WAVESTONE

REINVENTING THE CROSS-BORDER PAYMENT OPERATING MODEL

HOW TO COMBINE REGULATORY BURDEN AND BUSINESS IN THE CROSS-BORDER PAYMENT INDUSTRY

AUTHORS

THIERRY SANVEE
VICTOR BARRE
JONATHAN NGO
CHRISTOPHER BARANYAY

INTRODUCTION

The cross-border payment industry has faced multiple challenges over the last decade, from increased regulatory scrutiny leading to stricter monitoring requirements and transparency, to emerging players in the Fintech space seeking to disrupt the industry through innovation. Historically, engaging in cross-border payments and correspondent banking relationships have been profitable for financial institutions, but industry challenges are now posing a major threat to the businesses' profit margins. At the same time, customers have not seen improvements in their payments/banking experience. As the environment of the industry is evolving, banks will need to adapt to retain their profits.

Given these challenges, major financial institutions should focus internal investment on the implementation of a more efficient and simplified operating model to improve the cross-border payment process. The organization of financial institutions should be conducive to strengthening collaboration between Compliance, Operations, and the Front Office functions. Additionally, there should be a focus on the customer experience to improve the cross-border payment process for their clients. By effectively responding to these challenges, financial institutions can leverage the current state of the industry as an opportunity to emerge as a market leader.

THE CROSS-BORDER PAYMENT, A FLOURISHING BUSINESS IN PROFOUND MUTATION

Based on industry consensus, cross-border payment revenues are expected to double over the next decade, from $144 billion in 2014 to around $280 billion by 2024. The main contributor to this steady increase in revenues is the increasing payment volumes. Margins are expected to see continued pressure. According to the Bank for International Settlements, "costs for payments are more frequently cutting into margins in certain jurisdictions because of increased compliance costs".

Over the last few years, the cross-border payment industry has seen a shift in the traditional correspondent banking model. Banks are trimming down the number of correspondent banks they have around the globe chiefly because costs have increased to the point where maintaining a correspondent bank in some risky areas with low volumes has proved to be unprofitable.

The payments industry is also evolving due to recent disruptions coming from the emergence of Fintech. Companies such as Traxpay and Ripple are revolutionizing the way transactions take place. For instance, Traxpay provides an enhanced customer experience by allowing the customers to change any element of a payment transaction at any stage of the process. Furthermore, Ripple has created a new cross-border payment system based on blockchain technology. The Ripple platform allows real-time cross-border payments and minimizes transaction costs by eliminating the need for intermediaries.

Finally banks also need to cope with the regulatory burden of binding requirements on cross-border payments.

A HEAVILY REGULATED ENVIRONMENT

As part of a global effort to combat terrorist financing, more and more regulations have been put in place over recent years resulting in major shifts within the cross-border payments industry landscape. The U.S. Congress passed the USA Patriot Act six weeks after September 11th, 2001 to increase KYC controls prior to the opening of a bank account.

The U.S. Department of the Treasury via its Office of Foreign Asset Control (OFAC) has also enacted economic sanctions programs against countries and groups of individuals, by publishing its Specially Designated Nationals (SDN) list.

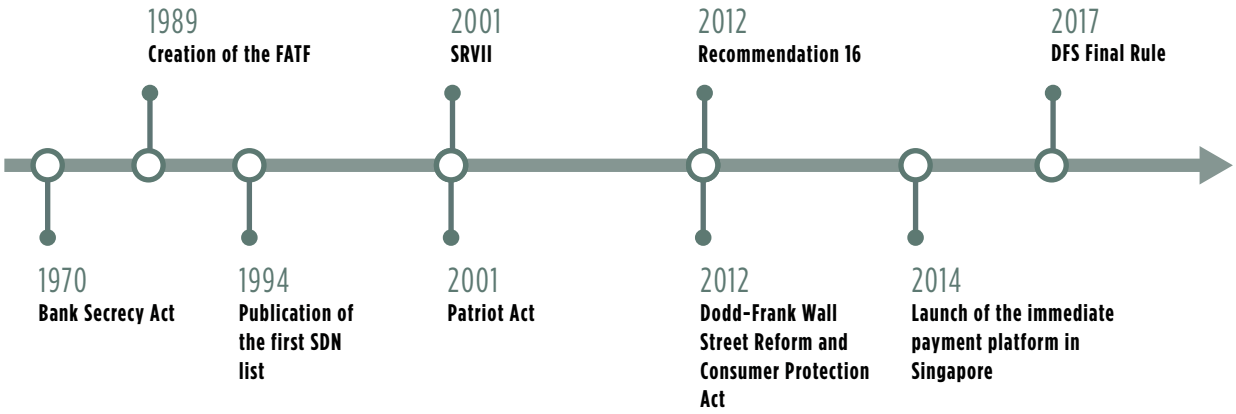
More recently, on June 30th, 2016, the New York Department of Financial Services (NY DFS) enacted a "final rule" requiring New York-regulated financial institutions to strengthen their transaction monitoring and filtering programs and to request accountability from their management to certify the compliance of the enhanced programs with the DFS requirements.

Globally, the Financial Action Task Force (on Money Laundering) (FATF) has established regulatory measures by issuing recommendations. In 2001, the FATF published Special Recommendation VII (SRVII) focusing on wire transfers, with the main objective of preventing terrorists and other criminals from having access to wire transfers by ensuring that basic information on the originator of the payment is available for screening purposes. The SRVII was revised in February 2012 and was renamed Recommendation 16. These recommendations impose additional scrutiny on funds transfers by requiring information about the beneficiary and by adding required controls during the end-to-end payment process.

In addition to addressing these anti-money laundering and terrorism financing regulations, banks must also cope with requirements promoting transparency for customers. For instance, in the U.S., Section 1073 of the Dodd-Frank Wall Street Reform and Consumer Protection Act from October 28th, 2013, outlines new protections for customers by requiring disclosures of fees, exchange rate, and the date funds will be available.

Non-bank digital entrants are also transforming the customer experience of e-banking tools by allowing immediate transfer of funds. To meet this new customer expectation for timely payments, banks are working on the adoption of an "immediate payment" model. Today, immediate payments only concern domestic payments but could soon become a requirement for cross-border payments as well.

Cross-border payment regulations timeline



BANKS ARE CHALLENGED TO BE EFFICIENT AND CUSTOMER-CENTRIC WHILE BEING COMPLIANT

Facing more regulations, banks have responded by adopting binding compliance policies. As these policies get more and more complex, banks need to assess how they will impact their customers.

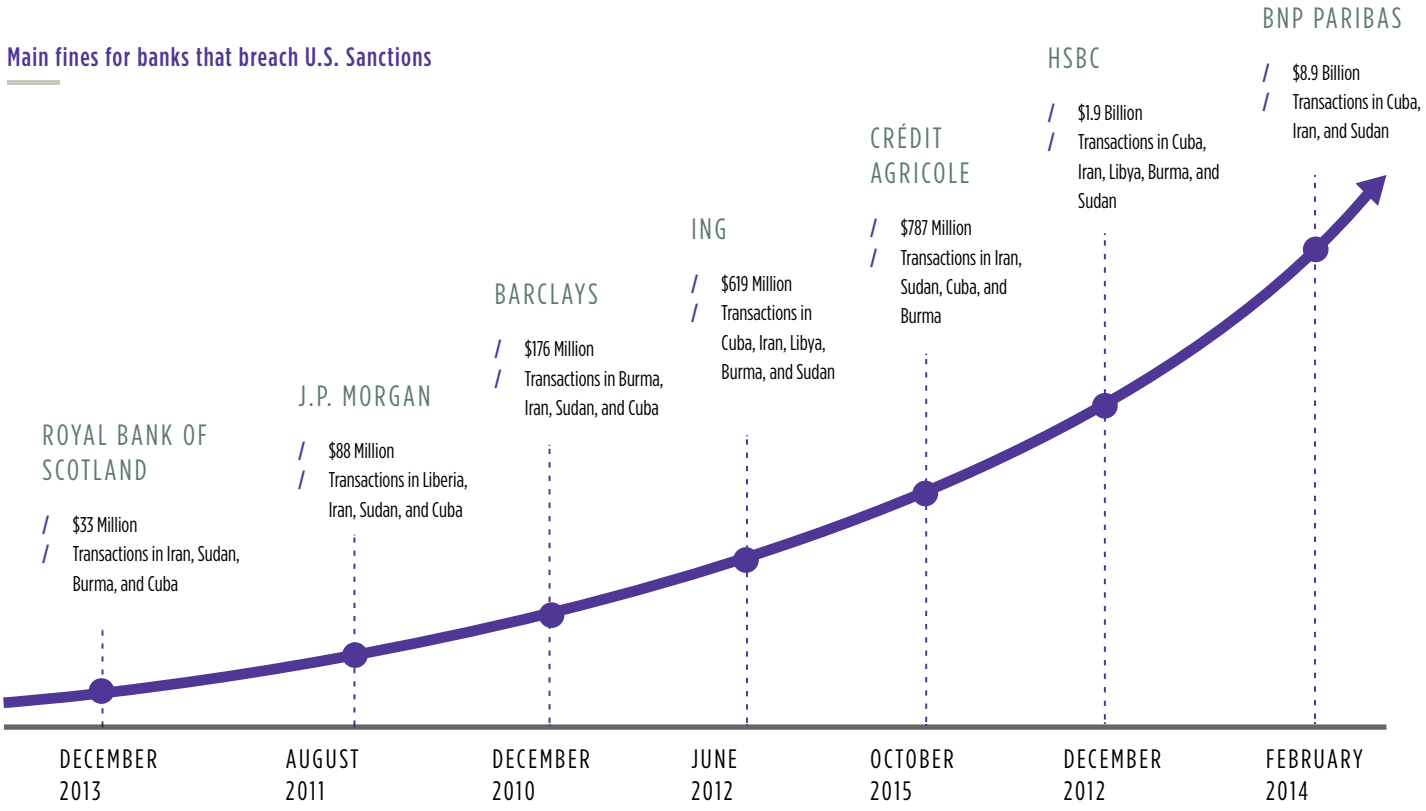
Banks have launched consecutive initiatives to cope with regulations. Due to increased scrutiny, many financial institutions have made commitments to regulators to strengthen their control framework. As a result of these commitments, many banks have had to manage the implementation of multiple compliance programs with heavy pressure from executive management. Out of urgency, banks are challenged to implement remediation actions and new regulatory requirements in consistent and efficient ways.

In addition, new standards for payment message filtering and the quality of data contained in payments messages continue to adversely impact the customer's experience if not implemented properly. More information is required from customers for a payment to be executed and sometimes the complexity of the control framework increases the payment processing time. In an era where Fintech companies are enabling customers to send domestic payments seamlessly and almost in real-time from their smartphones, customers will undoubtedly seek alternative payment methods. Banks are forced to improve their clients' experience to avoid loss of market share, in addition to addressing the challenge of making their operating model more efficient.

COMPLIANCE AND MARKET SHARE ARE AT RISK

Despite all the efforts made by banks to strengthen their controls, Regulators continue to issue fines to non-compliant banks. Since 2009, OFAC-related fines have skyrocketed, adding to the increasing cost of Compliance.

Main fines for banks that breach U.S. Sanctions



Source: U.S Department of the Treasury website

These fines not only hurt financially, but also damage the banks' reputations, as corporate customers may be discouraged from doing business with incriminated banks.
At the same time, some customers change banks because of slower processing times or poor customer experience resulting from increased transactional controls.

IT IS TIME FOR AN OVERHAUL OF THE PAYMENT OPERATING MODEL FOR THE BENEFIT OF CUSTOMERS

In these challenging times, the focus needs to be brought back to the customer. The myriad of different initiatives that have been implemented has drawn attention away from maintaining a customer-centric business. Regulatory and compliance spending has grown to unprecedented levels at the expense of investing in other areas of the business. In order to curtail dropping profit margins, banks need to improve the customer experience. They can achieve this by implementing better tools and focusing on client segmentation, shifting Compliance's engagement model, and reducing operating costs.

Better tools for customers and clients segmentation

The implementation of regulatory requirements has made payment processing more complex. However, this complexity should not affect customers. Updating customer-facing tools should help in easing the payment process from the customer's perspective. All the necessary information for a payment needs to be captured upfront so that payment messages are not blocked due to missing information (e.g. missing country information). The customer interface should also provide transparency on the progress of the payment through the bank's systems including the ability to track payments.

Considering the unpredictability of processing times, especially when a payment message generates a hit in filtering systems, banks should consider creating different types of payment services depending on the type of customer. For instance, banks can design a tiered service model based on customer priority. Payments from higher tier customers will be prioritized in case they create hits or require manual intervention. Alternatively, banks could possibly market this as a premium service and generate additional revenues.

Compliance's engagement model shift

Recently, bank Compliance functions have focused on raising regulatory awareness and emphasizing the importance of compliance through comprehensive training programs and communication campaigns across the bank. This has shifted the mindset of employees and incorporated compliance and regulations into business products and services. This change was made possible partly because Compliance teams in banks have often recruited resources that have had experience working in regulatory bodies (e.g. OFAC, Federal Reserve System). While these professionals provide the bank with a valuable regulatory perspective, they may be lacking business expertise. It is increasingly important for Compliance to hire resources that can understand the Business of the bank and how it operates. Compliance should extend its role a step further to strengthen the bank's engagement model by better understanding the Business and Operations functions and becoming more of an advisory team.

When translating regulations into policies and procedures, Compliance teams are not always aware of all the Business' strategies or operational pain points. Therefore, some interpretations of regulatory requirements could be more impeding on the Business' and/or Operations' processes. Our view is that, similar to how Operations and the Business needed to align a few years back, Compliance, the Business, and Operations should engage in more collaborative relationships in order to align with the bank's overall strategy. This new engagement model will ease the transition towards a more efficient, customer-centric, and compliant operating model. In order to align with the Business and Operations, Compliance needs to add an advisory role to its responsibility of enforcing policies, while continuing to maintain its independence.

CASE STUDY

THE REPERCUSSIONS OF A MISALIGNED ORGANIZATION

A correspondent bank struggles to align its Business and Compliance functions' best interests in its attempt to combine compliance and operational efficiency. To improve payment processing time and meet clients' needs, the Business wanted to set a limit for a maximum number of days it should take to resolve hits from payment filtering systems. This limit would help ensure that hits were investigated within a reasonable period of time. From Compliance's perspective, it is difficult to set a limit for a case given the potential complexity. In this situation, both parties did not understand each other's requirements and expectations in order to align and reach a compromise. Efforts to streamline the payment process were consequently limited because of the misalignment between its Business and Compliance functions.

Burdened Operational Efficiencies

Since the last financial crisis, Business and Operations functions have focused on cost reduction strategies. On the other hand, Compliance, pressured by regulators, has developed its capabilities. With stringent regulation, banks have been reactive rather than proactive. They have piled layers of new controls within their processes, new functionalities within their systems, and new responsibilities within their teams on top of their existing compliance operating model. As banks' compliance frameworks near maturity, they now need to start thinking about improving efficiency and reducing costs in their organization, while maintaining strong compliance controls throughout the bank.

The architecture of messaging, filtering, processing, case management, and reporting systems needs to be rationalized to account for the global nature of payments and compliance rules. For instance, in foreign banking organizations where decision centers are outside the U.S., the Compliance function for USD payments was operating in regional silos. Given that OFAC rules apply to any USD transaction in the world, this kind of organization has proved to be inefficient. The revamping of the global architecture will address issues like system redundancy to promote consistency across the organization. A rationalized architecture will enable process optimization, especially in the areas of list and case management, which are particularly hurt by fragmented architectures. Investments might be needed to upgrade, replace or integrate systems which will generate significant cost reduction for banks in the long run.

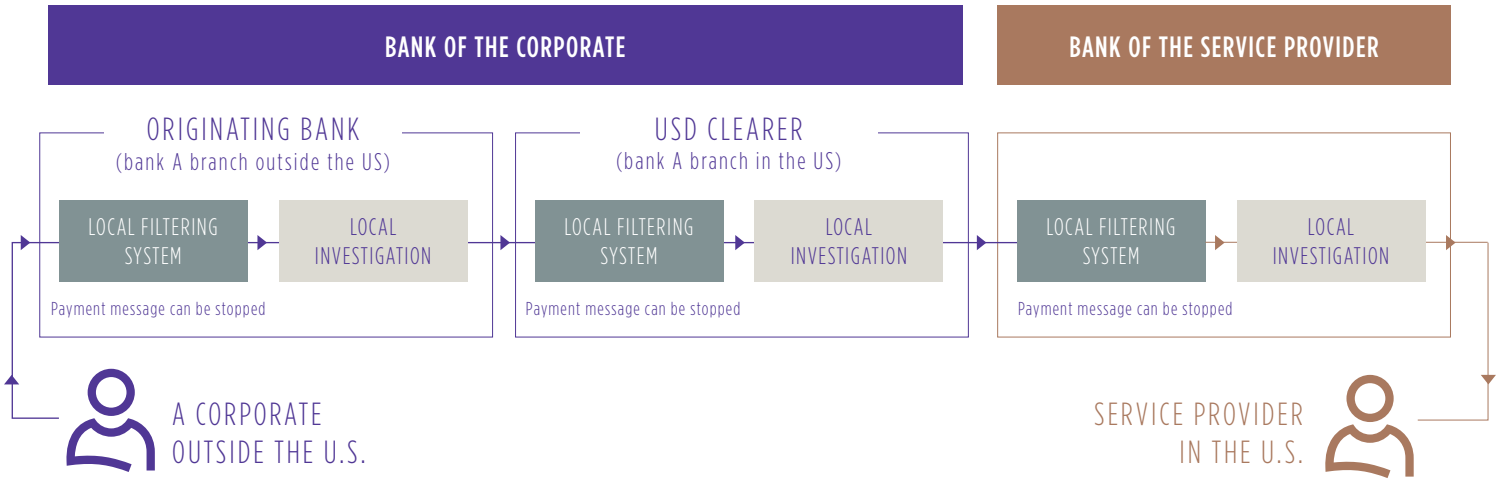
CASE STUDY

AN OUTDATED AND FRAGMENTED IT ARCHITECTURE

Several banks still maintain separate regional IT and organizational setups. Because of system fragmentation, cross-border payments can be filtered several times in different systems. As such, a payment identified to be a false positive can be stopped for investigation several times throughout its processing cycle.

The lack of consistency in the payments functional architecture hinders the banks' ability to maintain a streamlined approach for handling non-compliant payments. This not only burdens the teams investigating payments but it also hurts the client's banking experience due to longer transaction processing times.

Cross-border payment filtering duplication



- A corporate outside the U.S. needs to pay its service provider in the U.S.
- The payment will be originated and cleared by its bank through its branches outside and inside the U.S.

OPPORTUNITIES OF COST REDUCTION IN THE PAYMENT OPERATING MODEL

ENHANCEMENT OF THE FILTERING SYSTEM

An efficient filtering system should allow banks to minimize false positive alerts. The management of such alerts is time-consuming for banks and results in additional costs. Setting up a continuous improvement initiative for filtering tools will ultimately result in cost savings. The initiative should address topics including but not limited to:

- Upgrading or fine-tuning filtering algorithms. Choosing between deterministic or probabilistic algorithms. Both could be used depending on the type of data scanned
- Adapting the payment processing and filtering depending on customer risk profile
- Creating a "good guys" list based on historical hits which have been cleared as false positives
- Using data mining techniques to look at historical data and determine rules to lower false positives

IMPLEMENTATION OF A GLOBAL CASE MANAGEMENT SYSTEM

Regulators have forced banks to review their escalation process when investigating a hit. However, escalation is just one aspect of the overall case management process. Too often, banks are equipped with multiple case management systems which address requirements from one group involved in case management but not all the groups. An efficient case management system should allow for a seamless workflow between all the parties involved in case management and for sharing of all data required to resolve the case. To address the latter, interfaces with other internal systems such as customer databases or KYC systems should be implemented to facilitate the investigation.

DEFINITION OF THE MOST EFFICIENT OPERATING MODEL

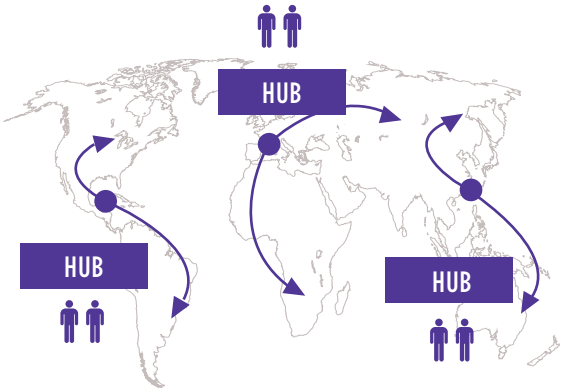
Hit analysis and case investigation are technical activities which do not require proximity to the business. However, they are part of a global business and could potentially be grouped in a shared service for the whole bank or by region or currency. Re-designing of the global operating setup into a shared services could generate major cost savings.

Additional cost optimization can be achieved by setting up either global, regional, or currency hub models for the different groups involved in payments (processing, case management, monitoring and reporting). While customer service and support benefit from proximity with the client, other functions like hit analysis and case investigation could be centralized in less costly geographies to generate cost savings. Therefore, the three models can be considered with different levels of centralization (see the following illustration).

Organizational models for global payments operations and compliance

GLOBAL HUB MODEL

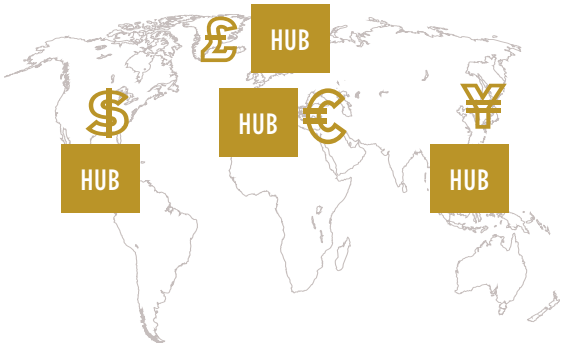
This model relies on a **global team** that is responsible for processing, monitoring, investigating and reporting all inbound and outbound **payments across the organization.**



REGIONAL HUB MODEL

This model relies on several **regional hubs** for the organization's payments operations and compliance.

Each hub is responsible for the management of inbound and outbound payments **from a specific region.**



CURRENCY HUB MODEL

This model relies on several **currency hubs** for the organization's payments operations and compliance.

Each hub is responsible for the management of inbound and outbound payments **from one or several currencies.**

> The most appropriate model will depend on the culture, the business offering, and the organization of the bank.

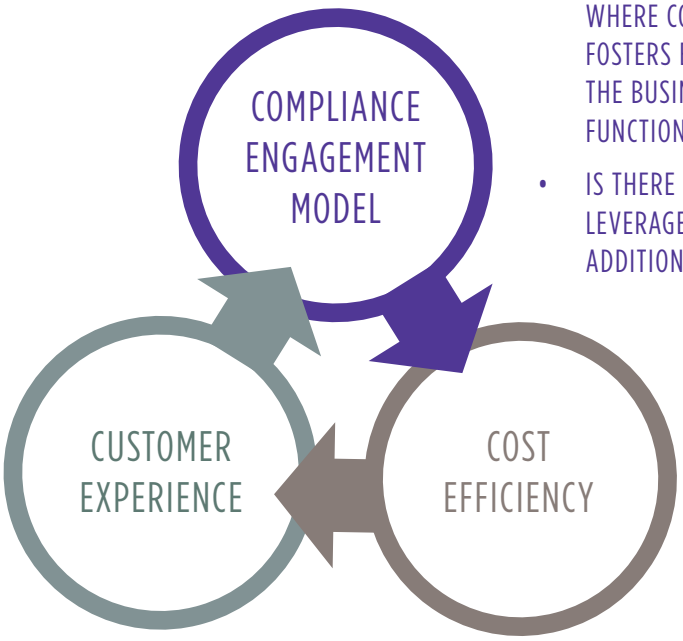
There is a real opportunity for banks which have been enhancing their regulatory controls at a fast pace to consider a more holistic approach to reviewing, designing, and reforming their operating model. They can become more efficient and improve Compliance's engagement model with a focus on the customer's experience.

ANSWERING THE RIGHT QUESTIONS TO COMBINE REGULATORY BURDEN AND BUSINESS

Banks involved in cross-border payments have been under pressure for many years. The level of regulatory scrutiny and the costs that it generates has made banks lose focus on their business and their customers. However, now that banks have acknowledged that regulations will continue to play a key role in their business, it is time to reconsider how compliance can be achieved without hindering business objectives. Therefore, executives should consider the following questions.

Answers to these questions are not straightforward and require management to step back from daily concerns. Banks that will take the time to respond and transform will gain a competitive advantage over other cross-border payment providers.

- HOW CAN WE CREATE AN ORGANIZATION WHERE COMPLIANCE'S ENGAGEMENT MODEL FOSTERS BETTER COLLABORATION WITH THE BUSINESS, OPERATIONS, AND OTHER FUNCTIONS OF THE BANK?
- IS THERE A BETTER MODEL THAT CAN LEVERAGE COMPLIANCE AS AN ADVISOR IN ADDITION TO ITS ENFORCER ROLE?



- HOW CAN WE IMPROVE THE CUSTOMER'S EXPERIENCE?
- ARE OUR CUSTOMERS FACING SYSTEMS ADAPTED TO FACILITATE ALL DOWNSTREAM CONTROLS?
- ARE THE TOOLS PROVIDED TO CUSTOMERS UTILIZING THE MOST CURRENT TECHNOLOGY?
- SHOULD ALL MY CUSTOMERS BE TREATED EQUALLY WHEN IT COMES TO PAYMENT PROCESSING TIME?

- WHERE ARE THE OPPORTUNITIES TO REDUCE COST IN THE CROSS-BORDER PAYMENT OPERATING MODEL?
- IS THE ECOSYSTEM ALIGNED WITH THE GLOBAL NATURE OF THE BUSINESS?
- ARE THE CASE MANAGEMENT PROCESSES OPTIMIZED?
- WHICH PROCESSES CAN BE INTEGRATED IN GLOBAL OR REGIONAL HUBS?

CONTACTS

THIERRY SANVEE
thierry.sanvee@wavestone.com
+1 646 318 4649

JULIEN BONNAY
julien.bonnay@wavestone.com
+1 212 203 5926

WAVESTONE

www.wavestone.com

Wavestone is a consulting firm, created from the merger of Solucom and Kurt Salmon's European Business (excluding retails and consumer goods outside of France). The firm is counted amongst the lead players in European independent consulting. Wavestone's mission is to enlighten and guide their clients in their most critical decisions, drawing on functional, sectoral and technological expertise.

Wavestone's Financial Services practice provide independent, fact-based advice and guidance to the world's leading retail and investment banks, asset managers, insurance companies and consumer finance firms. At Wavestone, we understand the highly competitive nature of financial services, the key industry trends and the regulatory challenges ahead. We are skilled in helping firms to cope with the demands for optimized efficiency, increased integrity, higher levels of liquidity, greater degrees of transparency and sustainability while simultaneously delivering a return on investment.