



BANKING  
CIRCLE



# REIMAGINING GLOBAL BANKING SERVICES IN THE CONNECTED DIGITAL MARKETPLACE



# CONTENTS

## INTRODUCTION: THE FINANCIAL UTILITY MODEL

What is a Utility?.....	3
Transitioning to a Utility model.....	4
Utility model saved US\$ billions.....	5
The banking industry's 'Utility' moment.....	5

## DIGITAL GLOBALISATION FOR SMALL BUSINESSES AND MERCHANTS.....

6

## CORRESPONDENT BANKING AT A CROSSROADS.....

7

## LOOKING TO THE FUTURE.....

8

## KEY CHALLENGES FOR BANKS AND FINTECHS IN THE DIGITAL MARKETPLACE.....

8

Cost.....	8
Time.....	10
Innovation.....	12
Geographic expansion.....	13
Customer relationship.....	14

# INTRODUCTION: THE FINANCIAL UTILITY MODEL

## What is a Utility?

A 'Utility' is an organisation that maintains the infrastructure to deliver a product or service used in day-to-day life - whether the customer is a consumer or a business community. Traditionally, the term is often associated with public sector industries such as power, water or natural gas.

Historically, utilities operated a structure in which a non-core activity of the industry was delivered alongside potentially competitive activity, in most cases comprising customer facing services. This structure has been prevalent in railways, postal services,

telecommunications, electricity, natural gas and many other regulated industries, for example. However, in recent years many of the players in these industries have undergone a vertical separation - moving from a do-it-all to a do-only-what you-can-do-well approach.

Fig 1: Examples of businesses across industries depending on utilities to return to their core business

Industry	Geography	Company	Utility model	Impact
Railways	United Kingdom		Virgin Trains uses the railway tracks and signalling infrastructure as utilities and focuses on customer-centric innovations such as customer information screens to show reservation levels, automatic delay repay systems.	Superior customer experience
Electricity	United States, Canada		Direct Energy is a retail energy provider that collaborates with transmission and distribution utilities to deliver electricity to business customers. The firm introduced an energy insight solution, Panoramic Power to enable businesses to track energy consumption right down to device level in order to reduce operational cost.	Cost efficiency
Postal Services	United Kingdom		CollectPlus, a store-based parcel delivery service, used PayPoint's extensive store network and the reach of Yodel's parcel delivery service to expand its network by 33% - from 5,500 to 7,500 stores within 12 months, with a longer term aspiration of becoming a more convenient option to the Post Office.	Geographic expansion
Telecommunications	Spain		In a highly competitive Spanish mobile telecommunications market, Simyo, a MNVO, uses the Orange infrastructure and drives its differentiation strategy through a unique DIY offer with more than 2,000 combinations, so each customer can build their own tariff, choosing their fairest deal.	Innovation
Airlines	Ireland		Ryanair outsources the ground services and maintenance services to reduce aircraft turnaround times from 45 minutes to 25 minutes.	Improve execution speed

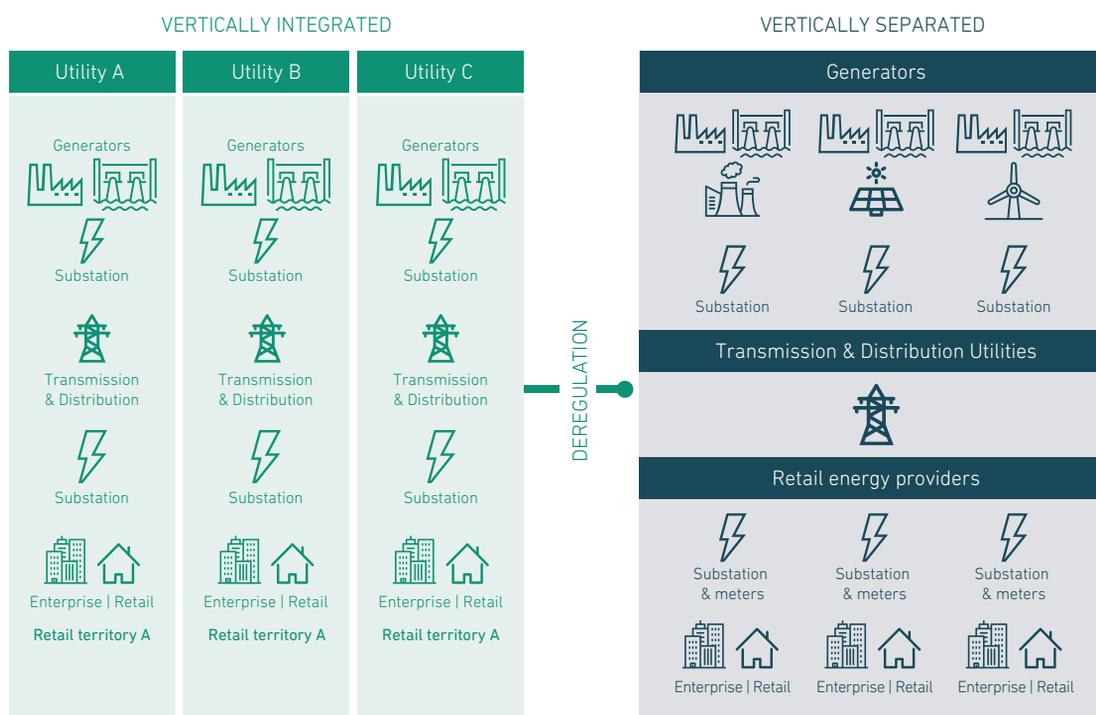


# TRANSITIONING TO A UTILITY MODEL

It is possible for an industry to become a utility, where it was not previously. One example of this is the US electricity industry, which transitioned to a utility model in the 1990s and 2000s following a wave of major regulatory reform.

An electricity market comprises three sectors: generation, transmission and distribution, and retail. As shown in the left side of Figure 2 (below), all three sectors had been operated by vertically-integrated utility firms in the US until the 1990s. Between 1995 and 2002 regulatory reform was introduced to increase competition and bring down prices which transformed the industry.

Fig. 2: The US Electricity Market before and after deregulation



The vertical-separation helped the industry bring about a great deal of innovation across different functions of the electricity industry. For example:

Electricity industry function	Innovation after deregulation	Benefits to customers
Generation	<ul style="list-style-type: none"> <li>Move from centrally generated electricity from fossil fuels to electricity generated (locally) from renewable sources</li> </ul>	Availability of green energy
Transmission and distribution	<ul style="list-style-type: none"> <li>Smart-grid</li> <li>Demand response</li> <li>P2P electricity trading network</li> </ul>	With P2P electricity trading network consumers are becoming 'Prosumers' as they are able to produce electricity by installing solar panels, and supplying it to the energy network. This reduces energy costs for the consumer providing the electricity and can even provide them with some profit from selling the excess electricity their solar panels have produced.
Retail energy supply	<ul style="list-style-type: none"> <li>Smart meters</li> <li>Panoramic power</li> </ul>	<p>Smart meters keep consumers informed of how much they are spending on electricity to make bills more manageable. They also encourage consumers to switch their consumption patterns to off-peak hours and reduce the amount of electricity used, reducing their bills.</p> <p>Panoramic power helps enterprises deal with potential equipment failures before they happen, and reduce energy inefficiencies and waste.</p>

## Utility model saved US\$ billions

In December 2016, the Energy Research Consulting Group (ERCG) examined the electricity cost savings achieved by commercial customers who switched from the traditional vertically-integrated utility rate to a retail energy supplier of the new deregulated structure. In the five deregulated states investigated, huge cost savings were achieved, as shown in the table on the right.

Deregulated states with Utility model	Total commercial savings	Annual commercial savings
Illinois	\$1.7 billion	\$337 million
Ohio	\$3.5 billion	\$706 million
Pennsylvania	\$3.4 billion	\$682 million
New England	\$1.7 billion	\$347 million
Michigan & California	\$3.3 billion	\$650 million

## The banking industry's 'Utility' moment

The banking industry is one of the last vertically-integrated industries left. As an essential service used in everyday life by both consumers and businesses, it meets the basic criteria of a utility, but has traditionally not held the same structure as other utilities. However, this has been changing in recent years due to the industry experiencing significant regulation and market competition challenges:

- **Regulatory focus on innovation:** The industry trend towards openness is inherent in the European Union's Payment Services Directive (PSD) 2 regulation and 'Open Banking Initiative' in the UK. This is seeking to encourage more FinTechs to use the banking assets and customer data to provide customers with more innovative services.
- **Low profitability:** While bank profitability has somewhat recovered in the past two years, it remains at very low levels. As of October 2016, the average return on equity of all banks in the EU stood at around 3%, and at around 5% for larger banks remaining below their cost of capital (estimated to be around 9%).<sup>1</sup>

- **De-risking by global banks:** Regulatory pressure in the form of new regulations and fines for non-compliance are proving to be prohibitive in conducting business in foreign countries. With more than 75% of global banks retrenching from foreign geographies<sup>2</sup> the correspondent banking network is under enormous stress. Regional banks are running out of correspondent banking partners through which to offer their banking services to international customers.
- **FinTech disruption:** FinTechs are seizing the opportunity to disrupt the traditional financial services model, with 55% of millennials in the USA and 52% in the UK preferring to do basic

payment activities using a FinTech<sup>3</sup> firm rather than using similar services provided by their banks. The US millennials highlight convenience (56%) and ease-of-use (55%) as key reasons for this preference.

- **Legacy technology overhead:** Despite the claim of becoming technology companies, most banks still run on core systems installed in the 1970s and 80s. According to an estimate by Euromoney, the total cost of maintaining legacy systems, investing in new systems and paying IT staff amounts to anywhere from 15% to 25% of a typical bank's annual budget.<sup>4</sup>

Learning from the electricity industry's move to the utility structure, the banking industry is now too reaping the benefits of outsourcing non-core functions to a third-party utility, enabling it to focus completely on owning, managing and growing the customer relationships.

Where the electricity industry allows the retail energy providers to access a centralised, open and shared grid to provide electricity to customers without being responsible for the operating and maintenance costs of generation, transmission and distribution infrastructure, banking service providers can use the utility platform and infrastructure to improve their current services, launch new sets of products and services and expand to foreign locations.

<sup>1</sup> Source: KPMG, October 2016: <https://home.kpmg.com/xx/en/home/insights/2016/10/the-profitability-of-eu-banks-fs.html>

<sup>2</sup> Source: International Monetary Fund, June 2016: <https://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf>

<sup>3</sup> Source: Salesforce Connected Retail Banking Report 2017, January 2017: <https://www.salesforce.com/uk/form/conf/industries/financial-services/connected-banking.jsp>

<sup>4</sup> Source: Euromoney, August 2017: <https://www.euromoney.com/article/b143rj4dz3cd92/technology-investments-drive-up-banks-costs>

# DIGITAL GLOBALISATION FOR SMALL BUSINESSES AND MERCHANTS

The world has become more intricately connected than ever before. For the first time in history, emerging economies are counterparts on more than half of global trade flows. In 1990, the total value of global flows of goods, services, and finance amounted to \$5 trillion, or 24% of world GDP. In 2014, \$30 trillion worth of goods, services, and finance, equivalent to 39% of world GDP, was exchanged across the world's borders<sup>5</sup>.

The Internet is now a global network instantly connecting billions of people and millions of enterprises around the world. Small businesses worldwide are using digital platforms to connect with customers and suppliers across borders. In 2014, more than 90% of

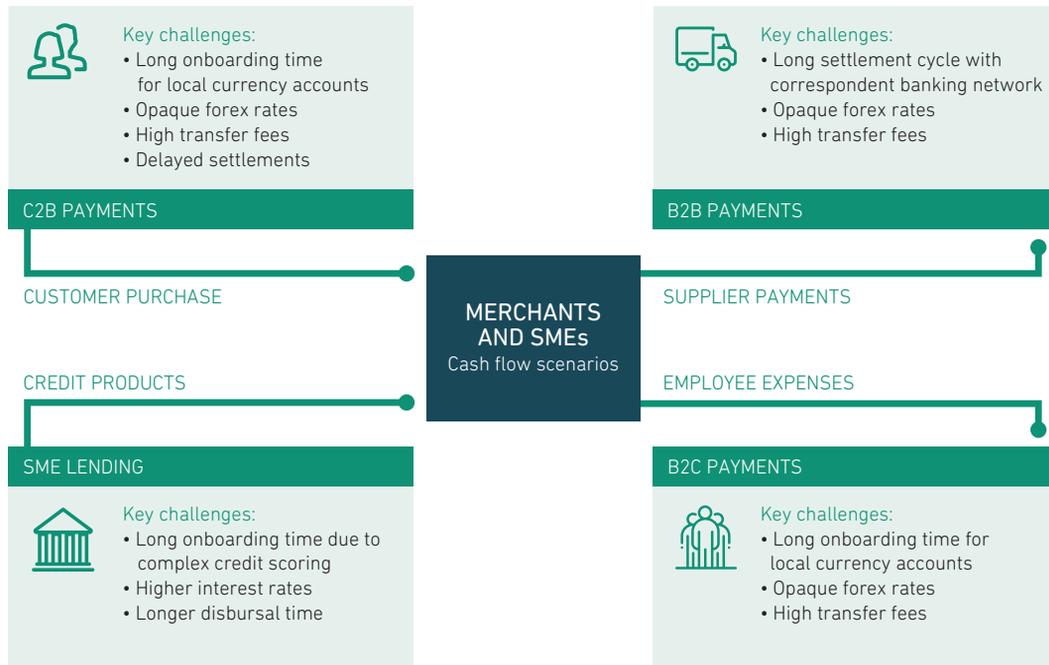
the US-based SMEs with stores on eBay marketplace and annual sales greater than \$10,000 were exporting internationally.<sup>6</sup> The story is similar outside the US where a vast majority of smaller technology-enabled firms export. According to a McKinsey survey in 2016, 86% of tech-based start-ups report some type of cross border activity<sup>7</sup>.

Despite the explosion of global trade and commerce that technology has enabled, borders still matter when it comes to making and receiving payments. Geopolitical developments, evolving regulation, foreign exchange and economic volatility and shifting trade corridors are some of the external factors affecting global

payment flows. A survey with SMEs across 112 countries revealed that they made up almost 53% of all rejected trade finance transactions.<sup>8</sup>

SMEs and merchants across the world are looking at the financial industry to help them tackle serious challenges on the cash management, cross border payments and global expansion fronts. Most SME cross border financing needs are still underpinned by the correspondent banking network. As companies become more global, there is an increasing demand for businesses to disperse, receive, and transact across borders, without delay, without friction, and using only a handful of bank accounts to manage liquidity.

Fig 3. Managing cash flow, a top challenge for merchants and SMEs across the globe



<sup>5</sup> Source: McKinsey Global Institute, Digital globalization: The new era of global flows, March 2016: <https://www.mckinsey.com/business-functions/digital-mckinsey/our-insights/digital-globalization-the-new-era-of-global-flows>

<sup>6</sup> Source: Merrill Lynch, Globalization's Digital Future <https://www.ml.com/articles/globalizations-digital-future.html>

<sup>7</sup> Source: McKinsey Global Institute, Digital globalization: The new era of global flows, March 2016: <https://www.mckinsey.com/business-functions/digital-mckinsey/our-insights/digital-globalization-the-new-era-of-global-flows>

<sup>8</sup> Source: International Chamber of Commerce, 2015 Banking Commission Global Survey on Trade Finance, September 2015: <https://iccwbo.org/media-wall/news-speeches/icc-banking-commission-global-survey-highlights-impact-of-trade-finance-gap-on-smes/>

# CORRESPONDENT BANKING AT A CROSSROADS

The correspondent banking model has changed very little in the last three decades, but is now under immense pressure to deliver on the demands of SMEs, supporting their global growth aspirations. And its evolution will be shaped by three dynamic and interconnected forces.

The first of these forces is the regulatory environment which has increased the compliance cost of maintaining correspondent banking relationships across the world. This has particularly been the case in the enforcement of Anti Money Laundering (AML) and Counter-Terrorist Financing (CTF) requirements which have caused massive de-risking by banks.

The second force is that the SMEs and larger corporates need and expect a much better response from banks in terms of reducing the cost of cross border payments. Settlement times

must be improved and complete transparency of the payment execution process provided.

Lastly, the emergence of technologies such as blockchain, the cloud and cryptocurrencies will be critical enablers in the transformation of the correspondent banking network.

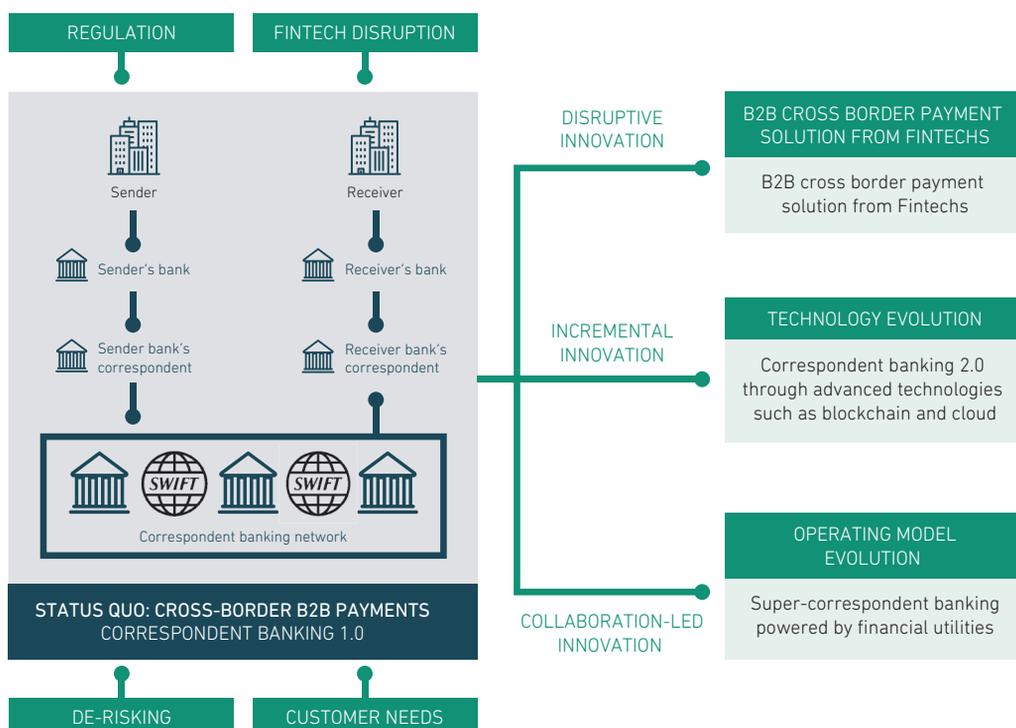
We see three different models of evolution for correspondent banking:

1. Following the lead from the successful disruption of the retail cross border payment industry, many FinTechs are working to bring the revolution to B2B cross border payments as well. SMEs, especially the tech start-ups, are quick to adopt these offerings from FinTechs in order to accept payments in countries in which they operate.
2. The incumbent SWIFT model is also trying to fix the problems through

its Global Payments Innovation (gpi) initiative.<sup>9</sup> Banks signing up to gpi are committing to improving the speed, transparency and tracking of cross border payments. 110 banks around the world are already on board, and are continually monitored to ensure they adhere to the gpi rules. Ripple is another blockchain powered initiative, designed to fix the issues of correspondent banking through real-time and transparent communication between banks powered by inter-ledger protocol.

3. The last model is the emergence of a super-correspondent banking network powered by a third-party utility which offers the infrastructure, liquidity pools and connectivity with payment rails across the globe to facilitate cheaper, faster and secure cross border payments.

Fig. 4: Future: Cross border B2B payments



<sup>9</sup> Source: SWIFT: <https://www.swift.com/our-solutions/global-financial-messaging/payments-cash-management/swift-gpi>

# LOOKING TO THE FUTURE

While each of these three trends will shape the future of the correspondent banking network, their suitability and adoption will vary across both the service providers and corporate customers using those solutions to meet their financing and payment needs. FinTech offerings will continue to evolve and improve, attracting many more customers from the digital businesses. At the same time, the FinTechs will see increased regulatory engagement and scrutiny as the size and sophistication of these entities grow.

Blockchain technology has been mooted as a potential challenger to the correspondent banking model but the technology faces significant hurdles in adoption, such as

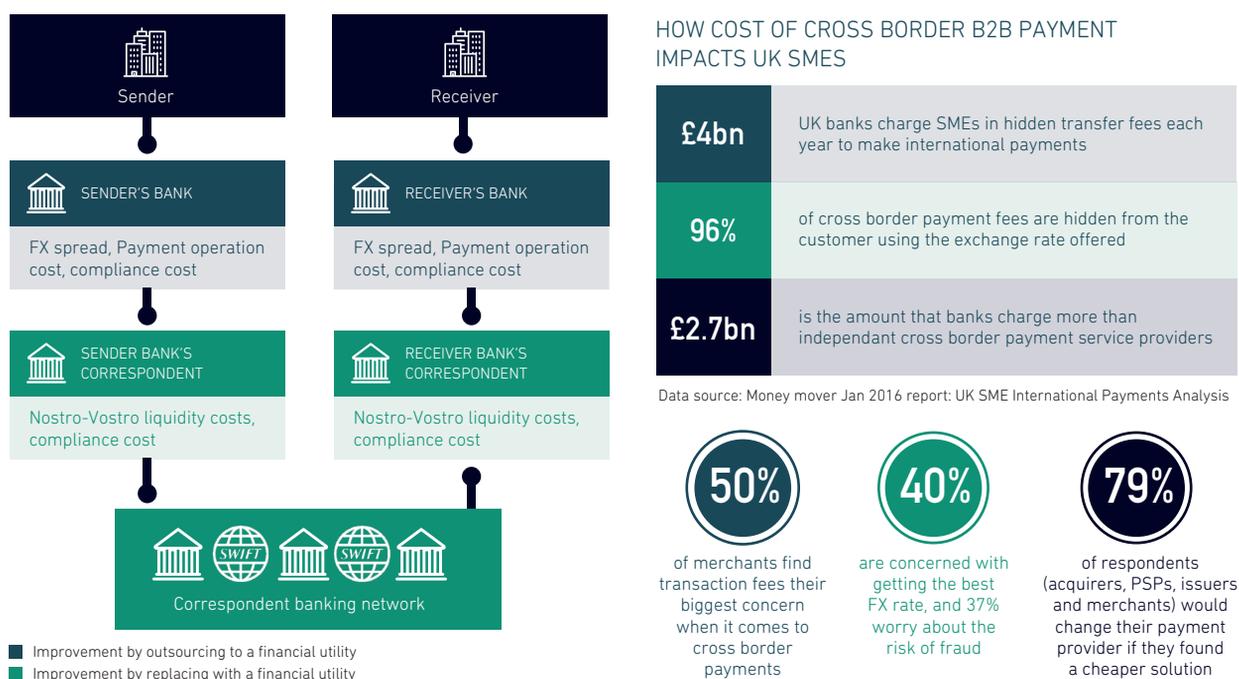
integration with legacy back office applications and compliance with existing and upcoming regulatory requirements. Security and privacy are other areas of concern. The information stored on the gpi cloud will be subject to very high levels of security, but when the idea of exchanging information between different clouds is considered, banks will be concerned about security issues as confidentiality levels vary between different clouds. Also, given that gpi's success will be contingent on all partner banks improving their internal systems to support straight through processing, this mode is only suitable for bigger banks with deep pockets who will offer the better services to large corporates.

The utility powered super-correspondent banking network has the potential to emerge as a great alternative for FinTechs, forex players, challenger banks and tier 2 and 3 banks to provide their customers with faster and cheaper cross border banking solutions, without the need to build their own infrastructure and correspondent banking partner network. The ability to outsource non-core activities to a third party can enable financial institutions to address the innovation and global expansion challenges, while enabling them to focus more on the customer relationship.

# KEY CHALLENGES FOR BANKS AND FINTECHS IN THE DIGITAL MARKETPLACE

## Cost

Fig. 5: SMEs are reeling under the pressure of high cost cross border payments



## Higher cost of executing cross border payments results in high rates for customers

According to the McKinsey report, the average cost for a bank to execute a cross border payment via legacy correspondent banking agreements remains in the range of US\$25 to US\$35, more than 10 times more than an average domestic ACH payment.<sup>10</sup> The fixed costs of compliance are high. In addition, bilateral relationships require banks to hold idle liquidity and incur FX exposures.

Manual and personalised payment operations, including the processing of claims and disputes by the back office further add to these costs. Finally, the significant market power of correspondent banks and capturing firms allows them to extract revenue through direct fees and FX spreads. 2015 research by McKinsey showed that correspondent banks charge anywhere between \$23 and \$70 for a cross border transaction.<sup>11</sup> The FX rate provided varies based on size of

the transaction, time of day, current volatility level, future implied volatility, quality of the customer, current market price action, and competitor quote levels. The diagram above highlights the impact of the unfavourable cost that UK SMEs incur while dealing with banks in executing cross border payments.

## Banks' B2B cross border payment revenue and profits at risk

Although cross border payments account for less than 20% of total payments volumes, they comprise about 40% of global payments transactional revenues (i.e., transaction-related fees and float income), and generated over \$300 billion in global revenues in 2015. B2B payments drive roughly 80% of cross border payments revenues and are a segment in which banks retain a near 90% share.<sup>12</sup> Although the competition from nimble FinTechs originated in the high-margin customer-to-customer (C2C) market, it is rapidly shifting to the commercial space and corporate treasurers

expect to receive the same levels of service as on the consumer side.

Traditional money transfer operators (MTOs) are also shifting their attention. Western Union Business Solutions, for example, is moving from traditional customer-to-customer (C2C) and customer-to-business (C2B) offerings to disintermediate corporate banking relationships. According to Banking Circle research released in April 2016, 79.39% of respondents (acquirers, PSPs, issuers and merchants) stated that they would change their payment provider if they found a cheaper solution. But 60% of the overall respondents have not looked at other options, either because they don't have time to dedicate to the research, or too many resources are required to implement the change.<sup>13</sup>

In order to capitalise on the burgeoning SME sector, banks therefore need to manage their operational cost for facilitating cross border transactions. Not only will this mean they can deliver a more efficient service, but they can pass some savings on to their customers, adding value to the customer relationship.

<sup>10</sup> Source: McKinsey Global Institute, Digital globalization: The new era of global flows, March 2016: <https://www.mckinsey.com/business-functions/digital-mckinsey/our-insights/digital-globalization-the-new-era-of-global-flows>

<sup>11</sup> Source: McKinsey Global Institute, Rethinking Correspondent Banking, June 2016: <https://www.mckinsey.com/industries/financial-services/our-insights/rethinking-correspondent-banking>

<sup>12</sup> Source: McKinsey Global Payments 2016: Strong Fundamentals Despite Uncertain Times, September 2016: [https://www.smefinanceforum.org/sites/default/files/post/files/McKinsey\\_Global\\_Payments\\_Report\\_2016.pdf](https://www.smefinanceforum.org/sites/default/files/post/files/McKinsey_Global_Payments_Report_2016.pdf)

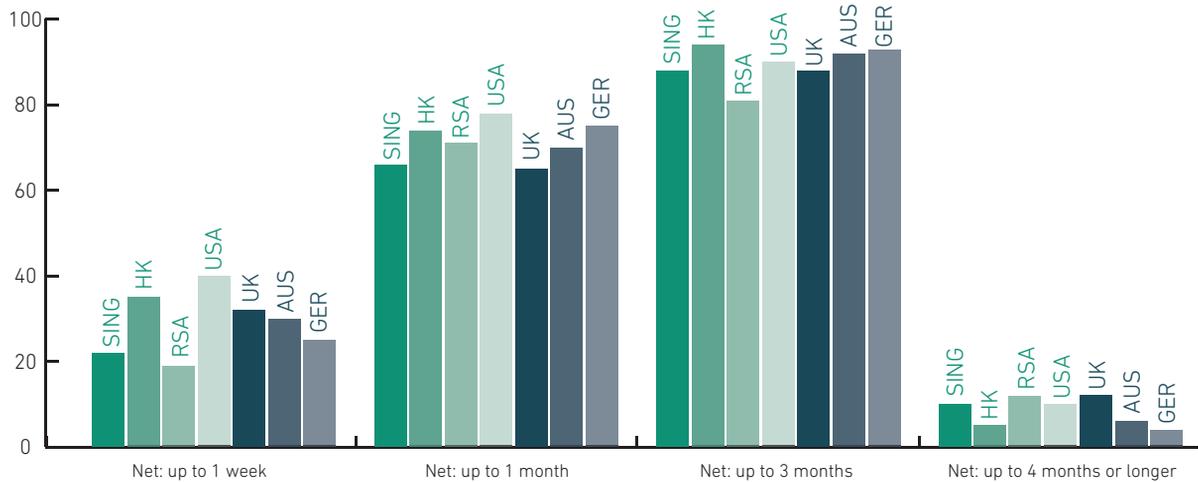
<sup>13</sup> Source: Banking Circle, Cross Border B2B Payments - Today's landscape, tomorrow's opportunity, April 2016: <https://www.saxopayments.com/todays-landscape-tomorrows-opportunity>



## Time

Fig. 6: SMEs across the globe experience long onboarding and payment settlement time

### CUSTOMER ONBOARDING TIME

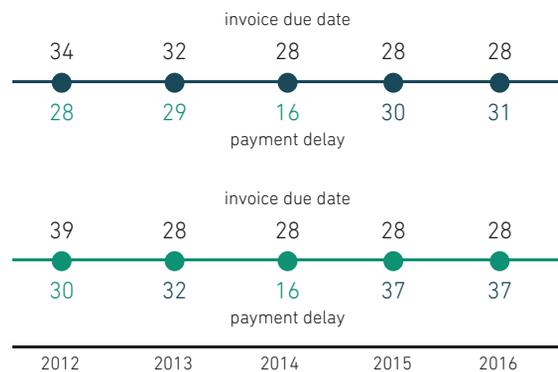


On average, survey respondents were contacted eight times during each onboarding process, with UK companies seeing this rise to 11

Source: <http://share.thomsonreuters.com/assets/forms/kyc-corporations-2016.pdf>

### PAYMENT SETTLEMENT TIME

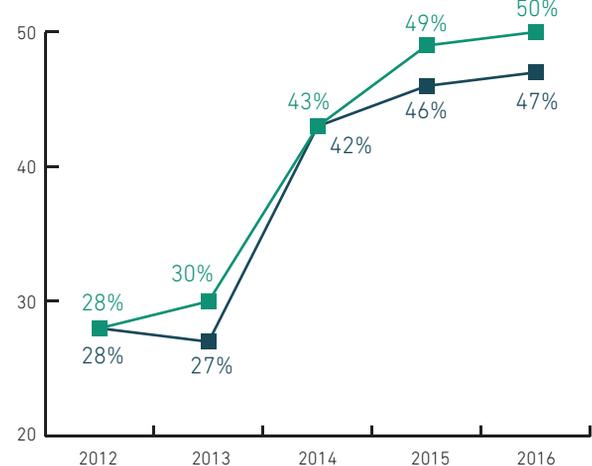
Payment duration in the Americas (avg. days)



■ Domestic  
■ Foreign

Source: Atradius payment practices barometer 2016

Past due B2B receivables in the Americas (avg. %)



41%

On average, survey respondents were contacted eight times during each onboarding process, with UK companies seeing this rise to 11

47%

SMEs face significant cash flow problems while 67% of those agree late payments lead to some SMEs going bust

63%

Companies consider speed of settlement to be the most important issue (apart from cost)

<sup>14</sup> Source: Atradius Payment Practices Barometer Americas 2017, September 2017: <https://atradius.co.uk/reports/payment-practices-barometer-americas-2017.html>

<sup>15</sup> Source: Atradius Payment Practices Barometer Western Europe 2017, September 2017: <https://atradiuscollections.com/global/reports/payment-practices-barometer-western-europe-2017.html>

<sup>16</sup> Source: Atradius Payment Practices Barometer Americas 2017, September 2017: <https://atradius.co.uk/reports/payment-practices-barometer-americas-2017.html>

## Merchants face lengthy and complex processes to get onboarded

A typical merchant onboarding process takes anywhere from 2-34 weeks from the point of acquiring to their merchant ID being generated in the core system of the acquirer bank. SMEs across different regions face similar challenges of delayed onboarding. The complications arise as a merchant entity can be of different types; for each entity type, there is a different kind of Know Your Customer (KYC) validation required. Most of the KYC process is manual, which, along with verification, takes a long time. This not only increases the time required for onboarding but also significantly increases the costs of acquiring and onboarding the merchants. This is one of the major reasons why acquirers (banks) focus on larger corporates and do not find it viable to onboard smaller merchants.

## Delayed payment settlement impacts business cash flow and operations

Sending money across borders is traditionally very slow. Payments can

be routed through many banks before they reach their destination, causing delays and incurring fees at each stage. Settlement times for cross border payments can take five days or more, even for the most common currency pairings.

The frequency of late payment and the total value of past due invoices varies widely by country. According to the Atradius Payment Practices Barometer 2017, foreign late payment amounts to 44.7% of the total value of foreign sales on credit in the Americas.<sup>14</sup> This compares to 39% recorded in Western Europe,<sup>15</sup> which is still very high. The survey also indicates that despite the lenient payment terms averaging about 27 days from the invoice date offered to businesses by suppliers, the late payment trend is on the rise in the Americas with firms on average taking 31 days to settle past due invoices.<sup>16</sup>

According to Amicus research in 2016, carried out with over 500 UK SME decision makers, 38% of SMEs face significant cash flow problems<sup>17</sup> while Zurich's 2016 SME Risk Index revealed that 67% of SMEs agree that late payments are leading to some SMEs closing down<sup>18</sup>. Businesses are turning to invoice finance or business

credit lines to deal with cash management problems.

In 2016 Banking Circle research, 63% of businesses stated that they would change their payment provider if they believed it would help enable faster cross border transactions.<sup>19</sup>

## Small businesses need a big solution for cross border payments

Tracking and visibility are hugely important for B2B payments in general because there are many ways in which payments can go wrong. According to the International Chamber of Commerce (ICC) Banking Commission's 2015 Global Survey, of 482 respondents from 112 countries, SMEs made up almost 53% of all rejected trade finance transactions.

The opportunity for error is even higher when SMEs have to deal with banks in different countries, with different regulations to manage. SMEs therefore seek the ability to track the payment, know when it's going to arrive, and find out quickly when something has gone wrong, and where the error has occurred, in order to optimise payment settlement durations.<sup>20</sup>

<sup>17</sup> Source: Amicus Commercial Finance, October 2016: <https://amicusplc.co.uk/news-and-media/07-12-2016/cashflow-problems-undermine-four-in-ten-small-firms>

<sup>18</sup> Source: Zurich SME Risk Index, January 2016: <https://insider.zurich.co.uk/risk-management/smes-owed-225bn-from-late-payments/>

<sup>19</sup> Source: Banking Circle, Cross Border B2B Payments - Today's landscape, tomorrow's opportunity, April 2016: <https://www.saxopayments.com/todays-landscape-tomorrows-opportunity>

<sup>20</sup> Source: International Chamber of Commerce, 2015 Banking Commission Global Survey on Trade Finance, September 2015: <https://iccwbo.org/media-wall/news-speeches/icc-banking-commission-global-survey-highlights-impact-of-trade-finance-gap-on-smes/>

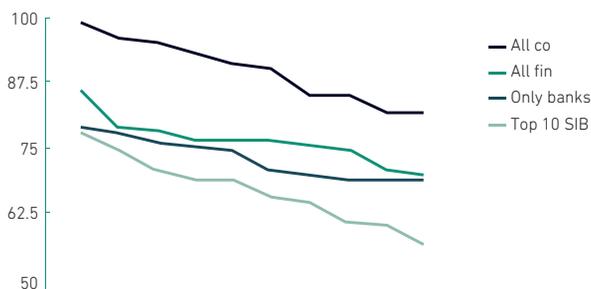


## Innovation

Fig.7: Collaboration is the way forward for banks and FinTechs to drive innovation

### BANKING INDUSTRY LAGS ON THE INNOVATION CURVE

Comparison of key capability indicators top 10 all companies, top 10 all financial companies, top 10 banks and top 10 systemically important banks



Source: The disruption house report – Why Banks are failing

### FINTECH COLLABORATION WILL ENABLE BANKS TO INNOVATE



23%

Banks expect to collaborate with FinTechs



53%

Banks want to invest in customer facing technology

Source: EY European Banking Barometer – 2016

### Banks of all sizes need to focus on innovation to serve customers

Banks, particularly systemically important banks, have a low innovation capability when compared with companies overall. Banks are lagging by 10-15% in comparison with a generic all-companies index, but more importantly the top 10 global systemically important banks (G-SIBs) lag the index of all companies as measured by key capability indicators by 23%, and lag other banks by 10%.<sup>21</sup>

PSD2 in Europe and the Open Banking initiative in the UK, promise to affect the sole ownership of the customer relationship by banks. But these regulatory initiatives also allow non-bank entities to deliver innovative financial services to customers by

using the customer data and account information held by banks. This means banks of all sizes need to rapidly accelerate their innovation efforts to ensure their ability to remain competitive by offering the next generation of financial services.

### Banks collaborating with FinTechs for digital banking innovations

In the last two to three years, banking giants have invested in FinTech start-ups, partnering with them in various forms. They're opening expensive new innovation labs and digital hubs and creating C-suite roles dedicated to leadership in innovation.

Companies that participated in the ACI survey indicated payments (68%) and banking infrastructure (43%) are the

areas they're most interested in working on with start-ups. Some 40% indicated they'd like to partner for e-commerce opportunities, 37% for remittances, 32% for security and fraud management and 29% for core consumer banking operations.<sup>22</sup> Of the more than 100 banking executives surveyed by industry strategist Jim Marous, 71% cited improving the digital experience in their top three priorities for 2017; half also identified enhancing data analytics as a priority and 41% cited reducing operating costs.<sup>23</sup>

Most smaller banks, with fewer customers and less capital, are still putting together their long-term digital strategies. As the smaller banks lack the resources to invest in FinTech initiatives and don't have the massive customer base to test pilots, they've been slower to move.

<sup>21</sup> Source: The Disruption House, Why banks are failing the innovation test, November 2015: <http://thefinanser.com/2015/11/why-banks-are-failing-the-innovation-test-and-how-they-could-do-better.html/>

<sup>22</sup> Source: ACI 2017 FinTech Disruptors Report, November 2016: <https://www.aciworldwide.com/-/media/files/collateral/trends/2017-fintech-disruptors-report.pdf>

<sup>23</sup> Source: Digital Banking Report, 2017 Retail Banking Trends and Predictions, December 2016: <https://www.digitalbankingreport.com/dbr/dbr245/>

## Geographic expansion

### With rising compliance cost and risks global banks are retrenching

After years of expansion, more than 75% of the larger global banks that once boasted of their global capabilities and scale are withdrawing their correspondent banking relationship in international markets, to reduce operating expenses and the chance of extraordinary legal costs.<sup>24</sup> At the beginning of March 2015, RBS announced that it would exit its GTS (Global Transaction Services)

operations outside of the UK and Ireland,<sup>25</sup> implying that cash management and trade finance activities will be wound down globally.

Deutsche Bank, to take another example, simply closed its markets business in Russia and plans to also retreat from 10 other so-called high-risk countries. Barclays has been pulling out of more than 100 wealth markets and aimed to reduce the number of countries in which it provides wealth and investment

management services from about 200 to 70 by end of 2016.<sup>27</sup> Credit Suisse withdrew from about 50 markets worldwide by 2014.<sup>28</sup> ANZ sold their wealth management and retail business in Asia to DBS in 2015.<sup>29</sup> As the retreat continues, regional banks are running out of partners to support their international operations and financial services to SMEs such as international payments, forex services and cash management services are badly affected.

Fig. 8 Banks retrenchment, a significant hurdle in SME expansion plans

### GLOBAL BANKS RETRENCHMENT IMPACTS SME BUSINESS



### SMES BULLISH ON INTERNATIONAL EXPANSION

74% <sup>1</sup>	of small businesses in EMEA planning to expand into another country over the next five years
27% <sup>2</sup>	SMEs in USA believe expanding into new international markets will be a contributor to financial performance
66% <sup>3</sup>	of UK SMEs expect international revenues to grow from 40% to 66% in the next 3 years
129% <sup>4</sup>	UK SMEs doing business in at least six countries will jump 129% in next three years.

Source:

1. Ricoh Report March 2016: SMEs starting small going global

2. Global Research from American Express Feb 2017

3,4. Money mover Jan 2016 report: UK SME International Payments Analysis

**39%** of merchants claim they have been stopped from expanding into new international markets, even though they already trade across some borders

**18%** of merchants only use one currency which could be a potential deterrent to new customers and suppliers

**32%** of merchants use two currencies

<sup>24</sup> Source: International Monetary Fund, June 2016: <https://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf>

<sup>25</sup> Source: Euromoney, June 2016: <https://www.euromoney.com/article/b12kmv8h21wln0/rbs-leaves-international-transaction-services>

<sup>26</sup> Sources: FT.com and Independent Online, September 2015: <https://www.ft.com/content/510111b4-5dd5-11e5-a28b-50226830d644?mhq5j=e6> and

<http://www.independent.co.uk/news/business/news/deutsche-bank-cuts-35000-jobs-by-2020-and-exits-10-countries-a6713246.html>

<sup>27</sup> Source: FT.com, September 2013: <https://www.ft.com/content/780a7db6-253f-11e3-9b22-00144feab7de?mhq5j=e6>

<sup>28</sup> Source: FT.com, September 2013: <https://www.ft.com/content/2b909272-2508-11e3-9b22-00144feab7de?mhq5j=e6>

<sup>29</sup> Source: FT.com, October 2016: <https://www.ft.com/content/a03d231e-cd5a-31a9-ac76-61b5791445a7?mhq5j=e6>



## SMEs looking to go global face cross border payment hurdles

SMEs across the globe understand that one of the fastest routes to growth is through exposure to new markets and more customers, and globalisation is a key component in this process. Research commissioned by Ricoh<sup>30</sup> in 2016 reveals that SMEs in EMEA are confident in their expansion plan – 74% of small and 86% of medium sized businesses plan to expand into another country during 2016-21.

2017 global research from American Express<sup>31</sup> found that 27% of SMEs in the

US believe that expansion into new international markets will be a contributor to financial performance. Easy access to digital communication and collaboration technologies, digital marketplace and digital lifestyles of consumers has improved the ability of SMEs and merchants to reach out to customers in new markets. At the same time a significant payment hurdle stands in their way: Consumers prefer to pay in their local currency.

Global expansion requires multi-currency conversion and settlement in currencies defined by card schemes, including exchange rates. Banks and payment service providers who extend the payment capability in international locations, along with the flexibility to settle multi-currency transactions, can help SMEs and merchants in their international expansion through cross border ecommerce.

## Customer relationship

Fig. 9: SME banking at cross-roads for a customer-centric evolution

### NUMBER OF BANKING RELATIONSHIPS FOR CORPORATE, GLOBALLY



Source: Thomson Reuters February 2016: KYC: A sound principle, but complex reality

### FINTECH PHENOMENON IN SME BANKING

FinTechs for supply chain finance	Orbian, Prime Revenue, C2FO, Taulia, Ariba
FinTechs for SME financing	Iwoca, Funding Circle, Dealstruck, Bond Street
Challenger banks for SMEs	Tide, Holvi, Kontist, Paragon Bank, Civilised Bank

Source: Burnmark



87% of merchants surveyed currently use a traditional bank to complete cross border payments



13% of merchants use a merchant acquirer



14% of merchants use FX specialists for cross border payments



9% of merchants use a dedicated payments service provider (PSP)

## The FinTech phenomenon in SME banking

SMEs across the world are looking beyond traditional financial institutions to meet their evolving needs. A report by Thomson Reuters<sup>36</sup> highlighted the fact that SMEs and corporates across the world, on average, have to

maintain relationships with more than 10 banks to run their business. A report from McKinsey reveals that FinTechs already control almost 10-15% of the supply chain finance market with SMEs.<sup>32</sup> Another McKinsey report, 'Global Banking Annual Review 2015', reveals that as much as 40% of revenues and up to 60% of the profits in retail banking businesses – consumer finance,

mortgages, small business lending, retail payments and wealth management – are at risk from a combination of factors such as dwindling margins and competition from FinTech start-ups.<sup>33</sup>

A suboptimal response from incumbents in many countries has opened the doors to FinTech insurgents in payments, trade finance, traditional lending, invoice

<sup>30</sup> Source: Ricoh, March 2016: <https://www.ricoh-europe.com/news-events/news/smes-starting-small-going-global.html>

<sup>31</sup> Source: American Express, Feb 2017: <http://about.americanexpress.com/news/pr/2017/amex-sme-survey.aspx>

discounting and even narrower niches. FinTechs and other new market entrants have used superior experiences to capture significant market across product lines.

These firms' products are, at their core, similar to what traditional banks offer, but the way in which they offer them and serve customers is closer to the experiences offered by Apple, Amazon and other digital experience leaders. Along with the advent of a number of new B2B FinTechs, the existing B2C FinTechs are also expanding into

the underserved SME market with innovative products and digital experiences, which has further eroded the SME banking revenue streams for banks.

### **Banks need to own the customer relationship to survive and thrive**

Many banks have taken an ambivalent stance toward SMEs so far. Large US banks, for example, are making fewer small business loans than a decade ago, forcing SMEs to turn to higher-priced alternatives. Banks have

also been slow to invest in digital platforms for SMEs, focusing instead on their retail and corporate customers.

SMEs, if nurtured, can become a significant revenue and profit pool for banks. SMEs represent 50-60% of corporate revenue for banks in Europe. But, as SMEs' business can be relatively complex, they require customised financial capabilities and are less susceptible to commoditisation than retail banking. It is time banks actively defended and sought to grow the SME banking business with a customer-centric approach.

<sup>32</sup> Source: McKinsey, October 2015: <https://www.mckinsey.com/industries/financial-services/our-insights/supply-chain-finance-the-emergence-of-a-new-competitive-landscape>

<sup>33</sup> Source: McKinsey, September 2015: <https://www.mckinsey.com/industries/financial-services/our-insights/the-fight-for-the-customer-mckinsey-global-banking-annual-review-2015>

<sup>36</sup> Source: Thomson Reuters, February 2016: <http://info.risk.thomsonreuters.com/COB-FI-Survey-Gated>

