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Frictionless Cross-Border Payments: Alternatives to Correspondent Banking

FEBRUARY 2021

Prepared for:

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EXECUTIVE SUMMARY

Frictionless Cross-Border Payments: Alternatives to Correspondence Banking, commissioned by Volante Technologies and produced by Aite Group, aims to provide an overview of the cross-border payments market, the opportunities for banks, and the importance of capitalizing on those opportunities. As the revenue potential from cross-border payments continues to rise, and the options available to make those payments evolve, banks need to be aware of the competitive landscape, available technology options, and how to provide a robust offering that captures the growing market of businesses that must make cross-border payments by enabling more cross-border payments services.

Key takeaways from the study include the following:

- Payments innovation is at an all-time high in the financial industry. The reality of real-time, frictionless payments has led to expectations of a better payments experience for all payments methods and types, including cross-border payments.
- Globalization continues to drive a higher volume of cross-border payments and a larger number of businesses that have a need to send these transactions. There is also significant revenue to be gained by providing cross-border capabilities.
- Next-generation cross-border solutions that minimize the inherent friction of the correspondent banking model are desired by businesses and their recipients. Not offering a more efficient way to make these payments will become increasingly detrimental for banks seeking to service these clients.
- Message standardization utilizing the ISO 20022 messaging format is a key component in improving cross-border payment automation and providing a foundation in developing interoperable services across geographic lines.
- Vendors and technology solution providers are utilizing cloud-based Payments-as-a-Service (PaaS) offerings to help banks more easily offer improved cross-border payments services to their business clients. This is leveling the playing field for banks that have historically been dependent only on their correspondent banking relationships to provide cross-border payments capabilities.

INTRODUCTION

A high degree of innovation is happening in the payments space today, and it's happening at a higher rate than ever. In 2014, there were only 14 local real-time payment schemes, and currently, that number is just over 60, with 20 of those networks launching in the last 18 to 24 months. Along with speed of payment settlement, these networks have spawned innovation in improved data, transparency of payment status, accessibility, and connectivity. This progress toward more frictionless payments has been primarily focused on the domestic payments space. It is now time for the industry to widen the focus to include cross-border payments.

Cross-border payments are transactions in which the payer and recipient are in two different countries. These payments are typically slower, more expensive, and less transparent than domestic payments that do not cross geographic borders. There is pressure on the payments ecosystem to find ways to simplify and remove the friction in the cross-border space. Where banks are lacking, businesses are seeking payment solutions outside their financial institution to solve their cross-border pain points.

This white paper provides an overview of the cross-border market, discusses the pain points that are forcing innovation, and looks at some cross-border payments initiatives creating change and improvement in the space. It also provides recommendations for banks to capitalize on the growth and innovation of cross-border payments and the technology that enables them.

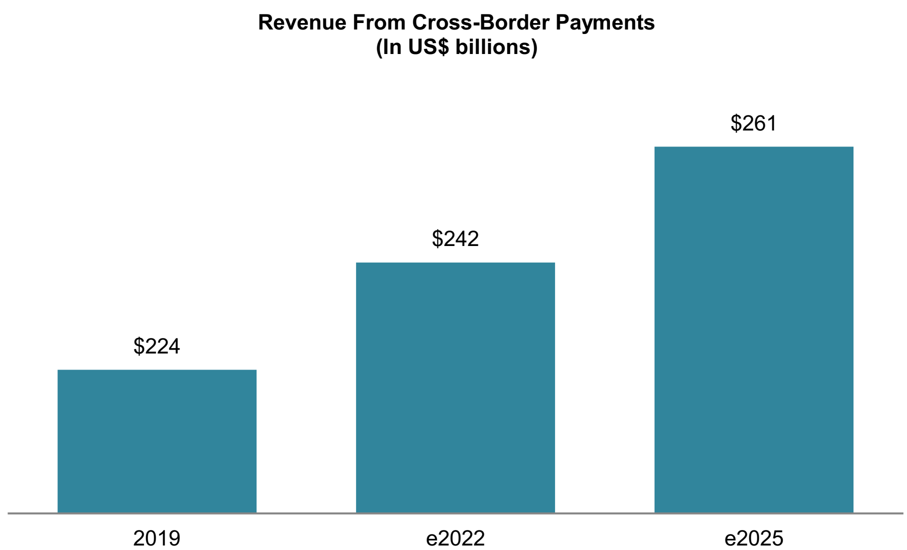
METHODOLOGY

This white paper is based on an Aite Group analysis of published statements from, and regular interviews with, international banks, infrastructure providers, fintech vendors, and regulators.

CROSS-BORDER MARKET OVERVIEW

Cross-border payments are a key component of the growing global economy. Historically, these transactions have been high-value, high-dollar payments, but this is shifting as the global market continues to expand and make more low-dollar, low-value payments across geographic lines. Prior to the COVID-19 pandemic, the volume and value of cross-border payments have been growing steadily in the last decade. In 2019, Aite Group estimates that cross-border payments totaled US$130 trillion and generated US$224 billion in revenue.[1] While 2020 saw a decline in these transactions for much of the year due to widespread shutdowns of businesses and countries, the volume of cross-border payments is expected to rebound and continue on the growth trajectory, as evidenced in the trends of the fourth quarter. The impact of the decrease during the first three quarters of the year has had a material impact on revenue generated by cross-border payments, which is estimated to be about 7% lower than the 2019 high of US$224 billion. Using historical data of this revenue and the expanded need beyond limited high-value, high-dollar transactions, Aite Group predicts that the revenue opportunity for banks and payment providers will continue to grow (Figure 1).

Figure 1: Estimated Growth of Cross-Border Transaction Revenue



Source: Aite Group estimates based on market knowledge and from McKinsey & Company

For banks, this means increased revenue potential from not only the transaction but also the foreign exchange (FX) fees that can be a significant revenue stream for banks. The businesses making these cross-border transactions are also making other payments and using a suite of treasury services ranging from online banking and positive pay to investment sweeps and

1. Philip Bruno, Olivier Denecker, and Marc Niederkorn, “Accelerating Winds of Change in Global Payments,” McKinsey & Company, October 1, 2020, accessed February 9, 2021, https://www.mckinsey.com/industries/financial-services/our-insights/accelerating-winds-of-change-in-global-payments.

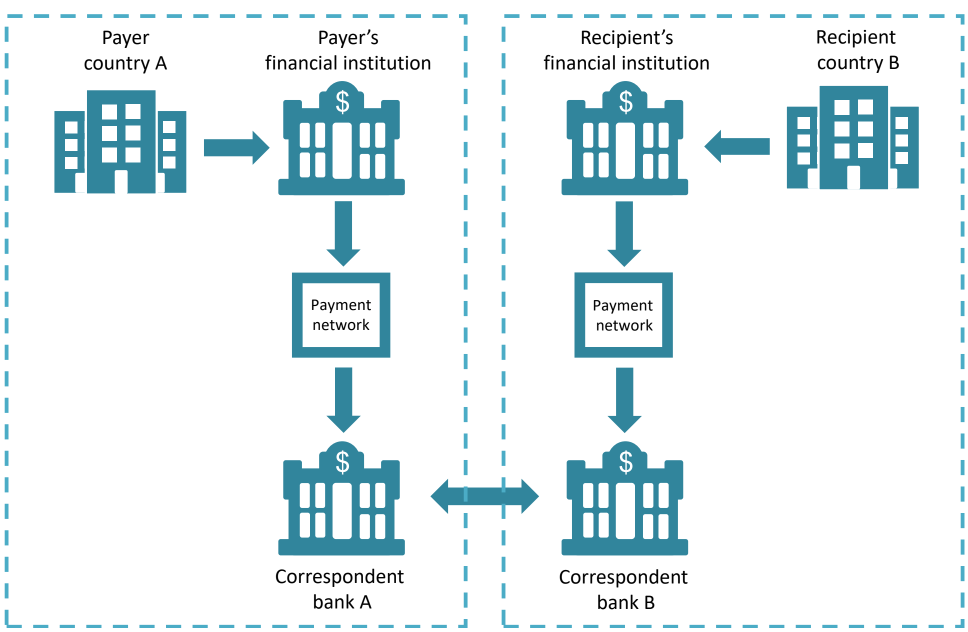
automated payables and receivables. While domestic payments will always significantly outnumber cross-border payments, the functionality goes hand in hand for the businesses that have a need to send and receive payments across geographic lines.

It is important for banks to understand the market need and opportunity in the cross-border space and the services that are utilized by business clients that make cross-border payments. Not doing so will certainly create gaps in growth and revenue potential from the key business segment that is making complex payments, and therefore utilizing more of the banks' treasury services. When a business client recognizes that there are other solutions available to make the payments process more streamlined, the risk of losing at least part of that client relationship is imminent.

CROSS-BORDER PAYMENTS FLOW

The cross-border market continues to be bogged down by the prominence of the correspondent banking model. While this model has been in place for over 30 years, it is a multistep process with inherent issues that create friction in the process. In the correspondent banking model, a business sends payment instructions to its bank. The bank, which likely does not have a presence in the country of the recipient, will send that payment to a correspondent bank. That bank will send to another correspondent bank that will convert the payment into the recipient's currency. The payment then goes to the recipient's bank and is credited to the recipient's account (Figure 2).

Figure 2: Cross-Border Correspondent Banking Model



Source: Aite Group

One of the biggest factors impacting the correspondent banking model is that the number of correspondent banks is shrinking significantly due to de-risking. Global banks are de-risking by eliminating relationships in emerging and developing countries, as these areas and institutions tend to be higher risk and generally low profit. Adoption of competing solutions to the correspondent banking model is also contributing to the shrinking numbers. The Bank of International Statistics reports that the decrease has been 20% in the last seven years, with markets outside the U.S. and Europe more deeply impacted.[2] This reduced number of correspondent banks reduces the options for smaller and emerging economies to access the correspondent banking network, adding even more expense to cross-border transactions or even cutting off access to these markets. Several pitfalls of the correspondent banking model create friction in the process:

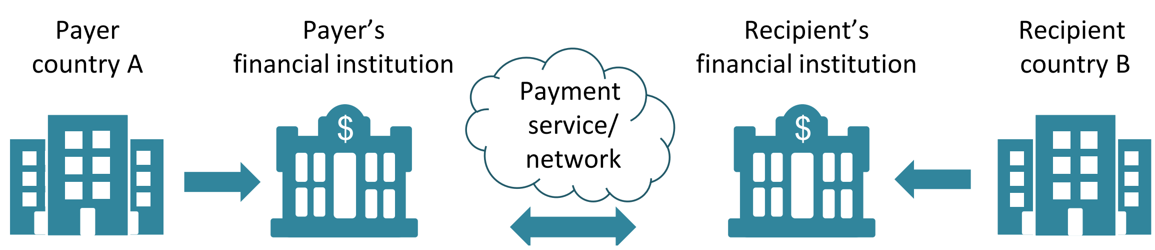
- Clearing and settlement time is typically at least two days, with potential for more delays due to the lack of direct relationship between the sending and receiving banks.
- Costs are high and unpredictable. Fees build up along the payment path, from transaction fees to correspondent banking fees to foreign exchange/currency conversion fees, which are often unknown before the transaction occurs. There also may be additional funds required to be sent. A payment can cost the sender US$25 or more, compared to US$10 to US$15 for a domestic real-time gross settlement (RTGS) transaction, which is the next-most-expensive type of payment.
- The final settlement amount can vary from the original transaction amount due to arcane fee structures during the correspondent banking process. This can disrupt the global supply chain and delivery of goods and services, as well as create the need for an additional payment transaction.
- Financial institutions can experience high internal costs due to payment repair or regulatory and compliance delays, such as with the Office of Foreign Assets Control (OFAC), that necessitate manual intervention. This reduces payment margins, which could already be thin with a need to be competitive in the market.
- There is a lack of transparency in where a payment is until it has settled. The communication and confirmation of payment settlement is independent of the transaction, and payee and payer must find a way to communicate important information. This is inefficient and can impact the flow of global supply chains.
- Payment reconciliation can be difficult and require manual intervention due to the lack of transparency and inefficiency of data. This manual intervention can be taxing on resources and disrupt the supply chain flow.
- Data can be lost or dropped during the process, making it more difficult for the recipient to reconcile or to send additional information with the payment. The lack of message standards, even where ISO 20022 is utilized, continues to perpetuate this issue.

2. Henry Holden, "New Correspondent Banking Data - The Decline Continues," The Bank for International Settlements, May 27, 2019, accessed February 9, 2021, https://www.bis.org/cpmi/paysysinfo/corr_bank_data/corr_bank_data_commentary_1905.htm.

Given the threat to the correspondent banking model and its infrastructure due to the above issues, improving this process and standardizing data is critical to businesses with global payment needs. One such is improvement is SWIFT gpi. SWIFT gpi is playing a significant role in the industry, not only through standardization efforts of messaging with the ISO 20022 message format in progress but also through improved transparency and speed when cross-border payments move between SWIFT member banks that subscribe to its service. But this is just one example of innovative improvements in the global payments space.

Innovation and investment in next-generation cross-border payments functionality removes the need for correspondent banks by enabling account-to-account cross-border transactions (Figure 3).

Figure 3: Next-Generation Cross-Border Model



Source: Aite Group

This flow greatly reduces the dependency on the correspondent banking model and eliminates the added correspondent banking fees while improving speed and predictability of settlement. Real-time settlement also helps increase straight-through processing. Banks that value the revenue and volume generated from business clients or that want to grow in this segment but are depending solely on the traditional correspondent banking model need to be looking at ways to offer this next-generation cross-border workflow.

WHAT BUSINESSES WANT

Cross-border payments should not be as painful today as they were five to 10 years ago. As technology across all areas of treasury and payments has been moving forward, it has taken a bit longer for cross-border payments to catch up. Even so, businesses that need to make payments across geographical lines are becoming aware of the benefits of faster, more transparent payment capabilities. The types of businesses that make cross-border payments look different today than they did five to 10 years ago—a greater number of less-sophisticated small and midsize businesses have the need for cross-border functionality. As globalization has made commerce across borders not just possible but critical to the health and growth of businesses of all sizes, the ability to facilitate payments for goods and services rendered is a requirement.

Aite Group research shows that about 30% of U.S. small businesses have the need to make cross-border payments, and that number increases to about 60% when looking across segments of all businesses. In Europe, this number is even higher, with an estimated 50% of small businesses making cross-border payments and about 85% across segments of all businesses. An important part of the strategy for many of these businesses is how to move money across geographies and in multiple currencies.

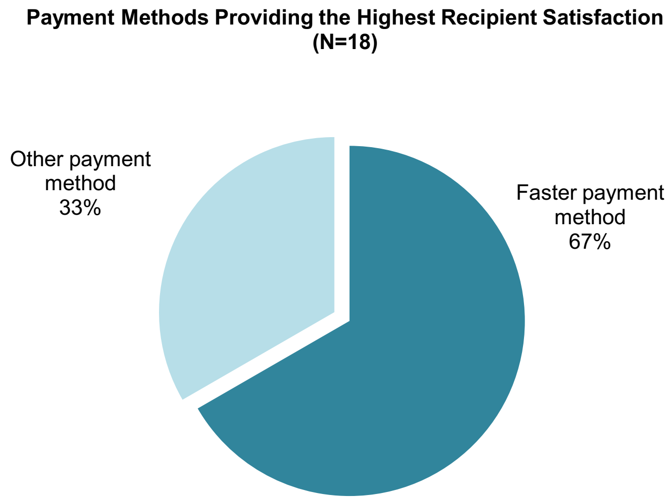
Where banks leave a gap in the functionality needed for businesses to optimize treasury operations, fintech providers are ready to jump in. As previously discussed, the revenue potential is high; however, the right functionality needs to be in place. For banks that meet the needs of businesses making cross-border payments, this can mean new and growing fee-based revenue, valuable cross-selling opportunities, and coveted deposits. For banks that do not meet those needs, the outcome is obvious—lost revenue and new business generation and deposits to other banks and fintech providers.

FEATURES AND NEEDS

Businesses want to remove the friction and pain points of cross-border payments. They want predictable fees, fast and secure settlement, transparency into payment status, and robust data attached to that payment. This is important for controlling and predicting the internal costs of doing business as well as the cash flow cycle. The outdated model of traditional correspondent banking is not good enough. Fortunately, businesses have options that are growing in efficiency and accessibility.

Recipient satisfaction is also increasingly becoming more important to businesses. Payment strategies are being developed that not only support the internal goals of the organization but also consider the external satisfaction of payment recipients. With continued globalization, businesses have greater choice of who to do business with, who suppliers are, and how services are provided and by whom. Faster payment methods, with account-to-account settlement, provide a significantly higher rate of satisfaction, strengthening business relationships (Figure 4).

Figure 4: Payment Methods Providing the Highest Recipient Satisfaction



Source: Aite Group survey of new-economy businesses, July 2019 to October 2019

For banks, this means that the expectation to enable frictionless payments, even in the cross-border space, is increasingly important. Businesses do not really care what payment network is utilized or the infrastructure in place to make that happen, but they do want fast, predictable, secure, and efficient payment settlement. Account-to-account technology solutions and PaaS-connected hub infrastructure allow banks to better meet these businesses' needs.

CROSS-BORDER NETWORKS

The global cross-border payments industry consists of several layers. At the top are the established correspondent banking-based networks, followed by domestic real-time payments infrastructures that are expanding to become regional players. Below those are the existing card schemes and their global networks, and further down the layers are the alternative payment mechanisms, such as the money transfer industry (Table A).

Table A: Existing and Emerging Cross-Border Payments Initiatives

Category	Solutions	Description
Correspondent banking based	Traditional SWIFT, SWIFT gpi	This is the traditional model of utilizing intermediary banks, whereby recipients are outside the sending bank's footprint or network. SWIFT gpi allows member banks transacting within networks to have near-real-time settlement and payment tracking.
Central infrastructure based	P27, GCC AFAQ, SEPA Instant, BUNA	These regional networks have cross-border, multicurrency capabilities that are limited to a set of countries within the network agreement.
Blockchain based	Ripple, Visa B2B Connect, Mastercard Track	Blockchain provides transparency, security, and speed that the traditional correspondent banking model cannot provide. Payments can settle in real-time without dependence on card numbers or intermediary banks.
Card network based	Mastercard Send, Visa Direct	The card networks have high market penetration and maturity, and have expanded payment capabilities through high-profile acquisitions. The capabilities leverage the card network utilizing card numbers.
Nonbank solutions	Western Union, StoneX (formerly INTL FCStone)	As the number of correspondent banks have decreased, nonbanks have stepped in to specialize in providing more efficient cross-border payments. Many of these providers have established relationships in hard-to-reach regions.

Source: Aite Group

ONE SIZE (NETWORK) DOESN'T FIT ALL

Depending on the receiving bank, currency, country, and payment value, not all cross-border payments can be serviced the same way: Payments to emerging regions may be better served by a blockchain solution, payments in which debit card information is available and known may be better served using a card network, and payments between financial institutions with a direct relationship may be most effective using a more traditional banking model. Financial institutions need to be aware of the options and enable solutions that allow them to serve business clients with the flexibility and transparency required for each transaction.

For now, the cross-border landscape is dominated by the major banks that make up the membership of the SWIFT messaging consortium. This has been particularly true since the introduction of the SWIFT gpi service, which effectively boosted the speed of international payments in line with domestic clearing systems—40% of gpi payments are credited to end beneficiaries in less than five minutes, and almost 50% within 30 minutes. Since its introduction in 2017, SWIFT gpi has grown rapidly. More than 65% of all cross-border payments on SWIFT are now sent via gpi, representing more than US$300 billion in daily value.[3] However, there is continued innovation in the space, providing alternatives to SWIFT gpi.

The card networks, particularly Mastercard and Visa, both of which have been quick to react to the opportunities and threats presented by the emergence of real-time payments networks, are major players in this space as well. Both Mastercard and Visa have solutions in the market that leverage the card network of debit cards to facilitate cross-border payments. Both companies also have distributed-ledger solutions to vastly increase market penetration, particularly where the debit card network is not an applicable option for payment messaging and settlement. Through significant acquisitions of Vocalink and Earthport, Mastercard and Visa have built account-to-account capabilities that remove the constraints of being just a card network. These create even more choice in the cross-border payments market.

A further set of cross-border services come from other providers, including money transfer firms such as Western Union, FX networks such as Currency Cloud, and distributed ledger networks such as Ripple. There are also completely new entities entering the market that attempt to modernize cross-border payments technologies with quicker settlement, greater transparency, and greater reach into emerging markets and regions. As traditional cross-border services age and fail to meet demands, innovation will continue to fill the gaps and provide businesses with robust choices. Understanding that a single solution will likely not meet all of the cross-border needs for business clients within a bank is important to note.

AMERICAS CONSIDERATIONS

All of the above-mentioned networks and solutions are available to banks in the U.S. and the wider Americas, providing ample market opportunity to grow market share of the cross-border payments volume. However, there are developments that are relevant to this region specifically. One example is the United States-Mexico-Canada Agreement (USMCA). The USMCA is attempting to remove payments friction between the U.S., Canada, and Mexico. As expected, tens of billions of dollars are moved between these countries every year, and the economies have strong ties to one another that would be strengthened by breaking down payment barriers to frictionless payments. The USMCA effort is also enabling fintech firms to innovate in each of

3. "SWIFT gpi Traffic Soars to $77 Trillion in 2019," SWIFT, March 2, 2020, accessed February 9, 2021, https://www.swift.com/news-events/news/swift-gpi-traffic-soars-77-trillion-2019.

these countries equally to access the market opportunity, which will spawn even more innovation.

The volume of cross-border payments coming from and going to the U.S. is significant, and U.S. banks have substantial opportunity to service the businesses that are making these payments and benefit from the associated revenue stream. Aite Group estimates that the current 60% of U.S. businesses that have cross-border needs will grow 2% to 5% annually.

EUROPEAN CONSIDERATIONS

As in the Americas, European banks have access to the above-mentioned networks and solutions but have some significant regional developments. The Single Euro Payments Area (SEPA) scheme only covers the euro-denominated payment, so it is not a cross-currency system, but it is cross-geographical. However, not all EU member states are part of the Eurozone. Poland and some of the Nordic countries use their own currencies but are also part of the SEPA scheme, as are several nonmember states, including Iceland, Norway, Switzerland, and the U.K., through their membership of the European Economic Area. Future development of its clearing systems will, however, provide connectivity for EU member countries that have retained their own national currency.

In a parallel development, banks in Sweden, Denmark, and Finland (of which only Finland uses the euro) are creating the P27 platform as a shared payment infrastructure to replace their multiple existing domestic clearing systems. P27 will also have a gateway connection to SEPA Clearing. P27 builds on a strong history of cooperation between the countries in the region—though Norway, which was originally a participant, has stepped back from it—and is being watched closely by observers of the payments industry.

MIDDLE EASTERN CONSIDERATIONS

Some initiatives in the Middle East are also worth noting. In a move parallel to the P27 initiative in Scandinavia, the Arab states of the Persian Gulf, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates completed the first phase of a regional cross-border payments infrastructure being developed under the aegis of The Cooperation Council for the Arab States of the Gulf (formerly known as the Gulf Cooperation Council, or GCC). The GCC Payment Systems Connection System, known by the transliterated acronym AFAQ, is part of a regional infrastructure being developed to underpin inter-GCC payments systems through enabling RTGS transfers among the central banks of the member states. The system supports dealing in the local currencies of GCC member states.

In common with SWIFT gpi and P27, AFAQ builds on domestic real-time infrastructures in the region, but it is not the only one in the region: Announced in 2020 was BUNA, a multicurrency payments platform providing multicurrency clearing and settlement services that meet the eligibility criteria related to the clearing and settlement of inter-Arab financial transactions, which are subject to Sharia banking rules.

TECHNOLOGY AND ENABLEMENT

According to Aite Group research, payment modernization efforts are a very or extremely strong priority at 86% of financial institutions around the globe. This means that more financial institutions are investing in payments technology that is capable of accessing multiple payment networks and utilizing ISO 20022 messaging standards to better meet the needs of corporate clients. Corporate clients want to have a single payment experience for every transaction regardless of payment type. Banks that are able to meet this need have a significant market advantage.

As part of payment modernization efforts, vendor solutions based on a cloud-native, open-API framework are leveling the playing field for banks, particularly those outside the global top 10. Complex and robust payments capabilities across multiple networks are assessable through partnerships with fintech firms that provide cross-border services. Without collaboration, these fintech firms become competitors and disintermediate banks by instead partnering directly with their business clients. Partnering with a fintech firm—one that specifically provides cloud-native hub technology—can provide benefits critical to growing cross-border payments market share:

- Quicker time to market with new payment capabilities and functionality to fill in current payment gaps as well as offer more innovative, data-driven services
- Access to multiple payment networks to drastically reduce friction in the cross-border payments process
- Estimated cost and resource savings of 30% to 40% when compared to noncloud technology implementations
- Simplified regulatory compliance process, especially in emerging regions where regulations can vary greatly
- Increased automation in payment routing and reconciliation, minimizing manual intervention of payments
- ISO 20022 messaging standard capabilities across all payment capabilities to provide consolidated, data-rich reporting

This cloud PaaS model also provides ancillary benefits to the bank across the cash management portfolio. PaaS as a business is attractive to banks because of the reoccurring revenue and the ancillary services attached, such as fraud tools, integrated receivables, automated payables, and investment services. In an environment with shrinking fee margins and domestic payments commoditization, differentiated cross-border payments services is a competitive advantage that should be a top priority for regional banks across the globe.

CONCLUSION AND RECOMMENDATIONS

Innovation in the cross-border landscape is creating new opportunities for banks around the globe. Banks that are not modernizing their cross-border payments capabilities are missing out on significant and growing revenue from these transactions. Key considerations and recommendations for banks to capitalize on this market opportunity include the following:

- The traditional correspondent banking model is rife with issues, including unpredictable settlement, greater costs for both the payer and the bank, lack of transparency, and inefficient communication and data capabilities. These issues can disrupt the supply chain flow and strain business relationships.
- The capabilities to offer improved services to satisfy the demands of corporate customers by solving pain points in the cross-border service with improved speed and security, greater transparency, and predictable costs exist in the market. Continued innovation will yield continued improvements in the space.
- Alternatives to the correspondent banking model include regional solutions through central infrastructure, blockchain solutions, card network-based solutions, and nonbank solutions. Access to this technology has become more affordable and accessible, particularly by partnering with a vendor for a cloud-deployed PaaS solution that allows banks of all sizes to improve cross-border product capabilities and increase cross-selling potential.
- Cross-border payments solutions that provide real-time settlement create efficiency in the reconciliation process, greatly reducing the need for back-off resources needed to focus on and manually review outstanding and pending transactions.
- Payments modernization to quickly enable connectivity to new payment rails is key for banks to offer their business clients more efficient payments and value-added services, such as a choice of clearing options or FX services. The ability to provide value-added data services based on ISO 20022 standards is also a significant benefit of modernization efforts.
- Meeting the cross-border needs of small businesses is an opportunity for banks of all sizes to profitably expand their potential client base to include these often-excluded smaller businesses. The accessibility of technology will allow small banks to target businesses further upstream; accordingly, large banks should also consider the strategy of moving downstream.
- As cross-border payments become more automated and ever-more homogenized, banks will find margins squeezed further, making it a greater priority to have efficient payment processing platforms and value-added services, including cross-selling opportunities.
- Banks that are not taking advantage of the innovations and technology in the payments space will find that they are losing business not only to other banks but also to the fintech providers, as they are experts at providing a more seamless payments experience.

ABOUT VOLANTE TECHNOLOGIES

Volante Technologies is the leading global provider of cloud payments and financial messaging solutions to accelerate digital transformation. It serves as a trusted partner to over 100 banks, financial institutions, market infrastructures, clearing houses, and corporate treasuries in 35 countries. Its solutions and services process millions of transactions and trillions in value every day, powering four of the top five corporate banks, 40% of all U.S. commercial bank deposits, and 70% of worldwide card traffic. As a result, its customers can stay ahead of emerging trends, become more competitive, deliver superior client experiences, and grow their businesses through rapid innovation.

In the cross-border payments arena, Volante provides banks and financial institutions with cross-border payment processing and connectivity solutions for multiple schemes: traditional SWIFT correspondent banking and SWIFT gpi; next-generation networks such as Ripple, Visa B2B Connect, and Visa Direct; and regional initiatives such as P27 and AFAQ.

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