
Processing: where business and technology meet

It's finally happening. Spurred on by the creation of SEPA, the European processing sector is beginning to consolidate. But what are the business implications of a more open and dynamic environment?

Overview

The consolidation of the European processing sector has been predicted for many years. With a steady stream of mergers and acquisitions it is now happening – and it's happening far faster than many people had imagined possible.

This White Paper provides an update on recent developments. It assesses some of the business implications for retail banks. And it provides insights from several perspectives – the retail bank, the third party processor and the industry vendor.

It also provides an overview of the role that Visa Europe sees for itself in a larger, more harmonised, more dynamic processing market.

In April 2007, Visa Europe hosted Insights 07: Payments Forum Europe, a major meeting for its member banks – the financial institutions who issue and accept Visa payment products.

Based on input from members and industry experts, the event provided a forum to discuss the themes that matter the most to today's payments businesses – from long term, strategic decisions to practical, everyday business issues. This is one of a series of White Papers which draws on the meeting content.

Other White Papers in the series include:

- Contactless: accelerating cash replacement
 - European banking: between the extremes
-

The plates are shifting

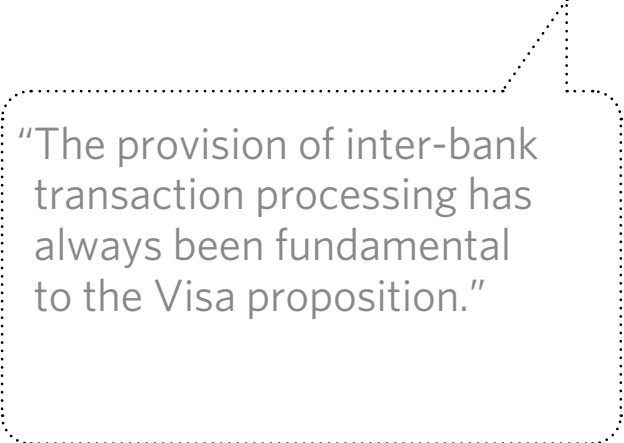
The provision of inter-bank transaction processing has always been fundamental to the Visa proposition. And, to gear up for the future, Visa Europe has invested substantially in an all-new, all-European processing platform.

The aim is for Visa Europe to:

- Develop payment and processing solutions from a European perspective
- React – quickly and effectively – to the huge changes taking place in the industry on what seems like a daily basis

Visa Europe therefore takes a close, vested interest in the changes occurring across the processing sector. And, at Insights 07, a panel of industry experts was invited to provide their own personal insights into:

- The change that is happening in their world
- How it affects them
- And how they are reacting



“The provision of inter-bank transaction processing has always been fundamental to the Visa proposition.”

Expert Insights – (i) the industry consultant

Chris De Smet is head of the Unysis European Payments practice, and also works as a consultant to Visa Europe. Over many years, he has seen the inside of the European payments industry from every possible perspective – having previously served in senior management roles for a major issuer, a major retailer and a major European inter-bank processor.

At Insights 07 he provided an overview of recent changes in the processing sector and provided his perspective on the implications for retail banks.

SEPA is the catalyst for change – but what is the impact?

De Smet noted that the SEPA initiative, and also the threat of further regulation, had catalysed the change, and he outlined what he saw as the big implications.

- **Price convergence** – In instigating the change the politicians focussed not on the way payments have always been processed, nor on the implications for banks, but on the cost of services to consumers or merchants. Consequently, there is a real risk that payments income will converge towards the lowest level. This, suggested De Smet, will have a severe impact on the bottom line, and many banks can expect to lose up to 50 per cent of payment revenues.

- **A full and expensive restructure** – Larger pan-European banks are able – and are likely – to bring their own costs down by investing in a new SEPA payment infrastructure. However, investments are very significant and, from De Smet’s direct experience, can easily add up to between €20 million to €100 million. For the smaller banks, there is little flexibility. Their fate will be largely determined by the developments in the processing sector.

- **An unbundling of scheme and processor** – The international card systems are expected to increase their inter-bank processing volumes whilst decreasing overall cost to the individual banks. However, this is not a foregone conclusion. Several other players, including the larger third party processors and also the automated clearing houses (ACHs), are eager to become more active in inter-bank processing. And, just like the domestic incumbents, the international card systems will have to be alive to the regulatory expectation for a complete unbundling of scheme and processing.

In demonstrating the scale of the changes afoot, De Smet reviewed the sheer frenzy of merger and acquisition activity over the past months. Despite the apparently high acquisition prices now being paid, he predicted that the trend will continue for many months to come.

Which areas of the processing business will be most affected?

Although processing is often described as though it were one homogenous business, it does in fact consist of three fairly discrete elements: issuer processing, inter-bank processing and acquirer processing.

De Smet suggested that the new environment would have little impact on issuer processing, but predicted major shifts ahead in the inter-bank and acquirer processing sectors. In particular he highlighted three big considerations:

- Pan-European merchants are pressing for consolidation of the acquiring market and require more integrated servicing. This, in turn, challenges the role of the banks, many of whom have already relinquished their acquiring operations to third party processors.
- The way the regulatory situation evolves will have a direct impact on the level of consolidation in processing. For example, a sharp reduction in interchange would create a significant strategic challenge for banks, which will also feed through to the processing market.
- The role of the card systems in the processing field is yet to be determined. “In my view there is clear opportunity to rationalise the overall value chain and make better use of the facilities offered by the card systems,” De Smet suggested. He also indicated there was real scope for partnerships to evolve between domestic players and international card systems.

Indeed, unless they pursue such options, the outlook for many domestic processors – especially those in small to mid-sized countries – is very challenging.

Different segments – with discreet needs

De Smet shared analysis from Unisys, which summarises the discreet needs of four types of bank.

- The large intra-regionals who, depending on group strategy, may be seeking their own group-wide platform. This would deliver a cross-border processing capability, liberating the true benefits of their on-us volumes and creating sophisticated value added services.
- Then there are the large domestic players. Again, they want to liberate the benefits of their on-us volumes. They are also looking to their processing partners to deliver an economic and modular offering, which takes account of their large payment volumes. And they have high expectations for sophisticated value added services.
- The smaller domestic players are in a more difficult situation. They tend to be very dependent on the integrated, end-to-end processing offer from their existing domestic processor. But, with lower volumes, they may have difficulty attracting the attention – or extracting attractive pricing – from the third party processors.
- And finally, there are the subsidiaries of international banks. They are at the mercy of their parents, and fall into two categories. There may be a clear group strategy, in which case they will deal at group level. Or the strategy may be nascent, in which case the needs will depend on the size of the bank itself or the group.

“From our own experience, the subject is very much on the agenda. Banks are actively considering their options. They are evaluating outsourcing and off-shoring. And they are looking specifically at their payments processing operational environment,” De Smet observed.

What sourcing options will be pursued?

Only the very large players, with clear ambitions to expand across Europe, are considering a total in-source option. And, to get a better payback from the necessary investment, they will be eager to offer their service to smaller banks.

Smaller banks will inevitably pursue an outsourcing strategy. They will be willing to outsource most, if not all of the payment processes. But, selecting the right partner will be a new experience. And they will need help in dealing with this changing dilemma.

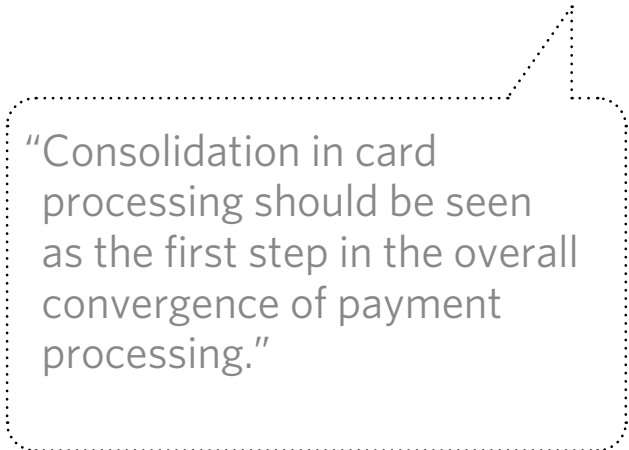
By contrast, medium-sized players, and those present in several countries, will opt for a multi-sourcing strategy. They will consider the strategic importance of payments within their business model and keep control of the core components. They will look at how they can consolidate within and across the group.

By moving all processes to one platform, and selecting their least expensive environment, they will be able to liberate big savings. But, like the smaller banks, they may need help in selecting what and how to outsource the remaining functions.

Doing nothing is not an option

In conclusion, De Smet offered up three central points:

- Banks should aggressively drive cost reduction across all aspects of their payment operation in order to compensate for the inevitable decrease in payment-related revenues. For every bank, this is an achievable aspiration. In particular, the structures of the past have entailed significant inefficiencies. SEPA provides an opportunity to re-model these structures – delivering greater flexibility and increased efficiency.
- If banks believe that payments are strategically important to them, they need to work much harder to understand, track and optimise their profitability. “Today, very few banks do this in a sophisticated or meaningful way,” De Smet suggested.
- Consolidation in card processing should be seen as the first step in the overall convergence of payment processing. This will have particular implications for the domestic processors (who will find it difficult to achieve enough scale to compete effectively). It will also have implications for the third party processors (who have traditionally offered “pure play” card processing services, and will need a broader role to succeed in the new European environment).



“Consolidation in card processing should be seen as the first step in the overall convergence of payment processing.”

Expert Insights – (ii) the multi-country retail bank

Herwig De Preter is general manager of KBC Group, with responsibility for product development and process management of debit and credit card operations in Belgium and Central Europe (with operations in the Czech Republic, Hungary, Poland and Slovakia).

KBC recently conducted a review of its payment processing operations and De Preter travelled to Insights 07 to update delegates on the decision-making process and the bank's chosen solutions. He began by emphasising the two key attributes of KBC Group with regard to its processing operations:

- It is a multi-country organisation which has grown (and will continue to grow) by acquisition
- It is in the business of retail banking

These two attributes have determined the nature of its legacy processing operations, the way they have already been adapted, and the way they will continue to evolve in the future. De Preter then went on to outline four key processing-related challenges faced by the KBC Group:

- KBC Group had inherited a different processing platform in each country. Yet, clearly, in order to create synergies and maximise efficiencies, more simplification and integration is crucial.

- The banks within KBC Group consider themselves a partnership of equals. There is no single dominant bank and they all operate within quite small national markets. An important part of the culture, therefore, is the respect for local management and a reluctance to impose monolithic solutions.

- As with any other publicly-held bank, KBC Group faces a pressing requirement to optimise its cost-income ratios. One means of achieving this is by pooling its payment volumes which, in turn, requires more consistency and integration of the processing platforms.

- The SEPA initiative is an important consideration for the group. While the immediate impact is in Belgium, the principles will be extended to the Central European operations, which also face the challenge of migrating to the euro.

In addressing these challenges, three key considerations were highlighted:

- For a group of KBC's size, and one which had previously had a positive experience with third party processors, some element of outsourcing is inevitable. The big question is how far should outsourcing go? And which parts of the value chain should be kept in-house?

De Preter suggested that the core banking functions (such as the management of the commercial relationships with cardholders or merchants) should, under no circumstances, be outsourced. At the other extreme, for international activities (such as authorisation, clearing and settlement) outsourcing was a necessity. And, in the middle ground, there was a strong rationale for seeking synergies.

Another consideration is, however, the cohesiveness and capability of the internal information communications technology (ICT) function. "When you want to in-source, your organisation must be ready and, in the past, our internal organisation was not ready for demanding, group-wide projects," De Preter explained. More recently, both ICT and payments have become global, shared services, which bring more flexibility.

- When rationalising the different processing operations, an important (and extremely sensitive) consideration is whether local platforms should be adapted or group-wide solutions should be adopted. "Intellectually it's easy. You should always simplify the group-wide systems. Practically it's far more difficult. You need to be sensitive to people and cultures," De Preter suggests.

The approach at KBC Group has been to ensure that local management is closely involved in the decision making process and to avoid "one size fits all" solutions. Some banks may, for example, do white labelling or front-end adaptation. Others will not.

- Governance of the processing infrastructure is also a consideration, especially for banks that have been accustomed to a collective approach. In Belgium, for example, KBC used to be a co-owner of Banksys, with direct representation in its decision making processes. Now KBC is a customer of Atos Origin.

"The shift from shareholder to customer is a significant one, which requires very different disciplines," De Preter observed. For example, there is much closer monitoring of costs and service level agreements. Equally, there is a real requirement to work as long-term strategic partners.

Looking to the future, De Preter made two broad observations:

- While the process of integration and simplification is ongoing, the banks in each country will always retain the flexibility to serve local customers in the most appropriate manner. As De Preter explained, "In the new SEPA environment, each local bank will still have its own platform. But it will be smaller, because the common payment factory will be bigger."
- Card payments are only one facet of the retail banking payments business and have to be viewed accordingly. In the future there will be a need to pool volumes of all electronic payments (that, is direct debits and credit transfers as well as cards) in order to deliver more flexibility and liberate greater cost efficiencies.

"The shift from shareholder to customer is a significant one, which requires very different disciplines."

Expert Insights – (iii) the pan-Nordic and Baltic retail bank

Jan-Olof Brunila is head of group card services for Swedbank, the leading bank in Sweden, Estonia, Latvia and Lithuania, with operations across the Nordic and Baltic regions. He is also a member of the European Payment Council's Cards Working Group.

He used Insights 07 as an opportunity to reveal the details of a major new processing deal with Visa Europe and also provided his perspectives on the wider changes in the European processing sector.

In terms of the deal with Visa Europe, Swedbank and Nordea will use VisaNet to switch and route all domestic point of sale (POS) and ATM Visa transactions. In addition Visa has, since 1995, provided all Swedish member banks with a customised solution for the clearing and settlement of POS transactions.

As part of the deal, Visa Europe updated its systems to meet Swedish security requirements, including:

- Dual authorisation for automated fuel dispensers
- Transmission of electronic watermarks for ATM transactions

As the deal becomes established, it is anticipated that more local banks will take advantage of the scale economies, with the potential for VisaNet to act as a major pan-Nordic authorisations platform.

Brunila said, "The decision to use Visa's payment processing solutions for domestic Visa payments can only improve the efficiency of card processing across the region since Visa is a new entrant in authorisations processing in Sweden. This will contribute to increased competition, which will benefit us as a buyer of these services."

Providing more background, Brunila said, "In the position we are in today, Swedbank uses more than one processor. But we are working to consolidate our own processing environment. As the first step, we are creating a single group gateway. All of our incoming and outgoing payment traffic will come through one in-house facility, and we will use Visa to route transactions to other parties."

Although the case for collectively-owned domestic processing services may become untenable, Brunila suggested there was still a rationale for the model to be used on a region-wide basis. He said that the Visa governance model gave the bank a good degree of understanding and influence over pricing policies.

As regards acquiring, he emphasised that, irrespective of what may be happening elsewhere in the industry, this was an area which Swedbank remained very much committed to. As well as providing oversight of the way cards are accepted, it was an important component of the bank's service to corporate clients.

Expert Insights – (iv) the third party processor

Kelley Knutson is managing director of TSYS Europe, one of the world's leading providers of issuer and acquirer processing services. With the recent acquisition of CardTech, it has also expanded into software solutions.

Knutson travelled to Insights 07 to provide his personal perspectives on the developments in the European payments processing sector.

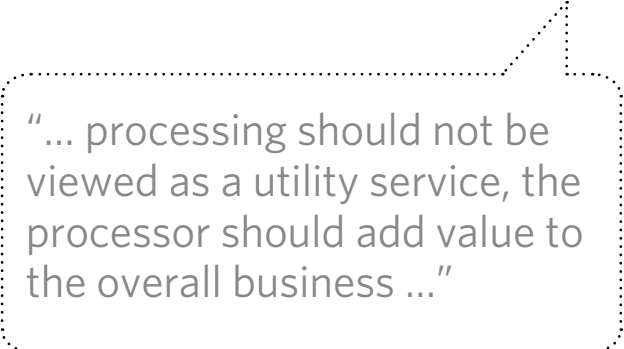
In terms of how the sector has already changed and the way it is likely to change in the future he said: "Two years ago there were 80 processors operating across Europe. Now it is down to around 65. And, over the next five years we see that consolidating to somewhere between 20-to-25."

Of these, he suggested that four or five would be large scale, high volume players. A further six-to-eight would succeed in finding a mid-range processing segment. Then, a whole range of players that have capabilities in a specific niche would successfully secure high volumes within that niche.

"This is not a winner takes all market," he said. "The belief that a single processor can give you everything you need is not going to happen soon and it might not ever happen. You need to look across the landscape and look at different processors providing different services."

In the longer-term however, he suggested that the more successful processors would be those that operated across the whole value chain. He also emphasised that processing should not be viewed as a utility service. Instead, the processor should add value to the overall business – and the choice of which processor is actually used should be informed by the bank's own business strategy.

"When you think about processing as a buyer of services, the conclusion is that it is a long term strategic relationship you are forming."



"... processing should not be viewed as a utility service, the processor should add value to the overall business ..."

A clear picture emerges

Based on the perspectives offered, a clear picture emerges.

The processing sector has already changed. More changes are coming. And this is giving banks more choices – and more strategic choices – about how they manage their payment processing operations.

This is one of the big SEPA benefits. The payments value chain is being unbundled. Banks are free to choose between more providers, and more commercially-minded providers, across every link of the value chain. And they are all eager to do more business.

Equally it is clear that several different processor models will be required. Different banks need different services. And no single processing provider will have the scale, connectivity or credentials to do everything for everyone.

The Visa approach

So, how does Visa Europe fit into the picture?

A clear commitment to SEPA

First, Visa Europe is fully committed to the SEPA. The organisation moved quickly to implement the SEPA principles in its own processing business.

For members, there are no mandated processing solutions, no bundled pricing, and a clear separation between Visa Europe's card solutions and its processing solutions. Domestic or cross-border, members choose when they use Visa's processing services and how they use them.

A clear commitment to processing

Having said this, Visa Europe is fully committed to processing more transactions. The organisation believes – very strongly – the more transactions Visa switches, the more value Visa's card solutions can deliver.

By processing more transactions, Visa Europe can:

- Ensure interoperability and reliability
- See the market dynamics and monitor service quality
- Support new payment services – like cash back, balance enquiry, recurring payments or card not present
- And, ultimately, accelerate cash replacement

In other words Visa Europe sees a clear linkage between the two sides of its business: the card solutions and the processing solutions. Each reinforces the other.

The Visa approach

A significant investment in capability and capacity

Because Visa Europe is so committed to processing, and because processing can add real value to member businesses, the organisation has invested heavily in its capabilities.

Visa Authorisation is the all new European switching platform. It is highly capable, very flexible and eminently scalable. Also, a new European clearing and settlement platform is nearing completion.

So, through Visa Europe, members get access to a pan-European switching system which is expected to lower transaction costs, deliver greater scalability and flexibility and also meet local market needs with locally configured payment services.

An important point to emphasise is that this is a collective investment. Visa members own the system, they control it, they choose how it is developed and how it is deployed. They also benefit from the economies of scale.

It is well established that Visa Europe offers best in class pricing – which covers today's processing plus all of tomorrow's development and compliance costs. So members have stability and certainty.

Today, issuers pay an average cost of just one cent per transaction, falling to half a cent for the most frequent users. The aim is to capture as many transactions as possible.

Also, because it is a distinct European system, all the data stays in Europe, which is what the regulators desire.

A clear business focus

Visa Europe is also very clear about the business it is in.

- It is not involved in acquirer processing
- It is not involved in issuer processing
- Instead its core capability is inter-bank processing – or switching

Switching is a small but essential part of the total processing business, but an essential part. It is, from Visa Europe's perspective, the pivotal point in the value chain. And, given the capability of its new European platforms, Visa Europe insists that it can do it better than any other provider.

Liberating a collectively owned resource

As well as working for members, Visa Europe is also well positioned to work with other processors.

- Supplementing their services
- Reducing compliance costs
- Rationalising interfaces
- Simplifying back-office processing
- Enabling product enhancement
- And partnering with them to deliver compelling, end-to-end processing propositions

The vision is for Visa to be the best switch for everyone, which ultimately means, that any payment traffic can be handled (Visa and non-Visa, card and non-card). The processing operation can therefore be regarded as a collectively owned, European asset, designed specifically to deliver value to European banks.

.....

To find out more about
this topic:

.....

Visa Europe Insights 07:
Processing: where business
and technology meet

.....

This is one of a series of publications that addresses some of the dilemmas facing players in the payments business. The series includes:

European banking:

Between the extremes

Processing:

Where business and technology meet

Contactless:

Accelerating cash replacement

To obtain copies of these publications, please contact Visa Europe Corporate Communications on +44 (0)20 7795 5463 or bartletl@visa.com