Challenges and innovations in cross-border payments

Rethinking the correspondent banking model as your sole payments provider

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Introduction

The desire for payments innovation has fueled the push for real-time, frictionless payments and includes efforts to reimagine cross-border payments.

Newer cross-border solutions are emerging that reduce existing inefficiencies, excessive costs, and the lack of transparency inherent in the correspondent banking model. These innovations are compelling banks to offer more efficient ways to make cross-border payments or risk losing clients to providers who do.

Correspondent banking remains an essential component of the global payments system. While the industry has seen entrants and interrupters into the P2P and remittance payments space, correspondent banks still transact the majority of commercial cross-border payment volume.[1]

By utilizing correspondent banking relationships, downstream banks access financial services in other countries and provide cross-border payment services to their customers to support their customers' ever globalizing businesses. Despite advances in cross-border payments, the system remains inefficient due to the multistep correspondent banking models.

Payments innovation, however, is rapidly developing in the financial industry. Real-time, frictionless payments are a reality which has guided expectations concerning all payments methods and types, including cross-border payments. Newer cross-border solutions that reduce existing inefficiencies, excessive costs, and the lack of transparency inherent in the correspondent banking model are desired by businesses and the entities they are paying. If banks do not offer a more efficient way to make these payments, their clients will begin to seek providers that do.

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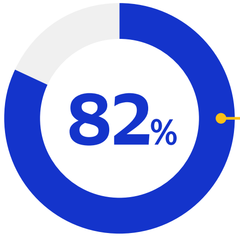
1 Cross-Border Payments Overview – The Federal Reserve – FedPayments Improvement blog, 2023 https://fedpaymentsimprovement.org/strategic-initiatives/cross-border-payments/overview/



82% of surveyed banks view **visibility of payment tracking** as one of the **most important** features when assessing their international payment service.[2]

While correspondent banking relationships remains the primary method by which banks move commercial payments internationally, legacy clearing and settlement methods have become a hindrance for financial institutions and their clients across the globe. These commercial transactions are expensive, opaque, and lack the amount of detail needed to process cross-border payments efficiently.

According to a cross-border payments study, it was reported that nearly 82% of surveyed banks view visibility of payment tracking as one of the most important features when assessing their international payment service.[2] Businesses do not care what infrastructure is used to make their payments; they merely want predictable fees, a fast and secure settlement, transparency into payment status, and robust data attached to their payments.

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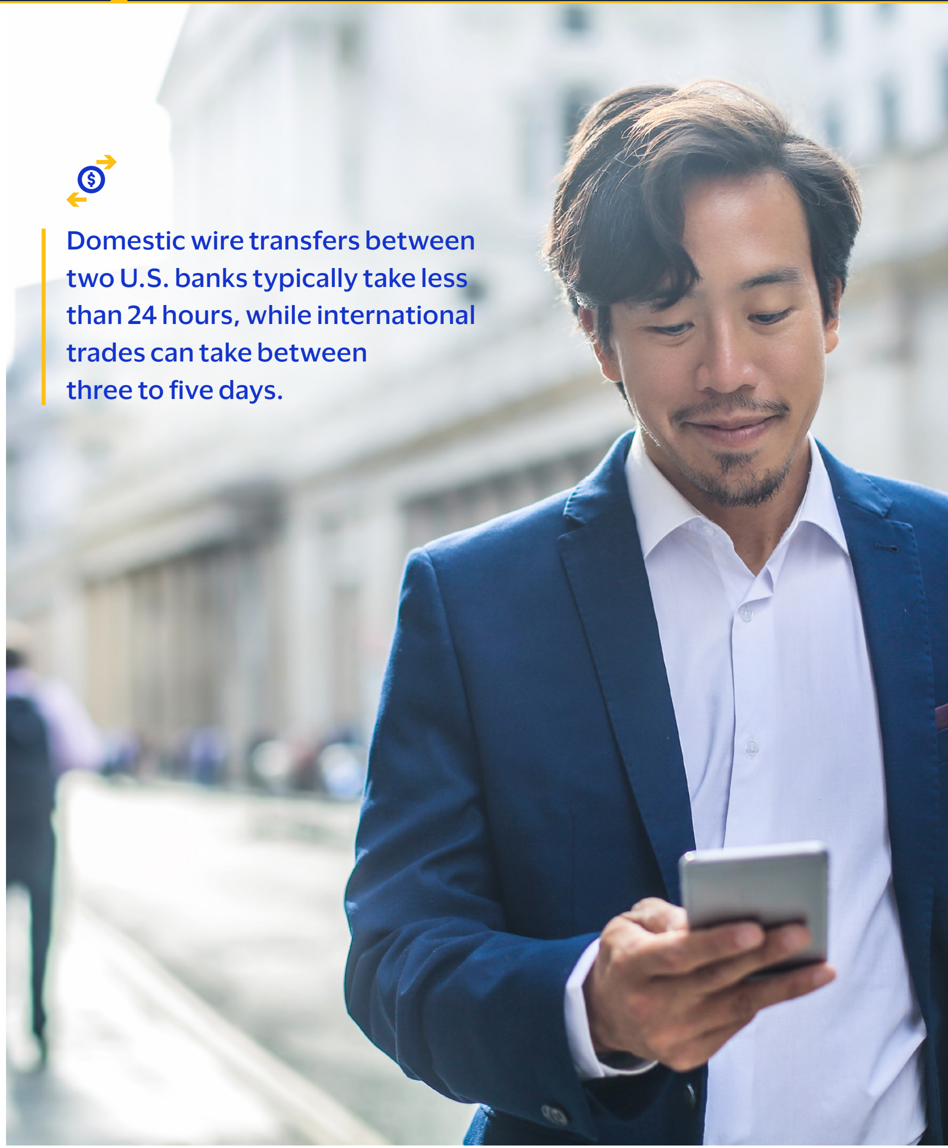
2 Cross border payments Visa sponsored research conducted by East & Partners in 2019

The cost of sending money internationally

Sending money internationally through traditional channels can be – simply put – costly. A major issue encountered while processing international wire traffic is the actual cost of routing funds through all the different channels involved in the transaction. Each bank in the chain covers their costs by charging a fee to move the money. These costs can add up very quickly.

The speed of sending and receiving cross-border payments can be lengthy, frustrating, and impactful on costs as well. Domestic wire transfers between two U.S. banks typically take less than 24 hours, while international trades can take between three to five days[3]. As result of this time delay, businesses awaiting arrival of a payment may need to maintain a cash cushion to cover expenses. Delays in the receipt of payments can increase liquidity costs, borrowing costs, and extend the working capital cycle, which can force customers to take costly and unanticipated actions to fund operations and initiatives.



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3 Juniper Research, B2B Money Transfer – Deep Dive Data and Forecasting, accessed May 2019

Multiple regulatory and compliance regimes

There are additional factors that increase the costs of cross-border money movement. International payments are subject to a myriad of laws and regulations imposed by the sending country, the ultimate beneficiary's country, as well as the home country of any bank involved in the correspondent banking chain. Every bank must screen the payment to ensure payments are not involved in money laundering, terrorist financing or some other misconduct. Whenever money changes hands, this process must be repeated.

The payment data needed to clear compliance regulations in one country may not be enough for other involved countries, forcing banks to subject the payment to additional scrutiny rather than rely on their automated systems. These stringent compliance checks further increase the time and cost of processing payments. The complexity of cross-border transactions brings with it a relatively high failure rate, necessitating the employment of investigation staff to handle customer inquiries when payments go awry. Maintaining suitable investigations and compliance staff to ensure successful resolution of issues adds directly to the high cost of processing payments through correspondent banking relationships.

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Lack of transparency and hidden fees

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A second obstacle is the lack of transparency that can accompany cross-border payments. The increased regulatory scrutiny associated with legacy clearing and settlement methods creates inefficiencies in the correspondent banking system. The hidden fees and complex structure of pricing models create a lack of transparency.

In addition to stated transaction fees, banks use a variety of other charging methodologies which create issues for remitter and beneficiary alike. As a bank evaluates their cross-border traffic, they should audit the various charges being applied to minimize costs to themselves and their customers.

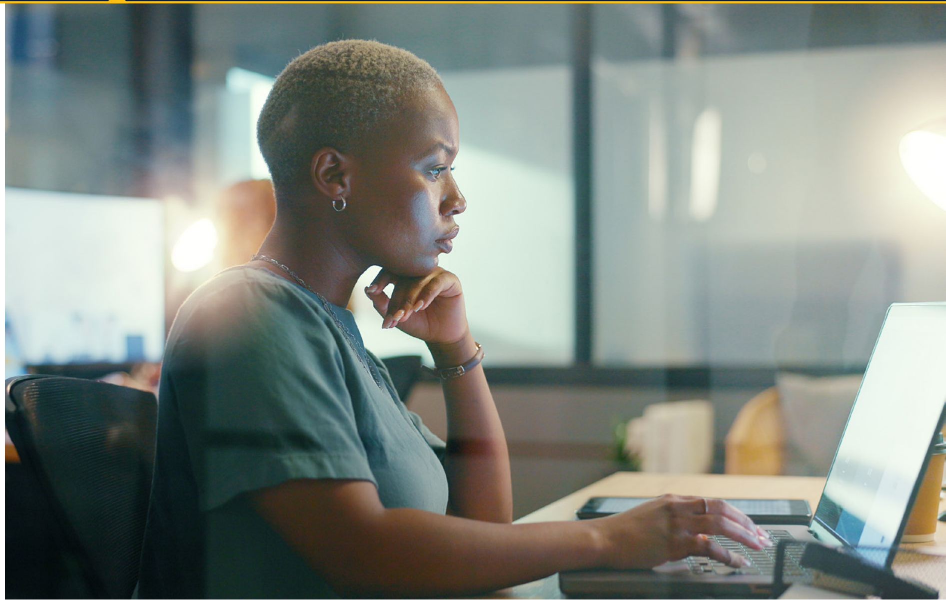
When it comes to fees, the industry standard involves banks deducting from the beneficiary's proceeds. The result is the beneficiary receives an amount which can differ significantly from what was expected or originally remitted. While the remitter may be aware of the deduction taken by its bank, they won't be aware of the numerous charges taken down the payment chain.

In addition to beneficiary deductions, another prevalent charging practice is credit deduct where the beneficiary bank deducts a charge from the incoming payment – again altering the amount expected by the beneficiary. The credit deduct charge is rarely known to the remitter. These uncertainties can cause difficulties in reconciliation and increase the need for investigations, further adding to costs and negatively impacting the customer experience.

Another stumbling block in the cross-border payment process is due to data loss which can lead to payment failure. There are multiple reasons why a payment might fail. In some cases, it is the fault of the payer who doesn't provide correct or sufficient payment details. They may lack the necessary funds or credit limit to transact the payment.

In other instances, the payment may be delayed or fail due to data incompatibility between banking systems, regulations and/or standards. The remitter, bank, or recipient will need to investigate the cause of failure and take remedial action to correct and reprocess the payment. These investigations and corrections can be costly, as they are done by dedicated staff performing manual tasks.

Data can be lost as a payment moves through the chain, making it more difficult for recipients to reconcile. The lack of message standards, even where ISO 20022 is utilized, continues to plague all parties involved. A lack of data and insight into failure and delays only serves to impede and slow down the ability to correct failed



transactions, further increasing the cost of operations for the business and negatively impacting customer experience.

Another issue banks and their clients face is the difference between the FX rate agreed upon with the payee and the rate used for conversion when payments are debited in one currency and paid in another. This difference is usually caused by fluctuations in currency values between the time the payout is initiated and the currency conversion. Without full visibility into rates and control over the transactions, there is no possible way of guaranteeing what amount the payee will receive.

This is also true with auto-convert programs where the remitter agrees to an FX margin for a payment, but the payment itself is converted at the market rate at time of execution. Again, this lack of transparency causes reconciliation issues for the client, as well as the potential for increased investigations for bank staff when questions inevitably arise.

A lesser known, but equally challenging practice, is when large clearing banks use preferred correspondent banks. In this instance, a clearing bank will choose a specific bank in a market to clear their undirected flows into that market. The chosen correspondent bank will receive payments and use artificial intelligence to determine if the payment can be converted into that market's currency and then paid onward to the beneficiary at the bank which holds the account. Conversion revenues are shared between the remitting bank and preferred correspondent.

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If it is determined that the payment cannot be converted, the payment is returned to the remitting bank which will then reprocess the payment through normal clearing channels adding further processing time before successful execution.

This practice creates uncertainty because neither the remitter nor receiver are aware of the preferred correspondent bank agreement for conversion, thus the amount the payee will ultimately receive is unknown. Timing may be affected as well because additional steps are added to the payment chain.

The search for alternatives

Corporates continue to need a third-party partner to transact their cross-border payments due to the complexities of the international financial and regulatory environment, but businesses are seeking alternatives out of normal banking channels as speed and transparency no longer become nice-to-have options, but must-haves.

While some of the new, innovative technologies available today promise faster payments, they continue to leverage the same bilateral framework, leaving companies to grapple with a lack of predictability, finality, and data transparency, as well as high costs, occasional regulatory hurdles and long dispute resolution timeframes arising from funds moving across the banking chain. Banks that want to continue in the international payments business have an opportunity to expand beyond the correspondent banking model and offer clients emerging, complementary options that better support cross-border workflows.

Maintaining an open global network across many different standards and under a strict regulatory framework is very costly for banks involved in cross-border transactions. More recently, the leading transaction banks have been rethinking the composition of their international correspondent bank networks and have been exiting less profitable locations, effectively reducing the scope of their networks.

For example, banks are continually reassessing the costs associated with maintaining nostro account networks. These networks are the collection of bank accounts held with foreign banks denominated in the home currency of the country where the accounts are held. Nostro accounts are used to facilitate the settlement of international trade and foreign exchange transactions.

The cost for maintaining these accounts among global banks amounts to approximately $1.5B annually.[4] In the U.S. alone, the average cost of maintaining just one nostro account is $27,270.[4] Global banks are continuously reassessing their business strategies against the backdrop of lower bank profitability, dampened risk appetite, and tighter regulation and supervision. Reducing the use of nostro (or correspondent bank) networks is an attractive strategy to achieve these highly desirable ends.

4 Cross border payments Visa sponsored research conducted by East & Partners in 2019

Account-to-account models offer an alternative

The good news for banks and their corporate clients is that complementary alternatives to correspondent bank networks exist. Such alternatives are due to tremendous innovation and driven by investment in international payments technology. They enable account-to-account transactions across borders.

This next-gen model eliminates a multitude of fees imposed by the correspondent banks, improves the speed and predictability of settlement, and provides robust payment data. The growing adoption of real-time settlement is also increasing the opportunity to achieve straight-through processing.

Innovative new cross-border payment models offer businesses, and the banks supporting them, a range of new choices when it comes to transacting globally. A centralized, permissioned network, where all participants are known, and which allows secure payments to be processed directly, can not only reduce the number of bank relationships that must be managed, but can also minimizes the cost of maintaining nostro accounts altogether.

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Another benefit of such innovation is the ability to gain access to critically important data that may otherwise be dropped with a correspondent bank set-up. Banks can now more easily partner with innovators to offer cutting-edge solutions to cross-border payments challenges.

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The opportunities within this space are enormous – both businesses and banks are eager to have a greater number of options and alternatives in cross-border B2B payments.

Correspondent banks continue to provide an invaluable service to traditional banks which need to process international payments instructions to multiple clearing systems throughout the globe, but it is not the only way to move funds. The opportunities within this space are enormous – both businesses and banks are eager to have a greater number of options and alternatives in cross-border B2B payments.

As marketplace needs continue to evolve, innovation is filling the gaps, providing businesses with a myriad of choices. Banks that do not take advantage of innovations and technology in the payments space could find themselves losing business –not only to other banks, but also to emerging fintech providers. Further study and education are necessary for all banks in order to better serve their customers

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About the author

Stephen Elmore is the Head of Visa B2B Connect Sales for North America. He is responsible for the bring-to-market strategy for Visa's B2B cross-border payments network. Prior to joining Visa in 2022, Stephen was a correspondent banker for over 20 years with several of the world's largest clearing banks, selling cash payments and trade finance products to banks across North American and European markets. He holds an M.I.A. and an M.B.A. from Columbia University in the City of New York and a B.A. in International Studies from The Johns Hopkins University.

About Visa

Visa Inc. (NYSE: V) is the world's leader in digital payments. Our mission is to connect the world through the most innovative, reliable and secure payment network — enabling individuals, businesses and economies to thrive. Our advanced global processing network, VisaNet, provides secure and reliable payments around the world and is capable of handling more than 65,000 transaction messages a second. The company's relentless focus on innovation is a catalyst for the rapid growth of digital commerce on any device, for everyone, everywhere. As the world moves from analog to digital, Visa is applying our brand, products, people, network and scale to reshape the future of commerce.

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