VIEWPOINT

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2018 OUTLOOK: COMMERCIAL AND ENTERPRISE PAYMENTS

Modernizing and collaborating remain key

Digitization continues to spread across the cash cycle as the commercial payments industry better adapts to the need for faster and improved next-generation technological capabilities while simultaneously improving fraud risk management.

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Overview

One of the keys to keeping a finger on the pulse of an industrial market space as important as commercial payments is to remain aware of the broader technologies, business solutions, and services that surround the myriad stakeholders, in effect providing the means for efficient movement of global business liquidity value exceeding $100 trillion per annum. The purpose of Mercator Advisory Group's Commercial and Enterprise Payments Advisory Service is therefore to provide insights across the complete cash cycle, including treasury, trade, and alternative lending.[i] To anticipate the future trends effectively requires glancing back to determine if previous expectations have materialized to the extent anticipated and within the assumed timeframes. We at Mercator have done that and believe the focus and direction of our 2017 Outlook on Commercial and Enterprise Payments[ii] were on target and have not substantively changed as we look ahead into 2018.

Mercator anticipates commercial payment developments will revolve around four general themes: (1) payments efficiency, (2) financial institutions' fintech collaboration, (3) real-time payments, and (4) risk management. Each of these areas has various subthemes that will define the agenda for Mercator's Commercial and Enterprise Payments Service in 2018.

Corporate Payments Remain a Key Business Priority

Digital Cash Cycles

As we predicted for 2017 and beyond, the trend toward digitizing the procure-to-pay process will continue and will accelerate in the coming year. The emphasis remains on payables solutions that incorporate workflow for e-invoices and allow for easier interaction with other solutions spanning from inventory management to general ledger posting and reconciliation.

There are certainly hard cost extractions to be realized in moving away from paper-based processes, the question for each organization being "How much?" As one indicator, the Association for Financial Professionals (AFP) estimates that almost 60% of U.S. companies have no straight-through-processing utility for either payables or receivables. This estimate is a logical consequence of AFP's findings of the continued high use of paper checks for business-to-business (B2B) payments.[iii] Much is to be gained from digitizing processes. Not only are direct cost benefits to be derived from digital initiatives, but there also are opportunity costs associated with nondigital systems and processes. These costs can be explained as the reduced ability (or the inability) to analyze end-to-end process efficiencies because the information is not readily available. An example is a corporate treasurer attempting to accurately forecast cash positions without any visibility into payments in transit. We also see increasing demand among corporate users for solutions through mobile channels, which can only be met through digital capabilities.

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Working Capital

In last year's Outlook forecast, Mercator anticipated that in 2017 the U.S. would begin to experience the long-awaited impact of a return to historical rate norms. Lending rates are typically driven by central bank monetary policy levers in reaction to economic activity. U.S. GDP growth in the wake of the recent economic crisis (2010–2016) has averaged 2.1%,[iv] and the Federal Reserve kept rates to near zero until 2016. The general expectation was that 2017 would see the federal funds rate targets inch closer to 2%, but they now hover at 1.25%. Two factors may begin to accelerate upward movement. The first is the recent GDP growth, which is about 3% for Q3 2017. The second is the potential for fiscal policy changes, which should drive more investment, further affecting GDP.

Rate increases will drive the need for working capital efficiencies, since corporate funding costs usually increase in line with a normal yield curve slope in a growth environment. Digital processes can help identify and leverage the efficiencies available in the cash cycle, especially for larger corporates. As one moves down the scale from largest companies to smallest, the greater need is liquidity, which can be found through an increasing number of alternative finance solutions available across the enterprise market space. Commercial cards payables solutions (such as virtual card accounts, also known as single-use accounts) also provide value as tools for working capital management. While recent indicators still point to corporates' cash hoarding (driven by a lack of general business investment confidence),[v] Mercator thinks this trend may well shift in 2018.

E-Payments Enablement

There is a general misconception that merchants' ability to receive all electronic payments is relatively ubiquitous, with the exception of cards. However, there remains a gap with regard to other electronic payments as well. One study indicated that less than 70% of payables operations use ACH and/or wire transfers for payments.[vi] While technical hurdles exist across the spectrum, card payments generate the most merchant friction.

There is an abundance of activity in and around the virtual card account space as growth rates have accelerated and payment service providers adapt to the wave of interest through new offers and partnerships. While this growth has been primarily in North America, recognition of the value proposition has also increased across other regions. Given the expected shift away from paper checks over the next several years and the limited window for issuers to capitalize on that environment, Mercator Advisory Group believes that enablement of suppliers to receive cards remains a top priority.

Standard Approaches

The annual AFP conference is a good source of insights on corporate concerns. Payments-related sessions predominated across several tracks at the 2017 conference, with roughly 25% of overall meetings/presentations including the topic. A common message was globalization and efficiency, where payments should be more effective, easy, visible, and measurable. The message is ongoing and certainly being heard by financial institutions. In one corporate study presented it was clear that preference is growing for both centralized systems and reliance on non-banks for execution.[vii] One approach to remaining in the middle of corporate transaction relationships is through the use of modern payment hubs, which allow for better integration between various delivery systems and greater data visibility.

Fintech Collaboration

Driving Transactions

Financial institutions are more heavily reliant on fee-based businesses in these days of declining net interest margins and tightened capital/liquidity requirements. One global banking study found that 65% of banks' net income is related to fee-based businesses (including payments) as opposed to core lending activities.[viii] It is in the banks' best interests not only to protect and grow transaction accounts but also to maintain the face of the client relationship through branding and product delivery options. Disintermediating banks from their clients is certainly an objective of financial technology (fintech) start-ups, which are designing applications to work more uniformly across various bank accounts. Banks have generally shifted from a defensive position to one accepting that collaboration with fintech firms will be the path to success over the longer term.

Fintech Investments

A recent estimate had 2017 global venture capital-backed (VC) fintech investments on a run rate of about $16 billion, more than 19% higher than in 2016.[ix] Banks are approaching the latest-generation technology frenzy in different ways. For several years now there has been a combination of innovation labs for internal development and accelerator/incubator programs for greater collaboration with nonfinancial entrepreneurs. JPMorgan Chase runs a commercial banking accelerator program called In-Residence, whereby fintech start-ups that qualify work alongside bank employees to solve problems and develop products. Banks have also been increasing direct investment in fintechs through internal venture capital, or VC, arms. Examples include Banco Santander's InnoVentures with investments in iZettle, Ripple, and Tradeshift, among others. Another is Citi Ventures, with a portfolio that includes Chain, R3, and C2FO.

Collaboration Focus

Mercator sees three areas of rather high interest with regard to commercial banks and fintechs working together, only one of which has some clearly broad market visibility to date:

Blockchain is a case study in ultra-hype given the early expectations for the technology, the hype almost bordering on delivering universal salvation. That exaggerated view finally appears to have died down somewhat. We are entering what could be called a third phase of blockchain's life cycle in the financial services industry. The first phase was industry participants' learning about blockchain and how it could be used. The second was (and continues to be) testing real industry sector use cases that may result in better operating efficiencies and potential new products. The bank blockchain consortium scenario led by the tech firm R3 is an example. The nascent third phase is where limited or modified products are in-market and expanded launches can be expected in 2018. The use cases for potential industrial-strength corporate banking services are mostly in three areas: (1) cross-border payments (Ethereum, Ripple, SWIFT, recent announcements by Visa and American Express), (2) trade and supply chain services (Bank of America, HSBC, IBM, R3), and (3) fraud management (IBM, Verifi).

Application programming interfaces (APIs) come in several types or levels of interaction between companies. Payment networks and banks are now utilizing the technology more actively to allow both clients and partners to more easily integrate payments services. One example is Visa B2B Connect, whereby participating banks use APIs to create easier cross-border payment experiences. Another is the fintech Stripe, which enables e-commerce merchants to integrate multicurrency payments acceptance on their websites.

Automated payables have been catalysts for a series of partnerships and investments throughout 2017 directly related to capabilities for making accounts payable an easier experience. The major card processing networks have all announced integration partnerships with payables software companies, as evidenced by Mastercard launching a B2B hub for accounts payable beyond cards. Individual institutions have recently invested substantial amounts in payables-related fintechs (for example, JP Morgan Chase with Bill.com and Keybank with Billtrust). This activity will continue throughout 2018.

Real-Time Payments

The Adoption Question

During the past several years, Mercator Advisory Group has covered the slow march toward faster payments systems (FPS) in the United States. The roots of the faster payments initiative can be traced to early discussions on faster ACH, followed by the Fed's 2013 consultation paper on improving U.S. payments systems. Launch has now occurred for both same-day ACH credits (September 2016) and same-day ACH debits (September 2017) as well as a first version real-time payments platform (RTP) from The Clearing House (TCH) in November 2017. This new reality of actual faster payments in the U.S. begs the question "What next?" There are a number of other faster payment systems in existence across the globe and impending versions in Australia and the European Union expected to be launched during Q1 2018. The difference between the U.S. approach and that of other sovereign markets is the lack of a regulatory mandate in the U.S. The Federal Reserve is taking a consultative role, expecting market-based initiatives, which is unlike the mandate of the European Union, for example, for faster payments. Achieving faster payments is certainly not as simple as flipping on an FPS switch. Now that faster payment systems are rolling out, banks must create the capability to originate these requests when received. Corporates will need to enable these payments types through various enterprise systems. Mercator will continue its close tracking of faster payments adoption and implications across B2B scenarios.

Near-Term Implications

Some of the outstanding questions around various FPS models are obvious ones related to pricing, demand, and launch effort, each a driver of adoption. Other frequently mentioned concerns are the potential displacement of other existing payments types (cards, wires) as well as the risk of fraud and comparisons of actual pricing/cost. There is already some data from same-day ACH credits, which have grown at a fairly high rate in year one, albeit from a zero base. There is obviously no data from the TCH launch of RTP version 1, only speculation. There is not much yet to glean from the existing faster payments systems around the globe since they have been mostly consumer-oriented systems and generally lacking available data, so it will be interesting to monitor ongoing B2B faster payments. Generally speaking, in the U.S. to date, interest in faster payments has been tepid among financial institutions and corporates, to some degree as a result of the previous lack of an actual system as well as missing details regarding pricing. Mercator believes 2018 will be a year of analysis and preparation for launch readiness of faster payments across the industry, with momentum increasing for expansion by 2020. As seen with continuing check usage in the B2B space, there is a fair amount of inertia among corporate treasurers for adopting new things. In effect, FPS cannot be ignored by financial institutions due to competitive concerns and is an additional modern payments tool as we continue the march toward digital payments. The coming year will provide much more clarity regarding long-term usage.

Keep in mind that all faster payments systems to date are domestic systems, although the European Union's forthcoming Single Euro Payments Area version known as SEPA Instant Credit Transfer (SCT Inst) is pan-European. The longer-term question about these systems concerns their ability to offer real-time cross-border services connecting sovereign systems seamlessly and at fair cost.

Fraud Risk Management

Protecting the Gates

The rise of cybersecurity risk around the globe is a concern for all governments and industries. Broad cyber assault is ongoing, with attacks on all types of global organizations, including governments, public infrastructure (e.g., power grids), and industrial corporations across all sectors. Once a data breach occurs, there is a chance for some of the stolen information to be used to transfer money to fraudsters. Financial services industry participants have particular vulnerabilities given that fraudulent value transfer will touch upon a bank system at some point. Direct data breaches in financial services also carry a higher risk of lost business as well as subsequent regulatory scrutiny and fines not typically associated with other sectors.[x] As such, banks and other financial institutions not only need to make substantial investments across their own scope of systems but also to closely monitor broader external security threats since similar breaches are likely to come knocking at the bank doors soon enough.

Prevention and Mitigation

The two major priorities for the industry are preventing breaches that can result in successful payments fraud attempts in the first place as well as having systems and plans in place to minimize the impact of a security incident once it occurs. Various solutions are available across the spectrum addressing all stages of risk management, including policies, procedures, and systems. Among the systemic solutions are enterprise risk systems and analytics for detection. Vendors occupy all spaces, providing software and managed services.

Mercator Advisory Group sees the use of artificial intelligence (AI) as being of increasing value in fraud management through detection analytics. AI has been around for a long time and should not be overhyped as the silver bullet of payments fraud prevention, but improved capabilities and computing speed make it another important tool for more efficiently detecting real incidents and reducing false positives. One must remember that AI does not work without strong data management capabilities. Another consideration is that fraudsters will use counter-tools, so the battle goes on. There is no real substitute or short cut in managing the problem. Financial institutions should have a comprehensive corporate strategy to address cyber risk, including effective utilization of policies, procedures, partners, and systems.

Conclusions

Looking forward in the commercial payments industry for the next 12–18 months, we see similar priorities and trends as in the previous year, with a focus on digital transition in many forms. Payments have core importance to the corporate banking segment. Corporations need to increase digital execution across their cash cycle functions, and banks therefore must deliver an easy experience and execute more quickly and efficiently in order to maintain their primary relationship status with their corporate clients. Start-up financial technology (fintech) providers have attracted massive investments in recent years. Banks and payments service providers are also continually seeking to deliver better services and maintain an edge over the competition. They are collaborating more directly and investing heavily to bring next-generation technology capabilities to their clients. Various technologies are continually being tested and implemented which are not always visible to end users. We expect that the newest faster payments systems now available will gain much more attention in 2018 as companies and banks analyze the systems' capabilities against their needs and associated costs. Fraud risk management remains an ongoing challenge given the increased cybersecurity risks faced across the globe. Financial institutions have particular vulnerabilities here and of course need to remain at the forefront in managing risk in all aspects of their organizations.

Endnotes

[i] Mercator Advisory Group, Commercial and Enterprise Payments service overview, see "Service Description' https://www.mercatoradvisorygroup.com/Services/Commercial/

[ii] Mercator Advisory Group, 2017 Outlook https://www.mercatoradvisorygroup.com/Notes/2017_Outlook___Commercial_and_Enterprise_Payments/

[iii] AFP, 2016 Electronic Payments Survey, https://www.afponline.org/publications-data-tools/reports/survey-research-economic-data/2016-afp-electronic-payments-survey

[iv] World Bank data, https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

[v] AFP Corporate Cash Indicators, https://www.afponline.org/publications-data-tools/data-tools/afp-corporate-cash-indicators

[vi] Institute for Financial Operations, Kofax – AP Efficiency Study, http://www.financialops.org/documents/11703/28927/2015+Kofax+-+AP+Efficiency+Study.pdf

[vii] FIS, B2B Payments and Bank Connectivity Study, https://www.fisglobal.com/-/media/fisglobal/files/whitepaper/payments-and-bank-connectivity-market-study.pdf

[viii] McKinsey, https://www.mckinsey.com/industries/financial-services/our-insights/remaking-the-bank-for-an-ecosystem-world

[ix] CB Insights, https://www.cbinsights.com/research/report/fintech-trends-q2-2017/

[x] IBM, Ponemon Data Breach Study 2017, https://www.ibm.com/security/infographics/data-breach/

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