OLIVER WYMAN

CORPORATE BANKING INSIGHTS

WHOLESALE PAYMENTS

DISRUPT FROM WITHIN

AUTHORS
Chris Allchin
James Davis
Ronan O'Kelly
Mariya Rosberg
Martin Sommer

Change is coming to wholesale payments and cash management. New competitors and technologies have the potential to profoundly reshape the industry. With $250 billion of revenue at stake, wholesale payments and cash management is a battleground that banks need to defend. To do so, they will need to take adopt a challenger mindset – developing immersive solutions that delight customers, building next generation technology from the ground up, and shaping the emerging industry structure. The path ahead is uncertain. But that is no cause for inaction.

THE $250 BILLION BATTLEGROUND THAT NEEDS DEFENDING

Wholesale payments and cash management (PCM) has long been a stable and comfortable business. The high cost of building and maintaining payments platforms, coupled with high switching costs for clients, have created strong competitive advantages for incumbents. Disruptive winds that have been buffeting retail banking and consumer payments have been lighter in wholesale PCM.

But things are changing. Technological advances are reducing the cost of market entry and the cost of switching, as are regulations that require banks to make client data available to competitors. A host of new players are targeting the space:

- **Fintech specialists**, such as TransferWise and Revolut, are building distinctive propositions in international payments and foreign exchange, capturing share from banks and driving down margins
- **Software providers**, such as Xero and Sage, are building partnerships and API connectivity to banking providers, enabling small businesses to make payments without directly interfacing with their bank
- **Large technology and platform businesses**, such as Apple and Alibaba, are building scale payments businesses and digital wallets that bypass the traditional banking system, leveraging their enormous customer bases and deep pockets
- **Banks that have not previously competed in wholesale PCM**, such as Goldman Sachs, are now targeting the space

The stakes are high. In 2017, wholesale PCM generated $250 billion of revenue and, unlike other areas of wholesale banking, they are growing fast. Revenues grew more than 10 percent in the first half of 2018 and we forecast growth of 5 percent per annum over the next five years, as growing volumes and rising interest rates more than offset margin compression. With relatively low capital charges, returns on equity can be as high as 20-40 percent, making an important contribution to the overall economics of wholesale banking. It is also an anchor product in the corporate relationship, helping drive cross-sell of other products, such as foreign exchanges.

"[Transaction Banking] – That's an opportunity right there. The adjacencies to our core franchise are striking and obvious… And then also the adjacency to our foreign exchange business is obvious"
Marty Chavez, CFO Goldman Sachs

THE WHOLESALE PCM BUSINESS

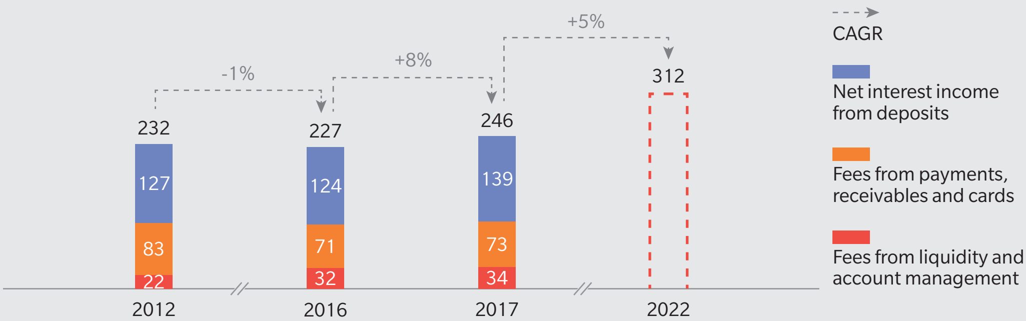
The wholesale payments and cash management (PCM) business provides corporate and institutional clients with solutions that facilitate payments to suppliers, collect funds from customers, and optimize their global cash and liquidity positions.

Banks earn fees from payment processing and account management services, as well as interest income from deposits and operational account balances. The business is an important source of stable funding for banks. And it is an anchor relationship product, providing opportunities to cross-sell other products, such as foreign exchange and trade finance.

Fee margins have compressed in recent years due to increased competition and banks cross-subsidizing low fee income with interest income or ancillary business, and we expect this trend to continue. Nevertheless, with payment volumes growing and interest rates rising, our base case forecast is that revenue will grow at about 5 percent per annum through to 2022.

Exhibit 1: PCM revenue pools and outlook

WHOLESALE PAYMENTS AND CASH MANAGEMENT MARKET REVENUES
US$ BN



Note: Includes revenues with corporates with revenues greater than $5 miilion, financial institutions and public sector. Excludes retail and small business

Source: Oliver Wyman Transaction Banking revenue pools

The scale and pace of change that new entrants will bring to the industry is uncertain. Incumbents still have advantages. The depth of systems integration between a large corporation and its payments supplier mean that switching supplier remains costly and time-consuming. And the ability to package payments with other services is also a potential source of advantage for the incumbents. Nevertheless, given what is at stake, and given the disruption caused elsewhere by tech players, incumbents will need to lift their game.

To do so, they will need to take adopt a challenger mindset – developing immersive solutions that delight customers, building next generation technology from the ground up, and shaping the emerging industry structure.

START WITH THE CUSTOMER

Technology firms have disrupted traditional businesses at a terrifying pace. Underpinning their success is a simple principle: start with the customer. Rather than designing products or features, they begin by understanding customer needs, pain-points, aspirations, and feelings. Their products harness data and algorithms to sharpen the experience, or function, or both. The result is delighted customers, and immersive solutions that meet previously unknown needs.

Applying these techniques in a PCM context requires a profound change in approach and, often, new capabilities. Tech firms develop products through a virtuous circle of innovation and adoption. This means quickly building a minimal viable product (MVP) and offering it to clients. It may initially have narrow functionality but feedback from its initial use allows it to be modified to better serve clients. The working style is agile and multi-disciplinary, bringing together customer experience, design, technology and financial engineering. By contrast, PCM businesses historically have delivered a set of rigid and disjointed products that have not meaningfully changed in decades.

Exhibit 2: Changing needs of corporate treasurer customers

CLIENT PRIORITIES	TODAY	TOMORROW
BUSINESS GROWTH	60 percent traditional channels; priority to developing new channels	60 percent new channels driving growth; e-commerce core
SUPPLY CHAIN MANAGEMENT	Varying standards; focus on "digital enhancements"	Digital supply network (DSN) with real-time integration
CUSTOMER ACCESS	Direct interface with customers through mix of off/on-line	Multi-channel – aggregators and industry platforms
COMPLIANCE & REG BURDEN	Clear and narrow nature of compliance requirements	Greater interconnectedness; more complicated compliance needs
TECHNOLOGY STRUCTURE	Mix of proprietary and industry platforms	Standardizing overall IT architecture
INNOVATION	Ad hoc approach; "Test and run" – innovation in pockets	Digital champions; agile everywhere

Source: Oliver Wyman analysis

Making the change is difficult but necessary, if only because of the increasing demands on wholesale PCM customers. Treasurers face complex and inter-related challenges. Among other things, they must optimize the liquidity profile of the business, minimize working capital requirements, and control the complexity and cost of treasury operations. And their needs are evolving rapidly, as their own business models and operations are transformed by digital technology (see Exhibit 2).

New platform businesses need to process very high volumes of micro payments and disbursements, and they need complex liquidity management structures to optimize their large (often offshore) cash reserves. The business models of firms in traditional industries are also being transformed in ways that will change their banking needs. For example, automotive manufacturers face a future where customers no longer purchase or lease vehicles but instead pay for subscription and per-mile usage fees in driverless cars. They will require new capabilities to support real-time payments for car usage, in-car purchases, and payments triggered by sensory technology.

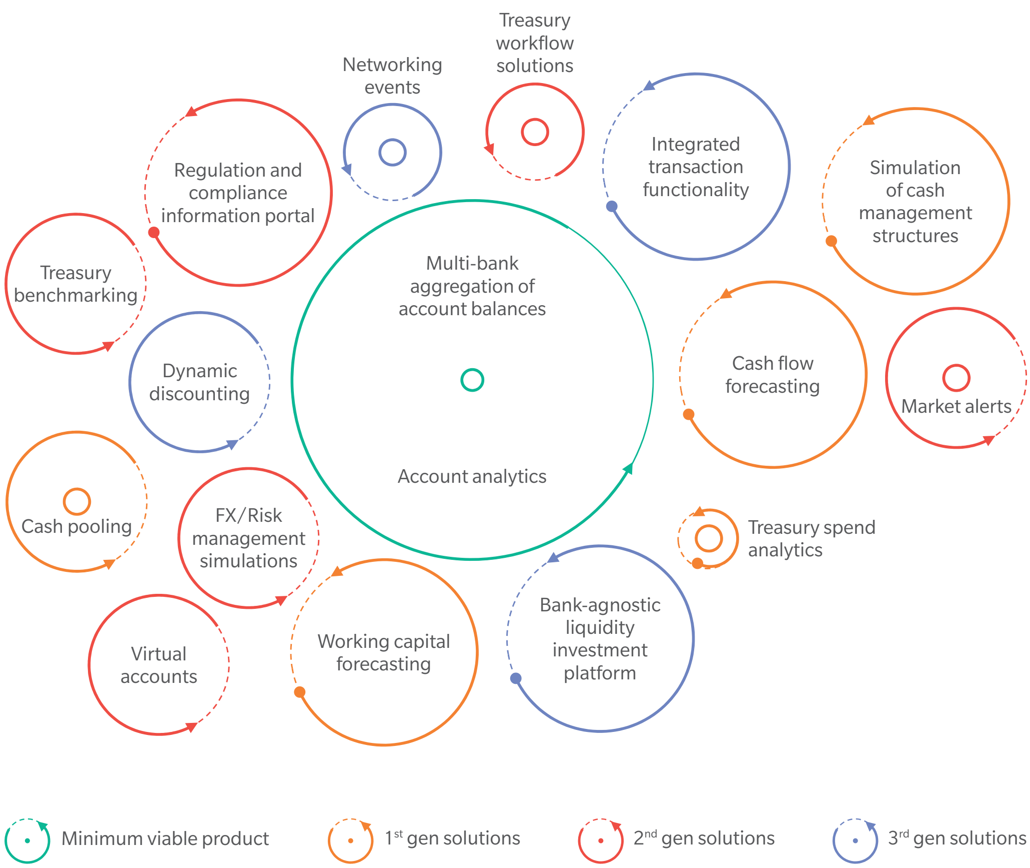
In short, treasurers need to squeeze more value out of traditional treasury operations, and they need to build new capabilities to deliver value as their business models change radically. Whoever can understand and solve those problems will be well placed to capture share and disrupt traditional PCM business models.

Consider, for example, a treasurer of a global pharmaceutical company. She has multiple regional treasury centres around the world, and manages a complex supply chain between raw materials, production and distribution. Today, she has only a partial view of her aggregate cash position, and must maintain large currency balances in each jurisdiction to manage cashflow uncertainty, tying up working capital. She is frustrated by poor control over her liquidity positions, and by the effort required to manage her banking providers.

To ease these pain points, an innovative payments provider develops a "next generation cash management portal" (see Exhibit 3). It might start with simple functionality that allows the user to easily aggregate account balances across multiple banks, with associated analytics that forecast cash flows based on historical inflows and outflows. With initial success, the second launch could allow the user to simulate different cash management structures, and a third launch could embed transactional information. Some of the functionality may go beyond narrow PCM products, to provide features that solve other problems for the client – such as reconciliations tools or compliance checks. This approach allows the product to solve end-to-end client needs and create a magnetic pull.

This approach is rapid, reduces the risk of sinking costs in ultimately unsuccessful products and results in a product better suited to customers' needs. It requires banks to adopt the agile working practices of tech firms that promote creativity and cut decision-making times.

Exhibit 3: Example growth flywheel of next generation cash management solution



Source: Oliver Wyman analysis

FUTURE-PROOFING INFRASTRUCTURE

PCM is essentially a technology business. This has been a source of advantage for incumbents, because the large fixed cost of building payments systems acts as a barrier to entry for potential competitors. Yet, in many cases, it has also become a source of disadvantage. The PCM businesses of many banks are built on a patchwork of legacy technology, the result of underinvestment and of mergers and acquisitions. Core banking systems often differ across markets, face volume constraints, and sometimes cause damaging high-profile downtime. Operating and constantly patching up such systems is expensive. The largest players spend $200-300 million annually – up to 15 percent of revenues – on simply maintaining existing legacy systems.

Retail banks face similar problems with inefficient legacy IT systems. Many have decided they will not be able to defend themselves against Big Tech and Fin Tech entrants by endlessly patching up and modifying their fundamentally flawed old systems. Instead, they have decided to build entirely new digital banks from scratch. Clients we have supported in this new venture have built new digital banks for less than $200 million, and in under a year.

Of course, wholesale payments is a different business. But the size of the prize is sufficiently large, and the cost of a targeted bet sufficiently small, that many challengers and more innovative incumbents are looking for ways to apply these techniques in the wholesale payments business.

Whether brand new or reconstructed, wholesale PCM businesses will need to invest in a number of aspects of their technology:

CUSTOMER INTERFACE. New regulations and customer demand will continue to require banks to expose APIs and connect to third party distribution channels. Some banks are investing in building new front-ends in the form of corporate banking portals or API marketplaces; others are integrating with online accounting platforms such as Xero

PRODUCTS. Banks need to develop new product offerings that meet client needs. Some of these will be next-generation PCM products, such as virtual accounts, while others will be value-added tools that enrich the proposition, such as reconciliation tools or cashflow forecasting

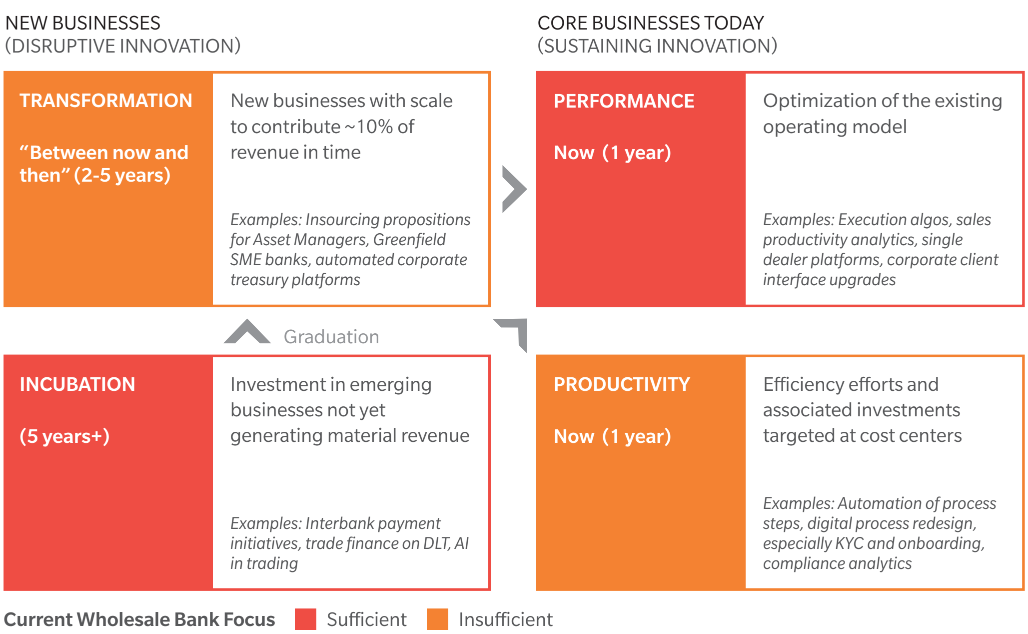
INFRASTRUCTURE. The underlying infrastructure must also be developed. Systems will need materially higher volume capacity to support an explosion in volumes of micro-payments. They will need to support real-time payments, and enriched payments messaging, in multiple markets. And they will need the flexibility to adapt to uncertain, but potentially transformational, market developments, such as distributed ledger technology and central bank digital currencies.

Meeting these technology demands will require major investments and careful prioritisation. Banks must balance optimising today's business with building the bank of the future. And they also must bring together the right mix of capabilities, drawing on expertise in other parts of the group and on external providers where needed. In our experience the key challenges are:

- Creating an incubation zone that creates the right conditions for experimentation without becoming entirely untethered from the organization (especially risk and compliance)
- Establishing a venture discipline to ruthlessly shut down initiatives that are not transformative and aggressively scale up those that are
- Delivering on more near-term productivity and efficiency initiatives with discipline and urgency.

Each of these zones of investment require different skills, and different ways of measuring success. Some banks have gone as far as to report separate investor results for digital versus traditional businesses.

Exhibit 4: Innovation zones



Source: Geoffrey A. Moore, 'Zone to Win' and Oliver Wyman collaboration

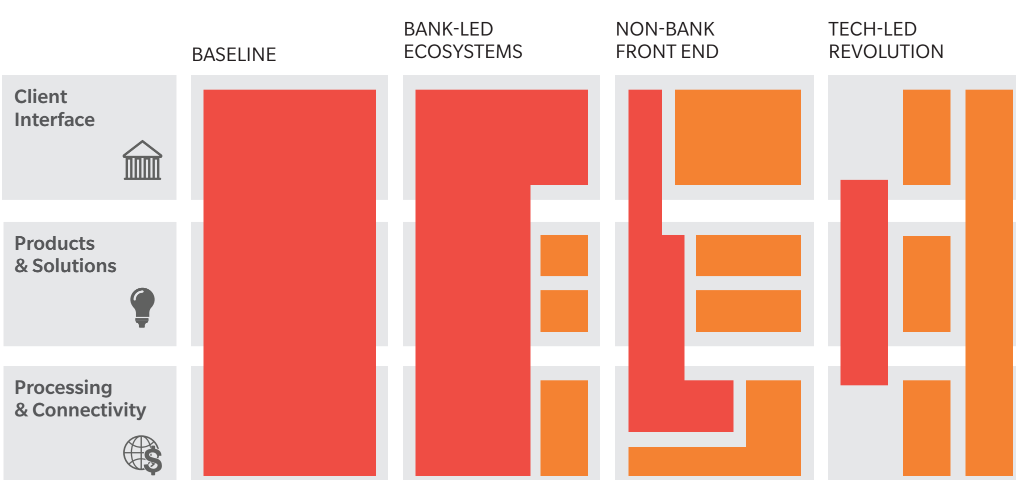
THE EVOLVING ECOSYSTEM

No bank is an island. As important as sharpening your own customer proposition and technology stack, will be understanding how your offer fits into the wider ecosystem. A range of industry outcomes are possible, with differing implications for the commercial attractiveness of various business models. Plans must continually be pressure-tested against a house view on how the landscape might evolve, considering a wide range of competitors and potential partners.

We have sketched four scenarios for the industry (see Exhibit 5), with varying amounts of revenue at risk for banks. In the most disruptive scenario, we see up to 70 percent of industry revenues ($175 billion) at risk. These revenues could be captured by aggressive challengers and returned to customers as competition drives margins down.

BASELINE. The market structure remains largely unchanged. Banks continue to deliver end-to-end client solutions and new entrants struggle to gain traction in the wholesale market. Such limited market change would likely be driven by factors outside banks' control, such as greater than expected customer inertia, a reluctance among non-banks to enter a regulated market, or perhaps a major security breach at a challenger.

Exhibit 5: Market structure scenarios



	Baseline	Bank-led ecosystems	Non-bank front end	Tech-led revolution
Bank revenue impact vs. baseline		+10% – +20%	(15%) – (35%)	(45%) – (70%)
What you need to believe	Client inertia; regulation defends status quo	Banks prioritize budget and resources	Banks integrate with third parties to offer product	Regulator support, tech players accept lower valuations

Bank provided · New entrants/structures

Source: Oliver Wyman analysis

BANK-LED ECOSYSTEMS. The largest banks take advantage of their incumbency. They build upgraded front-end platforms, provide sticky, integrated products, and incorporate solutions from third parties, all on modernised payments infrastructure. This is the outcome that is most attractive to banks, and the one most are working towards.

NON-BANK FRONT ENDS. Non-banks develop new tools and functionality for corporates, enabling them to capture the payments interface. Banks are disintermediated and become utility-like product factories. With reduced fees, scale becomes even more critical for banks.

TECH-LED REVOLUTION. Technology giants redesign the payments "rails", building new platforms with straight-through processing that bypasses the bank interface. Fees fall significantly, alongside an explosion in payments volumes. E-wallet solutions provided by non-banks reduce the traditional "float" revenue streams banks earn from interest margins on clients' operational balances. Up to 70 percent of banks' current wholesale PCM revenues could be at risk in this scenario, with banks being reduced to commoditized providers of highly regulated services.

Uncertainty about which of these scenarios most closely resembles the future means that banks face difficult decisions. Are they willing to offer their own products on third party platforms, to partner with third parties to provide enriched products, or to rent infrastructure from others? And which new propositions do they want to build for themselves?

With leading banks spending 5-6 percent of revenues on innovation and technological change, the largest players are outspending regional banks by more than 5x. Many smaller domestic players already struggle to monetise the fixed cost base of the business, with low single digit profit margins. They face an uphill battle against those with deeper pockets and higher volumes.

Some of the largest global PCM players may see an opportunity to consolidate share by building compelling customer front-ends and aggregating other banks' flows. Smaller domestic players may conclude that they do not have the resources to own and operate their own PCM infrastructure, and that they should serve local clients through white-labelling deals with larger players or technology providers. Commerzbank, for example, has decided to outsource its SEPA payments processing to Worldline, a specialist payments company.

Banks need to explore these scenarios, and war-game their responses. Hard decisions will need to be made.

With $250 billion of revenue at stake, wholesale payments and cash management is a battleground that banks need to defend. Lessons from big tech tell us that where there are unmet needs, or high margins, new and nimble challengers will find a way to provide compelling solutions. Challengers are presented with a large market, ripe for disruption. Incumbents must rise to the challenge, and find ways to deliver a generational change in wholesale payments.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

ABOUT OLIVER WYMAN CORPORATE BANKING INSIGHTS

Oliver Wyman Corporate Banking Insights is a series of perspectives on hot topics in corporate banking. It is targeted at corporate banking leaders across the globe, and aims to distil our latest thinking into a concise article with practical steps for banks to adopt. Our corporate banking experts would be happy to discuss any of the topics in this series in more detail.

AMERICAS
+1 212 541 8100

EMEA
+44 20 7333 8333

ASIA PACIFIC
+65 6510 9700

www.oliverwyman.com

OLIVER WYMAN