



### Building long-term competitiveness in payment services

Payment services represent a significant revenue stream for banks and are a vital link between a bank and its customers. Maintaining that link effectively, however, is proving to be highly problematic. That's because the payments function is forced to operate in a landscape of continually lowering margins, increased competition, heightened customer demand for new products, increasing costs and regulatory-driven changes. Banks have to explore new ways to retain and grow this business, or they risk being squeezed out and losing one of their last remaining franchises. There is a viable solution. The leveraged services utility model provides a structure that will enable banks to stay in the payments business for the long term. Better still, it offers them a way to seize new business opportunities, grow new revenue streams and leverage costs across multiple payment channels.

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### Author

Ed Herman  
Global Director, BPO Payments  
EDS  
Global Financial Services Industry

## Introduction

Banks face a dilemma. The cost of dealing with an accelerating cycle of change in the payments industry is making it increasingly difficult for many banks to retain a fully proprietary, end-to-end payments function in-house. At the same time, banks can't afford to lose this essential link to their customers. The big, global payments players typically have the available capital, and the payment volumes to justify the investment needed to deal with this changing environment and to continue to offer a broad range of payment services. Many of her banks do not.

Eventually, certain tier-one banks and many tier-two and tier-three banks will have to face a choice: Do they absorb the cost of continuing to run payments in-house? Or, do they partner with third-party service providers to buy "white-label" services from larger global players and rebrand them as their own?

Banks faced the same challenge more than a decade ago. The custody market changed almost overnight into one dominated by only a handful of firms with the scale, technology and processes to deliver efficiency. But, payments are different to custody. Payments are at the core of virtually every customer relationship. To lose control of the payments function is to lose control over the customer.

It doesn't have to be that way. A consortium of banks and a business and technology services provider can create a leveraged services utility payment business. One that enables banks to retain control over the payment relationship with their customers, while benefiting from technology investments made by other entities, and building scale and processes with the greatest quality and efficiency.

## Sharing competitive advantage

Global players shouldn't lose the competitive advantage resulting from their investments in technology, processes and domain expertise. At the same time, banks that can adopt new ways of doing business should be able to reap benefits, too. By collaborating with each other and with a business and technology services company, they can gain sizeable competitive advantage in the payments business. The goals of the strategy are ambitious:

- Slash the cost of payment processing
- Radically reduce the capital needed to provide future enhancements to a bank's payment infrastructure and operations
- Give banks a way to deliver best-in-class payment services while retaining control over the customer relationship
- Leverage similar processes across multiple payment channels to gain efficiencies and increase productivity
- Provide enhanced revenue streams for banks that want to be first-movers in the new market for utility payment services

## The importance of payments

Payment services are a fundamental part of a bank's offerings to its customers and a significant source of revenue. When many customers talk about their bank, they mean the one that provides core payment facilities. This holds true across the corporate and retail sectors.

Here's the challenge for banks: Although they can often generate substantial profits from payments, these profits usually are not associated with the transaction itself, but with the ancillary services provided. For nearly all retail, commercial and wholesale banking groups, payments are disproportionately costly to provide, compared with other services. Often, they also offer a lower return on capital than other parts of the business.

Only a small proportion of revenues generated from the payment area are directly related to the transaction itself. Greater revenues come from the direct and indirect interest charges, as well as the exception

processing, research and adjustments associated with payment processing. The payment function often provides the short-term working capital or generates income from extra balances accumulated during the transaction process. Typically, direct interest (on short-term borrowing facilities associated with payments) and indirect interest (on funds held by the bank during the transaction process) each contribute up to twice the amount generated by payment transaction fees.

Given this situation, banks could theoretically exit payment processing altogether, concentrate on these other direct and indirect services, and see an increased return on capital. But, the direct revenues from payments are only one part of the argument. Banks need to stay in the payment sector because it provides the key to the entire customer relationship – whether corporate or retail. The dilemma for banks will be further complicated as competition regulators, particularly in Europe, put additional pressure on the banks to reduce their float and interest earning from payments.

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Banks are used to this situation. As long as the costs associated with offering transaction processing can be controlled, the *status quo* can and will continue. Banks, though, are increasingly finding this is not the case. This sector is under heavy pressure to improve performance and respond to regulatory and competitive pressures, while at the same time being responsive to customer demand for new products, 24-hours-a-day payment capability and increased transparency of the payment process. It’s becoming clear that the cost of involvement in the transaction processing part of the payments business will increase in the near future.

This is a major problem for banks in which payments act as a loss leader for other services. If they are required to make a major reinvestment in the engine room of payments, the losses may become unsustainable. This is especially true for smaller institutions lacking the economies of scale open to that handful of giant global players. As the world’s largest banks begin to industrialize their back office, other banks have to find a way to match them or watch their competitive position erode further.

### Four key drivers for change

There are four key categories of transformation challenging the industry. There is some overlap, though. Regulatory changes, for example, will encourage change in customer behavior and requirements which, in turn, will lead to new opportunities for new competitors. The complexity of change is growing, and the impact it will have on the market is hard to measure.

#### Customer requirements

Corporate and retail customers want more from their payment providers. They want faster clearing cycles, better service, new products, 24x7 access, fewer failures/

exceptions and greater access to information. Corporate clients are savvy enough to measure these benefits and will demand them, whether their bank is large or small. Meanwhile, regulators and consumer groups are stepping up for the retail customer and demanding similar improvements in service quality.

#### New regulations

Regulators are key influencers over the structure of the payments sector. There are many reasons why they intervene. Some initiatives are designed to control perceived anti-competitive behavior. One example is the case of credit and debit card interchange charges. Regulators in Australia intervened to drive down costs; other regulators are looking at doing the same. Some regulatory authorities want to create a new macroeconomic environment, as in the case of the Single European Payments Area (SEPA). Others simply want to improve the efficiency of payments to reduce barriers and improve overall competition – as in the case of the UK Office of Fair Trading’s interest in check-clearing cycles, and the United States’ introduction of Check 21.

Additional regulation – such as Basel II, Sarbanes-Oxley and anti-money-laundering regimes – aim to reduce operational risk and increase the level of information available on the efficacy and risks associated with operational systems. These are complex requirements, and complying with them carries a hefty price tag.

#### Growing competitive activity from nonbanks

Banks must ensure they can stay in the payments business, but experience in the retail sector shows competition can develop. And, in fact, there already is new competition coming from the nonbank sector. In the world of e-commerce, nonbanks developed many new models and

structures. Banks even face potential competition for retail payment processing from the mobile telephone industry. Continuous change, such as the increasing use of chip and PIN environments across the globe, merely increases the pressure on banks. So, it's not surprising many are outsourcing elements of their retail payment processes to third parties.

This new competition comes on top of the challenge all national and regional banks are encountering: global banking players moving into their home markets.

### More standardization

Standardization is good. New standards are lowering costs and reducing operational and systemic risks. New structures and processes, however, are emerging at a helter-skelter pace. Major process changes, such as real-time gross settlement and continuous linked settlement, have been costly to the banks. New network standards and innovative approaches to data transfer through SwiftNet and TWIST also required investment. The pressure to continue introducing new processes and standards to improve the stability and effectiveness of the payments industry will persist. Plus, it all costs money and is extremely complex.

Of course, many of these challenges will lead to an improvement in the payments market. The downside is that the cost of remaining in the business will increase, while competition steadily erodes any profit margins that still exist. Most banks can't afford to let the cost of change and increasing competition drive them out of the payments market. It will undercut profits from the other products they sell these customers.

### How banks can respond to these changes

Sheer size provides a key competitive advantage for the largest global players. Their global scale can be immense, giving them the ability to consolidate processes and, if necessary, move to low-cost processing centers anywhere in the world.

Not all banks are so lucky. Those lacking the scale or the ability to make the necessary investments will struggle to equal the cost structures larger institutions can offer.

One solution is to use the white-label services provided, in one form or another, by one of the global banks. This is an option for some players, especially small banks. It enables them to offer global service to domestic customers the global players may not be targeting.

For many financial institutions, though, there is a problem with this model. Most large and mid-tier banks have key customers who choose a bank based on its payments capabilities. Often, these are major regional and global corporate customers. This makes using another bank's white-label service problematic, because the global banks may be targeting the same customers.

Banks in this position must find an alternative model – one that does not compromise their relationships with major corporate customers.

### The strength of many

These institutions need a way to achieve scale, retain control of the customer and build a degree of flexibility to deal with future change – at least equivalent to that offered by the global-scale players.

A leveraged services utility model offers this capability. Leveraged utility services, formed by groups of banks, can

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create the scale needed to build a new delivery engine based on the latest technological and operational approaches. This would future-proof institutions against further change – something few banks could possibly do in isolation.

This isn't the first time institutions have faced such a problem. Many elements of the payment process are already provided through mutual cooperation. In the cross-border market, SWIFT is a key example. In domestic markets, card schemes, which have now become global, enable costs to be shared and standards developed.

Such an all-embracing mutual model is unlikely to provide the right platform for driving rapid change in payments processing. But, the true leveraged services utility model, with ownership shared among the founding partners, offers a solution. It would effectively provide banks with a white-label service they control – one they can offer directly to their customers without any conflict of interest.

The utility model mirrors what many large international banks are currently doing with their internal organizational structures.

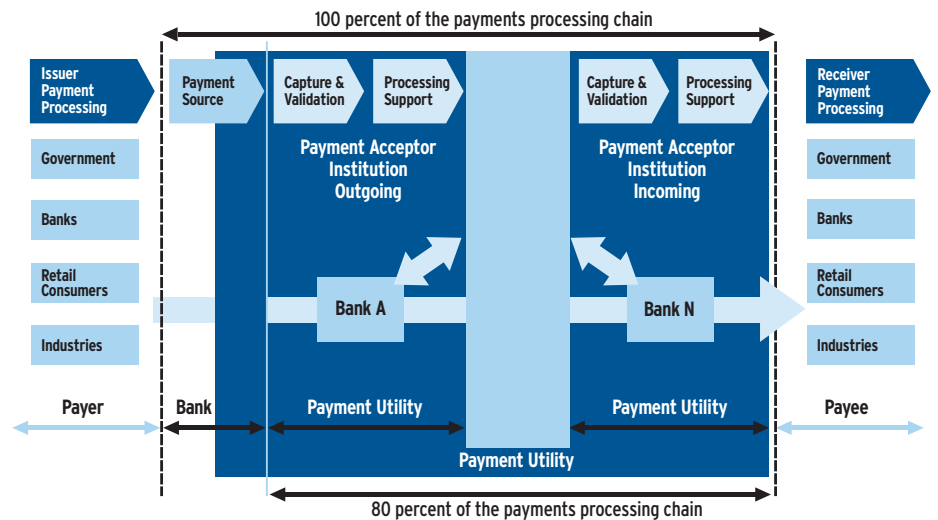
Many banks are creating “payment czars” capable of taking a holistic view of the bank's total payments chain. The leveraged services utility model does the same and more. It packages up the whole value chain and creates the ability to drive down total payments costs dramatically. It also provides new sources of revenue and increased levels of information to the heads of payments at each participating bank.

Figure 1 illustrates how a utility model offers banks potential savings across 80 percent of the payment process. At the same time, they retain their control of the customer relationship. This mirrors the structure many banks are creating with their own integrated payments functions. It also suggests how those can be made more efficient: by incorporating them into a payment utility.

Here are the key benefits of such a model:

- Control through an integrated view of IT, operational and business service level agreements (SLAs), as well as additional governance through an ownership stake
- The opportunity to reduce operational costs by transferring payment functions to a more efficient organization

Figure 1: Utility model offers efficiency gains



- Lower total costs through combined transaction volumes while making payment channels more efficient
- The opportunity to re-engineer payment processes, while controlling fixed costs and capital usage
- Best-practice methods and greater business intelligence within payment operation performance
- Future-proofing the payments function, thereby lowering operational risk
- Reduced capital charges against the payments business
- Sharing of risks, including new technology, payment channels and regulations
- Retaining customer interaction without potential competition from the payment utility
- Opportunity to extend the services offered by the bank and to provide a comprehensive national, regional and global payments capability
- Ability to use the leveraged services utility to generate new revenue
- Reduction in fraud and open items, and improved customer trust in the payments system

A well-structured leveraged utility service will include a range of complementary financial services institutions and service providers. Complementary institutions can bring scale and scope to the concept.

A key challenge facing individual banks is how to provide a comprehensive service to their corporate customers at a reasonable price. A leveraged services utility, on the other hand, provides those services to a larger customer base than any single bank could. It offers a global footprint and a much-reduced cost to each individual bank. It provides a model for retaining the existing payments business and also a platform for extending the services offered to a bank's customers.

With Basel II, Sarbanes-Oxley, the Patriot Act and all the other regulatory requirements facing banking institutions today, the payments division has to expect additional investment and greater usage of capital. But, with the leveraged services utility model, these costs are shared. In addition, if the utility service can be structured so it generates revenues on a per-transaction basis, those costs can be converted from capital-burning fixed costs into variable costs.

A banking institution can save more capital because a utility shares operational risk capital requirements among all participants.

Furthermore, while the utility safeguards operations effectiveness through service level agreements and other methods, the bank's payments professionals can concentrate on the customer franchise. Costs saved and management attention can be refocused on product and service capabilities.

### Building the right alliance

A key element of any utility-style solution is its governance structure. It is important for the utility owner-member banks to exercise joint control over the payments function and prevent any one institution from holding up development. In addition, the banks involved will want to shift costs from fixed to variable. They will be looking for a partner willing to provide significant services on this basis. This is where the involvement of a business and technology services participant becomes vital to the strategy. It is this organization's responsibility to provide the critical business and process engineering that is required. This partner must also form the basis of a structure that offers the participating banks uniform access and control, assuring independence and equal treatment for all participants.

The business and technology partner has another role to play in providing a risk-free,

neutral environment. One key risk any bank should consider when contemplating the use of a payments provider is whether they will lose irreplaceable skills. The service provider must have clear and well-practiced knowledge-transfer mechanisms in place. It must be able to absorb knowledge into the leveraged services utility when participants join, but also to preserve those skills so they can be transferred back to the banks, if necessary.

This structure ensures control remains in the hands of those institutions where payments is a fundamental offering to its corporate and retail customers. But, the service provider must have the incentive to provide services on a variable cost basis, with expected transaction volumes large enough to justify the investment required. In addition, no single bank can exercise control over the utility service, making it truly independent in the marketplace.

### Delivering full value

EDS' leveraged services utility payment strategy is based on years of experience in business process transformation – within the financial services sector and beyond. For example, establishing the Fin-Force payment service in Belgium involved rapid transformation of a payment back office into a commercially viable business providing intra-European banking services on behalf of its partners. This experience proves the opportunity exists for utility models in the financial services marketplace, and value can be generated quickly.

Utility-style concepts have been discussed and launched in this sector in the past, but they failed to deliver value to the participating banks for one of two reasons:

- The scheme was merely a cover for white-label services provided by a larger bank. The language of utility is sometimes used to disguise the true essence of the service –

*“The foundations of the strategy are the economies of scale and process improvements that will be generated by combining the transaction volumes of multiple banks.”*

for example, large banks “in-sourcing” transaction volumes from smaller players, with little or no control being offered to the banks using the service. This is a valid strategy for some banks. But, for others it represents an inappropriate relationship with a significant rival.

- Some previous efforts to establish payment utilities failed to deliver enough value in a meaningful timeframe. For example, a utility service that addresses 10 percent of the payment value chain and offers to improve efficiency by 11 percent is really only offering to save a bank 1 percent on its transactions costs. And, if it takes two or three years to see these improvements, the pain is not worth the gain for the outsourcing bank.

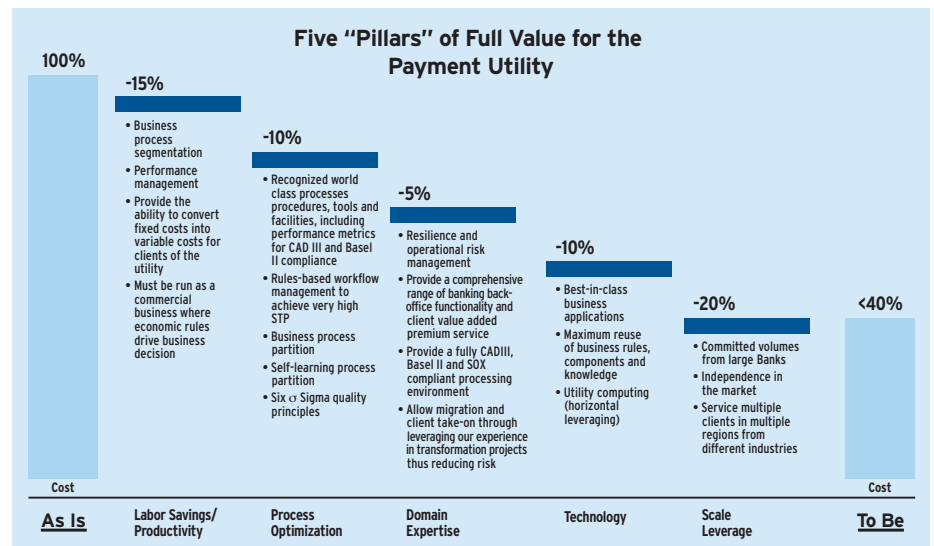
The leveraged services utility payment model is much more ambitious. A true utility will aim to address 60-80 percent of the total payment infrastructure currently run by participants, and improve efficiency on these operations by up to 60 percent. Successfully implemented, this represents a genuine solution for banks. Among other things, it will cause a major shift in the balance of competitive power for payments.

Figure 1 showed how a well-structured utility can take responsibility for 80 percent of the payment chain. Figure 2 shows it’s possible to make efficiency gains of more than 60 percent on these operations. This represents a huge opportunity to gain competitive advantage.

This improved efficiency will be delivered by taking a comprehensive view of the payment value chain and by leveraging volume, technical skills and excellence in process management. In addition, by leveraging common practices across multiple payment types, there is a tremendous cross-knowledge transfer that enables more efficient handling of post-clearing services such as exceptions, research and adjustments, and charge-backs.

The foundations of the strategy are the economies of scale and process improvements that will be generated by combining the transaction volumes of multiple banks. Higher volumes will make it more economical for the program’s business and services partner to build a highly efficient processing factory, using manufacturing excellence techniques such as Six Sigma. This will provide the basis not

Figure 2: Utility payments improve efficiency by more than 60 percent



only for immediate efficiency gains, but also for long-term improvements in value and customer service. This strategy will enable some benefits to be realized rapidly and lay the foundations for even greater improvements to come.

It also provides the basis for future protection, because optimizing processes improves an organization's ability to cope with change. The joint utility can invest in the future to ensure the service is fully compliant with new regulations. At the same time, it can spread compliance costs across the combined larger transaction flow. The outcome will be real capital savings for the banks. It also means the founders of the utility and its commercial customers can be certain that best practice will be applied to every payment process.

This means more than setting service level agreements, though these are important. Currently, few banks truly understand how their payment functions costs add up. These are often parts of the business that developed over many years, with many partially automated processes and lots of manual intervention. A clear purpose of the utility structure must be to provide participants with more information and knowledge about their processes and the costs involved. The utility can introduce the most up-to-date processes and best practices in operations. Increased levels of business intelligence can be created to provide banks with a holistic view of their payments business and the costs involved. For many, this will be the first time this has been possible.

Vital to any such framework is the technology that provides the front end to the payment utility. It must be highly efficient and highly automated to reduce the need for participants to retain any significant in-house processing. The software platform must offer effective straight-through processing

to ensure efficiencies gained in the utility are not lost through banks having to provide manual fixes elsewhere. It must also give banks the opportunity to provide customers with more value-added services in the future. These might include cash management information or extensions of the service into other parts of the business. EDS has a model for that type of framework.

There are several strengths banking institutions should look for in a business and technology partner for a utility-model payment service. It is essential the partner has extensive, direct experience in transforming payment and financial services back offices to deliver greater efficiency. This will require a proven track record in managing business processes, as well as deep applications and infrastructure capabilities needed to support those processes effectively. It must have vast experience managing many major transformation projects across a wide range of industries. This experience is vital in addressing key challenges the banks will struggle to meet. In Europe, for example, creating business structures that offer greater efficiency, while dealing with social impacts and providing long-term employee stability, is a massive challenge.

A global footprint is also vital for the services partner to the utility as the need for efficient cross-border payments increases. The leveraged services utility model will deliver the greatest value if it is able to expand to offer the same cost and revenue opportunities on a worldwide basis.

Individual banks may struggle with such issues, but the right consortium can draw on the skills of each founding bank's employees and leverage those skills when third-party banks join the utility. That's how first-movers will be able to protect and extend career opportunities for many of their most skilled payments professionals.

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## Reap the benefits

The utility concept would take up to 80 percent of participating banks' payments workload and set a goal to reduce costs by approximately 60 percent. The utility would be paid on a per-transaction basis.

This framework provides a number of clear benefits:

- Lower costs
- Controlled, shared capital expenditure, with future investments funded by the utility service income
- Enhanced revenues for participants through the ability to use the utility platform to enter new markets and for shareholders, from the utility income.
- Improved processes
- Enhanced levels of information

After one group of banks shakes up how payment services are provided, there will be a seismic shift in the industry. First-movers will have the opportunity to change their competitive position, while laying the foundation for future profitability. Plus, the benefits will be seen quickly.

EDS' global experience, resources and agile platform can provide tangible benefits for the banks involved in the initial consortium. It also offers enormous benefits to third-party banks attracted to the utility service's efficiency and value-added services.

Above all, the ownership structure offers the greatest reassurance to participants. For a utility to work, it must assure its independence in the market place. At the same time, it has to provide participants with improved process performance, improved operational risk control, lower operating costs and increased revenue opportunities.

This structure provides banking institutions with a route to enhanced competitiveness. But, best of all, banks avoid the risks associated with outsourcing their critical payments function to a major competitor.

## About the author

### Ed Herman

Ed Herman is global director for the BPO Transaction Services portfolio management group. His responsibilities include defining the strategy and managing the service offerings within the transaction portfolio to increase profitability and growth.

Mr. Herman comes to the position from EDS' Global Financial Services Industry. He joined EDS in 2003, previously holding positions as a partner in Ernst & Young LLP's National Cash Management Practice and as the Head of Americas for CashTech Solutions corporate banking solutions.

Mr. Herman brings more than 20 years of experience in financial services, payments processing, cash management and software solution development. He has worked with many of the major financial institutions in the United States in the areas of process redesign in payments and cash management, developing the financial supply chain, and instituting revenue enhancement strategies and processes.

Mr. Herman received an MBA from Indiana University and a BBA from the University of Notre Dame. He is a Certified Public Accountant and a Certified Treasury Professional.

### Contact

Ed Herman  
Global Director, BPO Payments  
EDS Global Financial Services Industry  
phone: 1 972 605 7987  
e-mail: ed.herman@eds.com

## About EDS

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## Contact us

### Corporate Headquarters

#### United States

5400 Legacy Drive  
Plano, Texas 75024  
USA  
1 800 566 9337

### Regional Headquarters

#### Asia

36F, Shanghai Information Tower  
211 Century Avenue  
Pudong, Shanghai  
China 200120  
86 21 2891 2888

#### Australia and New Zealand

Level 1, The Bond  
30 Hickson Road  
Millers Point  
New South Wales 2000  
Australia  
612 9025 0777

#### Canada

33 Yonge Street  
Toronto, Ontario  
M5E 1G4  
Canada  
1 416 814 4500  
1 800 814 9038  
(in Canada only)

#### Europe, Middle East and Africa

2nd Floor  
Lansdowne House  
Berkeley Square  
London W1J 6ER  
44 20 7569 5100

#### Latin America

Avenida Presidente Juscelino  
Kubitschek, 1830  
5th Floor – Tower 4  
04543-900  
São Paulo  
Brazil  
55 11 3707 4100

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