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THE PAYMENTS PROCESSING OPPORTUNITY FOR BANKS

Moving account-based payments from cost centre to revenue stream

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THE PAYMENTS PROCESSING OPPORTUNITY FOR BANKS

Moving Account-Based Payments from Cost Centre to Revenue Stream

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10 October 2022

This report was commissioned by Icon Solutions, at whose request Celent developed this research. The analysis, conclusions, and opinions are Celent's alone. Icon Solutions had no editorial control over the report contents.

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EXECUTIVE SUMMARY

The model used by most banks for processing account-to-account payments is under strain. Despite payment services being mission critical, a bank's payment operations are largely seen as a cost centre. Crucially, margins are being squeezed from all sides, making current approaches increasingly unsustainable. Engaging a third-party processor or taking a PaaS proposition from a vendor are two options that are gaining traction, and offer clear alternatives to managing this internally. However, this shift is also a commercial opportunity for those banks prepared to enter the market.

Driven by a combination of commercial pressures and changing scheme and regulatory requirements, many banks are investing time and resources in modernising their account-to-account payment processing infrastructure. One theme underpinning much of this activity is the more strategic question over where in the value chain the bank should play, and where they should work with partners. This reflects the growing orthodoxy across the industry towards focusing on the core strengths or assets of an organisation and partnering with specialists who are better able to deliver on the rest.

Partly as a result, there is now a growing ecosystem of players with offerings to address these needs. Adoption of vendor Payment-as-a-Service (PaaS) offerings and propositions from third-party processors continues to grow and shows little sign of slowing.

In parallel, the concept of Banking-as-a-Service has become one of the most important topics in the industry. The idea is a simple one: a bank provides a technology capability and licences for another party to deliver regulated services to its own customers. In short, they deploy their regulatory and technology assets to become a service provider to a third party. That could be a non-bank provider, but it could equally be another bank.

Banking as a Service (BaaS)

A **technology and capability stack**, along with the licences required, to **provide regulated financial services** for third parties to deliver to their own customers in turn.

The question this raises is whether this approach can be applied to payment processing. In other words, is there an opportunity in today's market for banks themselves to extend beyond the current models of correspondent banking and scheme access services to offer more comprehensive payment processing services to other financial institutions?

To investigate this, we have sought opinions and insights from a broad base of financial institutions across Europe. The aim is to understand where the opportunities are in today's landscape, as well as the appetite among banks to consider this kind of model. A key input to this process is a substantial program of primary research run through June and July 2022: the *Celent Payment Processing Survey*. Through this, we have canvassed the opinions of 92 senior executives at banks across Tiers 1–3, each with responsibility for (or insight into) the payments strategy of their organisation.

In addition, we conducted several in-depth interviews with senior executives at Tier 1 banks in Europe to further explore these issues.

The payment processing model is changing

When it comes to thoughts on the current payment processing model, the consensus view in the industry is that something must–and will–change.

Simply put, costs are rising, and revenues are not growing.

Indeed, the situation is becoming more challenging. In our 2022 Celent Payment Processing Survey, 86% of the Tier 1 banks noted that margins on payments are becoming more challenging to maintain. We asked the same question in 2021, and the response was 59%.

Banks are using partners to move away from non-differentiating activities

One important dynamic in today's market is that banks are deciding to work with partners for their payment processing to free capacity to pursue other strategic priorities.

While mitigating the costs of managing payment processing internally is the key driver behind the decision to work with partners, strategic considerations are also very important. Across our panel, 57% of banks in Tiers 2 and 3 noted that they decided to work with partners to focus their resources more effectively on innovation. In addition, 39% reached the view that payment processing is not a core activity for them.

57%

of Tier 2 and Tier 3 banks work with processing partners so that they can focus their resources on innovation.

There is an opportunity to move processing from cost centre to revenue stream

The concept of banks providing payment processing services to other banks (and non-bank entities) is not new. Indeed, this is already a well-established and profitable business for some banks. However, today's market conditions make this idea one that is worth looking at more closely.

This is certainly an approach that has been discussed by many banks. Among Tier 1 banks in Europe, 81% report that they have at some time considered spinning out payments as a separate business and providing those services to others on a standalone basis. While it's clear that most of those conversations didn't turn into concrete action, it nevertheless demonstrates that many banks have at least considered the benefits of taking a different approach to delivering payment services.

Given the demand out there for partner-delivered services, it seems likely that this topic will climb the industry agenda again.

At the core of this are three factors:

1. **At heart, this isn't a new concept.** Many banks already provide payment processing services to other organisations.
2. **Banks need to address their margin pressure.** Offering payment processing services to other banks should help restore margins.
3. **Banks are well positioned to bring something new to the market.** While there are many options when it comes to partners for payment processing, banks can bring new assets to the table.

There is clear interest among this segment for working with other banks. Across Europe, 22% of Tier 2 and 3 banks said they would consider working with another bank for these services. This certainly points to a potentially sizeable opportunity for larger banks to consider targeting.

Supporting value-added services will be key

The most urgent operational issues for many banks when it comes to payments relate to the pressures on costs and margins. However, when selecting a potential partner for payment processing, delivering improvements here is not the priority. While seemingly counter-intuitive, and despite the importance of these areas, they are table stakes. What banks do want to see is the path for a partner to help bring new and innovative services to their customers.

Enhancements in these areas ranked as the greatest in terms of overall willingness to pay or the biggest 'pull' to a new provider. Making better use of transaction data is one such theme and covers a range of different use cases, from supporting real-time transaction and balance information through to complex forecasting and analytics. Overall, 55% of banks in Europe reported that this would be of interest from a processing partner, while cost efficiencies alone are directly attractive to 35% of the market.

55%

of Tier 3 and Tier 3 banks in Europe want processing partners that can deliver value-added services.

This isn't the only area that is high on the agenda for the industry. Extended account services (such as virtual and foreign currency accounts) are of interest to 44% of banks, while 42% see the ability for a partner to manage customer support functions as valuable from a potential processing partner.

Banks considering this opportunity will need to invest

While there is clearly an opportunity for banks to enter this market, it is far from straightforward. Any institution wishing to develop a business here will need to invest considerable resources in the skills and technology platform required to deliver on the opportunities.

Unlocking the potential gains in this space will require new technology

Bringing a competitive offering to market will require investment in a new modern platform, with the elastic scalability of cloud-native design arguably the most appropriate approach. Enabling customers to integrate via a single API, potentially across multiple payment rails, has also emerged as a necessary design feature.

In addition, while offering cost efficiencies is a necessity, the ability to support product innovation is also required. Data monetisation is very high on the industry agenda. Delivering on these needs will require investment not just in the payment engine and associated functionality, but also the means to help clients to deliver stronger services to their end customers.

INTRODUCTION

The way banks manage their account-to-account payment processing is changing. Partnering with vendors and third-party processors is becoming more common, particularly where the internal costs of delivering for new infrastructures or scheme mandates create a clear business case. At the same time, the concept of Banking-as-a-Service is seeing many banks explore the idea of becoming service providers themselves. Pulling these two themes together, there seems to be an opportunity the industry should explore.

A new opportunity for the industry?

While this is a relatively simple question with which to open a Celent report, the idea is becoming an important conversation topic across the industry and merits further exploration.

This isn't an entirely alien notion to much of the industry, after all. Many banks already provide payment processing services to other financial institutions and have done so for years. Correspondent banking is probably the best example, but indirect scheme access models (also referred to 'agency banking' in the UK and other markets) are already well established.

The question is whether there is an opportunity in today's landscape for some banks to extend this principle further. Variations on this theme have been attempted before, of course, but the current dynamic makes this idea worth revisiting.

There is certainly a growing need among small and mid-sized banks for services from partners. The growing maturity and penetration of vendor Payment-as-a-Service (PaaS) offerings, and the more traditional service offerings provided by third party payment processors, demonstrate an appetite among banks to work with others for at least some elements of their needs.

Banks wishing to act as would-be service providers can also bring new sources of value to the table. As regulated entities, they can potentially offer something closer to a true end-to-end service, including elements of compliance and liquidity services, in a way that a vendor or third-party processer commonly cannot.

However, this is not just a case of pushing new volumes through an existing technology stack. Those wishing to enter this market will need to invest in new capabilities, while adopting the mindset of a vendor (or fintech) with regards to service delivery and improvement.

Celent's Payment Processing Survey

To explore this issue, Celent has conducted a significant program of primary research among large and mid-sized banks in Europe (including the UK). Through June and July we surveyed senior executives at 92 banks across the region to understand how each plans to manage its account-to-account payment processing over the coming years.

The research was conducted in two waves:

- **Top tier banks** – Typically the three or four largest institutions in each country, and commonly with an international footprint. Senior executives were asked about their current investment priorities, operational pain points and current processing strategies, as well as their potential appetite for offering services to other banks. Our sample includes 27 banks that would be considered Tier 1 in their domestic markets.
- **Mid-sized banks** – The next tier down. As well as understanding their perspectives on their business challenges, partner strategies, and investment plans, we focused on the potential appetite among this group to work with larger banks as partners for their account-to-account payment processing needs. Our sample includes 65 banks in this category.

In each case, we sought individuals with direct knowledge of the bank's technology strategy as it relates to payments. The questions we asked touched on the following themes:

- Investment priorities and business objectives for account-to-account payment processing in 2022/3.
- Current operational challenges and pain points.
- Current use of partners for account-to-account payment processing.
- Future strategy around offering and consuming processing services from third parties.

As a result, we have a very clear view on how banks in Europe view the current landscape for payment processing, as well as their appetite for variously offering and consuming such services from other banks.

Further information on this research can be found in the Appendix.

TODAY'S PAYMENT PROCESSING LANDSCAPE

Banks are changing the way they think about account-to-account payment processing. Unglamorous and ultimately a volume game, thinning margins, and the near-constant pressure to innovate are leading banks to look to partners to support their activities. Underlying this is a debate about which elements of payment processing are essential for a bank to deliver, and what can be most efficiently supported by partners.

The current payment processing model is under strain

Payments are an essential banking service and one of the most dynamic areas of the industry. New entrants, form factors, and payment rails are driving innovation in digital services across the spectrum, in turn supporting strong growth in volumes.

Innovation *around* the payment is also gaining traction. Value-adding services such as propositions to leverage the data in payment messages are high on the industry agenda, while payment initiation APIs and related services also provide new opportunities for service enhancement.

While growing demand for any service is undoubtedly a good thing, this pace of change makes payment processing an increasingly complicated area for banks to manage. Glance at the news reporting about an outage and it's clear that when banks talk about technology spending to keep the proverbial lights on, payment system uptime and resilience are at the top of the tree.

86%

of Tier 1 banks report that margins on their payments business are getting more difficult to maintain. This has risen from 59% in 2021.

As a result, most large banks continue to manage the bulk of their payment processing activities in-house. This is partly a function of a desire to keep control over what are mission critical systems, but it also reflects the sheer costs, risks, and complexity of trying to unpick what are commonly highly complex and legacy-rich infrastructures.

While this approach served the industry well enough when the market was simpler and margins more generous (at least in small business and corporate/transaction banking), this model is becoming increasingly unsustainable in the face of multiple pressures.

Simply put, costs are rising, and revenues are not growing.

Indeed, the situation is becoming more challenging over time. In our 2022 Celent Payment Processing Survey, 86% of the Tier 1 banks noted that margins on payments are becoming more challenging to maintain. When we asked the same question in 2021, the response was 59%. This indicates the degree to which this pressure is building.

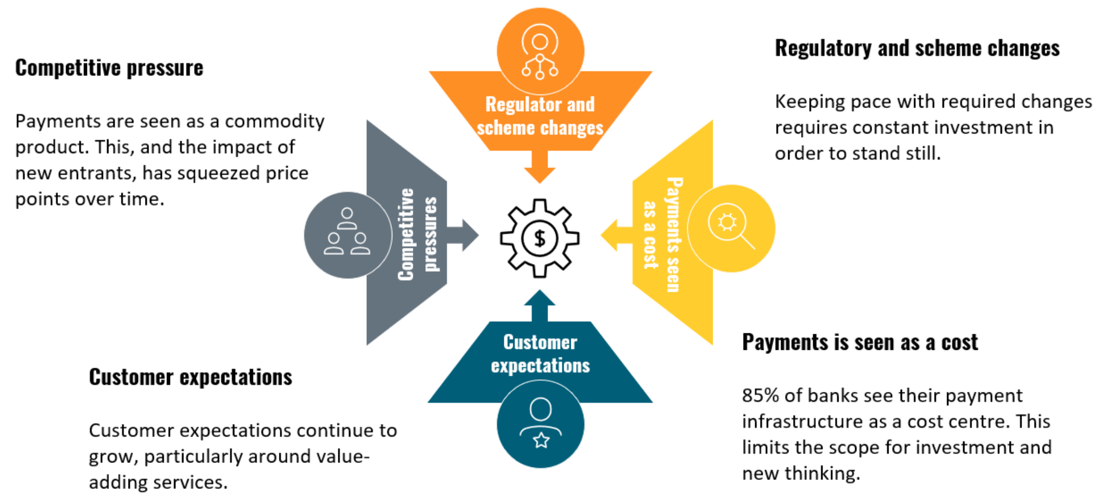
In response, many banks are now looking at new ways to meet their processing needs. Central to this is a re-evaluation of the activities in the value chain that are core for a bank to deliver, versus what can be more efficiently delivered by partners.

Margins are being squeezed from four directions

At a high level, there are four factors that create this margin pressure and the subsequent need to reconsider the current payment processing model:

1. Regulatory and scheme changes require significant investment to remain compliant.
2. Customer expectations drive the need for near constant investment to support innovation.
3. Payment processing is largely seen as a cost centre.
4. Competitive pressures continue to squeeze revenue.

Figure 1: The pressure on payment margins comes from four directions



Source: Celent

Regulatory and scheme changes consume resources

Maintaining regulatory compliance and keeping pace with changing scheme mandates often requires significant investment. Many of these changes can support significant business value or are otherwise important in supporting the ecosystem, so it would be wrong to characterise these as unnecessary burdens. However, the investment needed to meet these requirements does add cost to a bank's payment operations and can draw resources away from other initiatives to shape product development in other ways.

As the Payments CIO of a Tier 1 bank in Europe commented: "*When you see the pace of regulatory change such as ISO, DORA, PSD3, and others, it makes it difficult to focus on the growth agenda*".

To illustrate, regulatory compliance is seen as the biggest single operational challenge for Tier 1 banks when it comes to payments. Across our sample, 63% reported that this is one of their three most pressing issues, including 75% of those in France. To provide some context to this, cost and margin pressures were cited as a leading operational issue by 56% of top tier banks.

> When you see the pace of regulatory change such as ISO, DORA, PSD3 and others, it makes it difficult to focus on the growth agenda.
>
> Payments CIO at a Tier 1 European bank

Competition is squeezing pricing

While the revenue side of things applies more directly to corporate payment flows, competition is growing across the landscape for customer business and payment volumes.

In corporate banking, competition for customer payment flows has been growing more intense over time. On the one hand, the perception of payment services as a commodity has put downward pressure on unit pricing. Equally damaging has been the impact of new entrants and specialists looking to pick up volume in areas such as foreign exchange or cross-border payments.

Customers expect continuous innovation

Customer expectations continue to grow. While not a new phenomenon, there remains an almost constant pressure for banks to focus on innovation and product enhancement across all customer segments. This is driven partly by some of the regulatory and scheme changes outlined above, as well as broader shifts in the service experiences that customers experience elsewhere.

In the retail and small business space, open banking is a particularly important driver of activity. The ability to embed a payment initiation workflow into a broader customer digital journey has a wide range of use cases, from bill payments and enhancing the invoice process for business customers through to digital commerce. For banks, this represents an opportunity to innovate, as well as to increase their account-to-account payment volumes.

Another good example of this is a growing interest among corporate clients for value-adding services. Celent's 2021 report *Now Is the Time for Payments Data Monetisation* highlighted that corporate clients are very willing to pay for services that help them address their most urgent business pain points, with real-time balance information, tools to improve decision-making, and multi-bank dashboards all significant opportunities for the industry. While this is positive news for those banks able to meet these needs, corporate clients appear to be increasingly happy to move their business to access high-value services.

The risk of customer churn is real for those that can't keep pace with these demands, particularly given the growing maturity of non-bank and challenger entrants.

Payments is seen as a cost centre

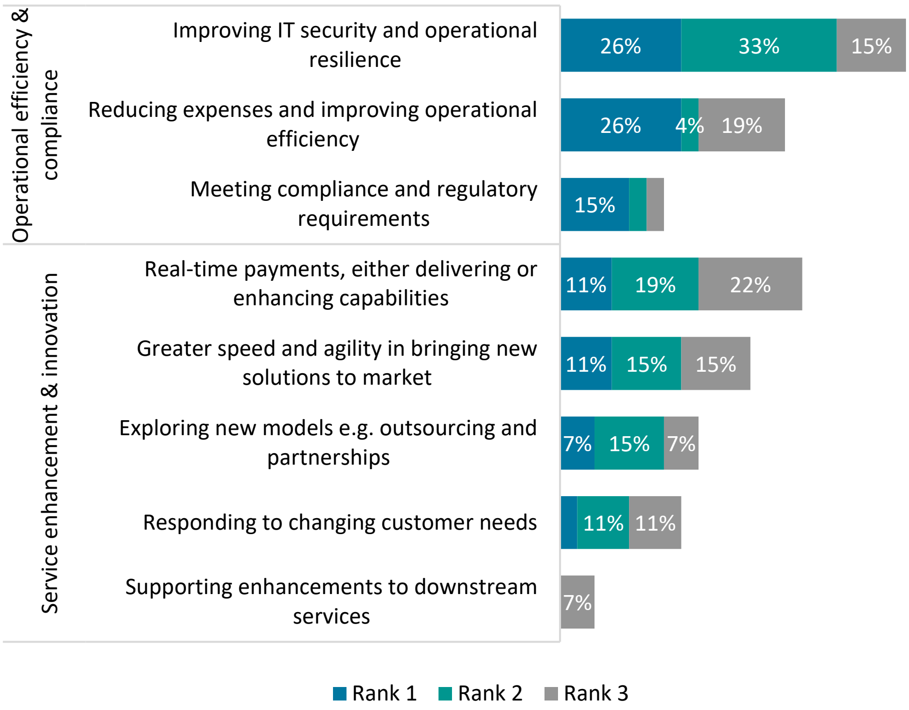
Today, around 85% of Tier 1 banks see their payment infrastructure as a cost centre. Given that many customers view payments as a commodity product, it's not too difficult to understand why. In retail banking, many payment services are offered to the customer free of (direct) charge, while pressure continues to build on payment revenues from small business and corporate clients. The requirement to keep pace with regulatory and scheme changes further reinforces this view.

As a result, 88% of Tier 1 banks report that they only invest in their payment processing infrastructure when it's required to meet compliance needs or to ensure business continuity. This was reinforced by an industry executive interviewed for this research who commented: *"Payments are mostly seen as a mandatory service and, from a pure investment perspective, is looked at as a compliance, risk, and cost case".*

This is further emphasised in Figure 2. When asked about the priorities driving investment in their payment infrastructure in 2022, Tier 1 banks are clear that innovation is secondary to security, resilience, and operational efficiency.

Across Europe, 26% are focusing on improvising security and resilience as their top priority (while a total of 74% cited this as one of their top three objectives), while another 26% listed cost control and operational efficiency as their most important priority. Investments around real-time payments are a clear focus area though, and 52% of banks cite this as one of their three priorities. Nevertheless, only 11% highlighted this as their most important priority.

Figure 2: Payment infrastructure investments are driven by compliance, resilience, and efficiency



Question: *What are the priorities driving your technology-related projects for non-card payments this year?*

Source: Celent Payment Processing Survey 2022

There are few surprises here of course, but the necessary emphasis on operational effectiveness and compliance makes it more difficult for a bank to recognise the opportunities from viewing their payment operations from a different perspective.

Banks routinely use third parties to support their processing

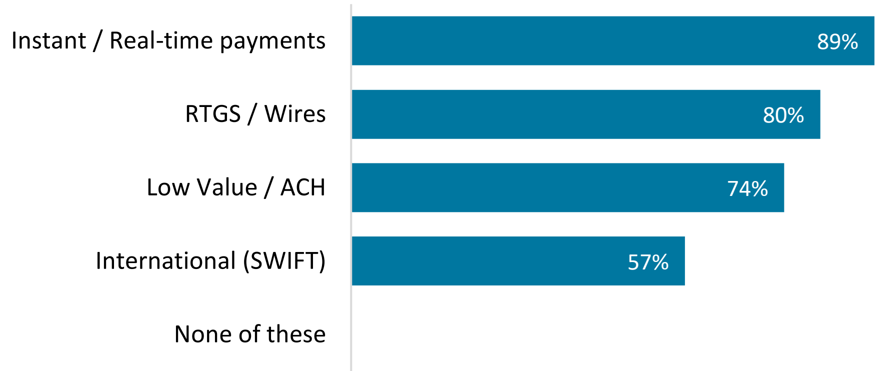
These pressures have been building over a long period and, partly as a result, most banks work with partners for at least some of their payment processing requirements.

Among banks in Tiers 2 and 3 for example, close to 90% work with partners (including software vendor and their SaaS/PaaS offerings, and more traditional third-party processors) to support their real-time payment infrastructure (see Figure 3), and it is rare to find a bank that doesn't work with a partner for a significant element of their needs for at least one rail. It's worth noting that this captures a very broad view when it comes to partnerships and is likely to also include cases where a bank engages with a partner for smaller areas of the value chain.

In many cases, this is becoming a default approach where significant system changes are needed. M&A, the launch of new national or cross-border infrastructures, rising unit costs for a particular payment rail (perhaps due to falling volumes), or substantial regulatory or scheme changes are all events that trigger these discussions. The growth of vendor Payment-as-a-Service models is an important driver of at least some of this activity.

This is not unique to mid-sized banks either, as 19% of Tier 1 banks have already or plan to outsource some or all their needs on at least one payment rail in the future.

Figure 3: The use of partners in payment processing is already commonplace among Tiers 2 and 3



Question: *Does a third party either do or manage some or all of your payment processing activities for the following rails?* All those answering 'Yes'.

Source: Celent Payment Processing Survey 2022

Innovation and freeing capacity for strategic priorities support the decision to partner

One important dynamic in today's market is that banks are deciding to outsource their payment processing or are working with partners to free capacity to pursue other strategic priorities.

Mitigating the costs of managing payment processing internally is the key driver behind the decision to work with partners.

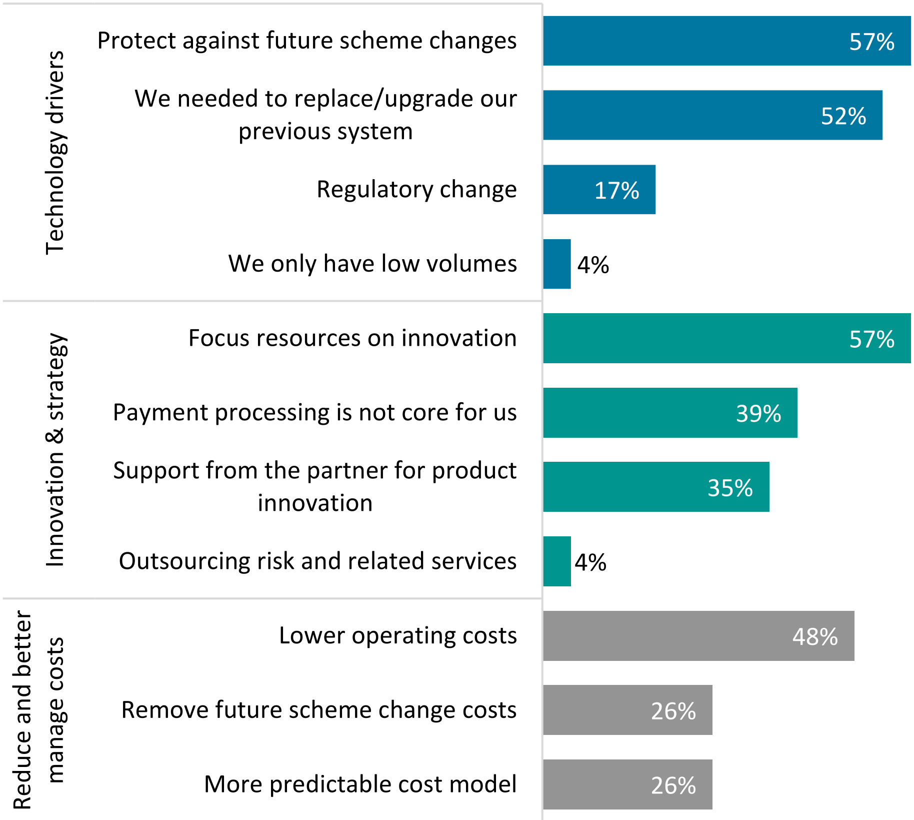
Looking at the banks in Tiers 2 and 3, the most important drivers of the decision to work with a partner were largely around either better efficiency or cost management. As Figure 4 demonstrates, 57% chose to work with partners to protect against future scheme changes, while 48% reported they simply wanted to lower their operating costs.

Related to both these factors, 52% of banks reported that the trigger for finding a partner was the recognition that they had to move away from the platform they were currently using. Presumably the costs of upgrading or otherwise replacing those capabilities made partnering with a third party the obvious choice.

However, there is more at play here than just cost.

Strategic considerations are also important, particularly the need to free capacity for priorities elsewhere. Across our panel, 57% of banks noted that they decided to work with partners to focus their resources more effectively on innovation. In addition, 39% reached the view that payment processing is not a core activity for them.

Figure 4: Cost control is a key objective for banks working with third parties for their payment processing, but support for innovation is a key consideration



Question: *What was the driver for the decision to have a third party manage some or all of your non-card payment volumes?*

Source: Celent Payment Processing Survey 2022

This points to a cultural shift across the industry, as the use of partners is becoming more widely accepted where it can enable the bank to focus more directly on those activities where it can bring greatest differentiation and value. The growth in the conversation around open finance and BaaS models is perhaps the best demonstration of this change in attitude.

As one industry executive interviewed for this report put it: *"15 years ago we'd have said, 'We're a bank, we'll build what we need to run our business'. Then a few years later, we'd have gone 'Ah, that didn't work' and we have lots more layers of legacy to deal with. So now it's more natural for us to think first about partnering".*

Banks will increasingly look to partners for processing

The consensus view in the industry is that something must—and will—change.

Across Europe, 89% of Tier 1 banks and 85% of mid-sized banks believe that the margins on payments will become more challenging to maintain over the next five years. Scale will become increasingly important, and this will continue to make the case for banks to find partners to help manage important elements of their processing.

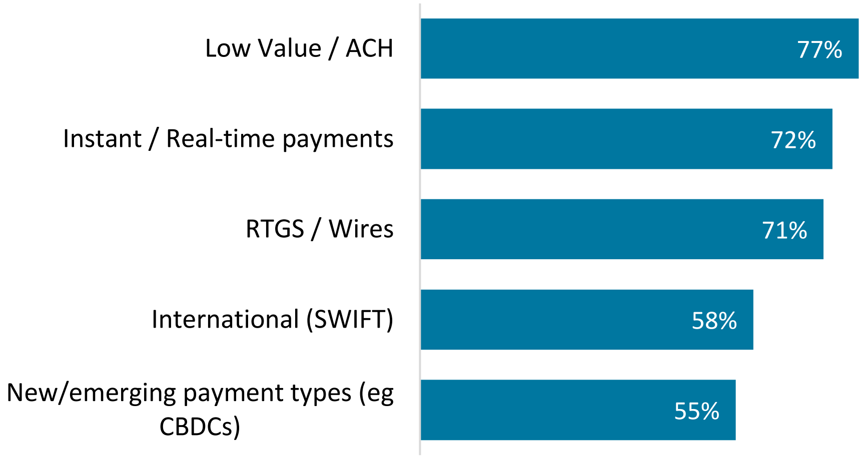
This won't be limited to banks either. The economics of payment processing and the need for scale will continue to drive consolidation among third party processors. This process is already well underway in Europe.

Among banks, regulatory and infrastructure changes will continue to be a catalyst for decisions over forming partnerships, as will broader initiatives to address legacy. Over 70% of banks in Tiers 2 and 3 either expect to make significant changes to their infrastructure in the coming two years, or are currently underway with such efforts for RTGS, ACH, or real-time payments.

As we have seen in the previous section, significant change projects are a catalyst for the discussion over partnerships. This chiefly comes back to whether a bank sees these activities as something commoditised, and therefore better left to a specialist, or a mission critical activity that must be retained in-house.

Ultimately this reflects a growing comfort with these partner and outsourcing models.

Figure 5: Banks in Tiers 2 and 3 expect to make significant changes to their payment processing infrastructure



Question: *In what timeframe do you feel the platform supporting each of the following payment types will require either major enhancements/upgrades or replacement?* All those answering 'This is a current project' and 'within 0-2 years'.

Source: Celent Payment Processing Survey 2022

THE COMMERCIAL OPPORTUNITY

As the way that banks manage their payment processing changes, this will undoubtedly create further opportunities for the vendors and third-party processors that currently deliver some of these services. Banks too should also consider whether they are well positioned to extend their current activities into offering account-to-account payment processing services.

The opportunity: Moving payment processing from cost centre to revenue stream

The concept of banks providing payment processing services to other banks (and non-bank entities) is not new. Indeed, this is already a well-established and profitable business for some banks. However, today's market conditions make this idea one that is worth looking at more closely.

Put simply, the tightening economics around payment processing are creating new demand for partner-delivered services. This looks set to grow over time and creates opportunities for banks to also consider entering this market by directly offering payment processing services to other financial institutions. This would involve moving beyond simple scheme access or correspondent services into providing something closer to an end-to-end proposition, potentially also including coverage across multiple rails along with support for value-added services.

This is certainly an approach that has been discussed by many banks. Among Tier 1 banks in Europe, 81% report that they have at some time considered running payments as a separate business. While it's clear that most of those conversations didn't turn into concrete action, it nevertheless demonstrates that many banks have at least considered the benefits of taking a different approach to delivering payment services.

Given the demand for partner-delivered services, it seems likely that this topic will climb the industry agenda again. For some it is already there. As one senior bank executive commented: *"The market need is definitely there, and the appetite to go beyond the agency banking model exists, but it's down to the capabilities that really make sense to externalise".*

At the core of this are three factors:

1. **At heart, this isn't a new concept.** Many banks already provide payment processing services to other organisations.
2. **Banks need to address their margin pressure.** Offering payment processing services to other banks should help restore margins.

3. **Banks are well positioned to bring something new to the market.** While there are many options when it comes to partners for payment processing, banks can bring new assets to the table.

Banks offering payment processing services is not a new concept

Across Europe, 48% of Tier 1 banks report that they offer some form of service to other banks. Much of this is correspondent banking and scheme access services (also referred to as 'agency banking'), but this demonstrates that these models are already well established in today's large banks.

These services are so entrenched a senior executive interviewed as part of this research report initially questioned whether the topic was worth discussing given that *"We do this already and have been for many years".*

These services are also performing well in most cases. When asked about this in our survey, 93% of banks noted that their processing services to other organisations are a growing area of their business. In addition, almost all report high levels of customer satisfaction.

> "The market need is definitely there, and the appetite to go beyond the agency banking model exists
>
> Senior Executive at a Tier 1 European bank

Building scale will address margin pressure

While this is not necessarily a straightforward proposition for any bank to offer, there are two clear benefits to consider. The first is the potential to generate revenue from these activities. As we have seen, payments is seen as a net cost to most banks. The opportunity to reverse this should be attractive.

At operational level, the opportunity to increase processing scale is a further benefit. All things equal, volume growth will feed through into lower unit processing costs and is something that several banks are potentially open to. Across Europe, 75% of banks noted that they would consider processing for others if it would lead to lower costs.

Some banks already have their own experience to point to in this area. Around 80% of Tier 1 banks report that growing their payment volumes was an important consideration when launching processing services (such as scheme access) to third parties.

Banks can bring new value to the market

This is undoubtedly a dynamic and highly competitive space. PaaS offerings from vendors are growing in both penetration and maturity, as well as frequently being very keenly priced. At the same time, the consolidation among third party processors is driving up scale and helping them to squeeze down per transaction costs.

Despite this, banks can bring new value to this market. While vendor PaaS offerings are growing in maturity and penetration, they do not offer a complete service. Banks working with these partners are still required to manage important parts of the payment process themselves. As licenced entities, banks are uniquely positioned to offer something closer to an end-to-end service to other banks, including leveraging their banking licence, compliance infrastructure, and their liquidity and settlement infrastructure.

There is demand for processing services from banks

Based on the insights shared by our panel of mid-sized banks in Europe, there is certainly demand for further processing services offered by banks.

One of the areas we focused on in our research among Europe's mid-sized banks was their attitudes to having different types of third parties involved in supporting their payment processing (Figure 6). This highlights some interesting points, not least the clear preference for working with partners for their processing needs. Across Europe, only 14% of Tier 2 and 3 banks report that they would always manage their payments in-house.

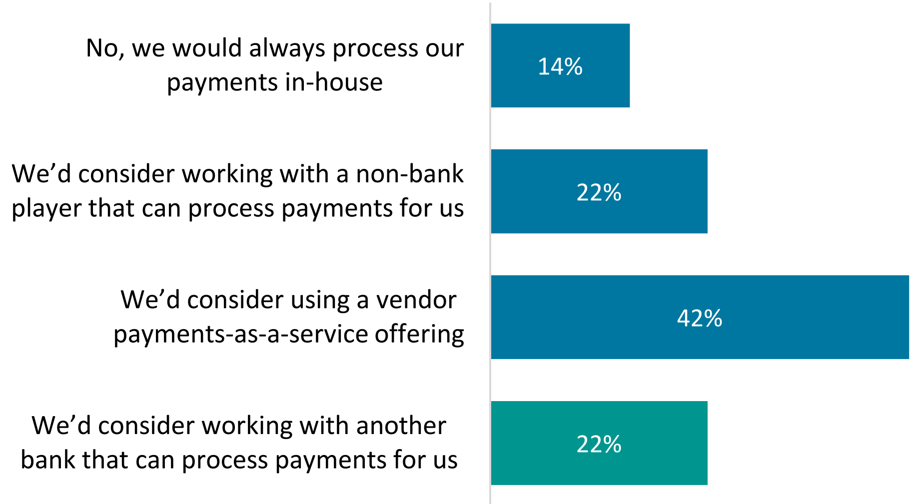
22%

of Tier 2 and 3 banks in Europe would consider consuming payment processing services from another bank.

Vendor PaaS offerings (a software-led approach) emerge as the preferred approach for this segment. Overall, 42% of mid-sized banks indicated that this is their most likely option, which reflects the growing maturity and impact that these offerings are having in the market. At the same time, 22% would prefer to work with partners in a slightly different capacity, such as a managed service with a third-party processor.

There is also clear interest among this segment for working with other banks. Across the region, 22% of Tier 2 and 3 banks said they would consider working with another bank for these services. This certainly points to a potentially sizeable opportunity for larger banks to consider targeting.

Figure 6: The majority of Tier 2 and 3 banks would work with partners for their payment processing, with vendor PaaS offerings the preferred option



Question: *Would you consider having a third party do or manage any of your non-card payment processing, whether from a bank, vendor, or fintech?*

Source: Celent Payment Processing Survey 2022

Tier 1 banks are also interested in working with partners

Demand for having partners manage large parts of their payment processing is not exclusive to mid-sized banks. Many Tier 1 banks in Europe appear to be open to the idea of working with third parties to manage or run some of their account-to-account payment processing.

We asked our panel of Tier 1 banks about their appetite for working with partners for their account-to-account payment processing. The question posed was deliberately open, to capture a view on the degree to which partner services are welcome as well as the differences by payment rail (see Figure 7).

Two important messages come through. The first is a surprisingly high degree of interest in working with partners. While not shown in the chart, 96% of banks said they would consider working with a third-party for at least some part of the value chain in one of the four rails covered in the question (the term 'third-party' in this context is broad and includes processors as well as vendor PaaS offerings).

This is supported by the view of a senior executive at a Tier 1 bank interviewed for this report, who noted: *"We're trying to unwind 40, 50 years of layered-on legacy. We want to have that cloud-based, API-based infrastructure but our view now is that* [rather than build this] *we'll find a partner that is doing this already"*.

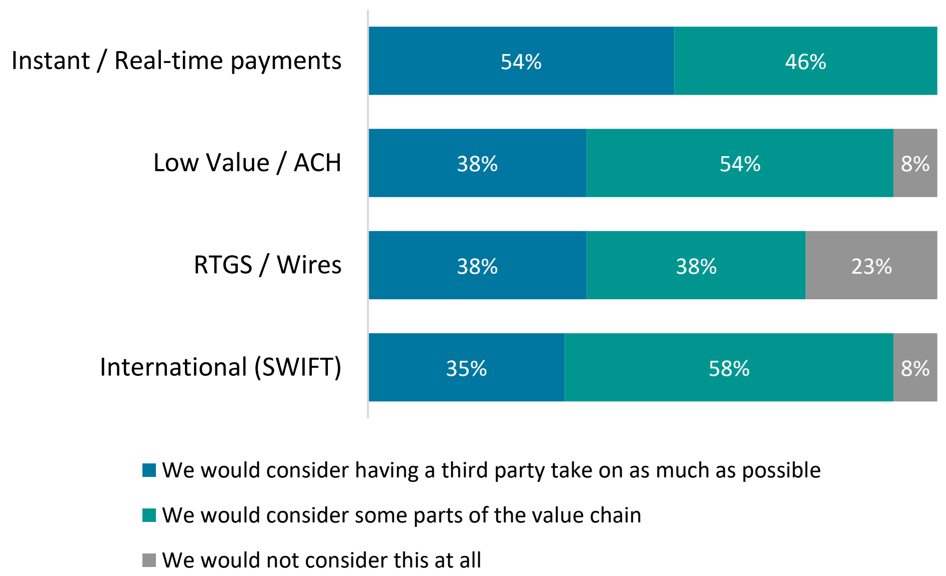
The second key message is there is clear interest even among this segment in handing over large elements of the value chain to partners. In the case of real-time payments for example, 54% of Tier 1 banks in Europe suggested they would be prepared to have a partner taken on 'as much as possible' from the value chain. This is lower in the case of SWIFT, RTGS/Wire, and Low value/ACH infrastructures, but nevertheless we see over 35% of the market interested in this kind of service offering.

> “We’re trying to unwind 40, 50 years of layered-on legacy. We want to have that cloud-based, API-based infrastructure but our view now is that *[rather than build this]* we’ll find a partner that is doing this already
>
> Senior Executive at a Tier 1 European bank

A significant proportion of the market is also interested in engaging with partners on a slightly more limited basis too. In the case of SWIFT for example, 58% of Tier 1 banks are open to a partner playing a more minor role in their payment processing, over and above what is done today.

While these findings are only directional in nature, this nevertheless highlights the potential opportunities for a provider with the proposition and scale to appeal to this customer segment.

Figure 7: Tier 1 banks are very open to working with third parties for their payment processing



Question: *Would you consider using a third party to do or manage some or all your non-card payments?*

Source: Celent Payment Processing Survey 2022

PATH FORWARD

The way that banks approach their payment processing is changing. Indeed, the metaphorical genie long since escaped the bottle. The appetite among banks to leverage partners and free up resources for service innovation is growing and is unlikely to slow. This will undoubtedly create new commercial opportunities for players across the value chain that have the capabilities to deliver on these needs, including banks. But what do banks look for in their processing partners?

Banks want support for innovation and value-added services

The most urgent operational issues for many banks when it comes to payments relate to the pressures on costs and margins. In Europe, 26% of mid-sized banks report that this is their biggest single challenge. However, when it comes to selecting a potential partner for payment processing, delivering improvements here is not the priority.

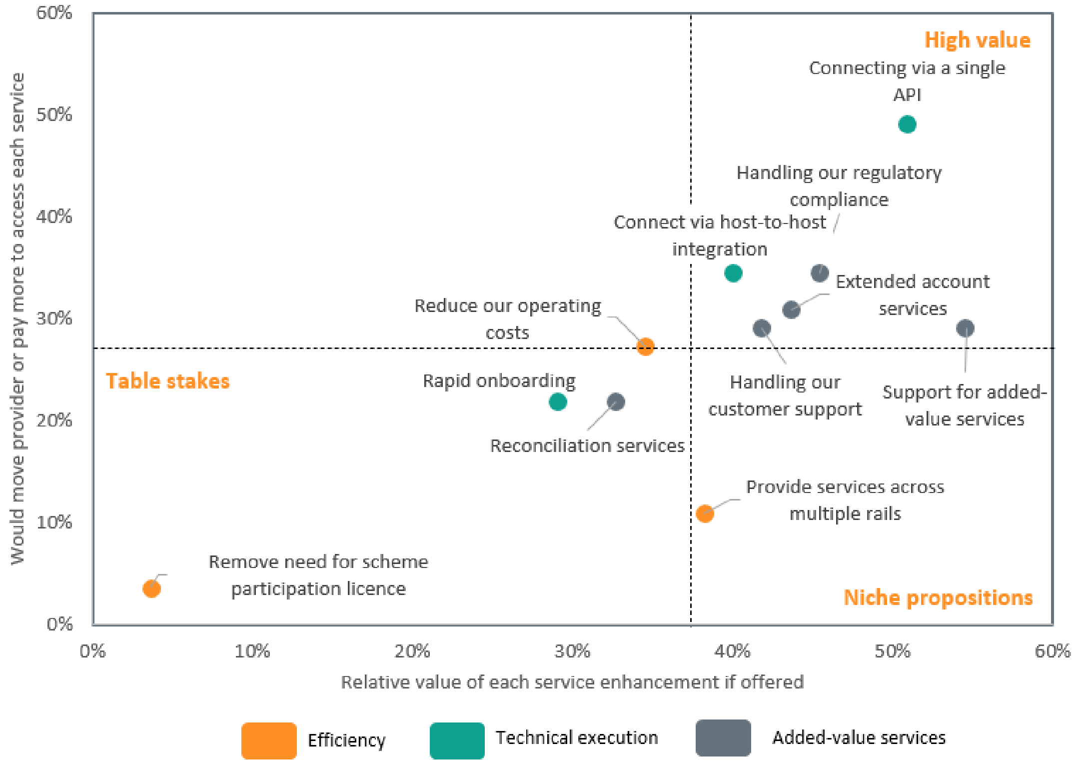
While seemingly counter-intuitive, this is table stakes. What banks do want to see is the path for a partner to help bring new and innovative services to their customers.

To examine what this means in detail, we asked our panel of banks their opinions on two different themes around potential processing partners. The first is the services they would find most valuable, and the second is a ranking around either their willingness to move to a new provider to access that feature or to pay from an existing one. These are positioned together in Figure 8.

The areas examined here are split into three groupings:

1. Efficiency – Primarily cost-related factors.
2. Technical execution – Focused on deployment and related options.
3. Added-value services – The features that go beyond providing the basic functions of payment processing.

Figure 8: Mid-sized banks want processing partners that can offer them new value in the form of new services and a simple integration path



Note: The dotted lines reflect the average response level for each question. The 'High value' segment therefore contains the areas that were ranked highly in both questions.
Question (y-axis): Which of the following would be particularly valuable from a potential processing partner?
Question (x-axis): *Please rank these features based on which would make you move to a particular partner or pay more from an existing partner.*

Source: Celent Payment Processing Survey 2022

Two findings emerge most strongly. The first is the obvious point that elements relating to efficiency, such as lowering unit costs and removing the need for scheme membership are very much the foundation of a payment processing proposition. These are indisputably important but rank poorly when compared to a range of other areas. As such they feature in the bottom-left portion of the distribution above.

Likewise, services around reconciliation and enabling easy onboarding are also seen as relatively low value. It's also worth noting that this is an aggregate view, and that some banks may attach far greater weighting to some of these factors when assessing their partner options.

The second important theme is the importance of strong execution and compelling value-adding services. These are the areas of differentiation for any provider of payment processing services to consider.

When it comes to technical execution, the ability to connect via a single API emerges as particularly high value. Across Europe, 51% of mid-sized banks shared that this is one of the service features of greatest potential value. This speaks to the desire to avoid complicated integrations with the bank's wider infrastructure, and to therefore deliver on the broader opportunity to reduce cost and complexity. It is interesting to note that host-to-host integration is also of interest to 40% of the market.

Beyond this however, the emphasis is squarely on supporting added-value services. Enhancements in these areas ranked as the greatest in terms of overall willingness to pay or the biggest 'pull' to a new provider. Making better use of transaction data is one such theme and covers a range of different use cases, from supporting real-time transaction and balance information through to complex forecasting and analytics. Overall, 55% of banks in Europe reported that this would be of interest from a processing partner.

This isn't the only area though. Extended account services (such as virtual and foreign currency accounts) are of interest to 44% of banks, while 42% see the ability for a partner to manage customer support functions as valuable from a potential processing partner. In addition, there are opportunities in areas such as open banking to create propositions that deliver new sources of value to customers.

A further noteworthy point is the value attached to support with regulatory compliance. This is the third highest ranked area in terms of value to midsized banks and is a neat reminder that the costs of running a payments business extend beyond pure processing and into several other areas. As with customer support and extended account services, this can become a potentially important differentiator for any bank wishing to deploy its existing assets to offer these services to others.

The shift to working with processing partners will be an evolution rather than a revolution

Despite the challenges facing many in the industry, most banks are broadly happy with their current payment infrastructure and processing partners. The decision to consider a new approach to payment processing will continue to be driven by either significant organisational change, costly new scheme or regulatory requirements, or where a burning platform becomes impossible to ignore any longer.

As we saw in the previous chapter, many banks are approaching at least one of these situations. Indeed, while 80% of mid-sized banks in Europe believe their payment infrastructure is currently fit for purpose, 5% have the reverse view. Extrapolated across the region, this alone points to a considerable number of potential conversations about partner-supported processing services.

At the same time, 77% are happy with their existing payment processing partners. However, 8% are not, which also suggests that there is a reasonably large pool of banks potentially open to a change. Offering a clean path to a new set of capabilities – including downstream service innovation – is expected to be an attractive proposition.

Some banks are hesitant about working with partners

While interest in working with partners is building across the industry, many still have concerns. Looking at the 14% of mid-sized banks that have a strong preference to maintain their own processing infrastructure, the biggest single reason for this is concerns over a loss of control. Indeed, 67% of those banks see control as a reason to maintain their own internal capabilities. There is also a strategic dimension here, as 44% of those banks committed to internal processing do so because they see this as a core activity for their organisation.

Two further concerns are commonly raised. Supplier risk is a consideration for 44% of the market, which reflects both the potential for a partner to fail as well as the potential for being 'locked-in' to a particular supplier where the integration process is highly complex.

One industry executive at a Tier 1 bank interviewed for this research summed this up: *"Even we're looking at SaaS solutions, but people in my world are more likely to want to build than outsource. It's a fine balance about how dependent you are on third parties from a risk point of view. You have to think about how far you want to go"*.

The final area is the question of innovation. For 33% of banks preferring to manage their processing in-house, the ability to support downstream service enhancements is important.

Any bank looking to enter this market would need to consider how to address these concerns, particularly when it comes to supporting innovation and the experience of the end-customer.

> " People in my world are more likely to want to build than outsource. It's a fine balance about how dependent you are on third parties from a risk point of view.
>
> Payments CIO at a Tier 1 bank

Banks considering this opportunity will need to invest in technology

While there is clearly an opportunity for banks to enter this market, it is far from straightforward. Any institution wishing to develop a business here will need to invest considerable resources in the skills and technology platform required to deliver on the opportunities.

Any bank looking to move into offering a broader set of payment processing services will have to justify the investment as part of a business case. Putting more volume through an existing legacy infrastructure won't cut it, particularly when the market has many vendor PaaS offerings and options from third-party processor offerings with far more modern underpinnings.

There is a precedent here, though. Those banks that offer services such as correspondent or agency banking typically modernised their infrastructure to do so. Indeed, among Tier 1 banks in Europe that offer these services, 93% invested in their capabilities to support this business line. Equally, among those banks that do not offer any form of processing service to other organisations, 67% reported that this was because their technical capabilities were not up the task.

Bringing a competitive offering to market will require investment in a new modern platform, with the elastic scalability of cloud-native design arguably the most appropriate approach. Enabling customers to integrate via a single API has also emerged as a necessary design feature. Some may wish to go further and consider the ability to bring together offerings from a range of partners into a single offering, along with the necessary orchestration.

In addition, while offering cost efficiencies is a necessity, the ability to support product innovation is also required. Data monetisation is very high on the industry agenda. Delivering on these needs will require investment not just in the payment engine and associated functionality, but also the means to help clients deliver stronger services to their end customers.

New skills and capabilities are also required, along with a view on where to play

Much as in the case of correspondent and agency banking models, becoming a provider of technical services requires more than just technical capabilities. One of the senior executives interviewed for this report observed that *“Processing puts you in vendor mode and you have to answer questions like, ‘Where’s your roadmap?’. While some banks talk agile, they’re not always delivering it”.*

While this speaks to some of the technology-led issues mentioned above, there are other factors at play here too. Meeting SLAs, maintaining proper account management services, and dedicated technical support are all core competencies. Some banks have elements of these capabilities in-house already in the divisions supporting their correspondent and agency/scheme access offerings, but this would need to be scaled up.

This also introduces the notion of risk and the discussion of where (or indeed whether) a bank would wish to play in the market. The more services a bank potentially offers to partners, such as customer care, and reconciliation, the greater the potential implications if something goes wrong. For example, the implications for a bank’s customer handling infrastructure are multiplied if the bank is meeting these requirements for the end users of several client banks as well as their own.

There are also potential reputational risks to consider. As one of the executives interviewed for this research noted *“There is a reputational risk for us if another bank we’re supporting does something wrong. It could even be something simple in their marketing for example, but the risk for us would probably be too high to consider* [entering this market]”.

Ultimately, the decision over whether to move towards those kinds of service elements does therefore involve a discussion of where to put the balance between risk and reward.

Business cases should consider the internal and external gains

Shaping a business case to invest in this area may be challenging for some banks. There are those that have tried and failed in the past, while it is reasonable to note that this is a far from greenfield opportunity given the number of vendor and third-party processor options available.

In addition, some see the potential gains as being outweighed by some of the challenges and potential risks involved. As one bank executive interviewed for this research noted: *"The risk is too high…we have no intention of doing that* [offering end-to-end processing services to other banks]*"*. Furthermore, it would require a large bank to build up a portfolio of several mid-sized banks as clients to make a meaningful difference to their volumes.

However, unlike some business cases there are two ways in which this can benefit the bank. The first (and obvious) one is the revenue injection this can create, particularly where a bank is able to utilise any spare processing capacity. Most intriguingly, there are top tier banks with an interest in working with partners for their payment processing. In some cases, these are greenfield opportunities, while others are looking to move away from some of their lower volume rails. Nevertheless, this demonstrates the scale of the potential market opportunity.

Indeed, while payments are seen by most banks as a cost line, several are beginning to take a revenue-led perspective to their payment operations. One of the executives interviewed for this report discussed the investments made in their organisation to pivot the payments organisation as an enabler of business value: *"We have spent a couple of years working on moving payments from being seen as plumbing to being a growth lever"*. The strategic journey that banks like this are on certainly involves consideration of the wider opportunity around expanding the reach of payment processing services to other banks.

> We have spent a couple of years working on moving payments from being seen as plumbing to being a growth lever
>
> Senior Executive at a Tier 1 UK bank

The second potential benefit for a bank relates to its own transformation objectives. Building a business case for significant payments infrastructure projects is difficult, and is often made more so by the perception of payments as a net cost to the bank.

Where these investments underpin a new and (potentially) commercially successful payment processing business, the nature of the business case changes. This is perhaps a little simplistic but is nevertheless an important factor to consider for any bank wishing to take different approach to scaling and growing its payments business.

There is one more approach here too. A bank that wishes to move quickly may decide to do so in parallel to its existing payment operations, either through acquisition of the necessary technology off the shelf or through some form of partnership with a vendor or similar provider. This would (at least in theory) enable a new payment processing business to be stood up relatively quickly, and certainly faster than by linking it with a significant modernisation program.

A bank successful with this kind of proposition would create the opportunity to migrate its own volumes onto that platform over time. There is certainly ample precedent for the ‘internal fintech’ approach to legacy modernisation across the wider industry that can offer a path for banks with their payment infrastructure.

APPENDIX

In preparing this research, Celent ran two dedicated pieces of primary research. Details of the sample and methodology are provided here but, for further information, please contact Kieran Hines (the report author) at khines@celent.com.

The Celent Payment Processing Survey

To examine the potential market opportunity for banks to expand their payment processing offerings, Celent conducted a significant program of primary research. The Celent Payment Processing survey ran through June and July 2022, and captured the perspectives and insights from senior executives at 92 banks across Europe.

The research ran in two waves:

- **Top tier banks** – Those banks (arguably) best positioned to become suppliers of processing services to other banks.
- **Mid-sized banks** – The segment of the market that represents a large potential customer base for payment processing services.

Further detail on our survey of top tier banks

We surveyed 27 senior executives at Tier 1 banks across 12 countries in Europe. The financial institutions in question are all in the top three to four banks in their domestic market by size, and many have a substantial presence across the region. This list therefore includes many of Europe's largest banks, and the majority have assets of at least $500 billion (or equivalent).

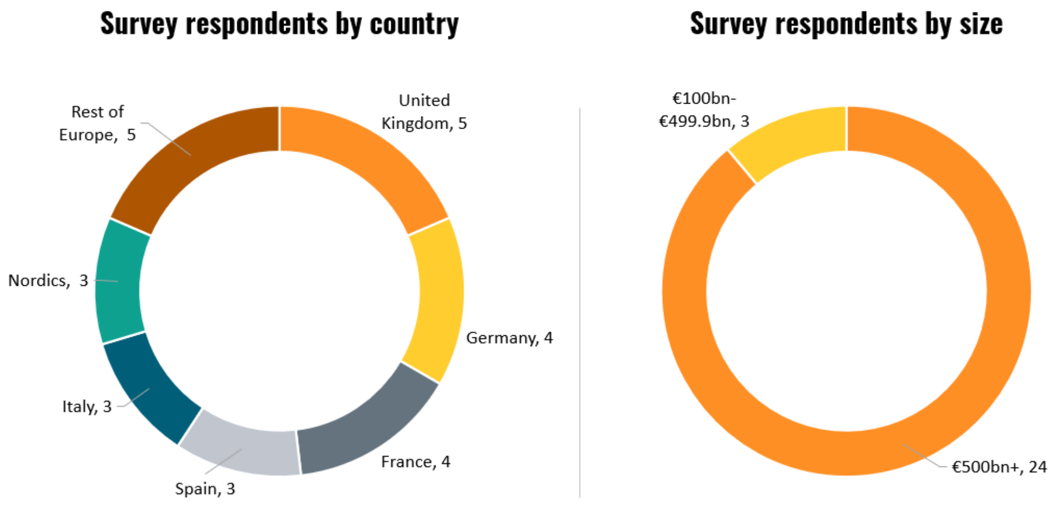
Our respondents were selected based on their ability to provide insights into the payment processing strategy and related technology roadmap at their institution. Example job titles include Head of Payments, Payments CIO, and Head of Transaction Banking.

The questions we asked this group covered several themes, including:

- The way that the bank's payment operations are viewed within the business.
- Technology investment plans and priorities as they relate to payment processing.
- Operational challenges and pain points around payment processing.
- Perspectives on the demand and needs for payment processing services among mid-sized banks.

- Future strategy around offering account-to-account processing services to third parties.

Figure 9: Demographics of our top tier bank sample



Note: 'Rest of Europe' includes Austria, Belgium, Ireland, Portugal, and Switzerland.

Source: Celent Payment Processing Survey 2022

Further detail on our survey of mid-sized banks

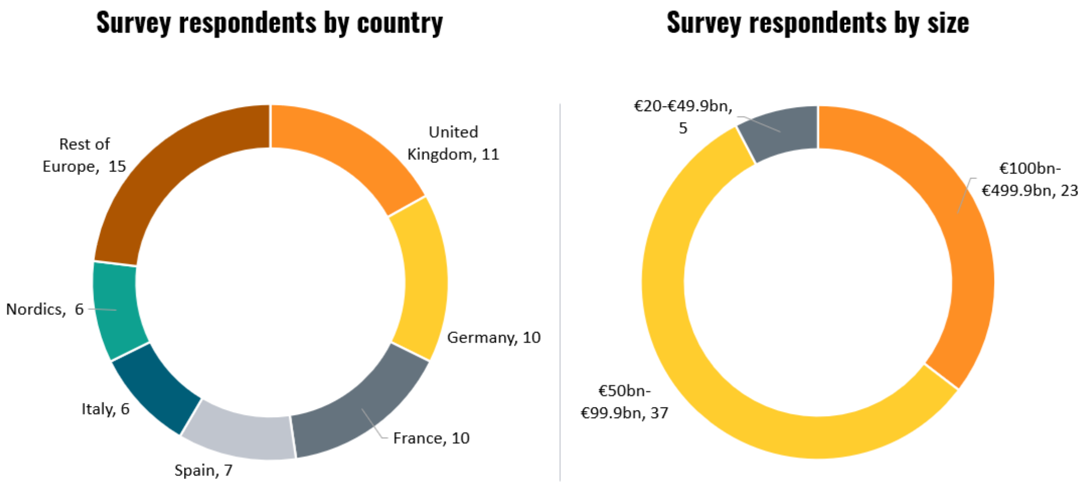
We surveyed 65 banks from across Europe in this branch of the survey. The financial institutions selected to participate were typically the mid-sized banks in each of our target markets, and most have between $50 billion and $500 billion in assets (or equivalent). In some of the smaller European markets, the asset size of our target banks was slightly lower, and in the range of $20 billion to $50 billion.

As with our survey of top tier banks, respondents were selected based on their ability to provide insights into the payment processing strategy and related technology roadmap at their institution. Example job titles include Head of Payments, Payments CIO, and Head of Transaction Banking.

The questions we asked this group covered several themes, including:

- Operational challenges and pain points around payment processing.
- Technology roadmap around payments, along with short-term priorities.
- Changing customer needs and service demand.
- Current use of partners for account-to-account payment processing, and drivers for this decision.
- Likely future demand around partner-delivered payment processing services and the service features of greatest potential value.

Figure 10: Demographics of our mid-sized bank sample



Note: 'Rest of Europe' includes Austria, Belgium, Ireland, Portugal, and Switzerland.

Source: Celent Payment Processing Survey 2022

LEVERAGING CELENT'S EXPERTISE

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Typical projects we support include:

Vendor short listing and selection. We perform discovery specific to you and your business to better understand your unique needs. We then create and administer a custom RFI to selected vendors to assist you in making rapid and accurate vendor choices.

Business practice evaluations. We spend time evaluating your business processes and requirements. Based on our knowledge of the market, we identify potential process or technology constraints and provide clear insights that will help you implement industry best practices.

IT and business strategy creation. We collect perspectives from your executive team, your front-line business and IT staff, and your customers. We then analyze your current position, institutional capabilities, and technology against your goals. If necessary, we help you reformulate your technology and business plans to address short-term and long-term needs.

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We provide services that help you refine your product and service offerings. Examples include:

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