McKinsey&Company

Volume 8, Number 21 May 2015

McKinsey on **Payments**

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New partnership models in transaction banking

Transaction banking—which typically includes domestic and international payments, cash management and trade finance—is vitally important for corporate banks, accounting for approximately 40 percent of total corporate banking revenues, contributing to liquidity and delivering attractive returns on risk-weighted assets, as well as enhancing client stickiness. However, a number of trends are leading to a fundamental rethinking of the traditional model by which banks offer these services to clients outside their established markets.

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Historically, banks built geographic coverage and product capabilities for transaction banking in-house. In cases where a company's needs exceeded the reach of the bank's network, banks have relied on correspondent relationships. Some have agreements with hundreds of institutions around the world, any one of which may expose the bank to significant operational risk, bring high complexity costs, and deliver low levels of service.

Compounding these risks, emerging technologies are now posing serious challenges to the correspondent banking model, including new threats of disintermediation by nimble non-bank attackers. Intense competition and low interest rates are both pressuring transaction banking margins, requiring banks to eliminate waste and manage profitability rigorously.

In this challenging environment, banks may seek to reduce the complexity of international networks by streamlining correspondent relationships and rethinking the overall strategy for partnerships. This article examines the market forces leading to the emergence of four new archetypes of bank cooperation and highlights the critical factors banks must address as they implement a global strategy for partnering.

Structural trends reshaping the market

The combination of an increasingly competitive market and reduced net interest income (NII) in a low-interest-rate environment is the most obvious factor contributing to the steady (and unsustainable) erosion of margins. At a deeper level, three interrelated

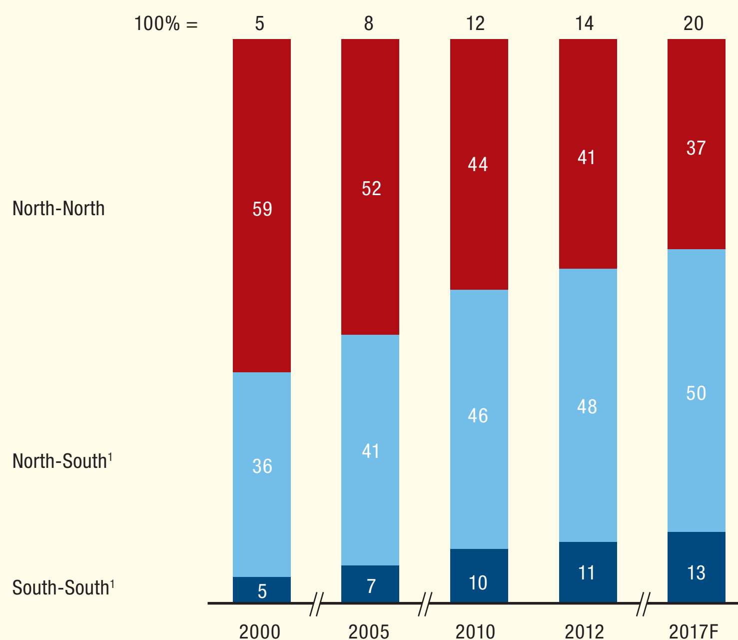
structural trends are exerting pressure on the transaction banking business and point to the urgent need to rethink the business model for cross-border trade and transaction services: globalization, multiple regulatory regimes and digitization.

- **Globalization:** Cross-border trade accounts for a growing share of world GDP. One reflection of this trend is the increasing number and type of companies requiring cross-border services to reach more geographically diverse markets (also discussed in "Insights into the dynamics of new trade flows," *McKinsey on Payments*, May 2014). The biggest new trade growth is along corridors linking established markets of "the North" (North America, Western Europe and mature economies in Asia) with emerging economies of "the South" (Asia, Latin America, Africa and the Middle East). This trend is due in part to the expansion of the middle class in large emerging market countries, which is turning once uni-directional trade corridors into bi-directional corridors. Trade flows between mature and emerging markets are expected to grow 9 percent annually over the next few years and account for half of global trade flows by 2017 (Exhibit 1).
- **Multiple regulatory regimes:** As they increasingly provide access to diverse markets, banks must comply with differing (and not always compatible) regulatory regimes, some national, others regional in scope. National standards may also differ for domestic and foreign institutions,

Exhibit 1

Emerging market trade corridors drive growth

Trade flow volumes by type of corridor (excluding services)
€ trillion, percent



CAGR, 2012-17
Percent

Corridor	CAGR
Total	**8**
North-North	**5**
North-South	**9**
South-South	**12**

[1] Emerging markets of the "South" include Asia, Latin America and Middle East, excluding Japan, China, Hong Kong and Singapore.

Source: IMF Direction of Trade statistics; Global Insights; McKinsey Global Payments Map

while regional regimes aim to harmonize standards across multiple countries. For example, an updated version of Europe's Payments Service Directive is expected to require all parties to a transaction—even those outside Europe—to be in compliance. The global patchwork of national and regional regulatory standards poses challenges for international players, particularly as they seek to establish a footprint in new markets to meet client needs.

Gradual yet steady improvements in industry standards and platforms strengthen the impact of digitization, enabling banks to automate processes and integrate systems.

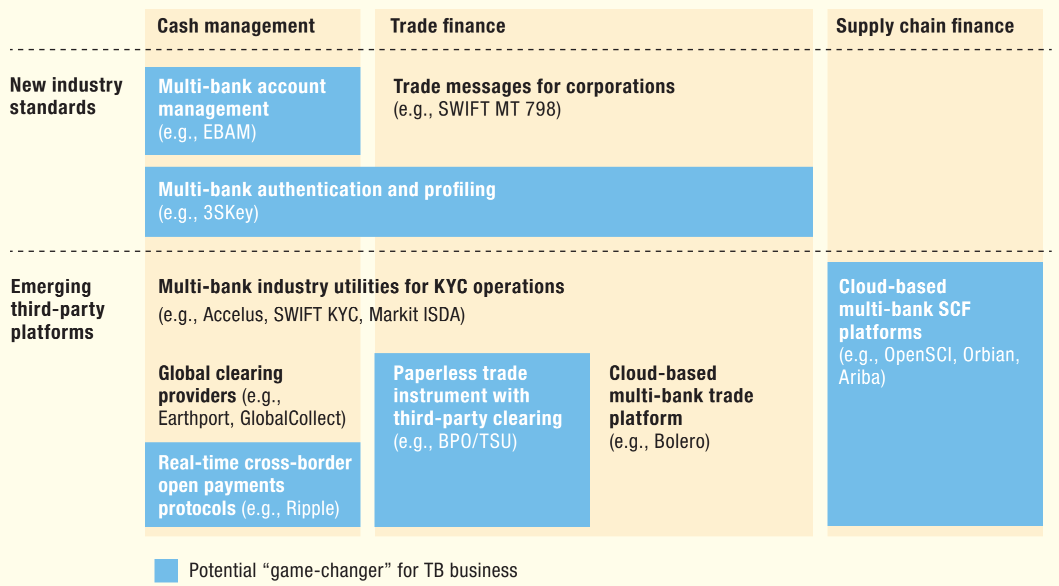
- **Digitization:** Gradual yet steady improvements in industry standards and platforms strengthen the impact of digitization, enabling banks to automate processes and integrate systems. In recent years, industry organizations have released new electronic standards to reduce paper and speed the flow of electronic data across diverse platforms (e.g., ISO 20022 for payments, released by the International Organization for Standardization; and numerous enhancements to SWIFT messaging, including EBAM for information reporting and account management, MT 798 to support trade-related messaging, 3SKey for secure authentication and authorization across multiple banks). Additionally, industry groups and third-party technology providers have introduced new platforms offering streamlined integration with bank and corporate systems. Initiatives such as the bank payment obligation and Bolero offer entirely electronic means for trade services, and numerous organizations support diverse supply-chain finance communities with cloud-based multi-bank platforms. It remains to be seen which, if any, of these new initiatives will gain critical mass. The potential game changers are highlighted in Exhibit 2 (page 14).

Together, these developments point toward a step change in digital channels, which promise to create opportunities on three levels of transaction banking service delivery: sales and channel access (anytime, anywhere access across integrated channels); data analytics (leveraging data from internal, public and third-party sources to gain client-specific insights into sales leads, emerging product needs and improved service levels); and processes (including the reduction or elimination of manual intervention in operations and the adoption of agile solutions development, where solutions prototypes are launched within a matter of weeks to reap the benefits of live market testing early in the development cycle).

Digitization also poses new risks of disintermediation. For instance, a cornerstone of the traditional correspondent banking model is banks' exclusive access to international networks for cross-border clearing and settling. However, third-party platforms are making it possible for banks, non-bank financial institutions, payments processors and other organizations to customize cross-border services in ways that go beyond the options offered by traditional correspondent banking arrangements. Ripple Labs, having developed a real-time, cross-border open payment protocol based on recent crypto-

Exhibit 2

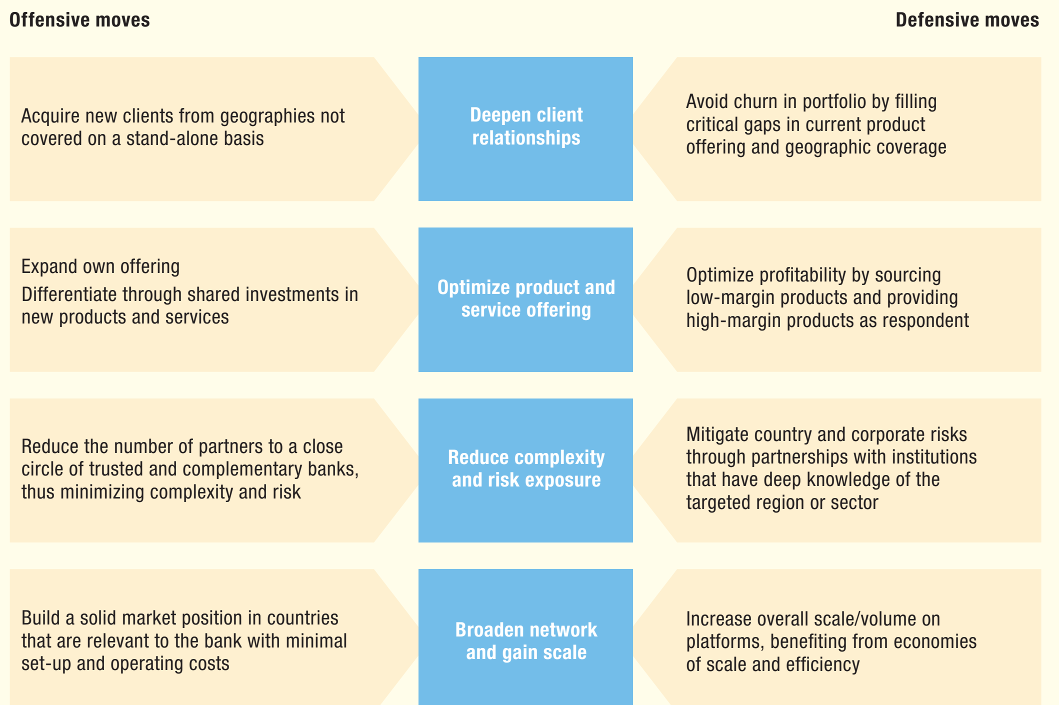
New standards and platforms improve connectivity and interoperability



Source: McKinsey Global Payments Practice

Exhibit 3

Partnership and cooperation models must serve clear strategic objectives



Source: McKinsey Global Payments Practice

currency technologies, is an example of these new types of third-party platforms. Such innovators allow financial institutions to streamline and improve the service levels and costs of critical steps in the correspondent banking infrastructure, such as message routing and settlement. The speed at which new entrants are evolving, as shown by Ripple's recent partnership announcement with Earthport, increases the potential for a significant disruption within the industry. (See page 19 for an interview with Ripple Labs CEO Chris Larsen.)

To maintain stronger control over risks and costs while also extending geographical reach, transaction banking providers are devising new approaches to cooperation.

As a consequence of these structural trends, banks are rethinking which markets they want to compete in and how to serve targeted segments and geographies with distinctive products and service levels. In crafting their strategy for market coverage, they focus on four main objectives: deepening relationships, optimizing products and services for competitive distinction, reducing complexity and risk exposure, and identifying markets that are important to their clients and where they can grow at scale (Exhibit 3).

Four models of banking partnerships

In order to maintain stronger control over risks and costs while also extending geographical reach, transaction banking providers are devising new approaches to cooperation. Whether the objective is primarily aggressive (that is, to expand market share) or defensive (to protect existing relationships), four distinct partnership models are emerging: regional-to-local agreements, inter-regional agreements, global-to-regional agreements and white-labeling (Exhibit 4, page 16).

Regional-to-local agreements

Regional institutions enjoy the broadest range of options for partnering, whether the main objective is offensive or defensive. A regional leader may partner with a local champion where the local institution has deep penetration and relevance in replacing multiple existing correspondent banking agreements.

On the local champion's side, these agreements aim to streamline the number of correspondent relationships, reducing complexity and risk exposure, mainly for the purposes of traditional trade finance rather than supporting international treasury operations. On the regional leader's side, these agreements allow access to new markets (in particular to serve SMEs) with limited upfront investments and capital allocation. It is important to note that service levels in this model typically will not exceed those offered in correspondent banking, and the primary objective of this model is to defend relationships that may be targeted by aggressive competitors. Furthermore, these relationships may become vulnerable if the regional player does not keep up with clients' evolving needs for both broader geographic scope and digital capabilities at competitive pricing.

Local players have a natural advantage in know-your-customer and access to liquidity and should exercise this advantage thoughtfully, weighing not only evolving client needs but the long-term strategic benefits of partnering with either a global champion or regional leader.

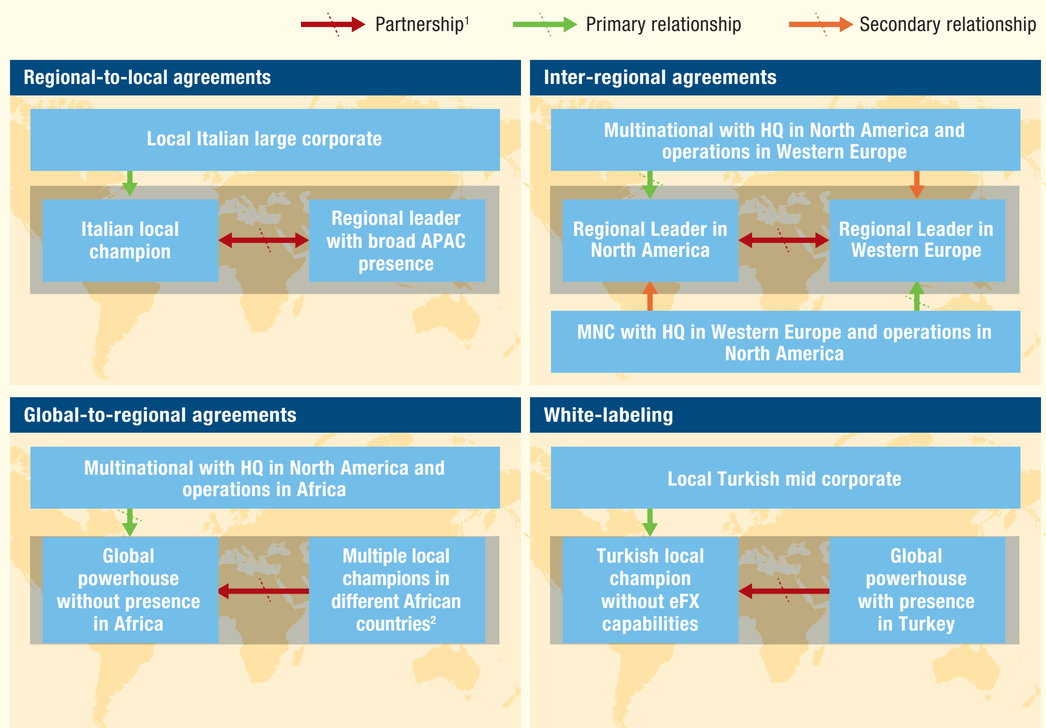
Inter-regional agreements

Inter-regional agreements are peer-to-peer partnerships between regional institutions that do not compete with one another, and therefore can complement one another's strengths in two separate regions (e.g., Central Europe and the Nordics or China and Africa).

Pursuing a strategy for aggressive growth, two regional institutions may reap large economies of scale by linking their networks or building shared technology platforms. As case studies in the airline and automotive industries show, this type of deep strategic alliance can be extremely successful. If the objective is primarily defensive, inter-regional arrangements typically involve light integration of IT systems to leverage common standards and raise service levels, enabling each bank to strengthen relationships that might otherwise be lost to global players. However, these lighter, defensive partnerships usually do not bring substantial new revenue and may falter if either partner does not stay abreast of market expectations and technological advances. A more aggressive play however, including deeper integration and potentially exchange of human capital, typically allows for further cross-fertilization of each bank's customer base.

Exhibit 4

Four models of bank partnerships for global, regional and local institutions, with varying breadth and depth (illustrative)



[1] Direction of arrow indicates flow of services; each slash indicates a space where a technology partner can add value (as partner or challenger).

[2] Or better, the global powerhouse might partner with a single regional leader with presence in multiple African countries.

Source: McKinsey Global Payments Practice

Global-to-regional agreements

Global institutions with networks spanning multiple regions have a proven value proposition for serving multinational corporations (MNCs). This is no reason for complacency, however. Indeed, a global bank's objectives in forming a partnership with a regional institution or a number of local champions may be to defend relationships from a new and far-reaching global alliance between two regional leaders. Alternatively, an aggressive partnership strategy might aim to undercut a global or regional competitor. Seamless service (based on deep systems integration) and transparency are competitive advantages.

New partnership models in transaction banking will have a deep impact on a bank's international operating model, and should thus be part of the CEO's strategic agenda.

However, these arrangements are costly, requiring ongoing investment in systems integration and platform connectivity, and the business case can be difficult to justify. Indeed, cost grows almost proportionally to the number of countries covered; *exponentially* if the bank partners with a different local player in each country rather than a single regional player.

Whether for aggressive or defensive reasons, partnerships will likely account for a growing share of business for each global powerhouse, and it is vitally important to select partners with care according to a global competitive strategy to extend reach and maintain distinctiveness.

White-labeling

Global and regional players with a technological edge continue to provide specific product capabilities to local champions, which is a way to leverage scale on their existing platforms. In practice, however, these arrangements involve a high degree of technical complexity. In addition, they will likely require significant upgrades (transparency, analytics and digital access) in order to remain attractive and competitive. The risk of cannibalization by the in-sourcing partner is relatively high.

Technology specialists have an important role to play both in building internal platforms and establishing seamless interfaces between institutions and clearing and settling networks. Technology firms such as Ripple Labs, Earthport and third-party supply-chain finance platforms may act as competitors as well as partners, particularly wherever there is an interface between correspondent banks. Furthermore, the non-bank provider of cross-border clearing services may appear to be highly attractive to the smaller partner, as there is no risk of cannibalization.

Five critical success factors

New partnership models in transaction banking will have a deep impact on a bank's international operating model, and should thus be part of the CEO's strategic agenda. Partnerships must be carefully aligned with the competitive strategy of each partner and with an overall plan for partnerships with bank and non-bank entities. Indeed, depending on the institution, technology partnerships may play a more significant role in achieving competitive distinction than correspondent banking arrangements. Five

Exhibit 5

Successful partnerships meet five criteria

1 Clear partnership strategy	2 Strategic fit of partners	3 Harmonized customer experience	4 Integrated platforms and processes	5 Aligned incentives
Clear perspective on needs to be fulfilled by the partnership, in particular: - Which customers will we serve? - What do we need to serve them? - What are the expectations of those customers?	Complementary footprint and client base Cultural compatibility, shared legal background and trust between partners, often established through successful historic business relationship	Harmonized customer experience regardless of which institution is actually providing the service, typically defined through SLAs Right-sizing the services provided to satisfy the needs of customers within a predefined scope (geographies, products) Common/compatible legal jurisdictions	Integrated platforms and processes, enabling a harmonized customer experience Clear reporting and governance structure to resolve issues and track benefits	Financial incentives, (e.g., exchange of equity stakes, smart/transparent transfer pricing, co-investments) Where high level of integration is needed: operational incentives (e.g., exchange of staff), transfer pricing

Source: McKinsey Global Payments Practice

major factors for success for evaluating potential bank and non-bank partners are a clear strategy, a strategic fit, a harmonized client experience, integrated platforms and processes, and aligned incentives (Exhibit 5).

* * *

Market and regulatory pressures dictate that banks take a new look at the role that partnerships play in overall business strategy. The traditional examples of correspondent banking have become too complex and risky, and they inhibit banks from providing the capabilities their transaction banking clients demand. Proactive banks will take a systematic and iterative approach to restructuring their correspondent banking relationships and non-bank partnerships, starting with a review of current partnerships, the setting of strategic priorities, and a robust partnership strategy governing each party in the alliance.

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