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Re-imagining correspondent banking – fresh perspectives

We all know blockchain and distributed ledger technology have the potential to become game-changing tools that can reshape the world of business in profound ways. Naturally, there's plenty of hype when innovation delivers something as ground-breaking as these technologies, but scratch the surface and you'll soon see that blockchain is not a panacea – it cannot provide the solution for everything.

Alan Marquard and Peter Klein, CLS

Evolution does not sweep away existing forms and functions in an instant; it generally adopts the best, most innovative ideas and marries them with the status quo to drive significant improvements.

Reform is most easily absorbed by structures that are ripe for transformation, such as the international payments sector. We know it has to change, but to switch – en masse – to a new disruptive technology would be an extraordinarily risky strategy.

The answer, we suggest, may be more evolutionary than revolutionary.

Correspondent banking today: fraught with challenges

Global correspondent banking is highly complex, and laden with challenges for banks, corporates and regulators. The current model relies on trust-based bilateral relationships between banks as a method to send or receive payments internationally. Each bank holds an account with the other (a nostro account) and acts to credit funds on behalf of the other bank as its client. The complex nature of this model presents various challenges for banks and the broader industry. It is characterized by significant funding and liquidity requirements, high operational costs and a lack of certainty in the payment delivery process – all of which affects banks' ability to provide competitively priced, high quality services for their customers.

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The large number of nostro/vostro accounts held by banks with each other to support a global network requires the effective maintenance of cash balances. Unpredictable transaction volumes can often result in considerable levels of inaccessible liquidity. This under-utilized liquidity exists across many nostro/vostro accounts, resulting in significant costs for banks.

These costs are exacerbated by the resources required to administer the network. It requires network managers to review contracts, monitor transaction volume, and ensure AML/KYC compliance for a large number of nosto/vostro relationships. And each bank's treasury division must manage funding and liquidity, which entails checking cash positions, negotiating rates, purchasing liquid assets and funding the accounts.

A lack of global standardized and harmonized rules and practices governing banks and clearing systems causes high payment processing costs, and in some cases, message truncation which requires manual intervention. As message truncation can occur at many points along the payment chain, manual intervention can add hours, or even days, to the transaction timeline. This results in a poor customer experience, higher fees, greater risks and delays in the delivery of payments.

Banks' reliance on a sequential series of bilateral relationships makes payment delivery timelines unpredictable, meaning they often spend hours tracking payments or responding to customer inquiries. Also, unlike domestic payments moving through a central clearing house or central bank RTGS system, there is no legal framework to provide settlement finality in the payment chain.

There is general recognition that the current correspondent banking model is unlikely to address rapidly evolving client needs and future market requirements and that the networked structure of the global model makes it impossible for any individual organization to drive change. However, there is an opportunity to create a global payment utility that enables efficient, low-risk, reliable and transparent payment services.

Market headwinds creating pressure

The correspondent banking model is facing strong market headwinds on several fronts. Regulators are pursuing better outcomes for the public, demanding greater transparency, heightened efficiency and lower costs (e.g. Dodd Frank 1073, Second Payment Services Directive (PSD2)).

Increased scrutiny from regulators has also led to the rationalization of correspondent banking networks as banks curtail activity in some jurisdictions or with counterparties perceived to be too risky. This has created challenges for market participants looking to establish or maintain secure international access to these markets as the global business environment becomes increasingly border-agnostic.

The recent influx of market entrants offering new technology solutions threatens to disintermediate banks from the end customer. In some cases, this technology is putting revenues from the traditional correspondent banking models at risk, with new value propositions including lower prices, enhanced visibility and greater convenience.

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Increasingly, central banks are also looking to revamp RTGS systems, seeking interoperability and promoting the standards of convergence across international payments. The Bank of England, in its May 2017 publication of "A blueprint for a new RTGS service for United Kingdom", highlighted interoperability as a key requirement, looking to facilitate the introduction of a cross-border and cross-ledger synchronization module as part of the rollout of its next generation RTGS system.

Finally, increasingly demanding end customers, prompted by the consumerization of corporate payments, rapid development of digital capabilities and Service Level Agreement (SLA) improvements in domestic payments, contribute to the long list of challenges facing correspondent banks.

The need for a new environment

Market participants now recognize the challenges associated with the current disparate and complex correspondent banking model (see below).

The pressures created by the current correspondent banking model have caused a tipping point. The industry has started to develop solutions to plug some of the gaps. However, few have attempted to build a comprehensive solution.

Challenges:

- Banks need to maintain complex networks with existing bilateral correspondent agreements, leading to costly operations
- Increasing complexity in regulatory compliance has a significant cost implication as banks seek to adhere to evolving regulations and avoid heavy fines
- The bilateral correspondent model requires funding of balances across a large number of nostros
- High operational costs resulting from time-consuming activities associated with exceptions handling and manual interventions. These activities are driven by inconsistent message formats, content structure, procedures and processes
- High and unpredictable fees across the payment chain due to each bank having its own fee schedules and charging policies
- Long and unpredictable processing times due to multiple systems, repeated compliance checks throughout the payment chain and higher liquidity costs
- Limited transparency of payment status.

Market participants now recognize the challenges associated with the current disparate and complex correspondent banking model.

The opportunity exists to reconstruct the correspondent banking model to enable a more cost-efficient, simplified, streamlined and transparent international payments process.

We believe a centralized international payment utility, that connects banks and domestic payment systems around the world and serves as a single point of access for facilitating international payments, will help address the challenges facing today's market participants.

This system will effectively act as a payment hub, processing, netting, settling and clearing payments bound for other jurisdictions in real-time. It will operate in a similar way to current domestic payment systems but with an exclusive focus on cross-border payments and domestic payments in a foreign currency.

No silver bullet yet

There are several market participants who are making progress in addressing some of the pain points, notably in emerging markets, but these typically focus on delivering three different value propositions:

1. Improve the end customer experience: offer intuitive interfaces with the ability to pay through multiple channels and instruments (e.g. Western Union, Traxpay, SAP)

2. Provide niche services: address issues such as high foreign exchange (FX) costs, by providing gateways/APIs to enable payments (e.g. Currency Cloud, Kantox, Midpoint)

3. Improve transparency and visibility in the payment chain: solutions that change how banks interact and move funds by improving access to local banks, domestic payment systems or transaction banks to facilitate transaction flows (e.g. Ripple, Earthport, SWIFT gpi).

While many have been successful at solving specific issues such as limited transparency and visibility or payment process inefficiencies, few offer a broad-based solution to the problems. Current solutions are still reliant on the existing correspondent banking network, payment rails and bilateral legal agreements. As a result, many of the challenges still exist for banks.

In order to fundamentally change the way international payments are handled, the industry has to depart from the current model. The opportunity exists to reconstruct the correspondent banking model to enable a more cost-efficient, simplified, streamlined and transparent international payments process.

Benefits

- Enable banks to remain competitive by minimizing high operational costs and liquidity burdens
- Reduce current inefficiencies, uncertainty, lack of transparency and risk
- Centralize and harmonize market rules and practices to provide increased predictability, effectiveness and protection for market participants.

An industry waiting for change

Growing regulatory pressures, customer demands and new technologies have created an opportune moment to challenge established processes. We believe the time is right for banks, regulators and market participants to work together to reshape correspondent banking, introducing new technologies in a pragmatic and innovative manner while maintaining and building on existing controls. A new way to transfer money across borders can be achieved in a graduated manner, keeping expectations both realistic and controllable – an approach that CLS has adopted before in the development of our leading payment-versus-payment settlement service for the FX market. We are confident the international payments sector is ready to embrace long overdue change and adopt new technologies and best practice, to stay at the forefront of a changing market.

Alan Marquard
Chief Strategy & Development Officer

Peter Klein
Program Director

London
Hong Kong
Tokyo

New York
New Jersey

info@cls-group.com
cls-group.com