

Digital Payments Transformation

Delivering 'urgent' and 'important' initiatives together is the new mantra

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Foreword

There is no denying that our payment industry is transforming at pace. Change is constant. We have come to accept it now but the rate of change can still be unsettling sometimes.

Payments players today have a Catch-22 on their hands: on the one hand, they need to deliver on key industry and market initiatives like SWIFT gpi, ISO20022 migration of various high value payment systems and Universal Confirmations and new regulations for payments. At the same time, they also need to manage their finite resources, with people being most key, towards delivering strategic changes like 'agile' and 'future-ready' payment architecture with high availability and fault tolerances to deal with needs of a 'real-time' world.

Navigating these challenges requires finding the right balance in your priorities – distinguishing the overlap between 'urgent' and 'important' initiatives to deliver on both.

It's always easier said than done, which is why we decided to engage with Ovum to carry out specific research on the spectrum of payment challenges faced by payments providers today and hopefully bring out solutions as well

A big thanks to Daniel Mayo from Ovum for bringing out key insights in this report.

We sincerely hope you will find it helpful to traverse your payment transformation path.

Happy reading!

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Summary

Catalyst In brief

Banks and payment service providers today have number of key industry-led initiatives to prepare for, such as ISO 20022 migration, SWIFT GPI readiness, and universal confirmations, which are current priorities for investment and enhancing client value propositions. However, such initiatives also take place within a broader requirement for digital payments transformation, driven by technology and customer trends within the economy as whole. Based on discussion with leading executives driving the payment industry, this report considers both these immediate payment priorities, the issues and challenges around digital payments transformation, as well as key technologies that are driving and enabling this change.

Ovum view

There has been much hype around digital transformation in banking over the last couple of years; however, for the payments industry, the requirement for banks to respond to threats from new entrants, new business models, and lower entry barriers from cloud-based platforms is a real one. The pressure to balance immediate business requirements with longer-term strategic initiatives has never been higher. While this necessitates a response to operate more effectively in the digital world, the underlying issue here is a business one, not just a technology one. Banks need to evaluate where payments business models will evolve to over the next five years, and transform to shift the culture, processes, and platforms to where they plan to go, but retain the agility to change throughout the transformation program. Critically, banks need to shift their approach to industry initiatives and walk the tightrope between focusing on urgent tactical fixes to meet deadlines, to strategic approaches that allow the bank to develop overall client propositions that will support their longer-term strategic initiatives.

Modern payments platforms will be critical here. Platforms that provide high levels of automation and can take advantage of cloud-native technologies will be important to change the cost dynamics. Importantly, banks need a platform that supports low cost and fast speed change, and is able to adapt and work with the emerging payments ecosystem to ensure that industry initiatives such as ISO20022 and universal confirmations are opportunities, not just requirements.

Key messages

- Banks need to walk a tightrope between what is urgent vs what is important and think beyond doing just incremental changes. There is a clear need for banks to take a strategic approach to imminent industry initiatives, such as SWIFT gpi, ISO20022 migration and universal confirmation.
- Competition, regulation, customer, and technology trends are driving banks to adapt existing payments business models.
- Banks need to transform their payments landscape with a roadmap for the medium term and flexibility to adapt on the way.

- Cloud offers security and scaling benefits, as well as access to the new technologies and ecosystems; however, banks should not just replicate current systems in the cloud.
- Artificial intelligence is important as business models shift to data but requires a strong data platform.

Digital payments transformation requires both business and technology changes

Payments transformation is a business-level imperative, requiring technology platform flexibility

Digital payments transformation has become a core requirement for the sector given changes in client expectations, new competition from fintechs and big tech, regulatory drivers, as well as industry standard initiatives. However, while the "digital" component suggests technology, and indeed technology is both a driver and enabler (and, conversely, an inhibitor) of transformation, the heart of the issue is the need for the payments industry to create new business models. New entrants are introducing disruptive business models, which pressurize traditional income sources and banks must evolve to survive. Finding new products and services, and reviewing new models around data and working in a broader ecosystem is vital.

The underlying technology platform is central to this change; banks must move beyond the traditional mainframe-based slow development cycles to take advantage of new technologies such as cloud, and dive into the API-driven ecosystem to provide and develop new services. But key to this transformation is flexibility, both in the ability to harness transformation across cloud, on-premises, or hybrid, but also to have a platform that is agile with a low cost of change when adapting to future requirements.

Banks think beyond cross-border payments and take a strategic approach to imminent industry initiatives, such as SWIFT gpi, ISO20022 migration and universal confirmation

Within the wholesale payments industry, there are a number of key initiatives driven by industry network bodies such as SWIFT that are driving significant change to payment process and systems in banks:

- **ISO 20022 migration** for cross-border payments and cash reporting is set to start in November 2021. This will change the way banks exchange cross-border payment instructions and reports, allowing banks to send richer payment messages through the SWIFT network.
- **SWIFT gpi** is an industry initiative to improve the customer-bank experience for cross-border payments, which should bring about quicker payments, with greater cost transparency and tracking visibility for customers. However, it will require adherence to tougher and more visible service-level agreements (SLA) by banks.
- **Universal confirmations** is a mandatory requirement by 2020 for all institutions receiving cross-border payments (through MT 103 messages) to confirm when a payment has been credited to the account of the beneficiary. This builds on payment tracker and unique end-to-end transaction reference (UETR) requires seen in 2018 and 2019.

The drive for these new messaging standards programs is ultimately to improve both the experience and capabilities of the payments industry to its customers, with initial focused particularly centered on cross-border payments. These will allow banks to provide enhanced services to clients, through greater payment visibility, speed and ability to develop new services.

However, banks need to think beyond the immediate requirements and impact. Clients want improved tracking, cost visibility and faster payments across all their payment services, for example all high-value payments, as well as cross-border. Similarly, while ISO20022 migration is only mandatory for cross-border payment instructions and reporting by 2020, other transactions such as corporate payments and cash management, securities, FX, treasury, or trade finance are likely to also come under this umbrella.

While banks need to start preparations and investment as soon as possible to ensure systems and processes are ready for imminent deadlines, banks need to move beyond tactical point fixes, focused on meeting immediate requirements, to consider how such requirements fit into a broader transformation strategy. Banks need such mandatory spend to help drive a strategic approach that facilitates ability to deal with ongoing change, and the ability to leverage investment across the business.

Competition, regulation, customer, and technology trends are driving banks to create new business models for payments

Looking at the requirement for broader change, there are four key external trends that are driving the requirement for transformation in the payments industry:

- **Customer expectations** have changed through the growth in digital economy with the pervasiveness of smartphones and convenient, intuitive access to services through apps. Even though this trend is driven from the consumer, it has an impact on the corporate side with banking clients demanding similar capabilities.
- **Competition** is a concern and Facebook's recent announcement about Libra provides a timely example. New competitors such as fintechs are stepping into payments and bringing disruptive business models with them. For many of these providers, payments is a means to an end rather than the prime business (in contrast to banks).
- **Technology** and, more significantly, technology accessibility has radically shifted in recent years resulting in far lower entry barriers. For example, payments service providers (PSPs) can be set up rapidly with limited capital, thanks to scalable technology platforms available to support new models.
- **Regulation and new global standards** (including ISO 20022) means regulators are pushing institutions to transform at an accelerated pace, with PSD2 and requirement for open banking a good illustration here.

One of the changes across these trends is that dynamics of the sector have shifted from bank versus bank, to bank versus "big tech" (such as Amazon or Facebook). This is driving the requirement to not only transform to adapt in new environments but to consider the more fundamental question – what is the business model of transformation; in particular, what do banks need to do differently? The underlying challenge is one of change management, difficult when most banks are bound to their mainframe-based legacy where change is measured in years and ideas are confined by budgets. The dynamics of the sector have changed in that banks can no longer just recalibrate the slide rule, they need to have an elemental rethink of how they can remain relevant.

Increasingly, banks are looking to drive greater STP and create new business in payments.

The key point about STP for corporates is that it is not just about how the payment is processed. Through instant payments, the payment is completed very quickly, but automation needs to extend

across the whole transaction value chain continuing into areas such as release of the payment statement and calculating fees and charges. The challenge for the banks in relation to their business model is that international business is often low volume, even if payment values are high, and there is pressure to charge for international transactions due to competition from fintechs. Similarly, in corporate banking, the bank needs to be able to create new business models to be able to support low or erratic volumes. For example, if a corporate mainly uses the bank for salary payments, there may be limited transactions for most of the month then a peak of high volume in one go. This creates challenges to serve effectively and the bank should be looking to adapt and create new business models to meet this challenge.

Banks need to transform with a roadmap for the medium term, prioritizing flexible platforms that can adapt with low cost

For banks looking to transform payments a consideration is, while the payments business requires technology, payments transformation fundamentally is not an IT topic; it is a business one. Banks cannot transform every three years, so they need to project into the future to change for at least the medium term. This projection needs to include the following considerations:

- What will client expectations be in five years?
- What will the business model be in five years?
- How will technology evolve?
- How will applications surrounding payments evolve?

The key point here is that banks will be unable to answer all questions fully, so while banks should create a roadmap, they need to find a way to remain agile and be able to change the roadmap when necessary. The approach to transformation also needs to change. Banks have often approached transformation programs as big projects, looking to do complete bottom-to-top renovation taking several years. The challenge here is that IT often ends up delivering a different end product to what the business was expecting, as the markets change over the period. Now banks are shifting toward smaller projects that transform toward a target roadmap over time but deliver value at each stage and with lower risk associated with each individual project.

From a program and platform perspective, these are the key points to consider:

- Banks should not look to simply replicate what is currently done onto a newer platform, as complexity will remain. It is essential to simplify as well as move onto newer, more flexible platforms. For example, banks could shift all outgoing credit transfers on to one type (e.g., SCT Inst) simplifying processes, and allowing scale.
- Banks should not just focus on digitalizing the front end without also addressing processes and automation at the back end. There needs to be an equilibrium in investment across the value chain.
- Banks need to be able to support anytime, anywhere payments. This requires platforms that can support 24x7x365 processing and availability.
- Platforms should provide flexibility to support complete digital transformation. For banks with legacy this means that solutions should be able to be delivered through the cloud, on-premises, or hybrid to provide sourcing flexibility.

- New business models will require banks to consider ecosystem plays, where products and services are built through a combination of different providers. Payments platforms need to be API-enabled, with payments services exposed via APIs to allow banks to be part of the ecosystem, both to support regulatory mandates and to allow development of new commercial services.
- The ability to cope with future change is critical, be it dealing with regulation, market initiatives such as ISO20022 and SWIFT gpi, or supporting new business models. Platforms need to be adaptable at a low cost.

Cloud and artificial intelligence are significant current and future enablers of transformation

Conversely, while payments transformation is a business topic, technology is a critical component of transformation. Moving to modern platforms that support scalability, high automation, and provide flexibility to create and adapt to new business models is essential. Within the platform space, there are a number of new technologies or technology approaches that support and enable this.

A key technology development here is the shift to cloud. Modern platforms built to cloud-native principles can obtain a level of scalability with cost efficiency through the cloud that significantly changes payments infrastructure financials. However, cloud advantages are broader than the cost-line, with cloud also facilitating access to a collection of new technologies and services that will enable banks to extend and adapt the business model.

An important technology development for the future of payments is also occurring within artificial intelligence (AI). This will be essential for helping banks develop new business models for the future, which will be tied more closely to the underlying data, rather than the payments transaction itself.

Cloud offers security and scaling benefits, and access to the new technologies and ecosystems

Most banks initially adopted a conservative approach to cloud computing at the start of the decade, particularly regarding use of public cloud, with concerns over control and security driving a stronger focus on creation of private clouds. However, this has shifted significantly over the last couple of years with public cloud now a core component of IT sourcing strategy for many banks.

This shift in approach has been driven by a number of factors. First, the security concerns that inhibited early adoption of cloud computing have effectively reversed with the realization that security practices of the leading cloud providers now surpass and lead enterprise standards, with new technologies deployed in the cloud being more secure than other services. Second, the financial benefits are significant. This is not just because individual line item costs are lower, but cloud use offers significant run-the-bank savings compared to older, mainframe-based, on-premises systems where there are significant maintenance costs. Third, cloud platforms provide access to a range of technologies and ecosystems of services, making it far easier to access new capabilities (such as analytics, AI, or machine learning) or new services to enhance systems and develop the business model.

For most banks, use of cloud for payments is relatively nascent; however, this is shifting, particularly when shifting to modern payments platforms built to cloud-native principles (e.g., with containerization and elastic scaling). These allow banks to scale and obtain efficiency very quickly and in contrast to

previous on-premises approaches where banks had to scale infrastructure investment to be able to meet peak volume, elastic scaling means that banks can pay for the workloads they consume and have more potential scalability than current infrastructure.

There are some important considerations here, however:

- Banks need to think about the end-to-end service level agreement for payments rather than just focus on infrastructure resources for peak sizing.
- Given most traditional banks will not have all systems on cloud, banks will need to operate systems across their data centers/private clouds and the public cloud. Banks need to consider their data traffic flows and look to optimize costs and quality of service levels here.
- When considering modern payments platforms, banks should look for cloud-agnostic solutions that empower banks' use and take advantage of cloud provider-specific technologies but are not tied to specific providers.

Banks should not just replicate current systems in the cloud

Another important consideration for cloud strategy is that banks should not just look to migrate all current systems to the cloud. As with broader payments transformation at the business level where banks should look to simplify their propositions, banks should also evaluate what they are migrating. One example of this is ABN AMRO. In addition to implementing a strong cloud strategy, ABN AMRO created a program aptly named "Clean" which focused on cleaning up and consolidating over 2,000 applications, moving the bank from having 99 platforms and 20 different operating systems to now running on three platforms and with three operating systems.

Banks need to evaluate whether applications are used and how much and look to rationalize and consolidate their platforms. Cloud platforms provide cost benefits, but banks should not look to just replicate complexity in the cloud, but rather use it to drive standardization.

Artificial intelligence is important as business models shift to data, but requires strong data management practices and data processing platform

At its heart, payments is a data business. While payments processing is critical, this aspect is becoming highly commoditized with significant pricing pressure around the transaction itself. Consequently, most of the future business models are likely to see revenue demands highly constructed around using and adding value to the data to allow clients to conduct their business more effectively. As a result, the emergence of AI and machine learning is of high interest to most banks in this area, even if use cases are not fully established yet. It has the potential to enable cost-effective development of new services.

Many banks are creating incubation units and innovation labs to look at how AI and other new technologies can be used across the bank. At the moment, many of the use cases tend to be on the retail side (e.g., digital banking or areas such as robo-advice) but this is likely to extend across the bank over time. Similarly, Temenos recently launched a Centre of Excellence for AI aimed at creating a collaborative ecosystem between Temenos, its clients, and its partners with a current focus on helping banks explore how AI could be used to optimize front-office solutions, payment exceptions handling, and real-time fraud detection.

The main challenge with both AI and machine learning is that you need to have data (lots of it) and it needs to be accessible and organized. Therefore, for banks looking to leverage AI to enhance business models, one of the first things they need to organize is their data architecture and data platforms to ensure that these are prepared to support AI. Developing use cases within an innovation function is to a degree the easy part; operationalizing AI requires a strong data platform to be effective.

For payments modernization programs, the key point here is that such data considerations need to be embedded into the design and architecture of new platforms, rather than seen than as adjunct capability. The ability to access, control, and leverage data will be crucial for future business products and services in payments. With the pace of change set to continue, banks will need to continue their balancing act between the urgent projects they face today, while simultaneously taking a strategic view of the future.

Appendix

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Ovum Consulting

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