Transaction banking takes off*

Transaction Banking Compass

*connectedthinking
Transaction banking is set to become one of the rising stars of the financial services industry

Although the nature and scope of transaction banking varies across different organisations, most definitions feature some common components. Figure 1 shows that transaction banking businesses, which have historically been focused on payments and cash management, now often include trade-related services, securities processing, and fund services.

In the next two to three years and as understanding of transaction banking improves, it will become normal for analysts to focus on transaction banking business lines when reviewing large financial institutions. The leading international banks will meet those expectations in both organisation and reporting terms, which will be to the ultimate benefit of their shareholders, customers, and staff.

Are you leveraging this opportunity and making yourself part of a potential good news story?

While many high-profile revenue streams have largely dried up in a market battered by the liquidity crisis, transaction banking business lines are proving their value and demonstrating:

- Year-on-year growth patterns in volumes and values;
- Attractive performance results;
- The value of core banking relationships; and
- Clear alignment with traditional brand values.

Transaction banking does not have a generally accepted definition, but an analysis of company reports indicates that in most cases banks with discrete transaction banking businesses have some combination of the five components above.

Source: PricewaterhouseCoopers' 

A clear business benefit doesn't mean an easy management challenge

If transaction banking offers such compelling value, then why hasn’t the idea already taken hold in more organisations?

Definition and scoping is a key challenge since banks organise and structure themselves in so many different ways. Often the explanation is rooted in the genealogy of an organisation, but there are two main factors that determine the extent of the challenge:

1. The nature of leadership, in particular whether the leadership style is federalist, centralist, entrepreneur or administrator; and
2. The nature of the barriers to change within the organisation.
The range of barriers can be significant, and typical examples are set out in Figure 2 above. These illustrate that the person advocating the creation of a transaction banking capability needs to be in a sufficiently senior position if the idea, rationale and business case are to be given a fair hearing. If not, then the response from their affected colleagues will be ambivalent at best and hostile at worst.

Many factors determine the willingness and the ability of an organisation to carve out a transaction banking business, which often necessitates the extension of a shared service utility. Whether these factors can be overcome clearly depends on the basis and the manner in which the reorganisation is first proposed and subsequently undertaken.

Motivating existing revenue holders to engage in the idea is a delicate task, and one that involves reviewing the incentive criteria and expectations of the business activities remaining under their control. Effective leadership is needed to carry this change through, and effective management to ensure that its latent potential is realised.

### A chance to break the mould

Many core components of transaction banking such as cash management, custody payments and trade finance have one feature in common: they all involve large transactional volumes that are amenable to automation.

However, the differing genealogy of these components often results in an unwieldy mix of concentrated and fragmented operational markets. The differing components also tend to serve several important customer segments, including retail consumers, financial institutions and corporate bodies.

For example, cash management is a highly fragmented business in which many banks compete and where there do not tend to be any obviously dominant banks or groups of banks. In contrast, the custody market is dominated by three or four global players. This means that the way in which different transaction banking components have to compete, and therefore their formulas for success, can be quite different.

During the late 1990s and early 2000s, many banks sought to address the inherent inefficiencies that resulted from this history by creating strategic business units. These were supported by shared service centre models, used more ambitious sourcing strategies and often involved deploying more technology to the issues. However, few of these strategies addressed the internal payments infrastructures on which the businesses in question were based, and fewer still addressed the actual business architectures that the infrastructure existed to serve.

Too often banks’ internal transaction processing capabilities are treated as cost centres and financed by complex internal charging structures. Typically they are also independent of product development and revenue-earning responsibilities. In short they are not run as a business, but as a utility, which can be seen in functional organisational structures as opposed to business line or market structures with common components. For many this has resulted in:

- Constrained research and development;
- Infrastructures that are difficult and expensive to adapt;
- Processes that inhibit regular infrastructure investment;
- Change agendas that are dominated by compliance expenditure;
- Scaled down, delayed or ‘cool-boxed’ commercial strategies; and
- High levels of customer complaint and operational incident.

If it is indeed to be a business in its own right, a transaction banking business needs to have a revenue stream. Where this is not already the case, this will normally involve a restructuring of existing business lines in order to reallocate appropriate revenue-generating activities into the new transaction banking business line. This may look like ‘robbing Peter to pay Paul’, but the potential for improved performance means this is a price worth paying.

Treating transaction banking as a business offers the prospect of better alignment of revenue, cost and investment. In short, a new way of doing old business.

### Stay ahead of the pack – go global

An increasing number of leading banks are beginning to recognise the potential value hidden in their transaction activities. They can see an opportunity to exploit this asset and are now working hard to leverage it. Others are content to ape the business activities of competitors, and to set their aspirations according to relative performance measures. The key questions for management should be whether their chosen strategies:

- Are sufficient to break away from the pack;
- Are likely to maximise total shareholder return in the long run; or
- Are going to expose the organisation to business risk in the real economy?

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**Figure 2: Management challenges of formation**

<table>
<thead>
<tr>
<th>Ability to define and agree scope</th>
<th>Pre-existing incentive structures</th>
</tr>
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<tbody>
<tr>
<td>Existing ownership and organisation</td>
<td>Talent loyalties</td>
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Let me get back to you

It requires a more sophisticated sell than simply arguing that you can make a great business if you can take key parts of your colleagues’ sales force, product teams and revenue streams.

Source: PricewaterhouseCoopers
Even for institutions based in the heavily regulated economies of the northern hemisphere, there are ways for some players to get ahead of the pack. To achieve optimal growth in transaction banking, financial institutions need to hitch their cart to the world’s fastest growing economies. It is time to look abroad.

In terms of trade flows, it is crucial to understand that since around 1994 there has been a break-out in global trade as a percentage of GDP. Significant liberalisation has taken place, and over the past decade or so trade volumes have soared on a long-term average from about 4% to 16% of GDP. In the simplest terms, countries are importing and exporting more goods and services than ever before and a lot of that growth involves emerging markets. Figure 3 illustrates the scale and geographical scope of some of these trade flows.

Obviously, a transaction bank business that is focused exclusively on the US or European markets risks missing out if it does not have a presence at both ends of the global supply chain. Growth in the transaction business is being driven by emerging economies, which also have a higher propensity to use trade products than their Western counterparts. The “E7” emerging economies (China, India, Brazil, Russia, Mexico, Indonesia and Turkey) are expected to be around 50% larger than the current G7 countries by 2050.

**Upping the game**

As well as positioning themselves geographically to take advantage of global trade flows, transaction banking businesses can also achieve great benefits from a more innovative commercial strategy.

A fresh approach to customer segmentation can drive up product margins and contribution per customer. Transaction banking businesses have traditionally segmented customers by turnover, sector and location. Similar approaches by competing banks have resulted in limited differentiation, and the end result has been a lack of real competitive advantage.

To be truly innovative in their customer segmentation, banks need to be present at both ends of the supply chain. This gives them better visibility of the total credit risk, including the transaction itself, not just the customer. It is also vital to assess the sophistication of the corporate treasurer. For example, does he or she understand derivatives and structured finance? Reviewing the customer’s level of operational sophistication and internal organisation is another important preparatory step.

By segmenting the market on the basis of customers’ needs, financial sophistication, credit dependency and operational capability, banks can identify different targeting opportunities. If they can then map those needs against specific products, banks can pinpoint the most attractive opportunities to pursue. These can then be targeted with systematic strategies based on relationship, price and product.

Historically banks have tended to give big borrowers many other services free of charge. This is akin to standing logic on its head. If a company is a big borrower from a bank, it probably means it cannot borrow the money elsewhere. If a bank becomes a hub for a significant proportion of a particular industry’s network of transactions, it will have excellent visibility of transaction data and be able to price its services more effectively. This will help the lender to charge its customer a fair market rate for transaction services, rather than giving them away. The end result will be a positive impact on revenues and earnings.

**What every analyst and Finance Director needs to know**

Currently analyst coverage of transaction banking, when it is reported at all, tends to be rather light; even though the transaction banking business of global institutions could be contributing 50% of their profit growth within the next few years. It is therefore vital to see the importance of this business if you are an analyst. For corporate planners there is also a great opportunity to increase enterprise value through reorganisation and better communication.
The message is clear: investors should be made aware that transaction banking earnings are significant, core and growing.

Unfortunately the message doesn’t always get out. Even among those banks that have put a strategic wrapper around their transaction banking business and made this structure visible to shareholders, some could still do much more to communicate future earnings potential to analysts.

There are therefore a number of ways to create and improve the value of transaction businesses, notably:

1. Create it;
2. Report it clearly;
3. Commercialise the cost base;
4. Brief analysts effectively;
5. Communicate key ratios transparently.

In this way analysts will be encouraged to ascribe more value to it. For example, and as summarised by Figure 4:

1. A bank’s share typically trades at 6 to 8 times earnings. In contrast the price-to-earnings ratio of a processing business is usually more than 20 times.
2. Assume that the transaction banking element of a bank is a $2 billion business generating earnings of $700 million per annum;
3. Taking a conservative approach to the average ratios shown above, a bank should be able to persuade an analyst to value its processing business at, say, 15 times earnings rather than valuing it by default at, say, 8 times earnings; and
4. This has the potential to create a valuation uplift of $4.9 billion.

The key is to see the sum of the parts

The sources of income in a transaction banking business are essentially interest margin and fees. In the example shown above, if the fee segment is broken out and sold off as a processor, it could create a business worth $4 or $5 billion depending on the multiples assigned. Equity investors tend to favour processors over banks, owing to their high level of transparency, low regulatory oversight and relative cost, as well as their operating leverage and scale.

Furthermore, many banks are currently short of cash and looking to sell off non-core assets, without fully realising that they are sitting on a huge operational asset. This is effectively a business that a bank does not need to own and one that many private equity firms would love to get their hands on. Is it therefore now time for banks to treat payments as the information processing business that it is and to concentrate instead on treasury and settlement risk elements?

This could be a compelling business case for a bank, provided that it avoids the pitfalls of previous deals and does not simply seek to outsource a problem. A more prudent approach would be to address the underlying operational, technical and people issues, all of which are within management control and scope, with a view to divesting the asset and to realising the gains that are created.

Conclusion

Transaction banking is a business, but one that is underleveraged. With significant upsides to treating it as a business, positioning it properly in the corporate structure and to managing it as a commercial asset, transaction banking should be on the agenda of every major bank.
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Transaction Banking Compass:

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