Correspondent Banking: International Payments' Future or Past?

Imagine the finance industry set out to build a model for international payments to meet today's needs. Would it build the one that exists today? Or is there something that would better serve customers and the industry? Neil Burton, Expert speaker for Earthport on payment strategy and Arthur Cousins, CEO of the International Payments Framework Association (IPFA) sat down to answer some searching questions.

An interview with:

By **Neil Burton**, Expert speaker for Earthport on payment strategy

Arthur Cousins, CEO, the International Payments Framework Association (IPFA)

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What is the status of correspondent banking today?

Arthur: Correspondent banking is alive and well, but we can see that the model is starting to fail to meet the needs of the newer generation of payments makers in the world today. They don't know the history behind the current model or care about it. They live in a world when everything can, or at least should, be instant. They ask why this isn't the case with cross-border payments - correspondent banking operates on a two-day basis. It's not an exaggeration to say that many people today send payments internationally and simply hope that they get there.

Neil: Correspondent banking, being a broad array of services through which one bank sub-contracts or sources from another, functions well. However the payments component of it, though strong for high value transactions, is less suitable for low value international payments. This is hardly a surprise; after all, the correspondent banking model was put in place at a time when there were relatively few such transactions. Since then, however mass migration of labour, economically active migrants, the internet and widespread adoption of mobile phones has led to a growth in demand for more retail-oriented functionality than is currently possible through correspondent banking.

What challenges are there then with cross-border payments?

Neil: Senders and beneficiaries making international payments expect them to have the same characteristics as domestic payments. They need payments to be transparent, predictable and they want to know progress. They need the process to incorporate information so that the recipient knows what the payment is for.

Arthur: Payments made by banks are based on an out-dated model. For example, they don't normally cater for payment status updates or providing confirmation that payment has been made into the account of the receiver. Meanwhile, payments made by other providers use proprietary standards and aren't suitable for more varied types of transactions. Cross-border payments are seen to be expensive and it's only a matter of time before the regulators focus in on this aspect. They also don't support e-commerce as well as they could and they don't cater for the un-banked segment of the global market.

Have these challenges changed over time?

Neil: In some ways, yes; consumers and corporates have become increasingly aware of the shortcomings of cross-border payments, and are gradually becoming more aware that the new generation of regulated payments service providers (PSPs), who specialise only in payments, offer a better service. Where action has been driven by regulators – be it directly or by just the threat of regulation, such as SEPA in Europe, service levels have been driven up and prices down. But in other aspects, little has changed; the average fee to make a remittance has remained stubbornly close to nine per cent, despite a G8 initiative to halve it. A participant at a recent conference I attended described the payments industry as, 'some kind of forgotten, isolated island, not yet overtaken by the IT storm that has been blowing this last decade with its new concepts and business models.'

Neil: The current models haven't kept pace with the way business is done today; they simply don't suit modern lives and they don't take into account the huge global population of migrant workers and the un-banked market.

How can these challenges be met then?

Neil: Payments is a multi-sided business problem; there is a first mover disadvantage, in that the first investor depends on adoption by many others before a return can be made. A solution to this challenge is to assemble existing components of the banking system in a different way, to achieve a better outcome. The IPFA is one example; it has established standards, based on industry-standard ISO 20022, which enables national automated clearing houses (ACHs) to interlink directly, so users in one country can get the benefits of the economies of scale of the domestic clearing in another country. At the 'scheme' level, firms such as Earthport are interlinking domestic schemes, via virtual accounting, to achieve a similar effect for settlement. These models have the benefit of operating 'within' the banking system, and thus help banks to re-intermediate into the flows. Other models include 'Hawala', a long-standing trust-based cash to cash mechanism and transfers via accounts managed by non-bank players such as mobile virtual network operators (MVNOs) and virtual currencies. In many cases though, these services operate outside the regulatory framework – and so the users of the service don't have the protection afforded by regulated providers. Users may not always fully appreciate the risks they are taking.

Arthur: New electronic message standards have emerged that should be adopted and the full functionality that they can permit should be explored in order to address the current service issues. Banks need to accept that they need to collaborate more closely to ensure payments become more instant cross-border. There is little point in making payments faster within a country when it still takes too long to get the payment into that country.

What is your vision for the industry?

Arthur: For the wholesale business world, my vision is for payments that support the business process; payments that are faster and have suitable processing reporting for all stakeholders. For the retail world it's about payments that are cheaper than those today, and that meet the needs of different segments, that is from the poor or un-banked to the well-educated professional segment. With domestic payments many, many more transactions are processed – hundreds of times those of international payments - so domestic ACHs have better economies of scale. It therefore makes sense to integrate those domestic ACHs internationally by enabling them to communicate with each other directly through a single common standard. Then regulated PSPs - banks and other authorised payments institutions – will have a different method of clearing payments internationally, with characteristics that differ from those of correspondent banking and are particularly better for low value transactions. The IPFA has established standards which enable such an approach. The ACHs that are members of the IPFA include Equens - in Europe - and Desjardins in Canada. PSPs including PNC, Earthport and FedGlobal and transnational schemes such as the South African Development Community are adopting IPFA standards. Together, IPFA and its members enable international reach via local payments schemes to over half of the banked beneficiaries in the world.

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Neil: At its most fundamental, payments is stuck in a time-warp. It has defined the business problem as moving value from one place to another, electronically. Mid last century, that was a suitable ambition. It's now outdated; nobody wants to 'buy' a payment, but they need payments to happen in order to satisfy some broader activity. Therefore the so-called payments business isn't a business in itself at all; it needs to redefine itself as having a much broader purpose. And that definition needs to be built around meeting requirements; ones that include transparency of service – how much will arrive? When? And at what cost? – real-time communication of progress, the interactive ability to enquire into a transfer, the reconciliation of received value to account, the incorporation of the purpose of the payment so that the beneficiary knows what the funds are being received for, and all at a substantially lower cost. Users of the service – senders and beneficiaries – care about the outcome, in their own terms; they don't care, and never have, about the underlying complexities. And this applies equally to corporates – all corporate treasurers have smart devices and expect the commercial world to deliver similar experiences.

What progress has been made so far to realise that vision?

Neil: Regulators in Europe have sought to introduce more diversity and choice, by creating a new regulatory framework for specialist PSPs. Hundreds of 'alternative' providers have also emerged, providing far greater choice. Work needs to be done in other jurisdictions so that such regulated providers are encouraged there; and work also needs to be done to give such organisations fair access to the national clearing and settlement systems, and to settlement accounts.

Arthur: Numerous efforts are under way across the globe to try and address various aspects of the payment chains. Bringing this activity together into a more cohesive single effort would be a positive step forward.

How do you see cross-border payments evolving in the future?

Arthur: Sadly it would seem that improvements will only be made by regulatory intervention. Then we may begin to see better payment services emerge at a lower cost to customers.

Neil: Whilst I agree with Arthur that to date regulatory intervention has taken the lead in effecting improvements, the rate at which consumer expectations are changing leads me to believe that it will now be market forces that force change. As consumers and businesses become more savvy, enabled with their smartphones – which we sometimes forget they've only had for a couple of years – they'll increasingly shop around for the best FX rates, as well as the lowest fees and best service. Whether banks adapt, perhaps by collaborating more, or whether a Silicon-Valley-mentality corporate gets there first, remains to be seen.

I also think that 'cross-border' will gradually fade as an adjective that is seen to be useful in financial services. In the past, bankers tended to think along nation-state lines but the evolution of technology doesn't; and increasingly, neither do people or businesses. It is a descriptor suitable for a rear-view-mirror view of the world, but unsuitable for the future. And 'payments' will also slide out of the vernacular. It is too narrowly defined for today's world; it will evolve towards a broader requirement; a broader business purpose, within a wider overall category of global commerce. That is a good thing for everyone; though the payment itself will become more commoditised, there's plenty of evidence that consumers value timely and useful information – such as the status of the payment. Smart devices make obtaining and presenting that information possible; so I see the evolution as making the market both bigger for providers, and better for consumers.

About the authors

Neil Burton

Expert speaker for Earthport on payment strategy

Prior to becoming Earthport's Director of Product Service Strategy in 2008, for 13 years Neil held the role of Global Payments Solutions Executive at IBM where he was instrumental in the successful bid to develop the technological infrastructure of CLS Group's continuous linked settlement service for foreign exchange trades.

Earlier in his career Neil worked at Logica and Braid Systems – a financial messaging and payments workflow management company.

Neil is a recognised speaker on the conference circuit – he has shared insight on payments and broader financial services topics at NACHA, EBAday, Sibos and IPS – and has contributed to articles in Banking Technology, The Banker and GTNews amongst others.

He holds a BA in Physics from Oxford University and an MBA from Kingston University.

Arthur Cousins

CEO, the International Payments Framework Association (IPFA), Payments Project Coordinator of the SADC regional payment project

In December 1969 Arthur joined The Standard Bank of South Africa. He commenced working in the bank branch network and transferred to the head office in 1971 where he held various positions in treasury, international banking, trade finance and custody.

Prior to managing the banks' engagements with industry bodies, Arthur was a director responsible for treasury, back office, trade finance and custody operations. Until December 2009 he held a position that entailed involvement in a number of domestic payments and securities initiatives as well as international initiatives and organisations including CLS, Global Payments Forum, IPFA, International Standards Organization (ISO) and SWIFT. Arthur is currently the CEO of the IPFA, payments project coordinator of the SADC regional payment project and a member of the World Bank expert group that is developing guidelines for the regional integration of financial infrastructures.

Arthur has previously held board member/member positions with: CLS, SWIFT, the Financial Industry Standards Association of South Africa, SA Banks Treasury Operations Forum, Money Market Forum, South African Central Securities Depository (STRATE) and The JSE Securities Exchange Advisory Committee for Clearing and Settlement. While at Standard Bank, he served as a member on a number of committees established by the South African Reserve Bank dealing with foreign exchange, exchange control and payment matters.

He holds a BA in commerce from The University of South Africa and is a certificated associate of the Institute of Bankers in South Africa (CAIB), obtaining an EDP diploma from Wits Business School.