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Reshaping the vision
Emerging stronger from market transformation

Transaction Banking:
Reshaping your business to take advantage of the shift in global commerce, clearing and custody.

October 2011

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Contents

Introduction

'Neither a wise man nor a brave man lies down on the tracks of history to wait for the train of the future to run over him'

'Neither a wise man nor a brave man lies down on the tracks of history to wait for the train of the future to run over him', said Dwight D. Eisenhower. For transaction banks, the locomotive of change is coming up fast as the focus of global trade (physical and financial) and the way companies transact are transformed.

As we examine in this paper, key developments include the rapid increase in emerging-to-emerging market commerce and the growing proliferation of virtual marketplaces and new digital payment platforms. Transaction banks must find ways to follow their customers and keep pace with their changing demands or risk losing revenues and relevance. At the same time, technology could help transaction banks to interact more closely with their customers and develop more effective ways to help them trade internationally and manage their working capital.

On the securities side, fund managers are adopting a more cautious approach to the custody of their assets and how their prime broker makes use of these assets. Reform of over-the-counter (OTC) derivative trading and the increased emphasis on central clearing are also driving the development of new business models, with the increasing demand for collateral and associated collateral services opening up significant revenue potential.

We have grouped the articles into four main sections, reflecting the key drivers that are shaping the changing environment for transaction banks:

- Thriving in a multipolar global economy.
- Keeping closer to your chosen customers.
- Managing risk and capital more effectively.
- Maintaining pace with market developments.

Each section opens with an outline of the relevant macroeconomic developments and resulting strategic implications for transaction banks identified in Project Blue: From ubiquity to precision, a wide-ranging PwC study of the prospects for the banking industry worldwide.

I hope that you find the articles interesting and useful. Please do not hesitate to contact either me or any of the authors if you have comments, queries, or would like to discuss any of the issues in more detail.

Julian Wakeham
Partner, PwC

Overview

Thriving in a multipolar global economy

Priming your business for the global shake-up

From central counterparty management to the development of new business-to-business (B2B) payment and transaction platforms, the value chain is in a state of flux and new business models are emerging. Western banks also face the challenge of building a presence within rapidly growing emerging-to-emerging market trade flows, much of which now bypass developed markets.

We believe there are three key questions that banks will need to address if they're to sustain competitive relevance in this rapidly changing environment:

1. How do you get closer to your chosen customers – who will be your key customers in 2020 and how can you develop a more profitable relationship?
2. How will you manage risk and capital more effectively – what is the impact of regulation on your business model and how can you develop a more favourable and sustainable balance between risk and reward in this new environment?
3. How will you keep pace with market developments – what competitive advantages can you bring to bear and what resources and technology will be required to support this?

Closer to your customers

Sustaining profitability in an increasingly commoditised market

As mainstream areas of transaction banking become increasingly commoditised, price pressure is going to intensify still further and already thin margins are going to be progressively squeezed. The shock of the financial crisis has also made sustaining liquidity the paramount priority for customers. This means that even the best transaction banks could miss out if they can't support a client's financing needs. Sustaining profitability in this highly competitive marketplace depends on being able to deliver the product and funding solutions that customers prize and are prepared to pay a premium for. The banks that are going to lead the way are already breaking down the silos between credit and transactions to develop mutually supporting solutions for their customers. The high value attached to liquidity also provides opportunities to market more sophisticated working capital solutions to mid-size corporations, with the latest innovations continuing to attract favourable margins, despite the aggressive price-cutting seen elsewhere in the marketplace.

Getting the most out of your sales force

The sales forces of most transaction banks are significantly under-performing other comparable sectors. As corporations look to rationalise their transaction systems on a regional basis, the pressure on banks to improve their win rate is going to be heightened by the likelihood of fewer, albeit bigger, mandates coming up for tender. Smart banks are rising to the challenge by seeking to develop the understanding and trust needed to anticipate client needs, pre-empt their competitors, and deliver larger and more sustainable revenue streams. The basis is more actionable client feedback gained through surveys of client staff, which is helping these banks to get under the skin of their clients and develop a more informed and better targeted approach to account planning. Yet, this will only reap the desired dividends if relationship managers are relentlessly pursuing the opportunities identified in the account plans, which will in turn demand a change of culture and working at all levels of the organisation.

Managing risk and capital more effectively

Getting to grips with Basel III

The latest proposals for Basel III would impose debilitating regulatory capital loadings on trade finance, leading to significant extra costs for banks and their customers. With the initial lobbying having made little headway, it's vital that banks make their customers more aware of the potential impact of the extra capital costs and harness their support in pressing for regulations that reflect the real risk and economic value of trade finance. Yet, even with concessions, the capital costs of trade finance are still likely to rise. While some institutions may choose to withdraw from an area of business they see as offering insufficient return on capital, trade finance will continue to be a key consideration in businesses' choice of banking partners. It will therefore be important to develop cost-effective ways to sustain trade support, including new structures, more efficient processes and closer collaboration with partner banks.

Prime custody – response to a growing market need

The Bear Stearns and Lehman defaults have led asset managers and hedge funds to demand greater transparency over where their assets are held and how they're segregated and re-hypothecated. The reform of OTC derivatives markets are also leading to the development of broker-clearing models, which are increasing demand for collateral and associated collateral services. In turn, traditional asset managers are moving away from long- only investment strategies to expand assets under management and increase fees, while at the same time exploring solutions to meet the need for safe and secure custodial services.

The result is a variety of solutions collectively known as prime custody, which fuse the roles of custody and prime broker:

- Broker using a third-party custodian to provide segregation of unencumbered assets.
- Build-out of prime business on top of custody in an in-house custody function.
- Outsource of asset servicing and focus on financing and client service.

Each of these models enables the custodian to assume a different role in the prime value chain. The challenge is how to provide the required level of security for clients and effectively segregate assets, as well as how to use client assets to collateralise positions in the most efficient way. A recent PwC survey of buy-side needs from their clearing broker highlighted collateral management and the ability to contain costs as key differentiators.[1]

Capitalising on new collateral demands

Regulatory developments are changing collateral requirements and making the efficient management of collateral a crucial competitive issue. Key developments include the move to central clearing of credit default and interest rate swaps, which is likely to require more and possibly higher quality collateral than would be the case within a bilateral trade. The market is also facing the impact of tougher capital and liquidity demands, new intraday reporting requirements and greater controls over how collateral is used and segregated.

As a result, forward-looking banks are pursuing ways to develop a more transparent, comprehensive and centralised approach to the management of collateral, which seek to use available collateral more effectively, reduce funding costs and offset risks. This in turn is likely to require greater automation and the elimination of product-focused silos.

There are also opportunities to expand the collateral offering to help clients trade more efficiently and reduce costs. This includes collateral transformation, in which higher quality collateral is deployed in exchange for lower tier assets. It also includes securities financing, in which collateral is lent to various parties to maximise profitability.

1. 'OTC Client Clearing, Voice of the Customer – the Buy Side' – October 2010

Keeping pace with market developments

Gearing up for the digital revolution

The advent of smart phones, social media and virtual marketplaces has already transformed business-to-consumer (B2C) commerce and now the way businesses transact, market their products and interact with each other is set for a similar shake-up.

Virtual platforms are capturing an ever-growing proportion of B2B commerce and creating ever-higher expectations for ease of access and usability. As virtual marketplaces proliferate, they're providing the financial infrastructure and trade guarantees that used to be the preserve of transaction banks. Recent months have also seen the launch of a new social media, currency-trading platform, which allows users to trade online, follow other traders and share tips in a chat room, all for free.

In turn, social media and mobile banking are shaping the way customers interact with financial services providers and creating openings for social media, telecommunications companies and other non-bank competitors to move into the payment and trade, finance markets.

This digital revolution opens up huge opportunities for transaction banks, allowing them to engage more closely with their customers, tap into rapidly expanding trade flows and extend the boundaries of commerce. Yet, it also raises expectations about ease of access and usability. Banks' ability to respond will be impeded by the weight of their legacy systems. They're also going to be facing increasing competition from mobile networks, internet service providers (ISPs) and other nimble new entrants looking to extend their grip on digital communications to the trading and transaction markets.

Turning cyber security into competitive advantage

The conventional approach to cyber security is coming under increasing strain. It's ill-equipped to keep pace with the constantly evolving and escalating threat of cybercrime. The 'lockdown' approach to security is also preventing institutions from making the most of mobile, social media and other digital opportunities. Keeping pace with criminal and commercial developments is going to require a more proactive approach to detecting vulnerabilities and developing the technology to counter them. It's also going to require a change of culture, in which business and security strategies are developed in parallel, and security becomes everybody's business.

Trading blocs: Where next for stock exchanges?

Recent months have seen a flurry of merger announcements in the global exchange sector. If they go ahead, they could accelerate the consolidation in an already increasingly concentrated sector in Europe and North America.

Leading stock exchange groups are looking to consolidation to help them trade across all continents and time zones, with the exchange industry providing a clear example of how macroeconomic trends, including changes in global capital flows, can drive consolidation and competition.

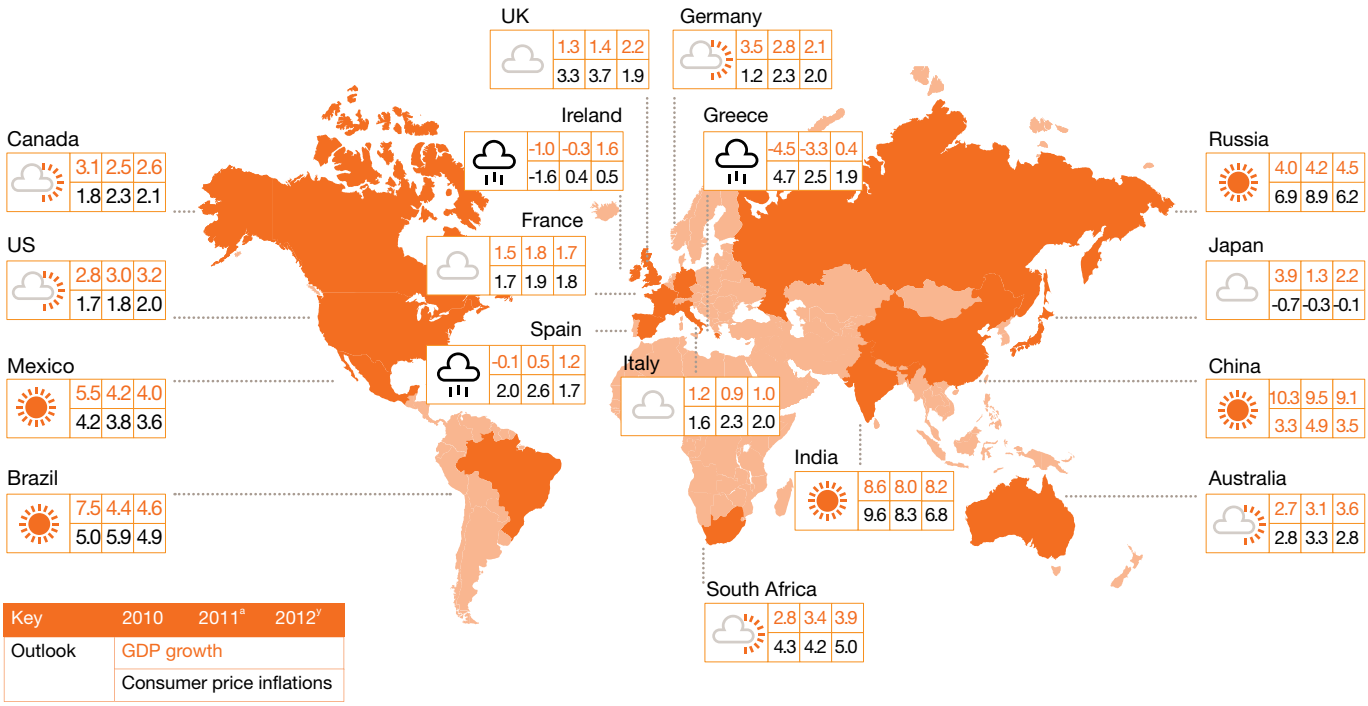
As IT costs rise and major groups face growing competition from new entrants, consolidation also allows them to shore up market share and develop economies of scale. In turn, the tie-ups can also help them to expand across the value chain. This includes developing their presence in derivatives and providing a full pre- to post-trading service where regulation allows. While it's trading that tends to attract the most attention, post-trading settlement and custody services are often the most complex and valuable areas of the business.

As the latest round of stock-exchange consolidation across Europe and North America comes to a head, the only remaining questions are how many exchanges the market can support and what happens to the handful of national exchanges that have retained their independence. As the axis of growth and market activity shifts South and East, the emerging markets are set to be the focus of the next wave of transformational deal-making within the exchange sector.

Thriving in a multipolar global economy

Priming your business for the shake-up in global trade

Figure 1: Eurozone faces a tough two years, while emerging markets are expected to expand rapidly



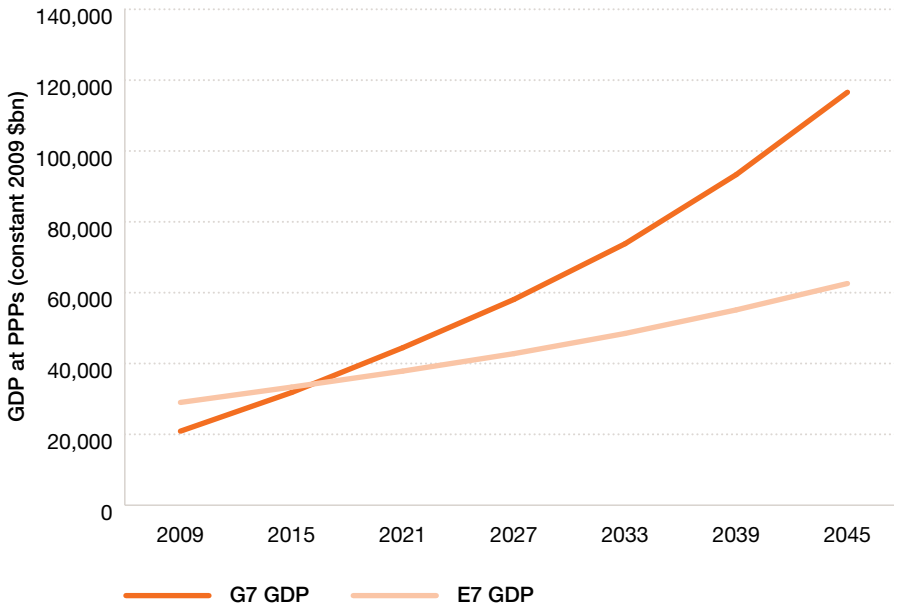
Source: PwC estimates (a) and forecasts (y): Wholesale price index

As growth in emerging-to-emerging market trade accelerates and an increasing proportion of trading and B2B commerce moves over to virtual platforms, banks need to be able to follow their customers, or risk being cut out of the transaction loop. How can transaction banks prime themselves for the rapid changes in the competitive landscape?

Global growth has now bounced back to its average pre-financial crisis level of just over 3%.[2] What has of course changed is that this growth is primarily focused on the emerging markets of South America, Africa, Asia and the Middle East (SAAAME) (see Figure 1). Our latest analysis anticipates that the GDP of the seven largest emerging economies (E7) will overtake the current G7 economies by 2020 (see Figure 2), and China may already have surpassed the US by the end of the decade.[3]

2. WTO and PwC analysis, April 2011
3. 'The World in 2050: The accelerating shift of global economic power:', published by PwC in January 2011

Figure 2: E7 could overtake G7 by 2020 in PPP terms



Source: 'The World in 2050: The accelerating shift of global economic power', published by PwC in January 2011

The crucial feature of the development of the SAAAME economies is not so much how fast they're expanding, but the growing connectivity between them. Although traditional trade routes will remain important, developed-to-developed market trade has been growing at a CAGR of just 1.5% since 2005, compared to more than 10% for intra-SAAAME commerce.[4] Although China, India and other new industrial powers' need to secure access to raw materials has been the main spur for the surge in intra-SAAAME trade, the rapid expansion of consumer markets is now also beginning to fuel mutual investment and commerce. Notable recent examples include Foxconn, the Taiwanese maker of components for iPhones and iPads, which is considering a $12 billion investment in Brazil.[5] By 2030, we estimate that emerging markets will make up most of the world's leading bilateral trading relationships and intra-SAAAME commerce will be the dominant global trading bloc (see Figure 3). As a growing amount of global commerce and investment bypasses the West, G7 transaction banks could be increasingly left out of the loop.

This shift in the focus of investment, growth and transactional activity will be heightened by the increasing urbanisation of many emerging market populations. In contrast, many developed market populations, and indeed, emerging markets such as

4. WTO and PwC analysis, April 2011
5. Reuters, 13.04.11

Figure 3a: Top 25 sea and air freight bilateral trade pairs in 2009

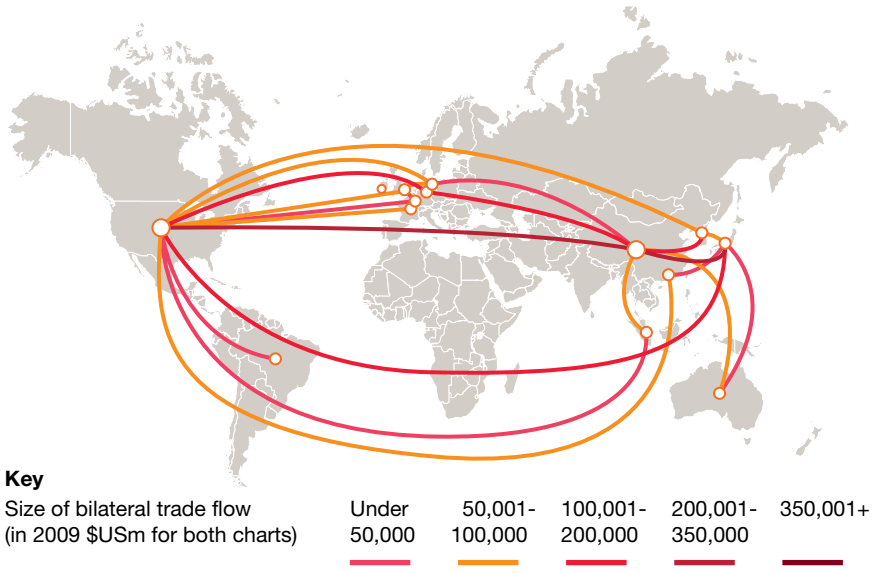
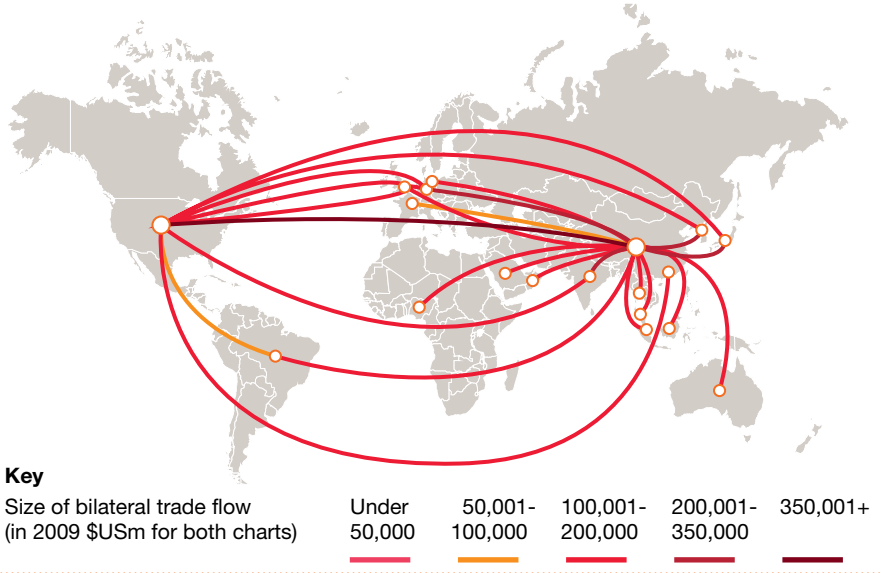


Figure 3b: Top 25 sea and air freight bilateral trade pairs in 2030



Source: 'Future of world trade: Top 25 sea and air freight routes in 2030', published by PwC in March 2011

China, are facing declining birth rates and rapid ageing. In Germany, e.g. the size of the most economically active 25–55 age group is expected to fall by nearly 30% over the next 40 years, which will have a considerable impact on economic growth, investment patterns and the product mix of financial institutions.[6] Changes in retail trade preferences will ultimately also drive trends in the wholesale trade markets in terms of raw materials, interim goods and capital goods.

Tapping into evolving trade flows

The growing economic power of the emerging markets is one of the 'megatrends' explored in Project Blue: From ubiquity to precision, our latest analysis of the prospects for the banking industry worldwide (see Figure 4). For transaction banks, the impact is likely to be especially pervasive. Developed market institutions must find ways to tap into intra-SAAAME trade flows that at present they may never see.

6. US Census Bureau, May 2010

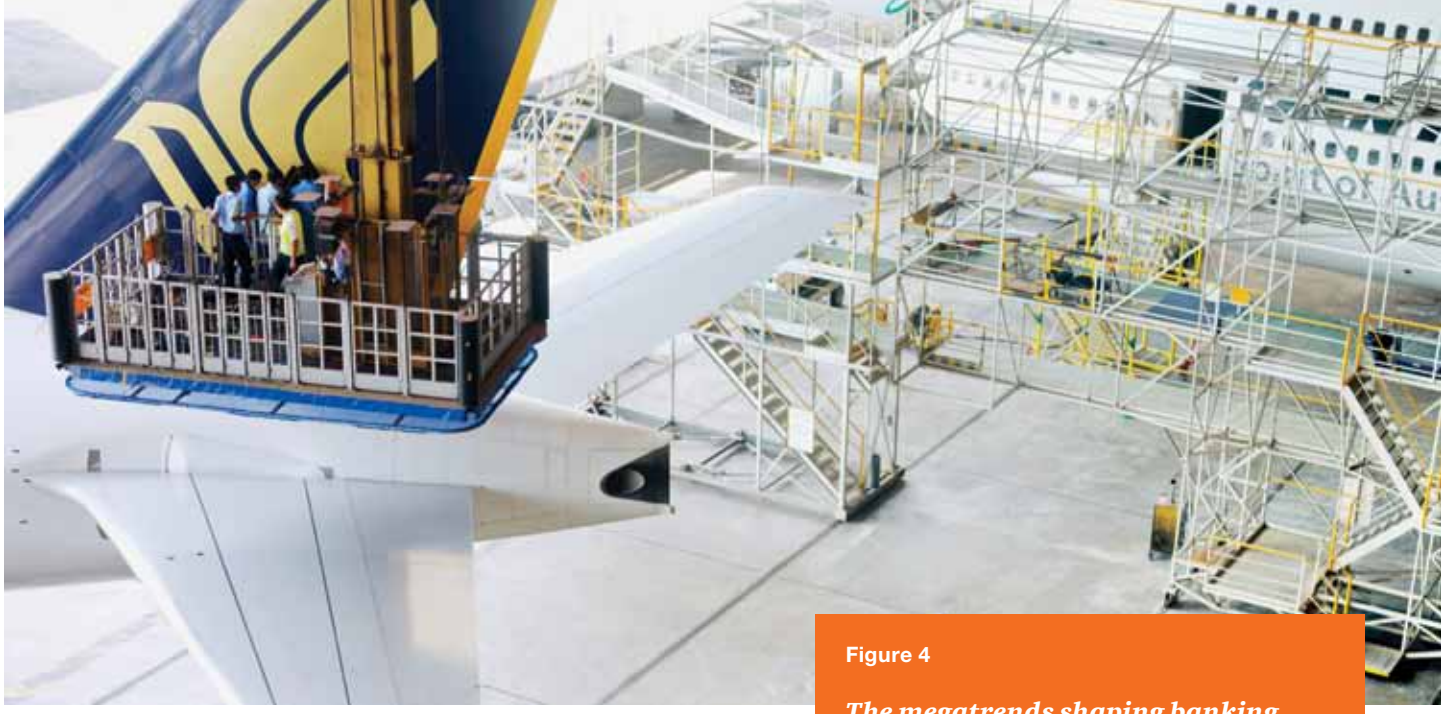


Figure 4

The megatrends shaping banking

- Rise of emerging markets (SAAAME)
- Demographic shift
- War for natural resources
- Rise of state-directed capitalism (regulation)
- Technology and social media
- Reconnection of financial and real economy

Source: 'Project Blue: From ubiquity to precision' (www.pwc.com/financialservices)

Some of the fiercest competition for global transaction banking business is going to come from banks based within the SAAAME bloc as financial sectors within these markets continue to develop and local institutions seek to provide the financial infrastructure to help local businesses expand internationally. Notable investments in recent years include ICBC's acquisition of a 20% stake in Standard Bank in 2008, South Africa's largest bank.[7] This was followed in 2009 by the signing of a strategic partnership between China Construction Bank and FirstRand, South Africa's third-largest bank, which includes providing advisory and structured services for Chinese clients looking to invest and trade in Africa.[8]

In turn, the increasing use of local currencies rather than the US dollar, euro or sterling within SAAAME transactions could affect returns for Western banking groups and tilt the competitive balance towards local banks. Sovereign wealth funds, many of them based within the SAAAME bloc, are also going to play an increasingly decisive role in shaping global capital flows, with banks vying to service these funds.

7. Standard Bank media release, 26.01.10
8. FirstRand media release, 30.07.09

Increasing digital penetration

It's not just where people trade, invest and transact, which is seeing fundamental change, but also how. Virtual platforms are capturing an ever-growing proportion of B2B commerce and creating ever-higher expectations for ease of access and usability. As virtual marketplaces proliferate, they're providing the financial infrastructure and trade guarantees that used to be the preserve of transaction banks. In turn, social media and mobile banking are shaping the way customers interact with financial services providers and creating openings for social media, telecommunications companies and other non-bank competitors, to move into the payment and trade finance markets.

Government in the tent

The underlying challenges include changing regulation and growing government influence over business. This includes the impact of Basel III, which could massively increase the capital requirements for off-balance-sheet letters of credit and change the pricing and return profile of trade finance. While transaction banks may choose to scale back trade finance as they focus funds on less capital-dilutive business, this could reduce their ability to attract customers within the SAAAME bloc, where letters of credit are still the primary and possibly only way to guarantee payment. Banking groups may also face political pressure to support domestic businesses in increasing exports and trade. Moreover, as prices and competition for scarce natural resources continue to rise, the potential for piracy, political instability and other trade risks is set to increase, spurring a possible move away from open-account trading and increasing demand for letters of credit.

The impact of new regulation can also be seen in the move away from bilateral derivative trading towards the central clearing of contracts. Central clearing counterparties are likely to impose higher margin requirements, while remaining bilateral trades will be effected by tough new capital and liquidity rules. Securities services' providers also face greater control over the segregation and use of client and house collateral. While challenging, these developments provide banks with an opportunity to boost revenues by helping their clients to overcome the increased cost and squeeze on the availability of eligible collateral.

Three key questions

We've identified three key questions that transaction banks will need to answer to sustain revenues and competitive relevance in this rapidly changing environment:

1. How do you get closer to your chosen customers – who will be your key customers in 2020 and how can you develop a more profitable relationship?
2. How will you manage risk and capital more effectively – what is the impact of regulation on your business model and how can you develop a more favourable and sustainable balance between risk and reward in this new environment?
3. How will you keep pace with market developments – what competitive advantages can you bring to bear and what resources and technology will be required to support this?

Many groups are already responding to these strategic challenges by focusing ever-more ruthlessly on their core relationships and sources of value (precision). This is reflected in sharper customer segmentation and more disciplined deployment of resources on business that offers the most favourable long-term prospects.

As they seek to strengthen key client relationships and wallet share, smart banks are looking at how to improve their understanding of, and ability to, anticipate customer needs, rather than simply waiting for a request for proposal. The development of mobile banking and social media capabilities is allowing them to interact more closely and frequently with their customers and build up a wealth of client data and insight.

While investment in technology is clearly going to be crucial in enabling transaction banks to keep pace with changing market demands, they face tough competition from other divisions and new regulatory demands for limited funds. This is going to heighten the need to target resources at particular segments or specialist areas where they can maximise differentiation and core strengths.

The articles in this publication look in more detail at the forces shaping the competitive landscape within transaction banking worldwide and how banks can turn these developments to their advantage. At the beginning of each section, we also outline the potential implications of the megatrends (identified in our Project Blue study – see Figure 4) for transaction banks.

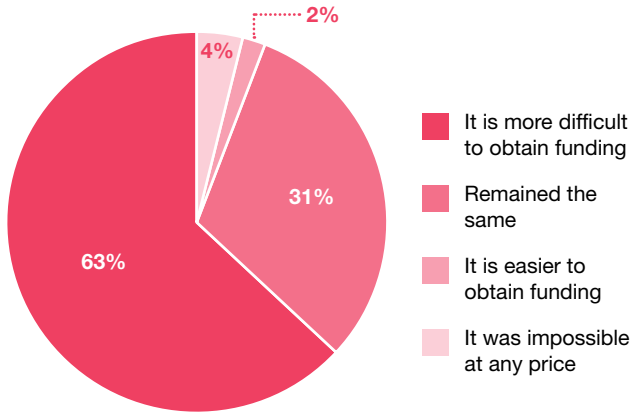
Closer to your customers

6 Macro-themes	Implications for Transaction Banking
Rise of emerging markets (SAAAME)	• Uncertainty regarding sustainability of existing customer base, given potential redistribution of future customer bases, driven by increase in intra-SAAAME trade flows and growing consumer markets in China and India
Demographic shift	• Increased urbanisation, particularly where population pyramids are growing, and reliance on new technologies drives new consumer behaviours, which are changing the way business operates and how relationships are defined
	• These retail changes drive further change in the wholesale transaction banking markets, e.g. by shifting the mix of goods (and therefore predominance of specific trade routes) demanded by the retail market and different consumption of capital
War for natural resources	• Potentially increased political dimension to all corporate relationships as a result of national policies related to scarcity of oil, water, food increases
	• Customer demands, fuelled by knowledge of improvements in MI and increased political pressure will force banks to be more transparent about sustainability of investments and business decisions
Rise of state-directed capitalism (regulation)	• State to play strategic role in developing trading partners and facilitating key trade routes through targeted investment (e.g. in African/South American infrastructure)
Technology and social media	• Rapidly changing consumer demands and technology innovation requires greater focus on customer engagement in the wholesale market as trends cross over. Will result in stronger customer centric approach for banks to succeed
	• Demand from corporate users for increasing access and flexibility in terms of managing supply chain will impact customer engagement tools and transaction bank sales' approaches
	• Technology developments raise customer expectations regarding the value-added services banks are able to provide
Reconnection of financial and real economy	• Deleveraging of Western corporates will reduce volume of real economy in developed countries – providers of liquidity and liquidity solutions will attract customers
	• However, pockets of growth, fuelled by trade with emerging markets will remain and will require ongoing financing and banking support for this expansion

Sustaining profitability in an increasingly commoditised market

The shock of the financial crisis has made sustaining liquidity the paramount priority for customers. This means that even the best transaction banks could miss out if they can't support a client's financing needs. Yet, the high value attached to liquidity also provides opportunities to market more sophisticated working capital solutions, not only to large corporates, but also to mid-size corporations, with the latest innovations continuing to attract favourable margins, despite the aggressive price-cutting seen elsewhere in the marketplace.

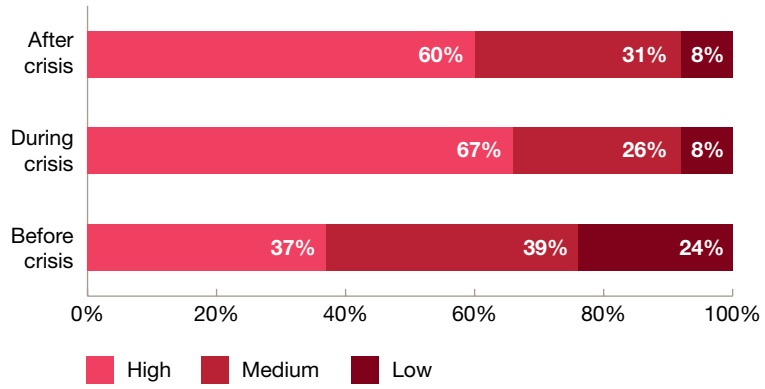
Figure 5a: Availability of funding during the crisis



For most companies, funding became more difficult, for some impossible...

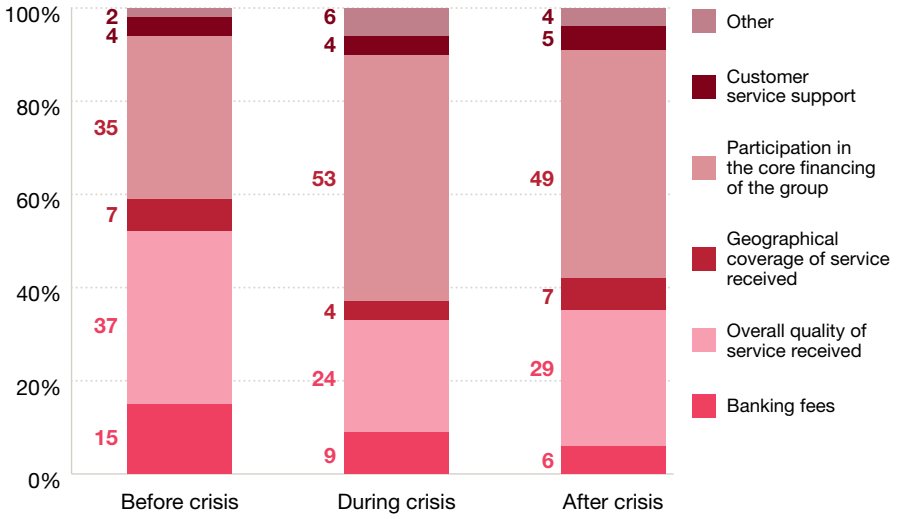
Figure 5b: Importance liquidity risk management

... and resulted in higher importance of proper management of liquidity risk



Source: 'Can the crisis make treasury stronger: PwC Global Treasury Survey 2010'

Figure 6: Important elements of the bank relationship



Source: 'Can the crisis make treasury stronger: PwC Global Treasury Survey 2010'

The financial crisis has transformed the way transaction banking is viewed by both customers and the banking industry.

For customers, the memory of seeing once-plentiful funding and liquidity suddenly dry up continues to have a powerful knock-on effect on transaction banks. A global survey of treasurers carried out by PwC last year found that more than 60% felt that finance had become more difficult to obtain as a result of the crisis, while 4% said it was impossible at any price (see Figure 5).[9] The proportion of treasurers citing liquidity risk management as important virtually doubled as a result of the crisis (see Figure 5).

9. 'Can the crisis make treasury stronger: PwC Global Treasury Survey 2010'

Although credit is now generally easier to obtain, corporations are fearful of being caught out again. This means that a request for proposal (RFP) for transaction banking services rarely goes out into the market without requiring strong credit line support. The same survey revealed that half of the respondents said that the single most important element to evaluate the bank relationship was the support of the financing of the group (see Figure 6).

As such, even if a bank can offer the best transaction products at good prices, credit availability is often the decisive factor in the client–bank relationship. Indeed, the past year has seen a marked rise in the number of customers looking to tender and possibly switch historical transaction banking partners if they can't support their financing requirements. Corporates now fully understand the value of transaction banking operations for the banks and aren't prepared to give it away without having established balanced relationships with their banking partners (i.e. meeting credit needs versus transaction banking sales' opportunities). The challenges this creates for transaction banks are heightened by the fact that many corporate treasurers are coming to see payments, collections, trade finance and other core aspects of transaction banking as virtual commodities, in which the services of different banks are largely interchangeable.

The challenges facing transaction banks are further complicated by the push and pull over the number of bank relationships customers choose to maintain, creating further turbulence for historical bank relationships (see Figure 7). Some customers have chosen to reduce the number of relationships as they seek 'tier-1' status with their banks and the favoured access to credit this would provide. Others are increasing the number of relationships as they seek to limit counterparty risk and broaden their funding options. As some customers spread their business more widely, this is eroding wallet share for transaction banks and making it harder to provide scalable and cost-effective solutions.

Fiercer competition

Within banks themselves, transaction banking is seen as more valuable as a result of the financial crisis and the rethink of risk and regulation that followed, offering a good source of revenue that comes with no associated regulatory capital requirements. Transaction banking's increased status within the business is reflected in higher investment and the fact that divisional chiefs now tend to have a seat on the board, which was fairly uncommon before. Yet, the renewed recognition of transaction banking's value has also heightened competition and put pressure on prices as banks jostle for market share. Canny customers are keenly aware of the mounting competition and crucial importance of transaction services in their banks' post-crisis business model and are using this to secure deals at prices that are increasingly unsustainable.

Figure 7: The hard choice of whether to increase or decrease banking relationships

Increase Bank Relationships

- More sources of funding
- Diversify counterparty risk

Category of <4
27% expect to increase post-crisis

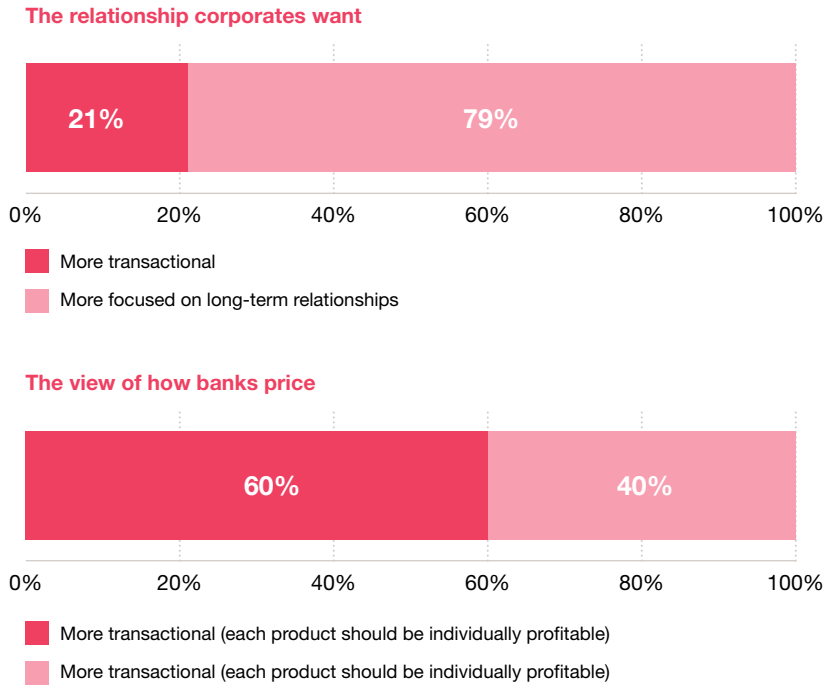
Decrease Bank Relationships
More business to less banks = Tier-1 status = Funding and Best Pricing

Category of >10
Average pre-crisis of 25,1

But expected to decrease by 20% post-crisis

Source: 'Can the crisis make treasury stronger: PwC Global Treasury Survey 2010'

Figure 8: The relationship corporates want with their bank and what they expect



Source: 'Can the crisis make treasury stronger: PwC Global Treasury Survey 2010'

Organisational collaboration

This interaction between liquidity and transaction banking will continue to shape client expectations, presenting both challenges and opportunities for banks.

A key factor in winning business and sustaining profitability is going to be the level of cooperation between credit and transaction teams. Our treasury survey found that almost 80% of participants are keen to maintain a portfolio-style relationship, in which the bank would look at the overall return from the customer (see Figure 8). In contrast, most treasurers believe that their banks want a transactional relationship, in which each piece of business has to be profitable in its own right.[10]

If liquidity and transaction banking are so inseparable in customers' eyes and the balance of power is shifting back to the buyer, then the latter approach is no longer sustainable. The worst-case scenario is that transaction sales' teams find they can no longer cut prices any further and begin to drive down credit charges to win business. The answer is closer collaboration between credit and transaction teams in developing solutions capable of meeting customer demands, while still delivering acceptable overall margins for the bank.

Opening up new markets

If liquidity is the overriding customer priority, then being able to deliver more effective working capital management solutions is set to be a key competitive differentiator. Our treasury survey highlighted particularly strong interest in more sophisticated tools and technologies including SWIFT connectivity, in-house banking and payment factories. These developments are seen by customers as adding significant value and hence attract relatively high margins, compared to other more commoditised aspects of transaction banking.

Until recently, the high development and unit costs of these technologies meant they were only realistically available to larger corporations (typically $2 billion annual turnover, or more). Now, a combination of growing demand and more affordable prices mean they're being increasingly implemented within mid-size companies (circa $500 million annual turnover). The ability to get ahead of the competition by developing cost-effective standardised solutions for smaller companies is going to be one of the most profitable opportunities in the years ahead.

As they look to concentrate cash, multinational companies are increasingly looking for regional and even global liquidity solutions. Banks that are unable to offer such capabilities are going to find it difficult to compete. Those that can, will able to consolidate relationships and hence increase wallet share.

Further opportunities include helping customers improve reporting within the Single Euro Payments Area (SEPA) network. One of the reasons why SEPA has so far failed to take off is that local alternatives continue to offer more effective reporting capabilities. Banks that can step in to bridge the gap would allow their customers to realise the cost benefits of SEPA and develop a strong presence in this unfolding market.

The competitive frontline

As mainstream areas of transaction banking become increasingly commoditised, price pressure is going to intensify still further and already thin margins are going to be progressively squeezed. Sustaining profitability in this highly competitive marketplace depends on being able to deliver the product and funding solutions that customers prize and are prepared to pay a premium for. The banks that are going to lead the way are already breaking down the silos between credit and transactions to develop mutually supporting solutions for their customers. They're also bringing innovative working capital management tools to new and wider markets.

10. 'Can the crisis make treasury stronger: PwC Global Treasury Survey 2010'

Getting the most out of your sales force

Cost constraints impact the sales organisation as much as any function. However, in an increasingly competitive environment the pressure to address sales performance is equally great.

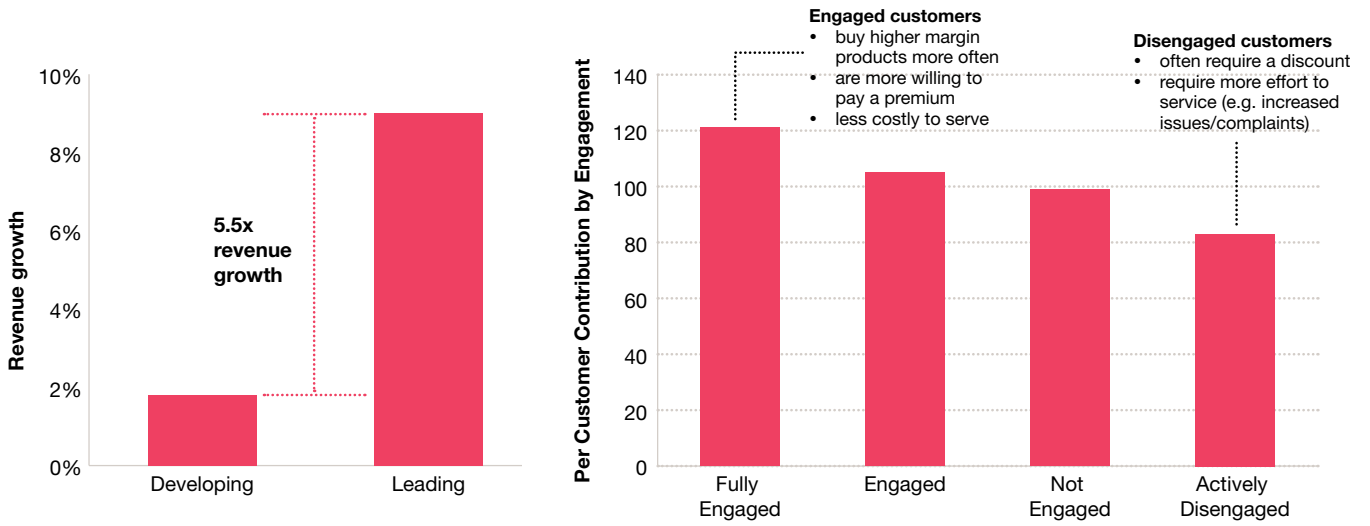
The question is – how do you sell more with less? How do you avoid creating a selling function model that is not scalable and is adding costs as it drives revenues? On top of this is a competitive pressure. As corporations look to rationalise their transaction systems on a regional basis, the pressure on banks to improve their win rate is going to be heightened by the likelihood of fewer, albeit bigger, mandates coming up for tender. Smart banks are rising to the challenge by developing a more informed, proactive and actively managed approach to sales and to adding value to the customer relationship. The prize is a much larger and more sustainable share of wallet. Banks that fail to respond run the risk of increasing competitive marginalisation.

As the previous article, 'Sustaining profitability in an increasingly commoditised market' highlights, mounting competition within the global transaction banking market is driving down prices and putting further pressure on banks to demonstrate how they're creating value for their clients. Yet most banks' ability to respond is hampered by a lack of real insight into what their customers are thinking and how the bank could best support their business. Banks want to be a trusted advisor and they want to add value to their corporate clients – but the sales and relationship management function does not appear to know how to make this reality.

As Figure 9 highlights, companies that engage effectively with their customers deliver higher growth and are cheaper to serve. Yet, the engagement and the customer insight that underpins this are often lacking.

Figure 9: Companies who engage effectively with customers deliver 5.5x more revenue growth YoY (2007–2009)

Engaged customers provide higher revenues and are less costly to serve



Source: PwC Global Sales Survey (2009–2010)

Typically, client feedback comes from a combination of day-to-day net promoter scores and annual satisfaction surveys. While net promoter scores can provide a reasonable indication of customer loyalty, the questions are too simplistic to identify specific areas where the bank is performing well and what it could do better. Although the annual satisfaction surveys are more detailed, they tend to be conducted with a senior executive at the client, who may have little direct experience of using the bank's products and services, and hence real understanding of what is working well and what isn't. It's telling that the results from the net promoter and annual surveys often conflict, highlighting the potential flaws in this conventional approach to customer evaluation.

We've been working with a number of banks to help them develop a better understanding of their customers, which seeks to gain perspectives from a range of users at different levels of the client organisation. This is delivered as a structured mix of face-to-face interviews with the CFO, telephone surveys of senior management and online questionnaires for operational staff. We gain specific customer insight from strategy to operations. The approach focuses on seven key attributes of customer engagement: Value, trust, rapport, emotion, loyalty, advocacy and overall satisfaction. This gives direct insight into customer engagement. The resulting feedback provides detailed and actionable insights into where specific improvements could be made and why the customer would value them. For example, recommendations might focus on developing industry-specific value propositions for key target segments and ensuring the proposition and the engagement insights are used to inform the account planning and management. In this way insight leads to understanding, which leads to action – and action that directly focuses on improving customer engagement. And this will lead to more opportunities.

Turning plans into action

However, while the openings identified through this deeper client engagement and understanding will provide a more informed basis for account planning, this will only be of use if the plans are properly followed up, monitored and delivered. Even if the target openings are clearly set out in the plan and supported by a strong business case, relationship managers may still fall back on seemingly easier wins or simply wait for request for proposals as before.

The underlying challenge is overcoming a mindset in which sales managers and relationship managers have little concern about what revenue mix they achieve. Any revenue is good revenue and any short cuts or behaviours this drives are acceptable as long as the overall target is met. This includes concentrating on the clients that have traditionally delivered a reasonably steady flow of income rather than focusing on the accounts that may have the biggest untapped potential. There may even be a temptation to offer cut-price credit or reduction in margins to help secure transaction business. There may also be a tendency to focus on the easy to sell, and not the right product mix. As Figure 10 highlights, there are clear shortcomings in the effectiveness of sales managers in how they control and manage selling effort.

A number of leading banks are therefore looking at how to develop a more transparent and actively managed sales process, in which the revenue target is no longer the sole objective. This entails aligning the account planning with the business planning – knowing which customers will drive what business for each product line. It also means aligning the account planning, or more specifically the actions from this planning, into a regular cycle of sales activity and sales pipeline management. It means a new standard of sales control and focus – involving more direction and guidance being given to sales and relationship managers. The goal is greater predictability of sales performance and a better mix of products being sold. The benefit is that the customer is being sold the products they value by a bank that understands their needs.

Figure 10: Sales managers are not equipped to manage effectively

- Significant time away from clients was spent on ill-defined reviews.
- 30% of meetings duplicated discussions from other meetings.
- 30% of meeting time was spent resolving data issues.
- Meetings focused on inspecting and telling people how to think and act.

- Managers spend 30% or more of their time in meetings.
- More than 50% of managers consider many meetings to be a 'waste of time'.
- 90% of managers attribute the failure of meetings to lack of planning and organisation.
- 75% of managers indicate that they receive no guidance on how to conduct a proper sales management meeting.

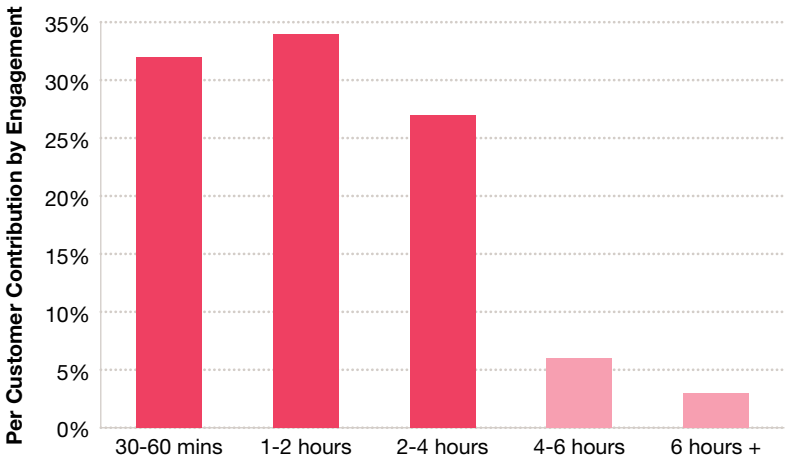
Source: From a PwC 2009 pan-industry study of sales management activities

Taking cost out while selling more

All of this looks like more cost, not less. And if it is applied without the necessary operating model and controls, that extra cost is a real risk. With one banking client we recently addressed this issue with the specific goals of delivering the same results with 20% less cost, through ensuring the refocusing of the selling effort onto the right activities, the right opportunities and the right clients. Too often sales staff are busy – just not busy on the right things. The biggest challenge here is the role of sales team leads and sales management – and the data and knowledge they needed.

We identified 'time thieves' in the sales activities – on average, a day a week that could be automated or reallocated to lower cost functions (much of which was found to be the ability to readily access the right data – see Figure 11). The newly refocused sales organisation managed to improve performance without adding overall resources.

Figure 11: Amount of times per day searching for information



Source: CSO Insights, Sales Performance Optimization, 2006

Fulfilling your potential

Most transaction banks are falling a long way short of their full sales potential. In a fragmented sector, smart banks have the opportunity to take a much bigger wallet share and compete for the fewer, but larger, mandates that characterise today's market. Improving client insight and engagement is helping them to anticipate client needs, pre-empt their competitors and develop the close bonds of understanding and trust needed to deliver larger and more sustainable revenue streams. The basis is more actionable client feedback gained through surveys of client staff, which is helping these banks to get under the skin of their clients and develop a more informed and better targeted approach to account planning. Yet, this will only reap the desired dividends if relationship managers are relentlessly pursuing the opportunities identified in the account plans, which will in turn demand a change of culture and working at all levels of the organisation.

Changing role of the relationship manager

In this new way of looking at sales, the relationship manager becomes more than just an orchestrator, who simply receives client requests and then works out how these can be delivered at a reasonably competitive price. Instead, the goal is to create a mutually beneficial meeting of minds in which the relationship manager should have enough insight into the client's business to anticipate what they need and make sure the bank is in a position to deliver. This meeting of minds should greatly improve the win rate as there is greater certainty about what the client needs and more time to develop an effective solution.

This more actively managed and client-centric approach is likely to require a cultural shift among relationship managers who have become accustomed to a high level of autonomy. Yet the potential revenue uplift and resulting rewards can provide the incentive needed to bring sales teams on board.

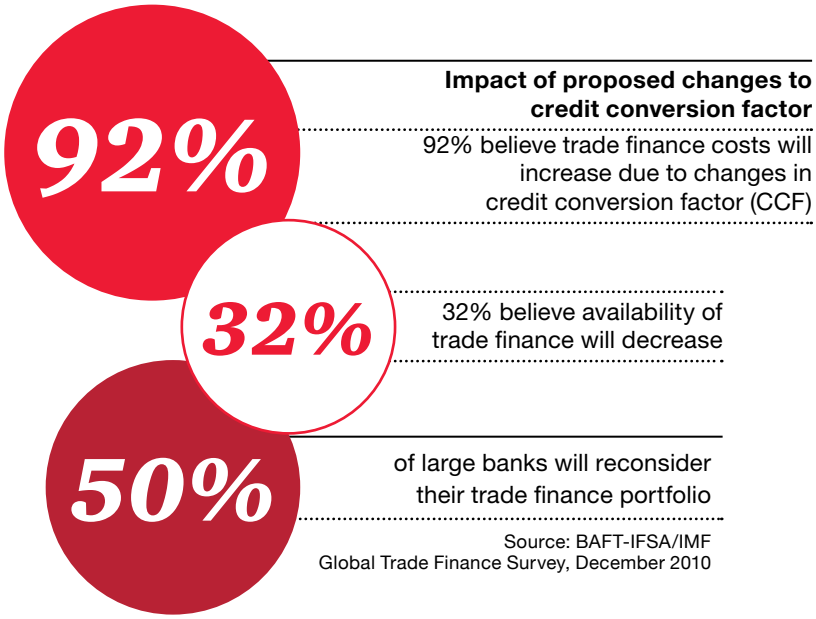
This approach also requires more effective support from across the bank. Leading institutions are investing in more efficient administrative and sales tender support so that sales staff and relationship managers can free up time to get to know their clients better and follow up on potential opportunities. These banks are also providing greater access to specialists, who can advise the client on the impact market and business developments. This helps to strengthen the trusted advisory relationship and could create fresh sales openings as the client assesses how to respond.

Managing risk and capital more effectively

6 Macro-themes	Implications for Transaction Banking
Rise of emerging markets (SAAAME)	• Capital flows will be redistributed, increasing intra-SAAAME assets under custody • Western 'middle men' will lose market share as SAAAME investors invest directly in other SAAAME opportunities, instead of through an intermediate fund • Increasing importance of sovereign wealth funds as global sources of capital – resulting in increased competition between banks regarding who gets to service these funds • Fund activities dominate in Asia, expanding value-added service demands in the region
Demographic shift	• Increased capital markets activities as a result of greater accumulation of wealth (accumulative pension funds) in countries with growing populations • With increased urbanisation, as people become more economically active, savings and investment activities will increase
War for natural resources	• Use of capital will become strategic instead of focusing primarily on investment returns – i.e. risk mitigation will assume a greater geopolitical dimension • OEMs to finance their own supply chain to bypass political considerations if banks are viewed as arms of the government • Impact on direction of trade and price (e.g. of letters of credit) given likely increase in risk (e.g. piracy, etc.) as competition for natural resources increases • Political instability will reduce open-account trade, increasing demand for letters of credit – will bank supply be sufficient or will export credit unions gain market share
Rise of state-directed capitalism (regulation)	• Myriad of regulation results in increased delivery costs and may challenge business models • SWF activities could impact the flow of capital and location of related services/activities • OTC regulations results in huge opportunities and challenges for custodians (banks) and infrastructure providers • Increased levels of government support, particularly in Asia, will favourably impact cost of capital and competitive advantage. Smaller capital requirements in SAAAME increase attractiveness of investments • Easing regulation in Asia allows for easier market entry versus increasingly regulated developed countries • Tighter regulatory regime in West creates opportunities where agent banks are unable to cope with new regulatory requirements • Business model/business mix likely to change, given impact on profitability of certain products as a result of regulation (e.g. Basel III), particularly in developed countries • Emerging market banks less constrained by capital rules and able to put downward pressure on prices • Global capital rules set by the West (e.g. Basel III and related regulation) likely to be challenged by SAAAME/Asian regime as global power shifts east, eventually create the new global standards • Increased reliance on non-bank financing as a result of increased protectionism
Technology and social media	• Greater global scale may allow for greater specialisation in specific asset flows (e.g. SWF assets in Asia and Middle East) • Technology can act as a differentiator by providing access to real-time consolidated information, niche and bespoke services – suggests that pre-eminence of Western financial markets likely to remain in the short term due to scale and sophistication of technology
Reconnection of financial and real economy	• Volume of securities reduces in the derivatives market • Increased listing of securities as a result of OTC regulation • Changing nature of investment flows reflect the changing nature of economic output distribution

Getting to grips with Basel III

The latest proposals for Basel III would impose debilitating regulatory capital loadings on trade finance, leading to significant extra costs for banks and their customers. With the initial lobbying having made little headway, it's vital that banks make their customers more aware of the potential impact of the extra capital costs, and harness their support in pressing for regulations that reflect the real risk and economic value of trade finance. Yet, even with concessions, the costs of trade finance are still likely to rise. While some institutions may choose to withdraw from an area of business they see as offering insufficient return on capital, trade finance will continue to be a key consideration in businesses' choice of banking partners. It will therefore be important to develop cost-effective ways to sustain trade support, including new structures, more efficient processes and closer collaboration with partner banks.



When the Basel Committee sat down to design its new capital and liquidity rules for off-balance-sheet instruments, it's unlikely that letters of credit were uppermost in members' minds. Yet, while the risk profile and economic substance of trade finance and credit default swaps are poles apart, Basel III treats them as equally risky propositions.

Under the latest proposals, banks would need to hold a 100% credit conversion factor (CCF) for a letter of credit,[11] five times the CCF of 20% applied at present. This doesn't reflect the relatively low risk of such instruments. According to a study carried out by the International Chamber of Commerce (ICC), even during the global downturn, there were fewer than 500 defaults out of 2.8 million transactions.[12] Letters of credit are also secured against physical goods and recovery rates are high. The impact on costs would be compounded by the higher capital charges for interbank lending, which is an integral element of this type of transaction. The effects may also vary by country and by region, depending on how local regulators choose to apply the rules, along with how government export guarantees are managed and classified (in many cases they're outsourced to private contractors and therefore may not qualify).

The knock-on impact on the cost, price and availability of trade finance is set to be significant. A survey of 118 banks in 34 countries carried out by BAFT-IFSA in conjunction with the International Monetary Fund (IMF) found that more than 90% of institutions believe that trade finance costs will increase as a result of the proposals set out in Basel III.[13] Larger banks tend to be more aware of the changes and therefore more concerned about their implications. Nearly 70% of large banks believe that letters of credit will be more negatively effected by Basel III than other products in their portfolio and 50% think that the availability of trade finance will decrease.

The areas of the global economy that would suffer most if trade finance became harder to obtain are not only those that have seen the strongest growth in recent years, but also the least able to find an alternative. A widely publicised report by Standard Chartered bank estimates that trade finance prices could go up by at least 15%, which would in turn reduce global trade by $270 billion and lead to a 0.5% drop in global GDP.[14] While open-account trading is the primary means of exchange for larger corporations in developed markets, letters of credit are still an essential facilitator of international commerce for smaller and medium-size enterprises (SMEs). Letters of credit are also a vital foundation of the bourgeoning trade flows between emerging markets. In Africa, which saw the greatest growth in the use of trade finance between 2009 and 2010 (21%), there are few if any other options for exporters.[15]

Getting the case across

The solutions are fairly clear-cut. The rules for trade finance instruments should be brought closer into line with their duration, default and recovery rates. A maturity waiver already exists within Basel III. The proposals also make the distinction between unsecured consumer credit and secured mortgages, so there would be a precedent for distinguishing letters of credit from other off-balance-sheet securities. Other desirable changes would include a single stable funding value for trade-related off-balance-sheet activities, which would recognise the security of trade transactions and avoid the potential distortions created by differing local interpretations of the regulations.

11. 'Basel III: A global regulatory framework for more resilient banks and banking systems', June 2011 update, published by the Bank of International Settlements
12. 'ICC global survey on trade and finance', published on 23.03.11
13. 'BAFT-IFSA/IMF global trade finance survey – anticipation of Basel III', December 2010
14. Wall Street Journal, 07.02.11
15. 'ICC global survey on trade and finance', published on 23.03.11

However, despite concerted lobbying by the banking community, the Basel Committee has so far yet to give ground. Admittedly, this is only one of a number of areas in which banks are pressing for changes and as it represents a relatively small proportion of their overall business, it can easily get lost. There is also some resistance among regulators and politicians to what they see, rightly or wrongly, as special pleading by the banks. It's therefore vital that banks communicate the implications to corporate treasurers and smaller business customers and bring them into the forefront of the lobbying, highlighting the implications for jobs and growth. Banking bodies in the UK, the US and other countries are working closely with governments and smaller businesses to develop a range of initiatives to support export finance. These contacts could provide a useful basis for raising business awareness of the proposed new rules and getting the message across to legislators and policymakers.

Assessing the implications

Even if the Basel Committee does come round, some change in the cost/profitability profile of already generally low margin trade finance transactions is likely. It's important that banks assess the impact of what may be a range of possible regulatory outcomes and prepare plans for each of the main scenarios. They will also need to factor in jurisdictional differences in the application of the rules.

These evaluations will form part of wider reviews of what business is core and non-core in the wake of the financial crisis and how Basel III will effect this. For some, trade finance is an area of specialisation. Others may conclude that the returns do not merit the higher capital charges and that funds could be better deployed elsewhere. However, as PwC's Project Blue analysis underlines, emerging-to-emerging commerce is the main source of growth in the global economy.

Withdrawal or reduction in letter of credit availability would make it harder for banks to tap into these evolving trade flows. As SMEs become increasingly international in their reach and ambitions, the quality and availability of trade finance is also going to be a key determinant in choosing a bank. Failure to provide adequate trade facilities could therefore mean that banks miss out on other business opportunities.

Gearing up for change

So how can banks maintain and, where possible, enhance trade finance facilities in this changing environment?

Cutting administrative costs will offset some higher capital charges and so help to sustain margins. Letters of credit are currently bound up in a huge welter of paperwork and slow communication. Investment in greater automation and process improvements could cut out much of this unnecessary red tape and associated delays and costs. This includes internet-based trade finance. Some market participants would like to go further by developing global e-exchanges. This would certainly be a much cheaper and faster transactional approach. It would also provide greater transparency and ease of selection over the risks being assumed and the associated capital requirements. However, e-exchanges would require a level of standardisation that has to date proved difficult to develop and agree across participating banks. Nonetheless, it's not unfeasible and banks may face competition from trade finance system providers if they fail to collaborate and promote more efficient platforms.

In turn, Basel III may well be the catalyst that finally leads to a take-off in supply chain finance (SCF). SCF would allow banks to pass on much of the risk to larger buyers and hence curtail their capital demands. It would also strengthen relationships across the supply chain and provide openings to other business opportunities. For buyers, the benefits include improved working capital management. Suppliers would gain from increased liquidity and more assured cash flows.

Cooperation with partner banks has always been an essential element of trade finance. As some banks choose to scale back trade finance or focus their capital on particular sectors or territories, cooperation/outsourcing is going to be even more important in providing the breadth of service needed to maintain a commercial relationship or meet government expectations. This will in turn demand more effective partner analysis and greater expertise in managing commercial networks.

Driver of banking growth

The proposed capital impact on trade finance fails to reflect the real risk of loss and could severely impede growth and prosperity. Bringing businesses on board to press for more realistic capital rules will be essential in getting politicians to listen.

The importance of trade finance far outweighs the level of revenue and returns it generates. While there may be a temptation to withdraw and target capital at seemingly more profitable areas of the portfolio, banks need to be able to offer these services if they want to benefit from the upsurge in global commerce and emerging-to-emerging market trade flows, in particular. There is huge scope for cutting costs to make up for the higher capital charges. Partnerships are also going to be crucial in helping to maintain trade finance support, while helping to manage risk and capital more efficiently.

Prime custody – response to a growing market need

The need for prime custody

In the wake of the Bear Stearns and Lehman defaults during the 2008 financial crisis, asset managers and hedge funds have begun to take a more cautious approach to their assets and how their prime broker makes use of those assets. The risks and exposure to thinly capitalised prime brokers has increased the emphasis on transparency on where assets are held, how they are segregated and rehypothecated. As the traditional asset managers move away from long-only investment strategies to generate better returns, expand assets under management and increase fees, they will be looking for both brokers and custodians that meet the need to provide safe and secure services.

Furthermore, regulatory-driven change around the reform of OTC derivatives' markets and the increased emphasis on central clearing is driving the development of broker-clearing models, which in turn, will drive an increased demand for collateral and associated collateral services. Cross-asset clearing services, incorporating collateral management and liquidity, are being developed alongside and in support of the firm's prime brokerage service offerings.

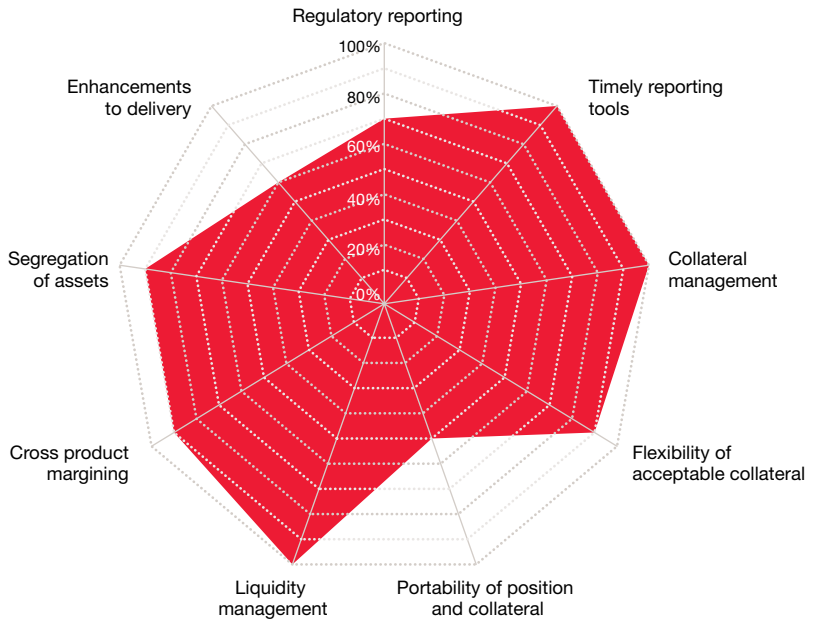
The chart opposite shows the results of a recent PwC survey where asset managers and hedge funds were asked to comment on the broker services they viewed as being most valuable.[16] Segregation of assets and collateral services scored highly, giving weight to the view that there is a growing need for enhanced custodian services.

Prime custody models

There are various solutions emerging, which are designed to meet the challenge and address client concerns; these are collectively known as prime custody. Essentially, they are seeking to meet the need to deliver enhanced security and transparency over the client's assets. This can be achieved through the set-up of new structures within the existing organisation, or by the use of third-party custodians. Emerging models include:

- Unencumbered assets held away – A broker uses a third-party custodian to provide segregation of unencumbered assets to give the custodian the role of fulfilling the desire for transparency over the location and availability of assets. This works well for some fund strategies that have long-term holdings and is less suited to high-turnover strategies.
- 'Custody plus' – Build out of prime business on top of an in-house custody function. There is a risk that all assets remain with the same entity, hence there would be a need for that entity to be well capitalised, or to hold the assets in a bankruptcy remote special-purpose vehicle (SPV). Also, the cultural and service change required to deliver the prime side (bespoke servicing, cross-asset margin, etc.) is a significant challenge.
- Broker – Custodian partnership – A focus on respective core competencies with the prime broker focused on client service, consolidated reporting, financing etc., and the Custodian on asset servicing, clearing trades, corporate actions processing, record-keeping and, regulatory and client reporting.

Figure 12: What clients value



Source: PwC analysis

16. 'OTC Client Clearing, Voice of the Customer – the Buy Side' – October 2010

These changes are one of many drivers we are seeing in the market, which is resulting in competitive threats to the positions historically held by different organisations in the end-to-end value chain as demonstrated in Figure 13.

Competitive challenges

As each of the respective players reviews their service offering and responds to these competitive dynamics, we believe that this is classic strategy and the challenges relate to the competitive advantage that can be gained from core competencies.

Core competencies of the prime broker are traditionally focused on risk management, financing and client services; however, the challenge for them is to be able to provide a level of security for their clients, and an ability to effectively segregate assets as well as effectively and efficiently using client assets to collateralise positions. The PwC survey (noted above) of buy-side identified that prime brokers needed to focus on capabilities around collateral management and services quality with the overriding emphasis on the ability to contain costs as a key differentiator. The comments on service standards were interesting as it was noted that mistakes by the broker or poorly trained staff could have a significant knock-on effect on the client's operational processes.

The custodian's traditional capabilities have focussed on asset servicing, securities lending and agency financing through tri-party repo' schemes. The resulting challenges of the new paradigm for custodians to deliver on client service level requirements, moving from long-only factory processes to dealing with rehypothectation, segregation, short positions, short corporate action notification times, also the needs of the clients changing, depending on the fund strategy. All requires investment in technology to meet everything from client reporting requirements to monitoring corporate actions and enhanced collateral management capabilities.

A further challenge for the custodians is where they sit in the value chain and their ability to effectively leverage that position to generate revenues. Clearly, the prime custody model presents the custodian with a revenue-generation opportunity; however, given the role is predominately about service provision, revenues are likely to be dependent on the ability to deliver a high-quality service in an efficient cost-effective manner in order to deliver volumes from multiple mandates. It also raises questions about the overall positioning of the firm, given the need to deliver financing to hedge fund clients, if a custodian is intending to tackle the end to end value chain.

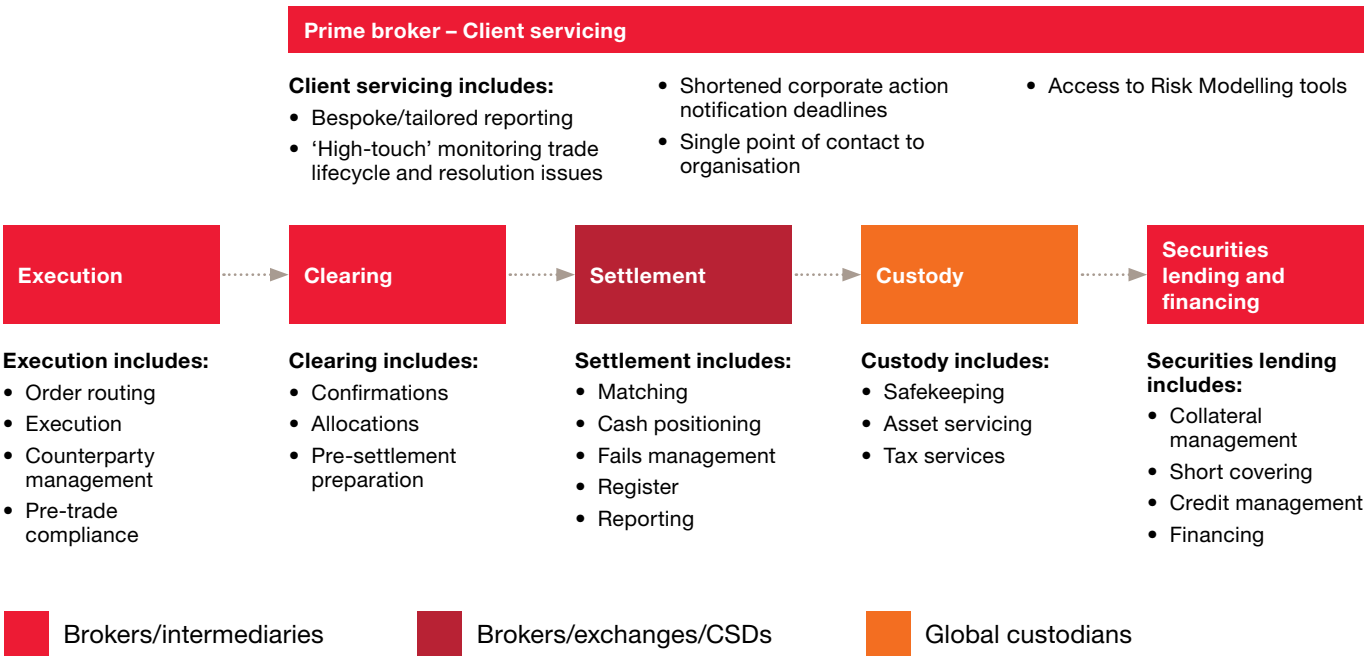
Characteristics of the winners

Providing buy-side clients with the end to end services outlined above is the aspiration of many institutions, but currently few are able to offer the capability. Major factors in determining a winner will be scale, investment, technology to support the service model and quality of service. Cost, not simply in terms of fees and commissions, but in the ability to optimise the use of assets, tight financing, and cross-asset margining in a safe and secure manner are seen as essential factors. There is real opportunity opening up for new entrants in this space, given the regulatory changes occurring in the market and the increasing move to multi-prime by investors.

Given the need to maintain high service standards and the implications for large-scale business models to make the necessary investments and support high-volume operations, it is likely that over time there will be only be a handful of players able to deliver a credible service. Furthermore, the nature of the prime custody service suggests that clients will not be looking at frequent changes in service provider, hence first-mover advantage is going to be important.

First-mover advantage will be critical in gaining client business and as a consequence, providers of prime custody solutions may oversell their offerings.

Figure 13: End-to-end value chain



Source: PwC

Capitalising on new collateral demands

New global regulations, which include capital and liquidity constraints and restrictions on collateral usage, will effect all market participants who actively trade derivative products. Furthermore, central clearing counterparties (CCPs) will only be willing to accept certain collateral, which will put a premium put on certain asset classes and lead to a potential shortfall of prime liquid securities. Securities service providers also face greater control over the segregation and use of client and house collateral. How can banks adapt to this very different market environment and ultimately turn it to their advantage?

Derivatives trading and the associated systemic risks have been in the sights of the G20 and local regulators since the financial crisis. The G20 meeting in Pittsburgh in September 2009 concluded that: 'All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.'

The resulting reforms are now being written into law. The most imminent development is the move towards central clearing of interest rate and credit default swaps under the US Dodd-Frank Act. Similar changes covering all types of derivative contracts are planned under the European Market Infrastructure Regulation (EMIR). While the scope, timing and detail of these new regulations are far from finalised, a number of broad themes and implications are emerging, with collateral management set to be a crucial consideration for both the buy- and sell-sides of the market.

Increased collateral demands

The majority of derivative trading is currently transacted on a bilateral basis, with counterparties setting their own collateral and margin requirements. Under the proposed central clearing model, margin calls and the associated collateral requirements will be dictated by a central counterparty. Although each CCP will have varying requirements and risk appetite, the results will be higher collateral requirements and more frequent margin calls. Globally, our analysis indicates that collateral could increase by up to 270% over the next five years.

A squeeze on prime liquid securities will result as CCPs will be requiring higher grade collateral to execute and clear certain derivative products. Market participants will need to look for additional sources of high-grade eligible collateral (e.g. government bonds) to keep funding and margin costs down. Furthermore, if collateral is not readily available, market participants face the prospect of purchasing the necessary collateral on the open market.

Higher cost of bilateral trades

The trading of derivatives within bilateral trading will continue over the next few years. However, once Basel III has been implemented (2018), market participants will face additional capital and balance-sheet requirements, which will effect their Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratios (NSFR).

Tighter segregation and control

The Lehman collapse has forced regulators to implement safeguards and other measures as a way to reduce systemic risk. At present, market participants are able to rehypothecate long collateral positions that have been pledged for other purposes to generate additional revenue. The new legislation may impose tighter segregation requirements between client and house collateral, and how they can be used.

Heightened scrutiny

Global regulators are also keen to institute greater transparency within the derivatives markets as a way to mitigate risk and reduce high concentrations of exposures to single clients and/or counterparties. Key developments include intraday valuation and margins calls, and a centralised repository (e.g. ISDA) that tracks and monitors all derivative transactions that were executed throughout the day, as well as exposure reporting across products, clients and legal entities. Furthermore, standardised reporting and legal documentation (e.g. XML) will help to provide a common framework for reporting and document retention throughout the industry.

Internal strategies

Meeting these collateral and reporting requirements is going to require a modification to many firms' organisational model. Industry leaders are moving away from product silo alignments and migrating towards a more centralised architecture in order to efficiently optimise house and client collateral. Banks may also discover that they're increasing their transaction and funding costs, as collateral that may be needed to satisfy margin requirements is already available within the organisation. Additionally, a siloed organisational model makes it difficult to report across business lines and on a legal entity level, hindering the firms' ability to provide aggregated reporting on a trade and position level.

The starting point for more effective management is a strategic appraisal that seeks to determine the most cost-effective means of trading for particular derivative types under the new rules (i.e. bilateral or centrally cleared) and bring these into line with overall trading strategies. Effective management also includes greater transparency over the availability of long collateral positions across the organisation, where they're needed and understanding how they're being used. In turn, market participants will look for additional capabilities such as cross-netting, in order to offset the risks and collateral needs across the various business lines. Sophisticated technology platforms and capabilities will be needed in order to automatically identify, allocate and substitute collateral.

Service opportunities

Clients will seek out preferred service providers to manage all functions throughout the derivative trade life cycle (execution to settlements). As a result of the growing demand, providers will need to enhance their current collateral management capabilities. Service offerings such as collateral transformation will help clients reduce funding costs and satisfy their margin requirements. In addition to this, robust financing and lending services will provide clients with strategic funding/financing alternatives to help them align their risk appetite and balance-sheet capabilities with overall trading strategies.

Of all the collateral management services that could be offered, collateral transformation is likely to be one of the highest revenue-generating offerings. Collateral transformation provides higher quality non-cash collateral in exchange for lower tier assets. Banks might also use various lending and financing capabilities such as repo' to exchange securities for cash collateral or allow cash or non-cash collateral to be transferred from one currency to another. Additional capabilities such as 'what-if' analysis will also be a key client requirement, providing them with an interface/ platform in which they can perform various scenario analyses, prior to execution, to see what a potential trade would do to their portfolio (e.g. exposure, concentration, obligor limits).

Making the most of change

Regulatory developments are changing collateral requirements and making the efficient management (sources and uses) of collateral a crucial competitive issue. The key to dealing with these changes from an internal perspective is a more transparent, comprehensive and centralised approach to the management of collateral, which seeks to use available collateral more effectively, reduce funding costs and offset risks. Securities services providers can also boost revenues by developing effective ways to help their clients overcome the increased cost and squeeze on the availability of eligible collateral.

Keeping pace with market developments

6 Macro-themes	Implications for Transaction Banking
Rise of emerging markets (SAAAME)	• Redistribution of trade and transactions, including increase in intra-SAAAME flows, with huge consumer market potential in Brazil, China and India fuelling further growth • Redistribution of financial centres to Asia, resulting in increased competition in emerging markets and globally from local banks (increasingly bigger), banking multinationals and other operators • Trade will increasingly be carried out in local currencies rather than USD, EUR, or GBP, potentially impacting profitability and continuing market relevance of existing players
Demographic shift	• Impact on remittance flows as volumes per location change, as a result of changing population pyramids and increasing intra-SAAAME immigration • Increased urbanisation, particularly where population pyramids are growing, increasing transaction velocity, private consumption and demand for imports in growing urban markets likely to result in increased trade (correlation with population growth)
War for natural resources	• Increased political dimension to all transaction decisions as scarcity of oil, water, food increases, which will impact volume and value of transactions • Improvements in MI and increased political pressure will force banks to be more transparent about sustainability of investments and business decisions
Rise of state-directed capitalism (regulation)	• State to play strategic role in developing trading partners and facilitating key trade routes through targeted investment (e.g. in African /South American infrastructure)
Technology and social media	• Increased demand for digital channel versus face-to-face will increase enterprise mobility in the wholesale space – requires investment in mobile infrastructure • Rapidly changing consumer demands and technology innovation requires greater focus on customer engagement in the wholesale market as trends cross over. Will result in stronger market, customer and product segmentation becoming critical if banks want to avoid disintermediation • Rapidly changing technology likely to increase productivity and reduce per unit cost, albeit with higher initial investment cost – likely to impact business model • Virtual marketplaces could disintermediate banks, e.g. Second Life, Farmville, Facebook Credits, and wholesale counterparts • Greater global scale and reach could allow for greater specialisation in terms of industry focus • Demand from corporate users for increasing access and flexibility in terms of managing supply chain will impact trade finance technology
Reconnection of financial and real economy	• Fiscal restraint in developed countries likely to decrease transaction volumes as a result of depressed spending • Deleveraging of Western consumers in reaction to financial crisis will further depress spending and transaction volumes • Virtual marketplaces will grow – and often without a link to real economy; however, real economy will continue to exist • Possible future tech bubble will further drive reconnection to real economy – value of tech companies and growth of virtual platforms may be difficult to sustain if they are disconnected from the real economy • Deleveraging of Western corporates will reduce volume of real economy in developed countries

Gearing up for the digital revolution

The advent of smart phones, social media and virtual marketplaces provides an opportunity to engage more closely with customers and improve ease of usability and access. Yet transaction banks are going to face tough competition from mobile networks, internet service providers (ISPs) and other nimble new entrants looking to extend their grip on digital communications to the commercial payment and transaction markets.

From films to fashion, one click and it's on its way. Consumers have become accustomed to the 'Amazon experience' and are now coming to expect the same ease of access and use in their business transactions.

In turn, smart phones, iPads and other such versatile mobile devices are very quickly becoming integral to modern life, further blurring the distinctions between home and work, and exerting a rapidly increasing influence on business priorities and behaviour.

People now want to be able to conduct business when they want, where they want and on the channel of their choice. This goes beyond straightforward purchases. Executives want to analyse performance in real time on their iPad, for example. As they travel from place to place, they want intuitive internet search services that adjust to their location.

The way technology is allowing businesses to reach out to new partners and trade more easily is evident in the development of new virtual business-to-business (B2B) marketplaces. It's notable that two of the most successful, IndiaMart and Alibaba, began life in India and China, respectively. This highlights the importance of e-trading within fast-growth emerging markets and why technology is likely to be so crucial in allowing transaction banks to establish and sustain a strong presence in today's evolving global trade flows.

Seeking out the 'killer app'

While the developments described so far are an opportunity for transaction banks to do what they do better and keep pace with ever-more exacting customer demands, they're not going to fundamentally change their business model. The next phase of technological and market development is set to be more ground-breaking and potentially disruptive to traditional transaction banking business.

At the heart of these changes is the rapid commercialisation of social media. Businesses realise they have to join the social media 'conversation' or risk losing relevance. This is where their customers pick up on and exchange ideas about products and services, and the companies that sell them. The growing power of social media is in turn allowing Google and Facebook to take the lead in shaping modern commerce. Of particular note to transaction banks is the way that social media is beginning to spawn and socialise a new set of currencies and means of exchange, which could eventually move over to B2B commerce.

Prominent new proprietary currencies on social media include Facebook Credits. All transactions for films or games provided by third parties on Facebook must be paid in Facebook Credits, with Facebook taking a 30% fee. We're also seeing the emergence of virtual digital currencies such as Ven, which is used to buy anything from coffee to commodities.

Looking ahead, the use of 'tap and pay' contactless mobile payments is set for take-off as McDonalds and other major outlets begin to accept them and mobile phone makers build the capabilities into their handsets. 'In the past few thousand years, the way we pay has changed just three times – from coins, to paper money, to plastic cards. Now we're on the brink of the next big shift', says Google, in the promotion for its new contactless, 'Google Wallet' system.[17] Google's Chairman, Eric Schmidt, believes the rapid uptake of tap and pay will pave the way for a 'trillion dollar' industry of mobile payments and advertising.[18]

Although it's too early to say how far and how quickly these currency and payment innovations will impinge on B2B commerce, such developments highlight the social media and ISPs' determination to put their stamp on what Google describes as the new 'open commerce ecosystem'.

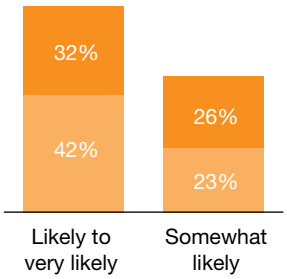
The impact of social media on trading systems can be seen in the launch of IBFX Connect by Interbank FX, a social network for its global FX customers, which allows users to trade online, follow other traders and share tips in a chat room, all for free. In an interview with the UK Daily Telegraph, Todd Crosland, CEO of Interbank, said: 'Just as traders follow news from the Bank of England or the Federal Reserve in the US, we believe they are equally interested in liking, following and copying traders from all over the world.'

Where are transaction banks now?

This combination of rising expectations and technological innovations is beginning to filter through to transaction banking. E-invoicing and payment factories are already allowing companies to greatly improve working capital management, for example. Technology has also been a key facilitator in the development of supply chain finance, connecting trading and financing partners and allowing them to track and trigger the supply chain movements that release the finance. Letters of credit and foreign exchange hedging are among the many areas that are primed for further digitisation, allowing the parties to cut much of the paperwork, telephone quotations and other potential sources of delay to bring the 'Amazon experience' to trade finance. While desk-based internet is still the main channel for such exchanges, the growing appetite for digital migration is reflected in the high proportion of businesses that are now willing to use mobile services (Figure 14).

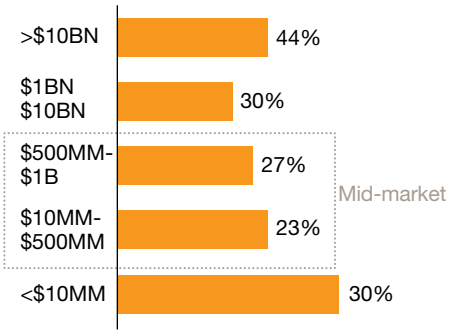
Figure 14: Businesses appear willing to use mobile banking services

Business willingness to use Mobile Banking Services



56% of businesses would use advanced mobile functions (mobile authorisations)

Likeliness to use Advanced Mobile Banking by Organisation Size[1]



Focus on mobile banking efforts should be on the mid-market segments

Source: 'The Business Case for Offering Corporate Mobile Banking Services', Aite Group, October 2010

1. Basic functions defined as checking balances and transferring funds. Advanced functions defined as approving transactions (wires, positive pay, release of payroll batches)

17. Google Wallet website, 27.07.11
18. Financial Times, 22.06.11

How can banks benefit?

These developments aside, digital migration is still a relatively new and uncharted departure for transaction banks. At a time when banks are striving to re-engage with customers after the dislocation and disillusionment of the financial crisis, early movers have an opportunity to mark themselves out in the marketplace as a bank that is prepared to invest in more flexible, efficient and personalised services.

In turn, social media and mobile banking would generate closer and more frequent interaction with customers, allowing banks to develop a better understanding of their clients' needs. As banks look to build up their wallet share, this intuitive digital profile would allow them to anticipate and respond proactively to changing demands, shape services and communications around clients' preferences, and develop a much more active and enduring relationship.

Are banks at risk of being sidelined?

Yet, as digital transformation gathers pace and moves off in new directions, it also opens up considerable challenges and even the risk of disintermediation for transaction banks.

Banks need to be clear about where they can add value and hence where they would sit in an evolving and often disaggregated value chain. To meet customer expectations, they would also need to be able to develop a sufficiently compelling, intuitive and user-friendly multichannel interface. Yet, achieving this would involve the migration of large and highly complex legacy systems. In contrast, the technology and telecommunications companies that are vying for this business have no such encumbrances. Having established their foothold within the business-to-consumer market, they're also better placed to impose their proprietary systems on the B2B marketplace.

Partnering with telecommunications companies would provide access to their technology platform. Yet it would also reduce control for the bank. The partner may also have differing priorities. For example, while payment is a core business for a bank, it may simply be a means to improve customer retention for a mobile telecommunications company or attract greater advertising revenue for an internet or social media network.

The underlying challenge is cost. While mobile banking could cut transaction costs overall, cost is relative and transaction banks are likely to find themselves competing with internet, mobile and other non-bank companies, who can undercut them as they have no legacy systems to maintain. If transactions are seen as a way to bring in and retain users rather than a key source of revenue in their own right, the non-bank competitors may even be prepared to provide such services at a loss, which would put further pressure on banks.

The difficulties faced by the music industry in coming to terms with digital downloads demonstrate how quickly relevance can be lost when businesses fail to get to grips with change. Banks will need to assess and address the challenges of where and how to compete as they seek to develop effective digital strategies. Transaction banking exists to facilitate trade. If banks are unable to follow their customers because they're failing to keep pace with technology or finding it difficult to position themselves within the evolving value chain, then they're sunk.

In the remainder of this article, we look in more detail at the developments in mobile banking, social media and virtual marketplaces, and assess the resulting strategic considerations and options for transaction banks.

Mobile banking

Social media

Virtual marketplace

Mobile banking

Moving into the mainstream

As mobile handsets become ever-more integral to the way people run their lives and conduct business, 'mobile banking' is set to become one of the main forms of interaction between banks and their customers. Yet far from being simply an extension of internet banking, mobile banking creates its own particular expectations and competitive pressures.

The development of mobile banking has followed distinct paths in the developing and developed markets.

In many emerging markets, more people have mobiles than bank accounts and therefore mobile banking has been rapidly embraced by local populations. Indeed, in many cases, this is the only way for people to gain access to financial services (Figure 15 compares mobile penetration and access to financial services).

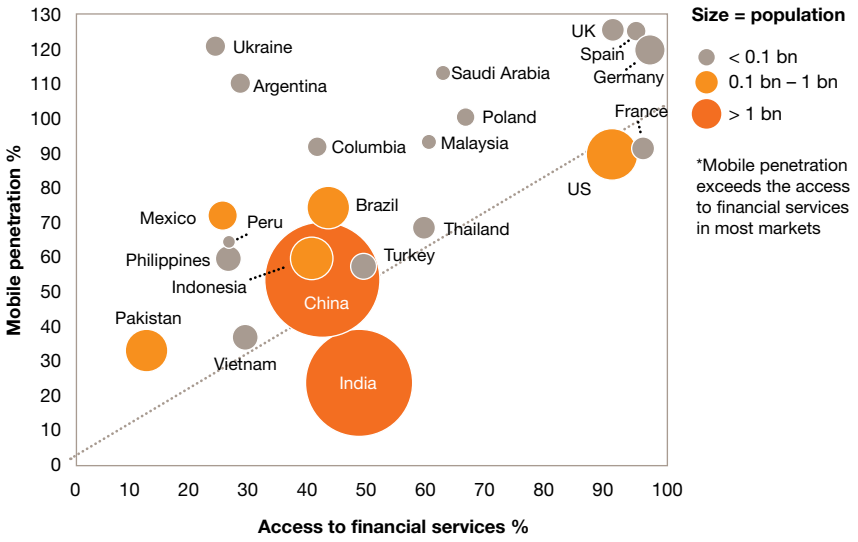
Prominent examples include M-PESA, which was launched in Kenya in 2007 by the Safaricom, an affiliate of Vodafone. The service allows users to pay bills, deposit and transfer money via their mobiles. A network of agents, many of them airtime sellers for the phone network, provides cash-in and cash-out services. M-PESA is now used by some 30% of Kenya's population, more than all the country's banks put together. Indeed, such is the dominance of M-PESA that 70% of its users actually have bank accounts, but still choose to transact through the system. The lesson for transaction banks is that once a mobile operator establishes a dominant presence in the marketplace, they can very quickly find themselves sidelined. While competition within the business-to-business market will initially focus on small and medium-sized enterprises, it could reach into larger businesses more sophisticated products as capabilities become available.

Personal and essential

Mobile banking has been slower to gain ground in developed markets. As most people already have bank accounts, there has not been the 'killer app' of access to financial services that has propelled the growth of mobile banking in many developing markets. However, as mobile handsets become more powerful and ubiquitous, evolving from being simply phones to become all-in-one cameras, music and video players, and gateways to social media and the internet, it was only a matter of time before they became the digital wallet as well.

Figure 3 highlights the mobile handset's ever-more important role as an access point for financial services. The more essential mobiles become to modern life, the more financial services will be channelled through them. Eventually, what was once just another channel is expected to become the primary form of banking, allowing customers to manage their entire financial lives, anytime and anywhere. Rather than just being an extension of internet banking, people expect mobile services to be intuitive, relevant and integral to their lifestyle. The distinctive nature of mobile banking is reflected in the emergence of Jibun, a full service 24-hour mobile-only bank.

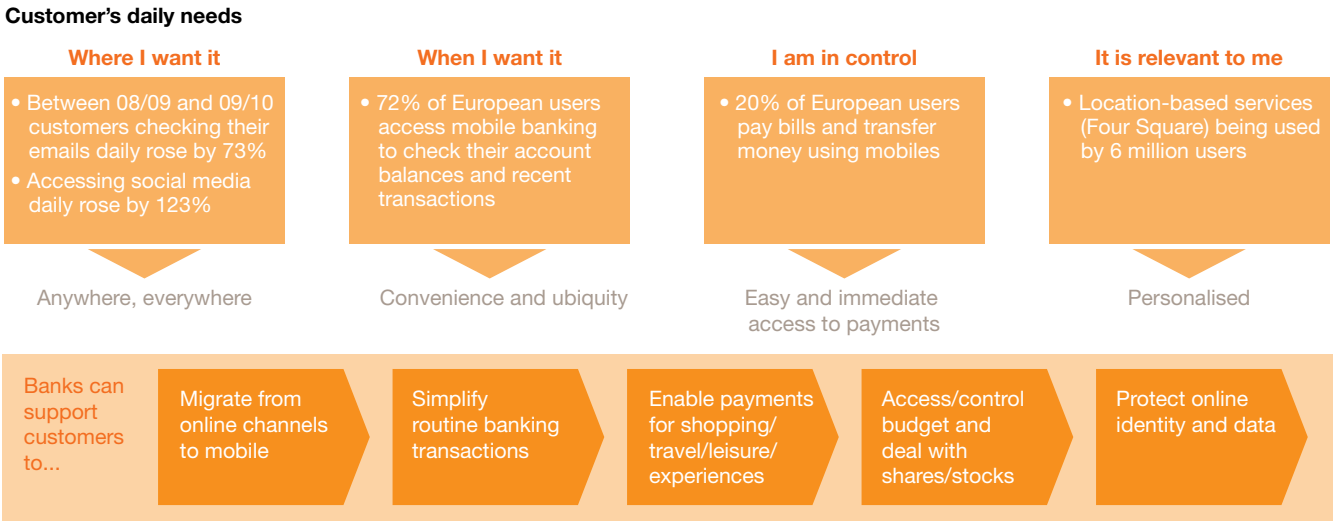
Figure 15: Mobile penetration*



* Mobile Penetration can include double counting due to multiple SIM cards, this is not adjusted

Source: Wireless Intelligence, World Bank WMM

Figure 16: When it comes to finance customers are seeking to enhance their lives, resulting in an evolution of their demands, expectations and needs



Source: Forrester

The move across to transaction banking has already begun, with several leading banks offering mobile payment and authorisation services, as well as providing treasurers with management reports relating to disbursements, returns and intraday positions. More frequent interaction is an opportunity to strengthen customer profiling and engagement.

Developing a new business model

Banks face a number of key considerations in developing their mobile strategies. As the M-PESA example highlights, they could find themselves competing with mobile phone companies for whom mobile banking is a relatively lower-cost venture as the network is already in place. In contrast, banks face higher costs in developing mobile capabilities and integrating these into what would need to be a seamless multichannel interface. Starting small and rolling out services gradually would allow banks to experiment and reduce the risk of big investments that could come unstuck. Yet, this is a market that is developing rapidly and if banks find they're on the back foot, as in Kenya following the fast adoption of M-PESA, they're going to find it difficult to catch up.

Banks can choose to partner with, or provide services for, a mobile phone company. In some countries, mobile phone providers aren't allowed to provide financial services and may therefore seek a joint venture with a bank. However, the culture and business model of a bank and a mobile phone provider may conflict. Many mobile companies are looking to banking to help strengthen customer retention rather than as a core source of revenue in its own right and may therefore have different pricing and return expectations to their banking partners. As a volume business, mobile operators may also want to expand quicker than banks, who may be concerned that moving too quickly may compromise reliability and open up reputation and regulatory risks. Partnerships work best if the benefits are mutual and each party concentrates on its particular competency.

Some banks are developing a new model in which they offer both mobile and financial services, allowing them to take full control of the pricing, relationship and cross-selling opportunities. Rabomobiel was launched by Rabobank in 2006. The bank is able to offer a tailored service, based on bundles of voice, data and mobile financial services usage and take advantage of the cross-subsidies between the various services.

Why should you care?

Mobile banking is fast moving from being just another way to bank to being the way of banking and raising the bar to what banks deliver and how. Fairly soon, a transaction bank without an effective mobile strategy will cease to be competitively relevant.

Social media

Joining the conversation

Social media open up opportunities for transaction banks to develop a richer dialogue with customers and use the insights to build more responsive services and more enduring relationships.

The eruption of social media usage is changing the communications between companies and their customers from one-way marketing and PR to an increasingly open dialogue. Indeed, the conversation about a company and its competitors' brands, products and performance may be taking place without its participation. At the very least, it's important therefore for banks and other companies to seek to listen to the exchanges. Ideally, they should also seek to contribute to, and act upon, what is being said.

In creating a dialogue with customers, it's important to identify what they might value from the conversation (social object) – for corporate treasurers, this might include seeking advice on how to pool cash more effectively or do business in a new market. Although a company can no longer control the content of the conversation, it can seek to establish trust, influence and ultimately, authority, as an expert – for a transaction bank, becoming the institution that companies look to for useful ideas and solutions within the social media forum.

Making the most of social relationships

The business-to-customer dialogue is now spreading to B2B commerce, with the latter shaping the expectations for the former as work and home lives converge. Customers expect the same depth of engagement, transparency and honest dialogue in B2B social media as they would in their consumer interactions. With some customers' faith in their banking relationships having been dented by the financial crisis, a willingness to listen and engage openly and honestly offers banks a valuable way to rebuild trust. The guiding principle for these social media interactions is that what is good for the customer is also good for the business – for a transaction bank, the more it can learn about a customer's working capital priorities, for example, the better it can advise and build saleable solutions around these requirements, both directly and in the development of new products. There are also, of course, risks, if these expectations are not met, including providing a medium for customers to voice their dissatisfaction and possibly compromise the brand.

As the emphasis within transaction banking shifts from a reactive response to request for proposals to a more proactive relationship-driven approach to generating sales (see 'Getting the most out of your sales force'), there would be valuable benefits for institutions that are prepared to listen to, and engage more closely with, customers and potential customers through social media. The competitive advantages include sharper customer insight, market agility, service response and sales enablement, along with overall improvements in sentiment and satisfaction.

Developing a social media strategy

Banks have moved to develop their social media presence at different speeds. In general, while most have been quick to pick up on the marketing potential, they have been more cautious about fully engaging in the conversation. For example, while they may have a corporate presence on Facebook or Twitter, they may restrict personal use of social networking sites at work or as a way for relationship managers to communicate with their clients.

Figure 17: Social media key priorities and operational enablers

	Novice	Intermediate	Advanced
Internal priorities	• Choose a social strategist who will shape the initiative • Begin to educate stakeholders • Create processes to hold internal stakeholders accountable	• Adopt a 'hub and spoke' organisation model • Launch a 'Centre of Excellence' for social media	• Empower stakeholders (the 'spokes') to use social media on their own • Social business becomes part of standard employee education
Customer-facing priorities	• Develop a rapid response team • Work with existing agencies to deploy initial social media programmes	• Use social media to direct ad and marketing spending • Identify and empower influences and customer advocated	• Seek guidance from boutique agencies with specialised expertise • Launch formal advocacy programmes
Technology priorities	• Invest in brand monitoring and appropriate workflows and processes	• Launch a community platform • Invest in social media management systems to meet customer demands	• Integrate social networks into the corporate website • Investigate social CRM; begin to aggregate customer data

Source: PwC

Creating a more 'social business' will require a move beyond marketing to embrace the two-way dialogue described earlier, in which social media engagement is embedded into relations with employees and suppliers as well as customers. This will effect sales, product development and customer relationship management, which will in turn require investment in training and technology, and progressive changes to the culture, operating model and business strategy of the bank

Figure 18 sets out a 'radar' for banks to plot their priorities and progress in developing the key components of social business and assess investment needs as their ambitions mature. Experience in business-to-consumer social media suggests that the best route is to start early and fail early. Banks don't need to get things right first time as honest efforts to engage will be well received. However, it's important to make sure that the engagement is genuine – any attempt to turn social media into a vehicle for slick marketing or PR spin can only alienate customers. It's also important to make sure that sufficient resources are allocated to providing prompt and appropriate engagement. A slow response or stale content will kill any effort to foster a continuing conversation.

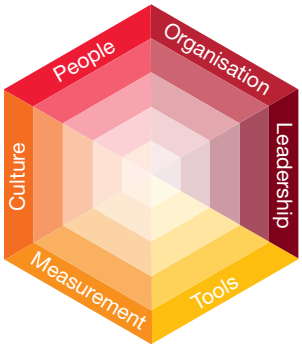
As social media evolves it will move from being a communication tool to a source of collaboration and eventually a transformational opportunity, in which the interactive philosophy behind social media begins to shape strategy. Figure 17 sets out some of the key priorities and operational enablers for each stage of development.

One of the first financial services companies to embrace B2B social media and now one of the most advanced is American Express. Launched in 2007, American Express's OPEN Forum is an online resource and social networking hub for small-business owners and entrepreneurs looking for practical information, tips from industry experts and the chance to communicate with other small business owners. Users create a profile, which allows them to log onto the network, share ideas and connect with other business users. There is also the facility to promote one's own business within this space. OPEN Forum has allowed American Express to change its communications from serious and impersonal to warm and intimate, reflecting the behaviour and expectations of customers in their personal social media interactions. 'The tone has to be that of a trusted partner, not a faceless corporate being', said Mark Roper, chief marketing officer of American Express UK.[19]

Why should you care?

There will always be some scepticism among bankers and other business leaders about the value of social media, especially as they have little control over the communications and the rewards are very difficult to measure. Yet, this is an important opportunity to re-engage with customers, understand their needs better and develop more profitable and enduring relationships. Banks that fail to respond or are reluctant to engage in a genuinely open way are going to lose customers to institutions that are prepared to make this leap of faith.

Figure 18: PwC's Social Business Maturity Radar



Source: PwC

19. 'It's time B2B got emotional', Simon Kershaw, www.haymarketgroup.com, 11.05.11

Virtual marketplaces

Revolutionising payment and exchange

The development of virtual marketplaces and the payment systems to support them is supplanting banks' traditional role as facilitator and guarantor of trade. Sustaining relevance is likely to require a rethink of trade finance products and investment in technology as banks seek to keep pace with an increasingly virtual world of commerce.

The rapid rise of Amazon, Ebay and other virtual marketplaces in business-to-consumer commerce has already demonstrated how quickly e-commerce can change the ground rules and put conventional businesses at risk. However strong their brand or existing market share, conventional businesses have to maintain a valued presence within these new electronic trading arenas to remain relevant, either directly, or in partnership with electronic providers. For transaction banks, the question of relevance is especially pertinent as the virtual marketplaces and supporting payment infrastructure that are being developed for business-to-business (B2B) commerce begin to encroach on their traditional role within the trading system.

Keeping pace with e-commerce

Banks' core role in facilitating trade is making sure that the assigned value is delivered. However, the operators of these virtual marketplaces and payment systems are assuming the role of guarantors, especially as they become ever-more international in scope, supplanting the letters of credit and advancement of funds that banks now provide.

One of the fastest growing virtual marketplaces is IndiaMart, which puts suppliers in touch with buyers, connecting more than 300,000 import and export businesses from around the world. IndiaMart also provides a tender portal for SMEs. Its success has led to the launch of new rivals such as TradeIndia.

The importance of virtual B2B platforms within emerging market commerce is also evident in the growth of Alibaba, China's leading international trade, retail and payment platform. Alibaba uses Alipay, a third-party online payment transfer network, which verifies delivery before releasing funds. Alipay is the first third-party online payment platform to offer cross-border payment, allowing Chinese people to use the renminbi to purchase goods priced in foreign currencies from overseas partner merchant websites. When a buyer pays in renminbi, Alipay will withdraw the payment from the buyer's account in real-time, use the funds to purchase foreign currency and then remit the sum to the international merchant's account in settlement. The key advantage of this system and something transaction banks will need to note as they seek to develop their own capabilities is that it allows online merchants from around the world to overcome the bottleneck of cross-border payment. It therefore makes it easier for them to tap into the commercial opportunities in China's massive consumer market.

Other virtual marketplaces include EuroPrompt, which matches European buyers with international manufacturers, and EC21, a B2B platform, based in South Korea, which brings together buyers and suppliers from over 200 countries.

Who owns the platform?

Social network payment could soon begin to move out of its origins in gaming to reach into new areas of commerce and may, eventually, provide a rival to interbank payment systems. The ability to develop a social media payment infrastructure will therefore be crucial if banks are to remain at the forefront of payment and trade finance.

Second Life, an online virtual world, has developed its own currency, which can be exchanged for real money and has created a host of traders and entrepreneurs on the site. Facebook has taken this currency model a stage further by requiring that all companies accessing its multimillion dollar gaming platforms use its proprietary currency, Facebook Credits, for which they pay a fee of 30% of each transaction.

Trade has always provided a catalyst for innovation and innovation a catalyst for trade. The interplay between technology, social media and changing global trade flows is evident in the development of B2B marketplaces such as Alibaba, IndiaMart and EuroPrompt, new virtual payment networks such as PayPal and Alipay, and new currencies such as Ven, BitCoin and Facebook Credits.

How is value exchanged?

According to its inventors, the Ven virtual currency is global, digital and can be exchanged by anyone. They believe that pegging its value to a basket of currencies makes it more stable and especially suitable for forward contracts on rolling physical goods. The inclusion of carbon futures in the price allows for an element of carbon offset.

Trade currencies are already in a state of flux, with a combination of sovereign debt concerns, exchange rate volatility and changing patterns of trade leads to greater diversification in the range of currencies commonly used in transactions.

The growing popularity of virtual currencies such as Ven adds to the challenges faced by transaction banks. Banks will need to offer trade finance in currencies that hold trust and businesses want to use, whether virtual or linked to a national economy.

What can banks do?

Trade finance will need to adapt to challenges of e-commerce. Letters of credit, documentary collections and other traditional forms of trade finance aren't in tune with the latest developments in e-trade and will eventually be superseded by more viable alternatives. These more viable alternatives need to be feasible in emerging markets, where mobile banking may account for the largest share of bank customers. For banks, the challenge is to provide both the products and supporting infrastructure to facilitate connectivity, minimise trading risk and sustain trust in the eventual settlement. They will also need to look at how to provide the necessary flexibility, ease of use and real-time exchange of information that customers expect.

Why should you care?

Innovation in trade finance is required to keep pace with the innovations in global trade. If not, banks risk losing their role and relevance as facilitators and guarantors of trade. Customers are also increasingly demanding real-time information on the progress of goods and payments as they look to manage their supply chain and the underlying risks more effectively.

Turning cyber security into competitive advantage

The conventional approach to cyber security is coming under ever-increasing strain. It is ill-equipped to keep pace with the constantly evolving and escalating threat of cybercrime. The 'lockdown' approach to security is also preventing institutions from making the most of mobile, social media and other digital opportunities. So how can transaction banks get security to keep pace with the digital revolution?

Earlier this year, the European Commission was forced to halt electronic transactions on the Emissions Trading Scheme (ETS) after it was revealed that the exchange had succumbed to another round of the cyber theft that has plagued the ETS since its inception.[20] At one point, up to 90% of ETS trading in some countries was fraudulent.[21] This isn't the work of a few isolated hackers. The phishing, VAT fraud and other forms of crime being perpetrated over the ETS have been traced back to highly organised criminal gangs. Not only does the ETS face direct losses, fear of crime is deterring legitimate trading.

The problems faced by the ETS highlight the comparable dangers facing transaction banks as cyber criminals move beyond individuals to target trading platforms and payment systems. The vulnerabilities have been magnified by the explosion in data traffic as companies increasingly communicate, transact and analyse information on personal devices such as smart phones and virtual cloud computing networks.

20. Wall Street Journal, 24.01.11
21. Daily Telegraph, 30.01.11

After falling for the last few years, the number and cost of security breaches appears to be rising fast

92% (72%)

of large respondents had a security incident in the last year.

45 (15)

is their average (median) number of breaches in the last year.

£280k – £690k
(£90 – £170k)

is the average cost of a large respondent's worst incident of the year.

2008 comparatives shown in brackets

Source: PwC Information Security Breaches Survey 2010

With the threats increasing and reliance on trustworthy systems growing, certain transaction banks have been responding by seeking to build ever-higher and more impenetrable technological moats and walls to safeguard their crown jewels, though this has been relatively unsuccessful in protecting them from major security breaches. Yet the people engaged in securing payments are struggling to raise their game faster than attackers whose tactics and use of technology are constantly changing. Banks' ability to keep pace is impeded by organisational structures that tend to be too slow and rigid to permit the speed and flexibility of response needed in the cyber world. Security also still tends to be pigeon-holed as an IT issue. As a result, the importance of people and processes are often overlooked and there is lack of communication and mutual understanding between business and security teams.

This inflexible approach to cyber security within many transaction banks is slowing down the commercialisation of mobile, social media and other digital capabilities. As customers look for greater ease and channel flexibility in how they conduct business, they will gravitate to banks that offer the most user-friendly digital experience. As the article on page 30 – 'Gearing up for the digital revolution' – highlights, these advanced interfaces provide an opportunity to interact more closely with clients and help strengthen commercial relationships and wallet share.

Keeping pace with criminal and commercial developments is going to require a more proactive approach to detecting vulnerabilities and developing the technology to counter them. It's also going to require a change of culture, in which business and security strategies are developed in parallel and security needs to become everybody's business. According to Dr Gunter Bitz, senior product manager for security at SAP, 'business in the cyber world means a disruption of traditional perimeter thinking. The task of cyber security is to enable users to do their business securely, wherever they may be and on whatever device they use.'[22] So what are the key features of this forward-looking approach to cyber security?

1. Learning to say 'yes'

Security teams should be at the forefront of the development, marketing and operational management of digital channels. The key question is no longer 'Are we sure we can bring these services to market?', but 'How can we make it happen safely and quickly?'

2. Turning security into a competitive advantage

As electronic transactions and data sharing become more prevalent, people are seeking out more secure avenues of exchange and will be prepared to pay more for the extra safeguards. Examples already include the Apple's 'app' store, which in effect creates a private 'walled garden' for secure downloads and sales. Bank premier and corporate customers are likely to want a comparable level of security and flexibility, and such platforms could be built into the value benefits of their accounts or bank relationships.

3. Being clear about the 'crown jewels'

As data proliferates, it's vital that banks pinpoint what should genuinely be protected, and focus resources to defend it at all costs. The Pentagon's wikileaks' exposures were rooted in the mis-classification and eventual dissemination of information that proved to be far more sensitive and damaging than those who originally rated its security clearance, realised. For banks, these crown jewels include confidential commercial and customer data, as well as information that could be reputationally sensitive such as executive pay.

4. Developing smarter authentication

Back in the 1980s, a lot of people couldn't use their credit cards on a Friday night because there was nobody back at the bank to authenticate the payment. Since then, banks have developed multiple ways to check whether the payment is valid, both technological such as chip and pin, and intuitive such as where the payment is made. As e-transactions become more prevalent, smart banks are looking at how to apply the same combination of intuitive control and technological development. Examples might include more effective use of GPS for mobile payments. As part of bringing security into the heart of the business, it will also be important to break down the silos between different payment and transaction channels, so information on a suspicious transaction on a credit card, for example, could be passed to and acted upon by the internet or mobile banking team.

22. 'Cyber Savvy CEO', published by PwC in August 2011

5. Keeping tabs on payments that may leave no trace

Payment models are already evolving through such developments as contactless payment cards. New forms of anonymous 'digital cash' could soon become commonplace. This clearly heightens already mounting money laundering challenges and banks will need to work with regulators and police to develop effective systems and processes for the future.

6. Developing formal controls for data standardisation and exchange

The regulation of data records and exchange is going to be reshaped as banks and other businesses look to share more information for business intelligence and to derive more revenue from interactive networks. It's important that banks reach out to governments and regulators to help develop workable regulatory solutions that provide proper customer protection without stifling the development of new payment and trading systems.

7. Safeguarding the national infrastructure

Banks may be targeted indirectly, but they are also vulnerable to a breakdown of, or indeed attack on, one of the main internet networks through which cloud, mobile, or internet data are transmitted. So it is important that banks work with governments and ISPs to strengthen protection and develop disaster recovery plans.

Creating a cyber-ready organisation

Creating a more security-aware and engaged organisation is going to require much more active direction from the top and greater collaboration on the ground.

Forward-looking banks are looking at how to develop a better understanding of the scope and scale of their cyber risks and opportunities, which is underpinned by a centralised 'cyber stack' through which information, intelligence and decisions can flow quickly. If security is a key competitive differentiator, then it's also going to require appropriate investment in skills, both within security teams and among the commercial personnel who are developing and running the new digital channels.

The key impetus for this more organisationally engaged and embedded approach is underpinned by clear board-level roles and responsibilities for security. Ideally, someone on the board should have clear responsibility for directing security. There is also increasing executive recognition that security's strategic value is more closely aligned with the business than with IT, which is seen in the trend towards chief security officers reporting directly to the CEO or CFO (see Figure 19). Given its crucial importance to business development, security may even emerge as a board-level role in its own right and across industries.

While many banks have been reluctant to promote their work on security in case it attracts malicious attacks, now may be the time to come out more publicly and communicate the strength of the institution's capabilities. Criminals may be minded to look for softer targets elsewhere, while customers are going to see this as an attraction. Some banks may even choose to go further by taking a more aggressive and even offensive approach to hacking and other cybercrime. This is certainly the direction in which some governments are moving.

Getting on the front foot

Corporate customers want to do business when and how they choose. While this heightens the security challenge, there are huge commercial opportunities for transaction banks that can meet these demands by embracing rather than resisting change. Just as banks need the right people, systems and investment to deliver new products and strategies, they will need to bring security into business planning, development and execution. Security strategies should also be flexible and proactive enough to evolve with market developments and keep on top of the constantly mutating threats. Banks that get this right will be able to turn security from a barrier to an enabler of digital business and ultimately a key source of competitive differentiation.

Figure 19: Who the CISO reports to

	2007	2008	2009	2010	Three-year change
Chief information officer	38%	34%	32%	23%	-39%
Board of directors	21%	24%	28%	32%	+52%
Chief executive officer	32%	34%	35%	36%	+13%
Chief financial officer	11%	11%	13%	15%	+36%
Chief operating officer	9%	10%	12%	15%	+67%
Chief privacy officer	8%	8%	14%	17%	+113%

Source: 2011 PwC Global State of Information Security Survey

Contacts

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