cent of total volume and 4.5 per cent of total value. But they amount to 11 per cent of total revenue. Indeed, one observer comments that while ‘analysts often refer to payments as a commodity business this is not true for cross-border payments. In fact, most providers in this space enjoy relatively attractive profit margins and do not use price as the primary basis for competition.

Furthermore, while fees per transaction are falling, growth in transaction volumes means the total revenue from cross-border payments is increasing nearly twice as fast (11 per cent compound annual growth rate (CAGR)) as revenue from domestic payments (6 per cent CAGR).

Cross-border payments encompass both trade and retail transactions. One way to categorise payments is according to the participants: a European Commission (EC) Green Paper defines a payment as retail where at least one party to the transaction is not a financial institution. Another way to categorise is by value. There are many views on the range of values that retail might incorporate. At the upper end, the European Central Bank categorises payments of €50,000 and below that are settled through its TARGET2 system as ‘retail’.

Analysis of the quantitative and qualitative aspects of cross-border payments reveals that international retail payments has become a market segment in its own right. It demands financial products and services designed to support it, rather than having to put up with services designed for a different purpose, in a different era.

GLOBALISATION OF TRADE AND DISINTERMEDIATION OF SUPPLY CHAINS

Despite the global economic downturn since the financial crisis of 2008, the globalisation of business continues apace. Export volumes grew by 13.7 per cent in 2010 and 5 per cent in 2011.

While the amounts that individuals send in cross-border payments have been moving up in value, trade-based payments have been moving down. More individuals and small and medium-sized businesses (SMEs) trade internationally than ever before, making smaller transactions the norm in cross-border trade.

How firms do business and with whom they do it is also changing. Corporates are purchasing more prefabricated parts from other countries, as well as more services such as IT development and back-office processing. SMEs are playing a more active role in the global economy and are now
responsible for more than half the total payments processed by banks, generating more than half of their cash management revenue.\textsuperscript{8}

Global e-commerce generates not only consumer payments for purchases (person-to-business or p2b) but business-to-business (b2b) payments as well. Online giants like Amazon and Apple need to make many thousands of cross-border payments to affiliates, agents, developers and others. As a result, the number of e-payment transactions in 2010 totalled 17.9bn. This is expected to grow at nearly 20 per cent a year to total 30.3bn transactions by 2013, with an aggregate value of €1.4tn.\textsuperscript{9}

THE CHANGING SHAPE OF P2P AND REMITTANCES

In parallel with this globalisation of trade and shortening of global supply chains, the remittances market has grown up. What used to be a predominantly cash to cash business is morphing into transfer to account, where the purpose of the funds is moving from sustenance to investment.

Migration has been an integral part of the human story, with people moving to escape disasters, deteriorating landscapes and conflicts, and seeking more abundant food sources and better climes. As the various regions of the world developed at differing rates, migration became primarily economic. Individuals from impoverished countries set off to find work in more developed economies, supporting families back home through the remittance of their earnings.

Today, while the flow of migration from low to high-income economies continues, many immigrant groups have settled successfully in their adopted countries. International migration has doubled in the last 25 years, to more than 215m people, and could double again by 2050. Diasporas are strategically powerful groups, as The Economist recently reported. The networks of kinship and language of diasporas make it easier to do business across borders. They speed the flow of information and foster trust. Skilled migrants not only send money home — they often return to set up new businesses.\textsuperscript{10}

Though most of the publicity around remittances focuses on developing countries, there are considerable flows into developed countries. According to World Bank data, the UK receives about double the amount it sends. In Belgium, the home of the European Commission, the figure is closer to two-and-a-half times, and in France it is three times.

Immigrant communities now generate over two billion payment transactions a year — the vast majority of which fall into the retail cross-border category. Remittance flows to developing countries are estimated to have reached US$372bn in 2011, and are expected to grow at 7–8 per cent annually to reach US$467bn by 2014. Meanwhile, remittance flows to high-income countries such as Poland and Canada reached US$129bn in 2011 and are expected to increase to US$148bn by 2014, bringing the total worldwide to US$615bn.\textsuperscript{11}

Consider the USA-India remittance corridor. India is the largest remittance destination and the USA is the largest remittance sender. Indians have become one of the fastest growing ethnic communities in the United States.\textsuperscript{12} According to the 2000 US census, 64 per cent of Indian-born residents have a bachelor degree, compared with 28 per cent nationally, and are five times more likely to have a masters degree or above. The median household income of an Indian-born resident in the USA is almost double that of native US residents. The Reserve Bank of India reports that workers’ remittances to India reached US$46.4bn for the fiscal year 2008–9, up from US$2.1bn in
Although more than half of these remittances are used for family maintenance, the rest are either deposited in bank accounts (20 per cent), or invested in land, property, and securities (7 per cent).

Remittances have accounted for 3–4 per cent of India’s GDP since 2000, and account for more than 5 per cent of GNI in 28 other countries. Since the average fee paid by a sender is around 9 per cent, for most of these countries fees amounting to around 0.5 per cent of GDP are ‘left on the table’. What used to be a predominantly person-to-person (p2p) cash-to-cash business is becoming more of an account-to-account business — and in so doing, ‘will often be indistinguishable from any other low-value, cross-border transfers, including small payments to and from businesses’. As a result, the potential fee income for banks has changed dramatically, from a small slice of a small-value transaction to the wide and complex financial needs of an affluent citizen — at both ends of the flow. Remittances are no longer a line of business that should be looked at in isolation — and, indeed, non-bank providers already take a broader view. Furthermore, like the checking account, remittance services are a ‘lead-with’ banking product: a way to earn the right to cross-sell a portfolio of services.

**ORGANISED FOR HISTORY, NOT THE FUTURE**

Banks have traditionally organised their systems and processes around their business lines, with payments services housed in those divisions. Thus, retail payments services were situated in the domestic part of the bank. Cross-border payments services were housed in the high-value, or high-care, or wholesale, or cash management services established to serve corporate customers. As banks expanded internationally, mainly to support their corporate clients, cross-border payments services became interwoven into their international infrastructure. In the absence of a compelling business case, integration of domestic retail and high-value cross-border payments has not occurred. These ‘silied’ services may have been good to start with, and have remained good enough for the market they were originally intended to serve, but market pressure is demanding change.

In today’s internet and social media-dominated world, vertically-integrated banks are becoming disadvantaged. If consumers can phone or SMS someone in Mexico or Manila instantly and reliably, they expect banking services to match. While high-value cross-border payments facilities and retail domestic systems work well, when it comes to retail payments across borders, the model breaks down. If an individual wants to make a cross-border remittance of say US$200, they are faced with significant — and unpredictable — fees of typically US$20 or more. Furthermore, service levels drop off and transparency disappears. Our smartphone-using children simply cannot understand why it can cost less, and be more predictable, to take a few notes out of an ATM and send them via an international courier than making the same payment electronically through the banking system.

Most of the payments schemes with which we are familiar have their roots deep in the last century. Correspondent banking relies on the SWIFT network, which was derived from the telex in 1973. Traditional remittance service providers also based their model on the telex, or even its precursor, the telegraph. The credit card was invented around 1950, and though convenient for consumers, cards are costly for merchants and incur around
six times more fraud than online banking (UK data).\textsuperscript{16}

The rate of change of technology is far faster than that of financial services. One response to the new challenges of the payments market is to go for a quick win and retrofit new technology onto old business models. While this may deliver short term business value, it inhibits innovation, partly by mitigating the need for more fundamental change and partly by increasing systemic investment risk. Following recent bank-wide outages resulting from outdated technology, senior bankers are beginning to acknowledge the need to prioritise more spend on payments systems.\textsuperscript{17}

**BARRIERS TO CHANGE**

Income from the traditional correspondent banking model is substantial. Fees of up to US$45 per transaction are not uncommon. It is also commonplace for both sender and beneficiary to incur charges, often without either realising that the other is also paying. Those benefiting from such fees are unlikely to change voluntarily to a more customer-friendly model.

These fee levels are barely noticeable in a transmission of US$1m. And anyway, safety, security and timeliness are paramount in high-value transactions. But for lower value transactions, cost-effectiveness, predictability and transparency become equally important.

But even where bankers acknowledge that the market has changed and want to provide appropriate services, there are significant challenges.

**The first mover disadvantage**

The problem with deeply-networked businesses — of which cross-border payments is an example — is that the first organisation to innovate must carry the investment costs for a long time. The return can be recouped only when others begin to participate. Such a business plan will not find favour, especially in today’s straitened times, and can lead to stagnation. As the Federal Reserve Board remarked in a recent paper, although competition in the payments market appears vigorous, there is little far-sighted cooperation to achieve the required development of clearing and settlement infrastructure. "Rather, infrastructure investment is concentrated on fine tuning clearing and settlement infrastructure that supports existing methods of payment, not on meeting present and future needs of the digital economy."\textsuperscript{18}

Network industries, where the benefits depend on the number of other consumers and firms that provide the services, are prone to this type of market failure. Also, consumers tend not to be organised to lobby strongly for their best interests, hence regulatory authorities frequently take that role. If the supply-side doesn’t invest, it is inevitable — and indeed right — that regulators should step in. The innovations demanded by Dodd-Frank Section 1073\textsuperscript{19} in the USA are a current example of such action. In Europe, the EC Payment Services Directive of 2009, issued to support the creation of a Single Euro Payments Area (SEPA), has sought to address consumer requirements in a different way, lowering barriers to entry while imposing on new entrants an appropriate level of regulatory oversight. As a result, by January 2012 there were 176 authorised payment institutions in the UK alone.\textsuperscript{20}

**ONE POSSIBLE SOLUTION**

National ACHs can be efficient at handling both low and high-value payments because they operate in standardised environments, usually as a result of local banks collaborating to build and maintain high-
performance infrastructure. The ideal for retail cross-border payments would seem to be some sort of global ACH. However, achieving this is easier said than done.

A global ACH would have to negotiate the global regulatory landscape — a daunting task given the number of countries involved and the diversity and complexity of their rule books. Even in Europe, where the banks collaborated via SEPA to enforce common technical standards to support standardised payments schemes across the region, regulation has had to be enacted to drive the project to completion. Even just to get this far, SEPA is reported to have cost over €9bn and taken nearly ten years. 21

Meanwhile, the International Payments Framework Association, with the support of the US Federal Reserve Board, Equens and others, is working on protocols to enable multiple national ACHs to interconnect directly. SWIFT Remit is a similar initiative focused on remittances. These efforts are primarily about setting standards — most commercial issues are outside their scope. Banks and end users must still establish business relationships with other participants in order to take advantage of the capabilities.

Furthermore, these initiatives focus only on the clearing of transactions, whereas most of the costs and risk of cross-border transactions lie in their initiation, capture, processing and customer service. Clearing accounts for just 8 per cent of total cost, settlement 4 per cent, initiation and capture 30 per cent, pre-processing and processing 35 per cent, and customer service and interaction 23 per cent. 22

So what is the alternative? One solution is the establishment of a new kind of correspondent model in which a payment services provider creates local entities and accounts with banks across multiple countries. This is analogous to the way corporates already manage their own accounts, but tailored to the business of cross-border payments. Such a model directly leverages the efficiency, predictability and longevity of existing domestic payments schemes. In effect, it takes the current payments model apart and reassembles the best components in a different way to get a better outcome. Such a model is a good example of industry collaboration, as it:

- widens the market which can be served to include the international retail payments segment;
- keeps the ownership of the end client with the banks and retains their important cross-selling opportunities;
- keeps the liquidity associated with the funds’ movements within the banking industry;
- provides the option to banks of retaining the foreign exchange element of transactions.

**CONCLUSION**

A fundamental re-think, not only of transnational banking services but financial services in general, seems necessary. From a narrower payments perspective, there is little doubt that an industry approach is appropriate given the networked nature of the business. Such a strategy is unlikely to emerge from a national payments council as most, if not all, are limited by mandate to a domestic focus. Current providers of cross-border services may have a vested interest in preserving the old model. It may be necessary to look to the edges of the current industry, or beyond, for the required innovation.

It may also be necessary to consider challenging long-established business boundaries. Given the financial and management resource constraints faced by most banks, it seems unlikely that individual banks will be able to effect the kind of change outlined in this paper.
There is therefore a strong case for industry utilities to shoulder a greater share of the effort — moving up from being curators of the business processes that all banks agree should be managed centrally, and pushing into areas which might to some, such as traditional correspondent bankers, be more contentious. However, it will be better to house such services in some form of neutral utility than to see them being brought to market by direct competitors.

As has been seen, it may be that the urgent changes required will not happen naturally through market forces and competition. It is in the interests of the banking industry to be proactive and to challenge, rather than protect, old models and structures, and establish new business approaches lest others invent a better way.

REFERENCES


(4) Grealish et al., ref. 2 above.


(16) Capgemini, RBS and Efma, ref. 9 above.


(20) FSA, internal data, unpublished.
