Alacriti

Payments in 2022: What You Need to Know

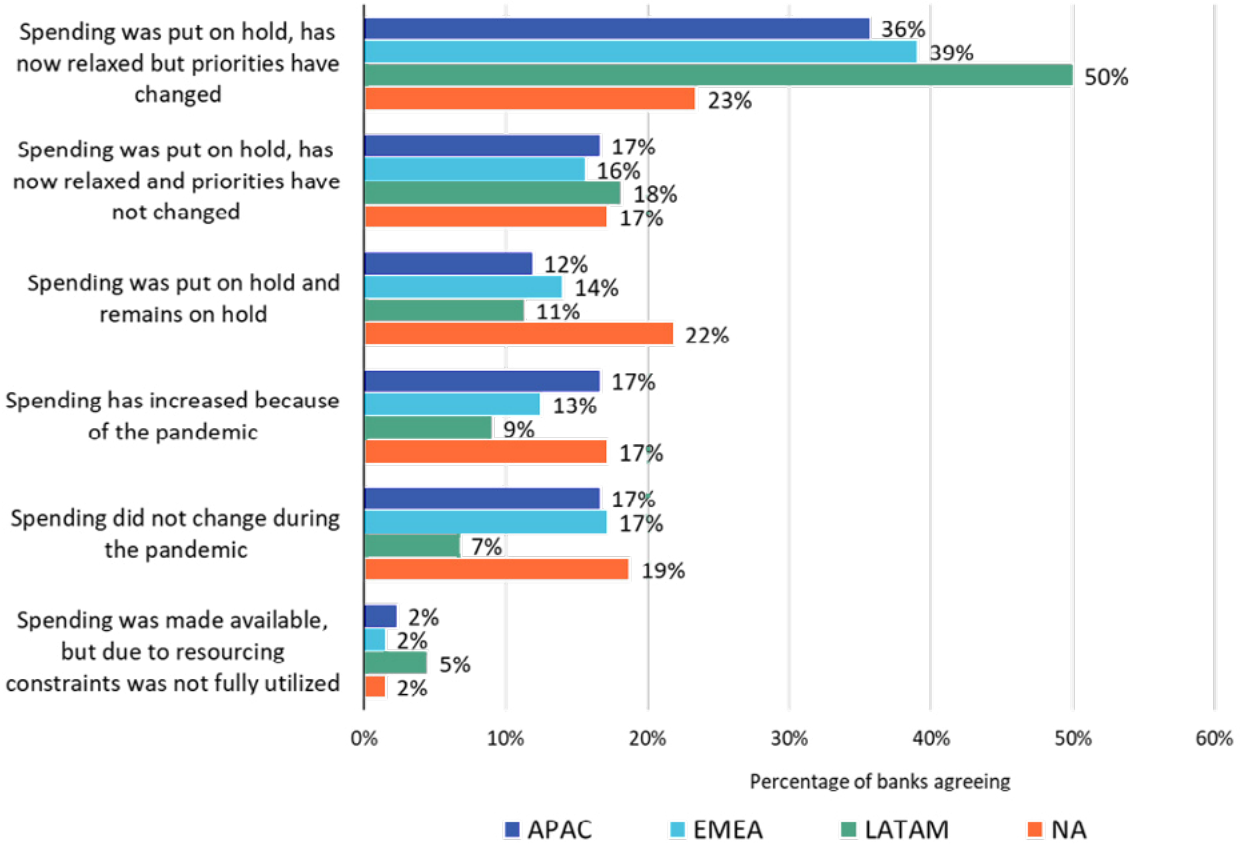
Financial institutions have had a lot to grapple with—from consumer payment habit changes to addressing the issues they had pre-pandemic, and not least the need to modernize their payment solutions to support new payment methods and rails. Two themes, in particular, are being discussed at every bank—cloud and real-time payments. In a webinar, Gareth Lodge, Senior Analyst, Global Payments at Celent and Mark Ranta, Payments Practice Lead at Alacriti discussed how banks should approach this opportunity to be at the forefront of change.

Changes from 2020

There have obviously been massive changes over the past two years with the pandemic. However, Lodge had predicted a lot of change for 2020 even before the pandemic. "I do these kickoff for the year calls on a regular basis, whether for banks or for vendors or investors or government agencies. And I was reminded that when I did the equivalent in January 2020, I was saying 2020 was going to be the most pivotal year in payments, possibly ever. And that was because of the scale of change that was taking place, not just in a particular market but right across the board touching pretty much every single bank globally at the same time."

2020 changed where we do business, and how we pay for things—which changed the revenues of banks dramatically. The revenues for the Coalition Transaction Banking Index showed that cash management was hardest hit. This resulted in significant pressure to cut costs and find new sources of revenue.

Celent did a large global survey (The State of the Nations for Payments Modernization) on 200 banks in different countries. The below chart of the survey results shows how banks responded when asked how COVID-19 impacted their investment in payments technology. By late May 2021, 22% of U.S. banks reported IT spending remained on hold, with another 23% seeing their budget priorities changed.

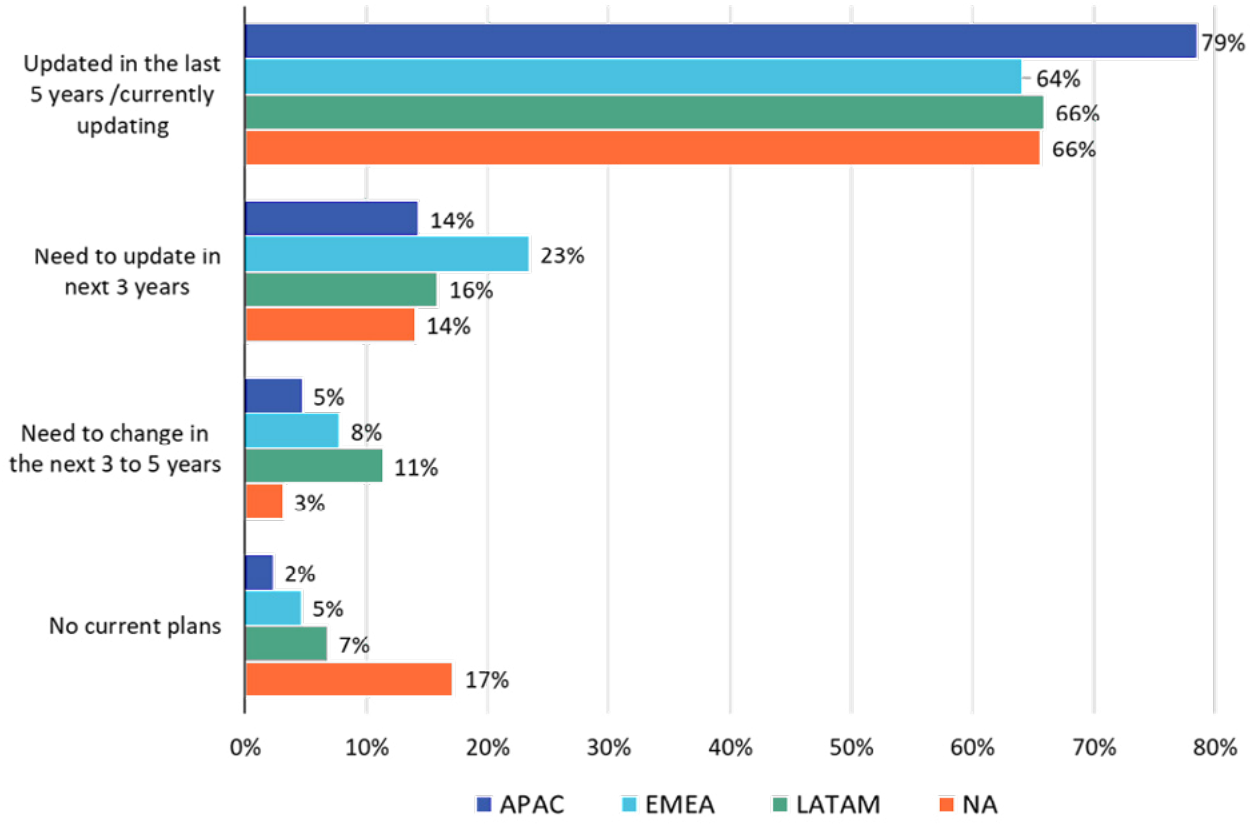


Source: Celent "State of the Payments Nation Survey", May 2021

Banks were finding that some of their digital processes weren't as digital as they assumed they were, e.g., the ability to allow customers to open and close bank accounts remotely. So they went into 2022 with a backlog of items that should have been done over the last two years, and an increasing list of things to do *because* of the last two years.

Wire Modernization

Wire modernization is well under way for every region—except the U.S. Twenty percent of U.S. banks reported that they had no plans to update their wire platform. Because of the SWIFT MT to MX conversion, more than 9,000 banks globally had to migrate to that new platform to be compliant with ISO 20022 standards. Real-time payments go hand in hand with updating the wire plan. Lodge recommends that in 2022, financial institutions start with wires. "So why do we say 'start with wires'? Well, because it is going to happen. There's been an awful lot of pressure from banks in the U.S. and other countries around the world to say the U.S. can't afford not to upgrade its wire system in line with the rest of the world. They will be the only major economy globally that hasn't."



Source: Celent "State of the Payments Nation Survey", May 2021

Modernizing the payment platform prevents issues with truncation between banks at different stages of their migration. According to Lodge, "There's no point in the rest of the world sending a data rich message and then reaching a U.S. bank and having to be truncated. We're losing a large part of the value of the migration."

U.S. banks should also consider that even European banks who were already doing ISO 200222 for ACH payments for a decade are struggling with the migration. It's a difficult process with old technology, and it's very different right across the value

chain. There is also the added pressure of a firm timeline. The American Bankers Association told the Federal Reserve in January 2022 that it supports their plan to migrate to ISO 20022 standards for their real-time gross settlement system (RTSG), and that a single-day switch should happen no earlier than November 2023. While 55% of banks have said they are updating wire systems now or over the next five years, that doesn't leave the 20% who have no plans at all, a lot of time to respond to this. So planning is more critical than ever.

There is a great synergy between a wire replacement and a real-time payment. They're not the same, but it's better to get a system that can do both with an extra spend than going with two completely different systems. There's an opportunity to piggyback one opportunity on the other. Mandatory spend almost always gets approved for the budget, and doing it this way ensures the additional spending does something that will generate revenue.

Wait for FedNow?

The vast majority of banks will be on FedNow. However, Lodge asserted that waiting for FedNow doesn't make sense considering the 1% Rule of Payments:

- The NACHA Top 50, 0.5% of the total number of banks, show that in 2020 accounted for
  - 86% of all originated volumes
  - 61% of all received volumes

Also consider that:

- Zelle has:
  - over 850 active participants
  - 1.2 billion transaction
  - Users from over 7,000 institutions
- Yet:
  - The 7 banks who own Early Warning are all The Clearing House owners as well
  - Many smaller banks use many of Early Warning's other services

To better understand this concept, YouTube is a good model. Only 1% of the users globally are actually creating and uploading content. Then there is only 10% or so who are regularly interacting and commenting etc. The vast majority of people are only using YouTube when they need it. If you apply the same kind concept to payment and use ACH as an example, the top 50 Originating Deposit Financial Institutions and Receiving Deposit Financial Institutions account for roughly half a percent of the total number of banks. Rounding that out to 1% in 2020 showed they accounted for 86% of all originated volume and 61% of all received items. The same logic can be applied to that top 50 banks by revenue, and the biggest corporates as well. The biggest billers in the U.S. all bank with them, whether there is a TV service,

a mobile service, or a car leasing company—they're all with the big banks. Or the major employers are with those big banks, and they're sending out payments. When you look at your individual bank and ask 'what proportion of payments are going to the big banks versus everybody else'?, it will start to make more sense why you need real-time payments.

There is also a very clear demand. Zelle now has over 850 active FI participants. There are users from pretty much every institution in the U.S. using the service. They've actively signed up to a service to get access to real-time payments. And the volume shows that they are using it as well. It's not a one off. Another common objection from banks is that they don't want to be beholden to TCH banks even though they're using Zelle and Early Warning. Lodge questioned, "Pretty much all the owners of TCH are the owners of Zelle and Early Warning. So why is it okay to do it in two examples, but not the example where actually they could generate revenue?"

Real-Time Payments and Revenue

It's important to understand the revenue model. There is a common misconception that real-time payments are just P2P. Lodge presented modeling that Celent did on the total payments in a number of markets. In most markets, only 6% are really P2P, and they don't have to pay to receive or send. Consumers on the other hand, generate 8% of all transactions (e.g. bills, shopping, restaurants, etc.). There's far more consumers than businesses—however, businesses account for 80% of transactions (e.g. payroll, insurance payments, etc). And they always pay to send or receive the money. Consumers are what creates the demand that businesses have to take real-time payments. They go into the business and say, why can I do this as a consumer, but I can't do it here at work? They're generating the interest and they're also generating the payment volumes, which the businesses will ultimately pay for.

Real-time payments are a tool to deliver payment solutions. Overlays are scheme-wide solutions available to all. They include QR codes, RfP alias directories, etc. and can be available off- and on-line. RfP can mean more sophisticated offerings for your customer, such as a discount when submitting early prompt payment without having to do manual paperwork.

Digital tools reference how the real-time payment is used. Leading banks expose APIs to allow or provide clients to embed real-time payments in their flows, or for themselves to use. Examples include: instant loan disbursal, “pay me now”, and conditional payments (e.g., factory gate release of goods).

Businesses don’t necessarily realize the value of real-time payments at face value, and it’s useful to help them understand what business problems will be solved by real-time payments. For example, a large Indian bank working with the largest internet retailer in India uses real-time payments to reduce significant manual steps in the return of goods chain. The courier presses a button on a hand device to scan the item returned and then everything else is automated. The consumer gets the refund in their account before the courier even leaves the premises. This leads to a much better customer experience, but also allows for automatic reconciliation. So the bank really sold a solution to a business problem rather than just real-time payments.

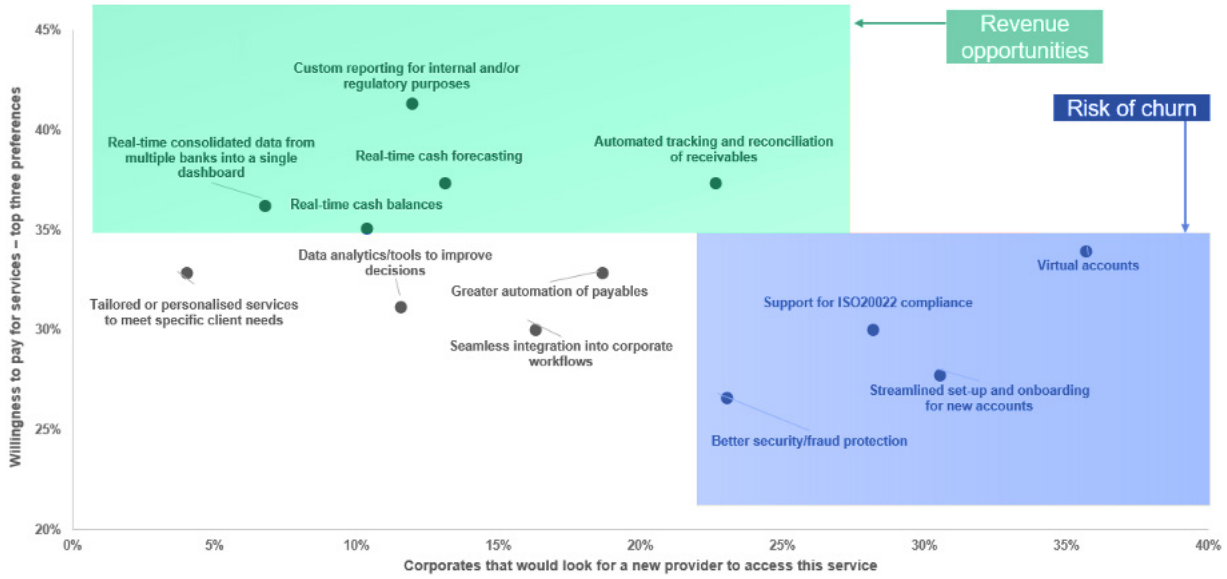
Another example is quick service restaurants. They tend to have staff that work on a casual basis, are relatively low paid, and don't work the same hours week to week. As a result, the manager has to sit down several times a week to figure out how many hours each person has worked and how much they’re to be paid. They literally take money from the till and put it into an envelope in the safe to pay an employee when they need to pay it. This results in multiple trips to the safe in a week because people work different shifts. Lodge shared that they’re seeing that restaurants in a number of countries are using relatively simple technology that allows the staff to clock in and out and it calculates what they’re owed. The workers may have a preference for how and when they get paid. The default might be weekly or fortnightly, but some might want immediate payment, which can be accommodated. That’s a massive saving in time and effort for the store manager who doesn’t have to do all that accounting, and it's much more accurate. It's definitely a worker retention tool, but there's also more benefits because they don't need to have as much cash on premise. Their business insurance rates are lower and they can put cash into the bank much sooner. So again, the business doesn’t realize necessarily that they’re buying real-time payments, but real-time payment is what's enabling all of this.

There are constantly new use cases coming out for real-time payments. “The bill payment focus of the request to pay/request for pay model (depending on which network you're talking about), has the potential of changing the way we as a nation pay bills. We've been in a biller direct model or bank bill pay model. The Request for Pay model is going to bring those two models together. The pilots that Verizon ran with BNY Mellon, and Chase for B2B is a first step in seeing this more. So from

a perspective that bank bill pay is a high cost item, this is an area to keep a close focus on, and another use case that I think we will see ROI cases pop up around," said Ranta.

Demand for Real-Time Payments

Celent did a 2021 survey on 200 plus corporates and 200 plus banks globally where they asked questions around payments and data monetization. The research clearly showed that the corporates are asking for what they *think* the banks can deliver, but they have pretty low expectations about what a bank *can* deliver. So Celent redefined the type of thing they might want to buy. In the below chart, it's very clear that the top box is related to real-time payments. The value comes from getting the payment, seeing who it's from, that it can be reconciled, and the ability to use the money. The top box shows real-time consolidated data, real-time cash forecasting, real-time cash balances, automated reconciliation—all things that are driven by real-time payments that a financial institution can deliver. There are a few things that are churn opportunities. They might not look immediately to real-time. But when we look at it by size and sector, a good number of corporates are saying they would swap a bank if their bank can't provide it.



Source: Celent

Urgency for Modernization

Failure to prepare is going to be the critical piece with so much that has to get done in such a short period of time. With the Fed migrating to the ISO 200222 standard for their RTSG, there is little time to get a new UI system live, which most likely means that financial institutions can't use an on-premise solution.

Lodge shared that in other countries (e.g., Malaysia, India, China, Europe, Australia etc.), there have been companies that use the real-time rail to bypass the card networks. In Hong Kong, there was a noticeable drop in card volume at all the major banks when companies like Alipay and Tencent bypassed the card networks with QR codes. Financial institutions can assume that if they don't offer real-time payments, behemoths like Amazon or PayPal will. Also consider those who *do* have this capability are going to be attracting more customers, making modernization a must.

Current systems can't be simply updated for ISO 200222. Now is the time to choose a vendor who can support your transformation. Lodge also predicts that the cloud will increase in significance. "Everything's going to be cloud going forward. In the last 18 months, probably even just 12 months, every single RFI we've worked on or seen has gone to a cloud service, every single one. And that's from the biggest banks globally."

Ranta agreed on the urgence of payments modernization. "2022 is the year that you can't wait. You have to start looking at these projects and your payments modernization. Those RfPs are going to start coming in and being needed to issue. And if you wait too long, you're going to be too far back in the queue to meet those dates. The TCH RTP® network has 200 FIs right now. The volume is growing at a pretty impressive double digit CAGR month on month. This is a year of action for starting your projects or at the very least planning for your projects."

A New Perspective

Ranta also recommended not looking at the systems independently. "You need to be looking at all three of these together. This is the new payment platform. Think about real-time payments that are ISO 20022-based together down the line that could lead to interoperability. With all of the use cases, revenue opportunities and risk of churn—you need to have all of that data coming through one system. So I think it is important to not look at these systems independently of one another. They shouldn't be looked at as monolithic applications in the same way we did the on-prem deployments 15-20 years ago, but instead, a holistic platform."

The key is to take a customer-centric approach when looking for a new faster payment solution. Think about the user experience and it's orchestration of the payment from the clearing and settlement. A platform that has multi-rail access with a fast time to market is going to be key for a lot of financial institutions who don't have the budgets to build independent connections and bring them back together through a middleware technology layer.

Which Network is Best?

When asked if financial institutions should choose TCH, FedNow, or Zelle, Lodge explained that it's not as simple as one being 'better' than the other. "I think increasingly we will see vendors who integrate all of them, with the routing decision done by the vendor. So I think at the moment it's about understanding what you need

today, but the landscape is going to look quite different in 2-3 years time. And it's likely we'll end up with all of them. So it's really the prioritization rather than saying, 'I can only choose one going forward'."

Ranta added, "The volume of digital payments and the volume moving to these bank networks is, at some point, going to start eating into debit card payment, credit card payments, and some of the existing systems that are there because we didn't have real-time rails at the heart of our ecosystem. If you think about where we are on the adoption curve and where we are as a country, banks are going to have to support consumer decisions with respect to paying how they want to pay and where they want to pay. There's a very good chance that all of those networks and more are in our ecosystem in five years. And some of that is going to come at the expense of existing systems like ACH and cards. But as a whole, I think we're going to see an increase in digital payments and all of those networks will see their fair share of volume."

Moving Forward

'What does a migration project actually take?' is a common question. Every financial institution is different. But with cloud-based deployments, it's significantly different than the on-prem or even data center deployment for the last 10 years. Thinking about these things as projects that will take months to years is not the case with a lot of modern technology. With the cloud-based providers it's more weeks to a few months, or a quarter at the most to get the project up running.

With the upcoming ISO20022 migration of FedWire, and the growing importance of RTP and volume growth, and the FedNow pilot now in full gear and getting ready to launch, it's really time to take action. It's a short project to connect for receive only—Alacriti has had clients that take as short as ten weeks. So from a project planning perspective, it's not a heavy lift. By not starting now, you're losing out on deposits and the customer base that's looking to get their funds immediately into their counts.

The business case will vary from bank to bank, although most payment rails and products have very long shelf lives. The average age of the technology in many banks is 15-20 years. So think about what the world will look like in 5, 10, and 15 years. We expect everything to be instant, so does it make sense to think we'll still be using slow ACH and checks? The business case is positive in terms of revenue, but there's also a strong business case for the cost of *not* modernizing.

*To learn more what 2022 has in store for payments, watch the full webinar, **Payments in 2022: What You Need to Know**, featuring Aite-Novarica Group and Alacriti.*

Today's legacy and siloed banking technology infrastructure limit financial institutions' ability to rapidly innovate. It's time to look at money movement in a new way. Alacriti's Orbipay Unified Money Movement Services does just that. Whether it's real-time payments, digital disbursements, or bill pay, our cloud-based platform enables banks and credit unions to quickly and seamlessly deliver modern digital payments and money movement experiences. To speak to an Alacriti payments expert, please call us at (908) 791-2916 or email info@alacriti.com

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