CORRESPONDENT BANKING STEPS INTO A NEW ERA

Cross-border payments

Correspondent banking relationships may have been scaled back because of a stricter regulatory environment since the financial crisis, but a refocusing of bank strategies, close industry collaboration and exciting new technologies are ensuring cross-border payments are keeping up with the demand. Christian Westerhaus, global head of clearing products, cash management, at Deutsche Bank explains why the future is bright.

It is not news that correspondent banking has come under pressure in recent years. Increased regulations, sky-high customer expectations and fresh competition have thrust this traditional banking model into the spotlight. Yet for corporates settling cross-border payments, it remains the go-to mode of payment, with most of their international payments being settled bank-to-bank.

New initiatives are coming to the fore in this rapidly changing environment. For example, Swift global payments innovation (gpi) joins payment intermediaries via a cloud-based cross-border payments tracker (see interview with Swift's Wim Raymaekers on page 113).

Swift reports that 50% of gpi payments are credited in less than 30 minutes and approximately 92% within a day, which has had a dramatic impact on the industry. Banks can credit payments within minutes or even seconds, while their customers benefit from shorter supply cycles and can get down to the business of shipping goods much more quickly.

HEAVY TRAFFIC

The correspondent banking industry is aware that the speed, transparency and traceability of cross-border payments are hot topics when it comes to customer expectations, but the nature of correspondent relationships must not be overlooked: maintaining the size and reach of the network is vital. The Swift network, which is the way financial institutions reach one another today, certainly has this reach, handling a large amount of traffic.

In April 2018, Swift recorded a daily average of 30.62 million FIN messages, which transmit information from one financial institution to another. In addition, traffic grew 12.1% in the year to June 2018, with reporting messages contributing 50% of this growth and representing 47% of the total traffic.

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It is not yet clear how alternative payment providers outside the network can attain the same level of reachability. Merely offering connections to single banks is not enough.

Counterparties are also now increasingly demanding in terms of being able to track and trace their payments, and want assurance that the network is secure. Swift gpi not only provides this, but provides greater visibility over transaction fees and foreign exchange rates.

This, along with payments intermediaries being connected on one system, drastically reduces the time it takes credits to reach beneficiaries, from days to less than 30 minutes. This usually results in banks crediting funds on the same day of receipt. Thanks to Swift gpi, corporates and financial institutions are operating in an environment that paves the way for growth and efficiency unseen before.

A REGULATORY BALANCE

Stricter regulations affecting correspondent banking have come largely in the form of know-your-customer requirements and anti-money laundering controls. Ensuring effective compliance, while essential for the safety and integrity of global payment networks, can require significant time and budget commitments from banks.

While this is certainly true in the global cash space, the largely paper-based trade finance space – although slowly digitalising – has perhaps suffered the most. Collecting data and cross-checking reams of documentation to ensure compliance is a serious effort, pushing up transaction costs, and many banks have understandably had to scale back correspondent relationships.

The Financial Action Task Force has been active in addressing this problem. It has highlighted how derisking can increase the number of payments in less regulated channels, reducing transparency and excluding certain parties, in turn raising money laundering and terrorist financing risks, a counter-intuitive possible result of increased regulation. It advises financial institutions to fully identify and understand terrorist financing and money laundering risks, and implement the necessary preventative measures.

BETTER RELATIONSHIPS

Banks that are scaling back are therefore prioritising deeper, more strategic global financial institution partnerships within existing correspondent networks, assessing which contracts offer the most value, then realigning efforts accordingly.

Swift's paper 'Correspondent Banking 3.0' breaks correspondent banking relationships into three tiers. The first is partner banks, where there is a strong relationship and usually a focused geographic presence, so that they can handle high payment volumes across many products. Second is specialist correspondent banks, which have strong expertise in specific products. The third tier is coverage banks, which enhance the geographic footprint of a bank where it might not have a presence.

Correspondent banks, such as Deutsche Bank, are using such frameworks and other resources to turn the challenge into an »

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opportunity, not only managing and mitigating risk so that they are compliant with regulations, but also ensuring these measures increase efficiency and support growth.

This means communicating risk tolerance standards to other financial institutions via policy statements on prohibited or high-risk transactions, for example. Such measures help correspondent banks not only to identify new risks, but increase the capacity for financial institutions to comply.

CUSTOMER DEMAND

In addition to compliance, digital advances are driving corporate demand for better pricing, speed and transparency of services. Yet the complexity of large corporate treasury structures means that fully integrated, highly refined solutions are the only way to solve their liquidity and working capital problems. As such, third-party instant digital payment providers and fintechs do not yet pose a threat to correspondent banks, who can leverage their vast networks and expertise.

But banks should not rest on their laurels. Cross-border payments and foreign exchange simply cannot return to the times when beneficiary accounts took a week to be credited as they wound their way through opaque, long-winded banking chains.

Swift gpi has gone a long way to ensuring this will not be the case. The gpi Tracker, for example, enables end-to-end visibility of a payment through status updates of unaltered remittance information and transaction costs, and can be updated by FIN message or application programming interfaces and accessed via a graphical user interface, ensuring interoperability with back-office systems. This has met customer demands for transparency, just as same-day clearing of funds across the world has met those for speed.

TAKING STEPS WITH TECHNOLOGY

At the heart of the modernisation of correspondent banking is technology. No technology has generated more interest in the corporate sphere than blockchain, a form of distributed ledger technology (DLT) that is already making its first appearances in real trade finance deals, following a series of successful proofs of concept.

Beyond this, blockchain lies at the heart of several initiatives. For example, blockchain-based We.trade is a joint venture between nine banks – built specifically with mid-caps and small and medium-sized enterprises in mind – that links trading partners across a supply chain.

Swift has also considered DLT, having recently completed a proof of concept to test whether nostro account owners and their service providers could share a private, confidential ledger recording transactions related to their nostro accounts. The solution harnesses gpi technology and ISO 20022 messaging standards to create a unique end-to-end transaction reference with integrated intraday liquidity standards.

These are promising innovations, but the banking industry must be pragmatic when looking at the timeline. In the long term, blockchain initiatives and other innovations have the potential to reshape banking models, but the evolution will be neither quick nor easy, particularly given the structures of today's regulatory environment. To overcome this, each step forward must be considered and effective, with the aim of solving client challenges the driving influence behind every new step.

There will be other challenges. Solutions initially tailored to an individual client's needs and fine-tuned for compliance must be reinforced to handle larger sums of money at higher volumes before they can be rolled out to the wider market for international trade. Likewise, solutions must be comprehensive in geographical scope, offering full connectivity across countries, currencies and bank accounts around the world.

AN AI FUTURE

With an eye on the near term, however, there are other innovations that can already be adopted more widely. Artificial intelligence, for example, promises to increase efficiency and reduce costs for risk management processes. Artificial intelligence systems can learn typical patterns and trends in the movement of money – highlighting potential risks before they emerge – and analyse contextual data surrounding a counterparty to generate a refined risk score for a given partner or transaction.

These are just a few factors contributing to the ongoing modernisation of correspondent banking. At a time when efficiency is of immense importance, technology is driving these improvements and simplifying processes across the board, and has the potential to underpin a dramatic overhaul of the banking landscape over the next decade or so.

The transformation will be gradual and at each step along the way the industry must prioritise moving funds as securely as possible. It is on this foundational principle that the infrastructure of a new correspondent banking era can be built, and realise the long-sought benefits of speed, efficiency and transparency. TB