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MERCATOR ADVISORY GROUP

PAYMENTS INFRASTRUCTURE OUTLOOK: REAL-TIME PAYMENTS TAKE THE LEAD

A Mercator Advisory Group Research Brief Sponsored by Alacriti

Alacriti

May 2021

Contents

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Introduction

Payment products and services have long been acknowledged as the connective tissue at financial institutions, and as collectively providing a significant core revenue stream. Yet payments products and services operate in the larger context of institutional IT infrastructure and planning, subject to the objectives of multiple consumer, small business, and commercial business units. What are the business and technology priorities and market dynamics that drive this diverse array of payment services?

Our survey of senior FI executives, summarized in this research brief, shows strong institutional priority for building payments infrastructure in general, and for investing in real-time/faster payments in particular. Broad acceptance of cloud-based IT approaches is notable and somewhat surprising, considering the traditionally conservative architecture approaches of FIs. To a large degree, the speed of product evolution, opportunity for new revenue sources, and competition is motivating decision makers to embrace the advantages of cloud-based IT, especially in payments. Real-time payments are a key motivator for financial institutions to press forward with their infrastructure modernization; executives surveyed expect an average 4.1 years before real-time payments become a significant method of payment in the U.S. With real-time payments on the horizon, for many financial institutions, the time for infrastructure modernization is now.

REAL-TIME PAYMENTS ARE A KEY MOTIVATOR FOR FINANCIAL INSTITUTIONS TO PRESS FORWARD WITH THEIR INFRASTRUCTURE MODERNIZATION.

Research Approach

Mercator Advisory Group designed an online executive questionnaire in collaboration with Alacriti to explore the opinions of senior leadership at banks and credit unions. Using an online business panel, the following responses were obtained during March 16-22, 2021:

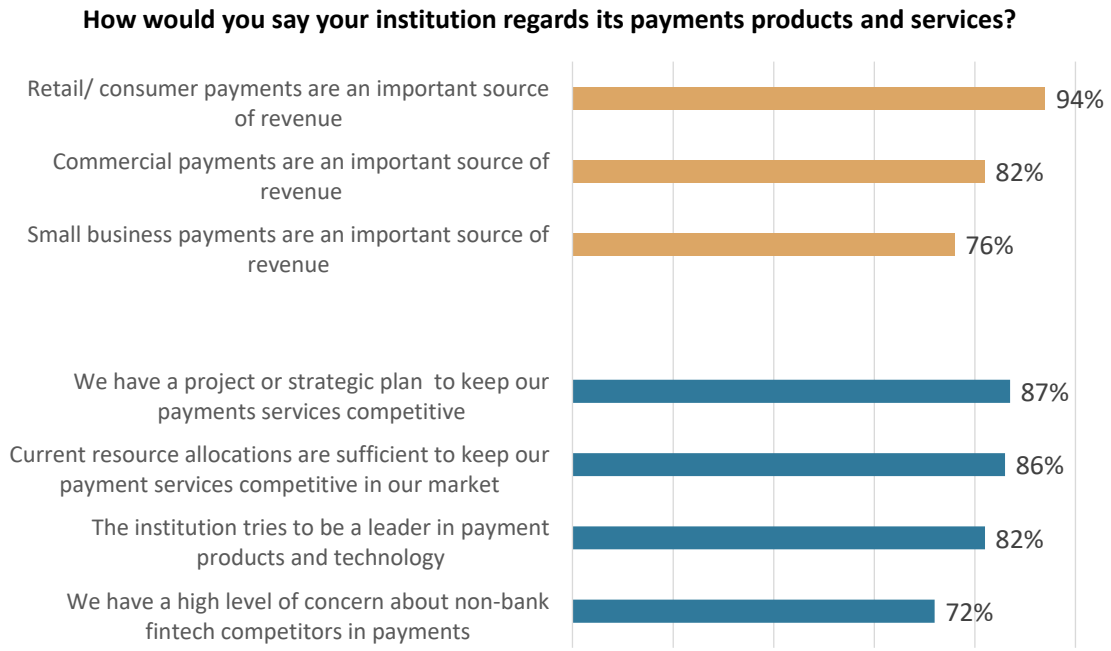
- Survey completed by 100 senior-level bankers, with 19% representing community banks or credit unions.
- Institutions ranged from $750MM to $10B+. 51% had assets of $5B+.
- 47% of respondents were CEOs, and 32% were C-level.
- Over one third were involved in both consumer and retail business lines (37%), 32% were consumer-focused, 18% commercial-focused, and 12% small business-focused.
- 86% reported they were sole decision makers regarding "any services, strategies, vendors, or IT within consumer or business payments."

The Central Role of Payments

Consumer, small business and commercial payments are seen as providing important revenue streams to each business sector (Figure 1), with nearly all executives noting the importance in consumer business lines. Somewhat surprising, although consistent with the importance of payments, are the perceptions that the FI is actively maintaining a planning focus on payments, and is allocating resources sufficiently to that strategic effort.

Eight out of ten (82%) perceive their FI to be working to be a leader in payments products and technology, a bullish point of view that is tempered by concerns about competition from non-bank fintechs (72%) who may be instigators of the drive to modernize.

Figure 1: Executives are bullish on the importance of payments, and see their FI's commitments in line with that importance



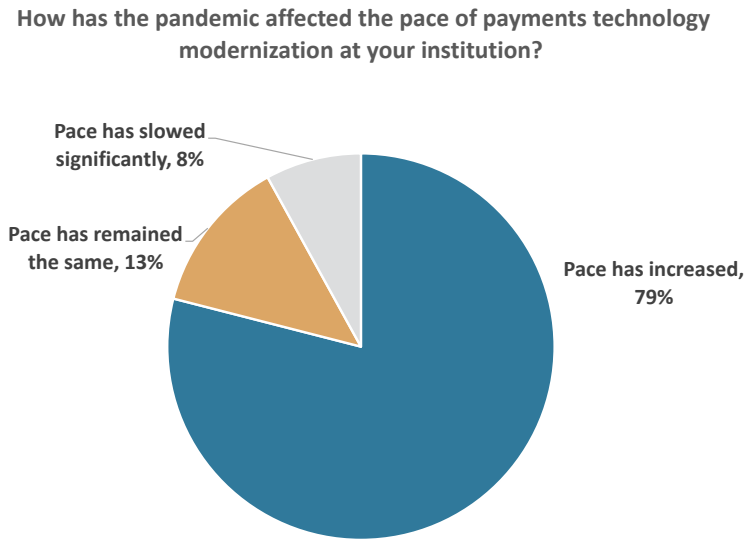
Source: Mercator Advisory Group Survey of Senior Banking Executives

It is notable that the positive attitudes noted above regarding the centrality of payments businesses were not restricted to large institutions. No statistically significant differences were noted in responses categorized by the asset size of the institution.

When asked to characterize their FI's pace of payments technology modernization, a remarkable 68% saw their FI as a market leader. This point of view on technology modernization was much more common among banks (78%) as compared with community banks and credit unions (26%). Those who saw their FI as "fast followers" (22%) or as staying with the market (8%) were much more common attitudes among community banks and credit unions (53% fast followers and 16% staying with the market).

The current pandemic-focused business environment has actually been favorable to payments modernization; **nearly 8 out of 10 indicate the pace of modernization has increased during the pandemic** (Figure 2).

Figure 2: Payments technology modernization efforts have been boosted by the pandemic.



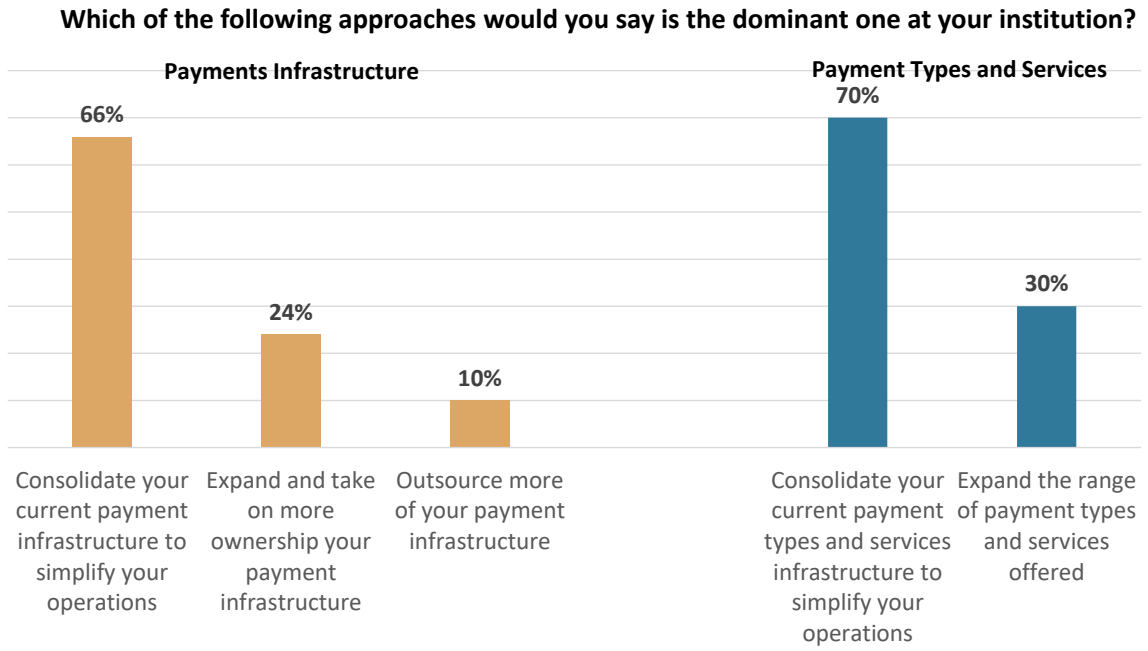
Source: Mercator Advisory Group Survey of Senior Banking Executives

Overall IT and Payments IT Strategies: Harnessing the Cloud

Over the long run, rapidly evolving business lines and products add complexity and proliferate IT infrastructure. In today's environment, banking executives tend toward consolidation on both payments infrastructure (66%) and payments products (70%) to simplify operations (Figure 3). That said, some institutions were viewed as in expansion mode (24% expanding infrastructure ownership, 30% expanding payment types and services).

CLOUD-BASED INFRASTRUCTURE IS PREFERRED BY 9 OUT OF 10, WITH HIGH RECOGNITION OF ITS SUPERIOR END-USER EXPERIENCE, SPEED TO MARKET, PAY-AS-WE-GO AND IMPLEMENT-AS-WE-GO ADVANTAGES.

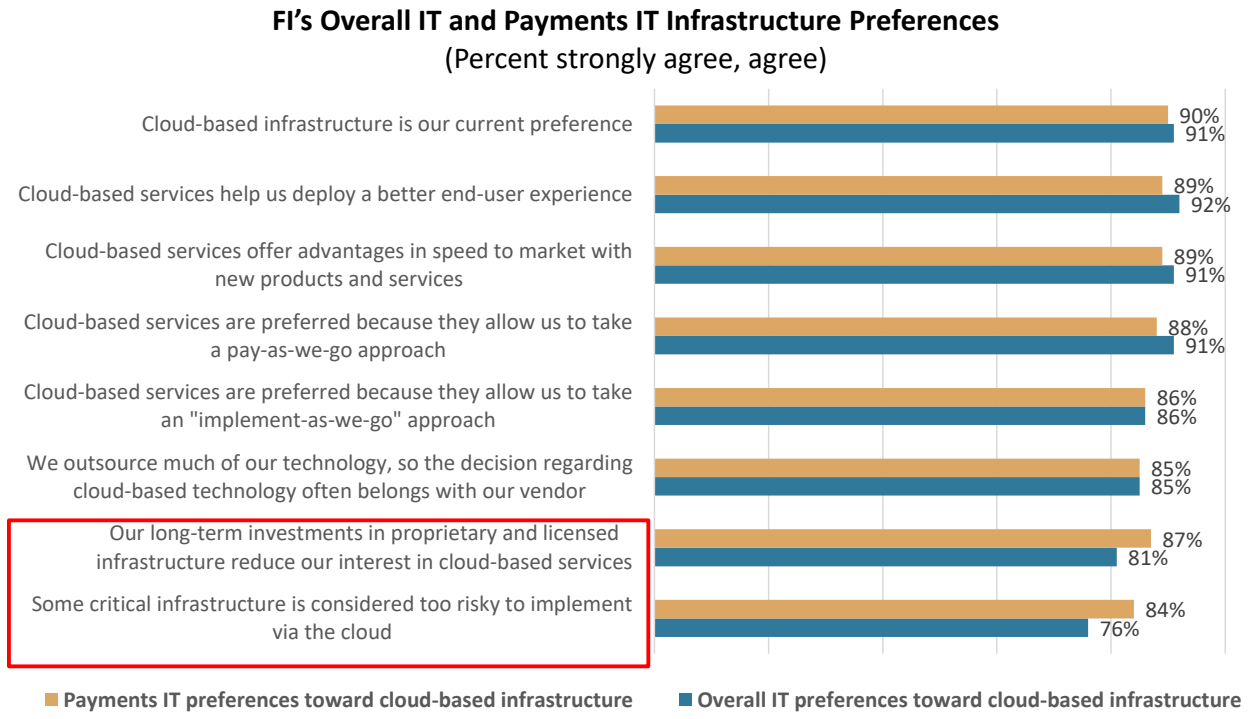
Figure 3: Simplification of payment operations is a dominant orientation, even as the importance of payments is acknowledged.



Source: Mercator Advisory Group Survey of Senior Banking Executives

Financial institutions have historically pursued ownership-based IT strategies as the most conservative and reliable approach to service delivery. Given this history, plus the prevalent simplification-driven orientation, it is remarkable how positively executives responded cloud-based IT and payments-specific strategies. As Figure 4 illustrates, cloud-based infrastructure is preferred by 9 out of 10, with high recognition of its superior end-user experience, speed to market, pay-as-we-go, and implement-as-we-go advantages.

Figure 4: Infrastructure Preferences Favor the Cloud, With Caveats



Source: Mercator Advisory Group Survey of Senior Banking Executives

In spite of these extremely positive ratings for cloud-based IT and payments infrastructure, some important caveats remain**.** As highlighted in Figure 4, it is also common for respondents to note that past sunk costs in proprietary and licensed IT, sometimes termed as maintenance burden, can also reduce interest in cloud implementations, or that some critical infrastructure may still be considered off-limits for the cloud. Analysis of these responses confirms that it is significantly likely that respondents both note that while their FI prefers cloud implementations for IT and payments IT specifically, it also has prior investments or perceptions of risk that mitigate against cloud-based approaches. Historical factors, it seems, have not completely dissipated.

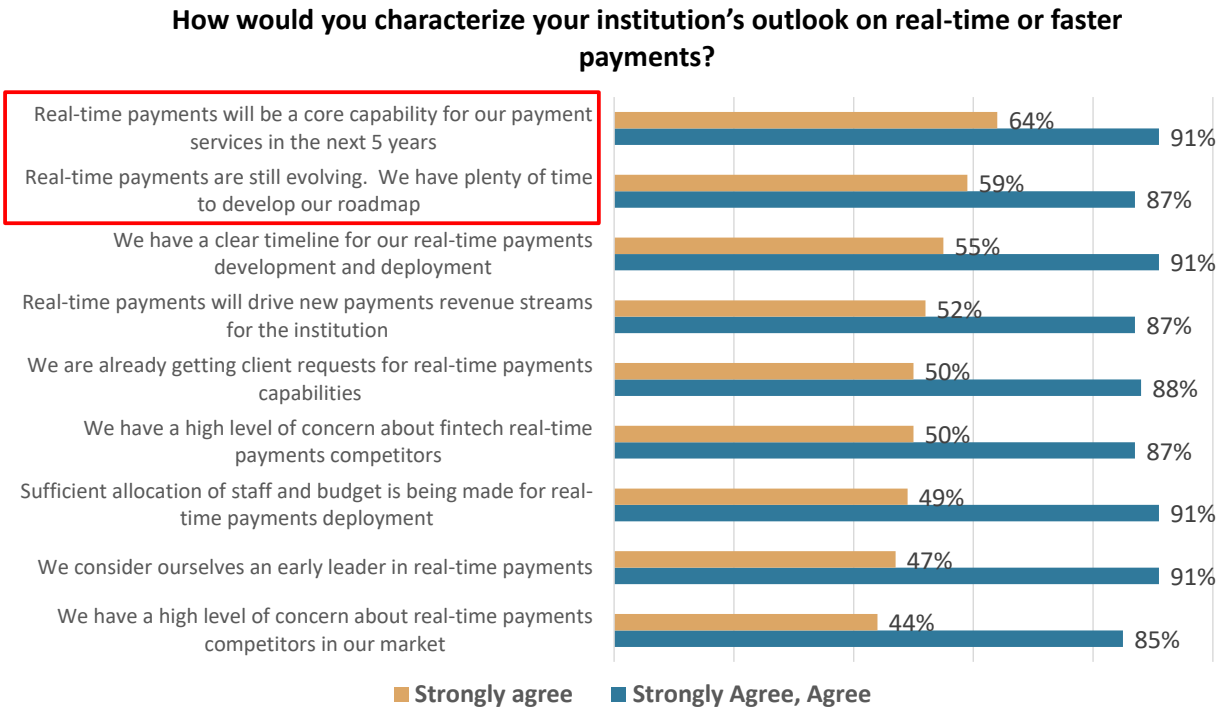
PAST SUNK COSTS IN PROPRIETARY AND LICENSED IT, SOMETIMES TERMED AS MAINTENANCE BURDEN, CAN ALSO REDUCE INTEREST IN CLOUD IMPLEMENTATIONS, AND SOME CRITICAL INFRASTRUCTURE MAY STILL BE CONSIDERED OFF-LIMITS FOR THE CLOUD.

Ultimately, it is clear that outsourcing vendors will have the last word; 85% agree that since they outsource much of their technology, the outsourcer will make the final cloud-based decision. In these instances, the decision to outsource sets the overall IT infrastructure strategy to that of the outsourcer.

Time for Real-Time

Most executives surveyed expect real-time payments will be a core capability within 5 years, as the industry realizes the benefits of faster transactions, and the efficiencies that can be achieved through the adoption of message standard ISO 20022, which allows a significant load of data to accompany the payment itself. A majority of respondents also agree that the space is still evolving with time to adjust the plan (Figure 5). Again, two seemingly conflicting concepts are held simultaneously. However, multiple ISO 20022 based payment channels are still to come (FedNow and FedWire updates) in addition to the already available rails from TCH RTP and SWIFT, which could help to explain these still evolving plans.

Figure 5: High priorities for real-time payments, but still a moving target



Source: Mercator Advisory Group Survey of Senior Banking Executives

As we saw earlier in terms of attitudes toward payments businesses, executives show **surprising confidence in their planning timelines, resource adequacy, revenue potential, and intentions to be market leaders in payment products and technology**. There is also **the consistent concern about non-bank fintech competitors in the real-time payments space.** Most agree that real-time payments will drive new revenue streams (87%), and that they

are already receiving client requests for services (88%). It is interesting to note that community banks and credit unions are more bullish on new revenue stream opportunities (84% strongly agree) compared to banks (44% strongly agree).

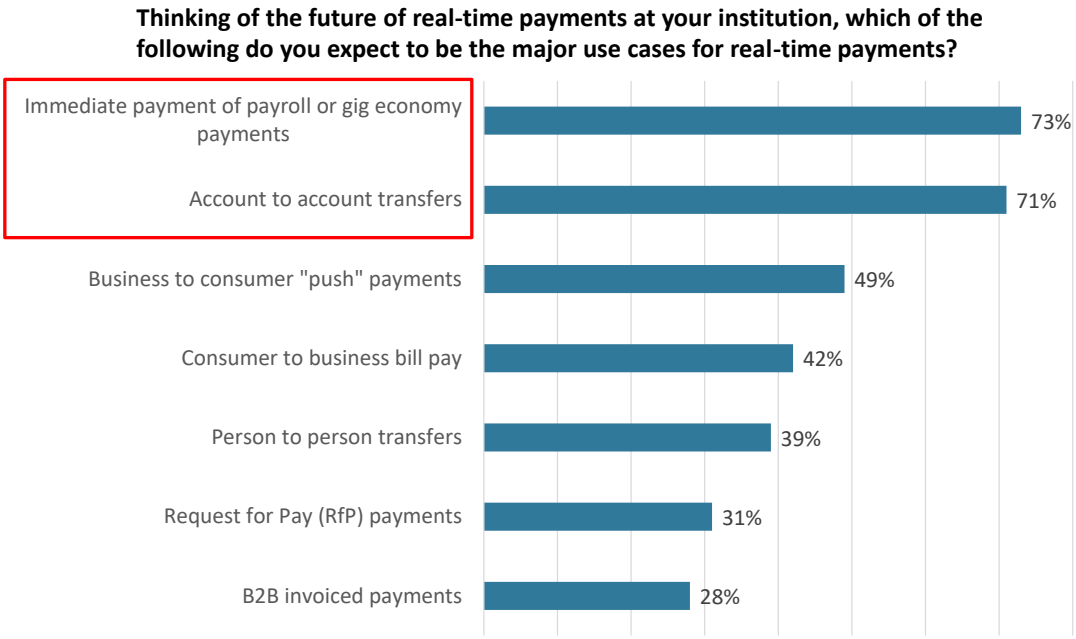
Where are real-time payments revenues expected? Current perceptions are focused on the relatively well-developed applications of immediate payments (73%) and account-to-account transfers (71%) (see Figure 6). B2B applications (RfP payments, B2B invoiced payments) fall lower on the list of expectations. Notable is the lower ranking of person-to-person transfers. Perhaps the availability of common bank and fintech offerings in the P2P space suggest fewer revenue opportunities in the evolving real-time environment.

WHAT ARE REAL-TIME AND FASTER PAYMENTS?

REAL-TIME PAYMENTS: A NEW AND DISTINCT ELECTRONIC PAYMENT SYSTEM AVAILABLE CONTINUOUSLY FOR ALL PAYMENT TYPES SERVING BOTH CONSUMERS AND BUSINESSES THAT CLEARS AND SETTLES TRANSACTIONS WITHIN SECONDS BETWEEN ACCOUNTS. TRANSACTIONS ARE IRREVOCABLE.

FASTER PAYMENTS: FASTER PAYMENTS ARE SIMPLY PAYMENTS THAT TRANSACT MORE QUICKLY THAN LEGACY SOLUTIONS. THEY ARE BUILT ON AN EXISTING PAYMENT INFRASTRUCTURE AND MAY BE FOCUSED ON SERVING SPECIFIC NICHE MARKETS AND USE CASES. THE CLEARING AND SETTLEMENT ASPECTS OCCUR ON DIFFERENT TIMEFRAMES, AND RETURNS AND CHARGEBACKS MAY BE PERMITTED.

Figure 6: Real-time payments B2B applications fall lower among expected use cases.

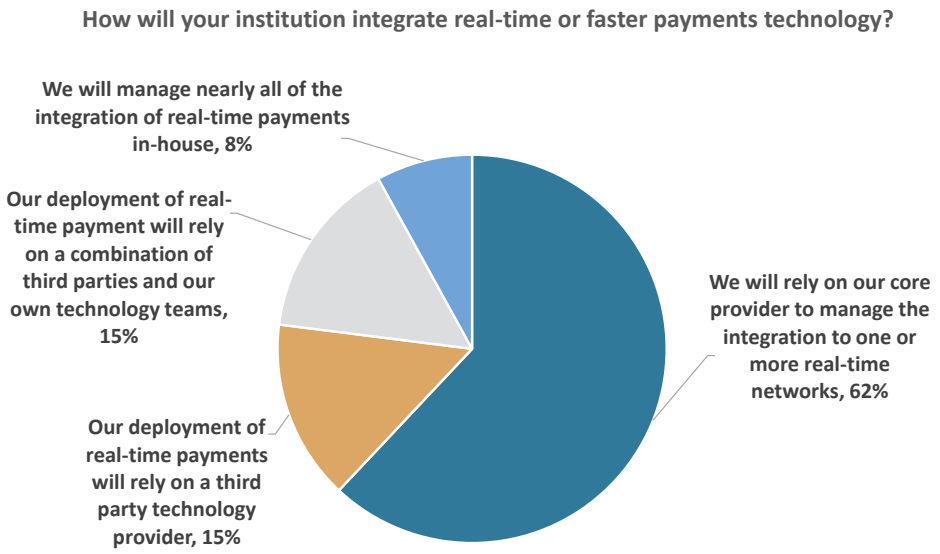


Source: Mercator Advisory Group Survey of Senior Banking Executives

Executives report, on average, a 4.2-year timeline for their institution to develop and deploy real time payments. On average, they expect 3.9 years before revenue begins, and perhaps surprisingly, consumer-focused organizations expect significantly sooner revenue realization (2.9 years) than commercial/small business-focused FIs (5.2 years), or FIs with combined consumer/business focus (3.5 years). Nearly half (47%) claim they are already driving real-time payments revenue. Executives expect an average 4.3 years before real-time payments becomes a mature product at their institution, although 40% claim to be generating revenue from these products today. These perceptions are consistent with executives' personal expectations for an average 4.1 years before real-time payments become a significant method of payment in the U.S.

Given these timelines and deployment expectations, how do executives expect real-time payments to be integrated at their institutions? The answer is overwhelmingly through core providers and other third parties (Figure 7). This expectation builds on the key role outsourcers and third-party specialists play in determining cloud-based payments strategies, as discussed previously.

Figure 7: Third parties will play critical roles in real-time payments integration



Source: Mercator Advisory Group Survey of Senior Banking Executives

Strategic Implications

The electronic payments era has been one of fast evolution of products and infrastructure. As payments have come to comprise a strategic component of non-interest income at financial institutions, and as payments-generated data streams enable the creation of new payments products and services, financial services decision makers have become open to cloud-based infrastructure that supports faster product rollouts, improved customer experience, and flexible "as-you-go" implementation and cost realization. For executives likely to cast their institutions as leaders in payments, these capabilities are essential.

The advent of real-time and faster payments is turning up the urgency of infrastructure modernization, a process already accelerated by the pandemic environment. Banking executives expect real-time payments to be contributing revenue within five years; some are already realizing revenue attributed to faster payments, likely via the earlier rollouts of same-day ACH and interbank P2P services. The under-five year timeframe leaves time to develop strategic plans and commitments, but awareness of the looming competitive challenge is high.

Just as FIs have come to accept and rely upon cloud-based infrastructure, so have they come to rely on outsourcing partners. Even executives from large FIs acknowledge that decisions regarding payment solutions architecture, including cloud-based implementations, will be substantially in the hands of their outsourcing partners. In the fast-evolving business of electronic payments, the **collaborative and flexible combination of cloud-based implementation via outsourcing partners had become well-accepted as means to achieve modernization needs in payments.**

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