Measuring and communicating the value of a bank's payments business

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ABSTRACT

This paper explores the following paradox: the payments business offers tremendous opportunities, yet most bank payments executives struggle to obtain strategic levels of funding. A framework is presented for valuing the payments business, evaluating key drivers of shareholder value: scale dynamics; ancillary revenues generated by payments transactions — primarily balances and FX; stability and diversity of cash flows; and strong return on capital resulting from the bank acting as an agent, not a principal. An analysis is then provided of the reasons why bank executives and institutional investors fail to understand the value of the payments business. (i) With some notable exceptions, banks fail to organise their payments activities into material business units and do not publish financials for their payments activities. Payments businesses, such as treasury services, are often zeroed-out at the general ledger level, showing up as net fees and non-interest expense. (ii) Most equity investors and even some senior banking executives are unfamiliar with the payments business and its profitability dynamics. (iii) Confusing and improper cost allocation and valuation methodologies distort the profitability of payments businesses. (iv) Payments businesses may be strategically subordinate to lower return on equity (ROE) businesses such as credit. The paper closes with a suggested course of action for bank executives: (i) ensure the business is valued correctly; (ii) improve the visibility of the business, both within the bank and with external investors; and (iii) ensure the payments business takes greater importance in the overall strategic direction of the bank.

Keywords: payment strategy/strategies, scale, deposit/deposit valuation, treasury services, institutional investors

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INTRODUCTION

Now, more than ever, payments executives at banks need access to capital to grow and transform their businesses. Yet many payments units receive just enough investment to maintain the status quo. The difficulty payments executives face in acquiring capital for their businesses points to an underlying business problem — the financial value dynamics of the payments business are poorly understood — both by many bank executives and by the investor community.

The investment community sees the payments business as opaque and confusing. While non-bank payment businesses earn multiples of 15–20 times prospective earnings or more, universal banks trade in the range of 10–13 times earnings. Few banks detail the financial results of the payments business in a transparent manner, causing investors to fail to recognise the many ways in which payments businesses contribute value. This paper outlines how payments executives can create a transparent and compelling value story that warrants continued, favourable access to capital. The analysis in this paper draws not only upon the author's research and consulting engagements, but also discussions with major equity analysts as to how to define and measure the value of the payments business.

The approach a bank takes to valuing and growing its payments business is of paramount interest to corporate treasurers as well. Those banks that can articulate the value of their payments business will be the most likely to receive significant investment funding, enabling them to continue to innovate on behalf of their corporate customers. Conversely, banks that fail to understand the value of the payments business will most likely not direct sufficient investment to their payments business, resulting ultimately in outdated services. Given the long-term nature of transaction services, corporations will want to select as partners banks that understand, value and invest in payments capabilities.

ACCESS TO CAPITAL — JUST ENOUGH TO 'KEEP THE LIGHTS ON'

The US$70bn global treasury services business is flat, producing minimal growth. The outlook for the traditional business is modest owing to a variety of factors, including increased pricing pressure, the migration to electronic payments and reduced cross-border payment revenues resulting from the coordination of global settlement systems. Under classic business portfolio management, banks would be directed to cut costs and limit new investments — maximising profits while seeking growth elsewhere. Indeed, that appears to be the case. Many payments executives at banks receive just enough investment dollars to 'keep the lights on'.

To evaluate access to capital, the IT spends for the treasury services businesses at four universal banks were reviewed. While IT spend is not a perfect measure of growth dollars, it is a good indication of capital access. It was found that these businesses were getting just enough resources to 'keep the lights on' (see Figure 1).

On the surface, the treasury services business appears to receive significant investment in IT — roughly 15 per cent of every expense dollar is spent on IT. The breakdown of this investment, however, shows that 8.7 per cent of spend is directed toward infrastructure and network, and another 5.4 per cent is directed toward maintenance such as basic system upgrades and modifications for compliance. Only 1 per cent of total dollars is directed toward increased functionality, and the vast majority of this is spent on

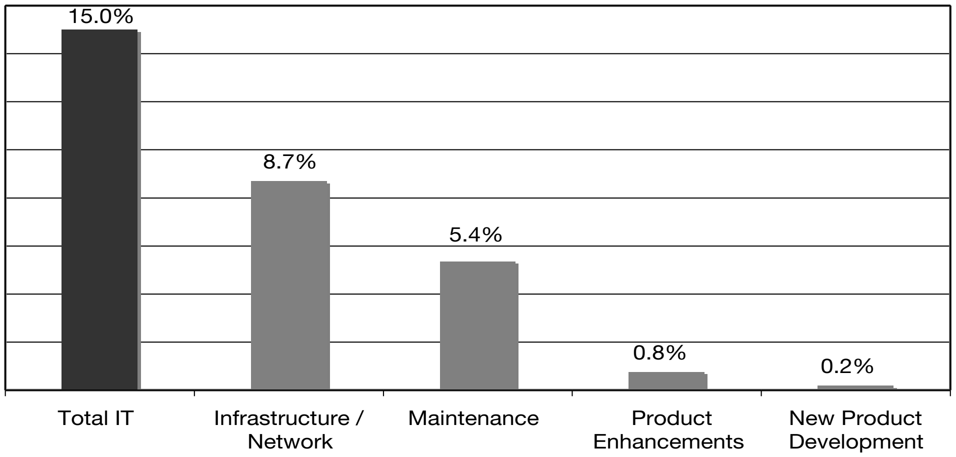


Figure 1 IT investment as a percentage of total treasury services expense

enhancements to existing products, such as positive payee or automated clearing house (ACH) filters. Only 0.2 per cent of expense dollars were directed toward the creation of new lines of business. To put that in perspective, a US$1bn treasury services business was only directing US$2m toward creating the business of the future.

THE CASE FOR GROWTH

If there were no more growth opportunities available to banks, this would be the end of the story — a mature business line that is appropriately being starved of capital. The payments business offers significant growth opportunities, however, and these opportunities are earning a premium in the market. Non-bank providers are competing in adjacent spaces in the payments market and generating significant growth and high price-to-earnings ratios. The opportunity remains for banks aggressively to redefine the business, transforming treasury services in terms of scale, functional scope or target segment.

There is considerable opportunity in redefining and growing the business. While the US$70bn global treasury services business is mature, it is a fraction of the US$1trn corporations globally spend on services, technology, information and people to manage working capital. In order to understand this landscape, the working capital expenditures of corporate clients were reviewed, and that was combined with knowledge of provider revenues. From these data, a rough estimate was formed of how the corporate spend on working capital is composed by function and provider type (see Table 1).

Banks only dominate one functional area: cash and short-term investments. In many functional areas, banks significantly lag behind technology firms, processors or professional services firms. In the case of accounts payable (AP) and accounts receivable (AR), the majority of expenditures consist of the internal staff that manage these processes.

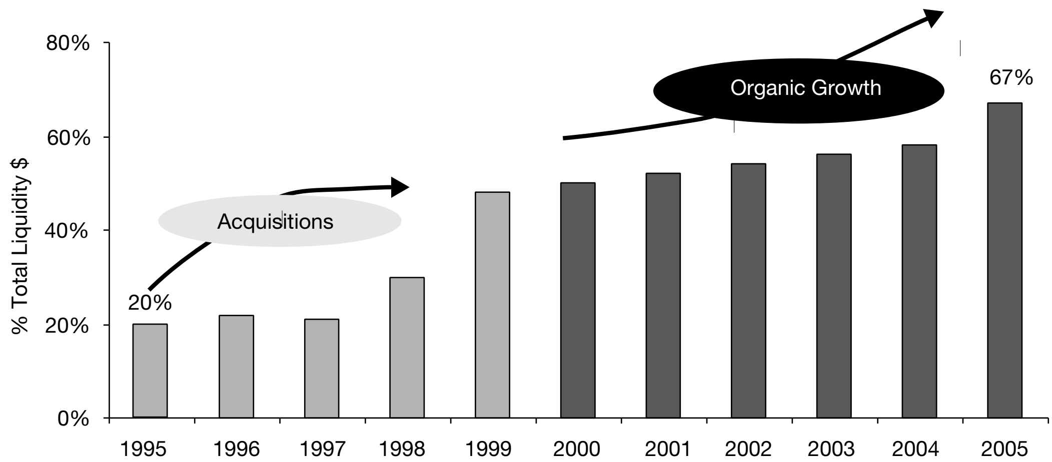
While banks have a relatively weak share of the total working capital spend, two factors suggest banks can successfully expand their wallet share.

(i) First, in the case of AP and AR, banks have proved adept at getting

Table 1: Global corporate spend by function and provider type

Function	*Banks*	*Staff*	*Tech Firms*	*Sec Firms*	*Prof Svcs*	*Processors*
Procurement/AP	10 to 25%	>50%	10 to 25%	<10%	<10%	<10%
Billing/AR/Collections	<10%	>50%	10 to 25%	<10%	<10%	10 to 25%
Point of Sale	<10%	25 to 50%	25 to 50%	<10%	<10%	25 to 50%
Cash & ST Investment	>50%	<10%	<10%	10 to 25%	<10%	<10%
Risk/Control	<10%	25 to 50%	<10%	<10%	25 to 50%	10 to 25%
Reporting	10 to 25%	25 to 50%	25 to 50%	<10%	10 to 25%	<10%

Figure 2 Bank share of cash and short-term investments



Source: Treasury Strategies US corporate liquidity research programme.

corporations to outsource their activities. For corporations, this is often a largely unconscious process — as with the case of wholesale lockbox, they do not see this as business process outsourcing, but as a service that helps them accelerate working capital and reduce risks and costs. Based on corporate behaviour, this outsourcing will most likely occur through a gradual extension of tightly defined services that solve pressing needs, rather than 'big bang' e-commerce solutions that attempt to re-engineer the entire value-chain at once.

(ii) Second, banks have proven that they are able to 'take a hilltop' once they see and understand the situation. Consider the one area where banks now dominate the corporate wallet, cash and short-term investments. It was only ten years ago that banks enjoyed a marginal 20 per cent share of this function in the US. Yet through acquisitions and organic growth, banks have now achieved a 67 per cent share of market (see Figure 2). They did this by acquiring the dominant competitors (security dealers) and then leveraging their franchise power of settlement to deliver convenient and effective solutions. This approach certainly warrants consideration in other functional areas.

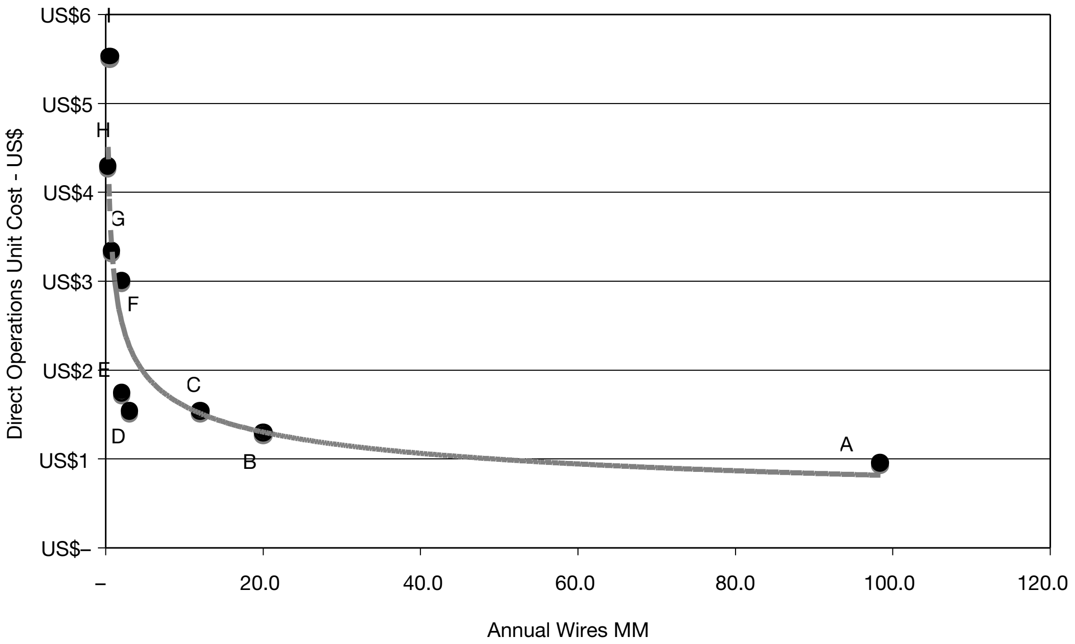


Figure 3 Wire processing scale

Notes: each dot represents a unique bank; direct operations costs include personnel, equipment, IT, third-party fees and supplies; volumes include FedWire, SWIFT wire payments and CHIPS.
Source: Treasury Strategies benchmarking study.

THE CASE FOR VALUE

The payments business not only offers growth, but it is a highly valuable franchise that can translate into stronger share prices. Properly understood and measured, the payments business is a tremendous source of value.

- *Profitable*: Scale dynamics yield operating leverage, enabling leaders to widen profit margins. Transaction businesses generate a host of high-margin ancillary revenues from balances and FX transactions.
- *Stable*: Revenue is diversified, predictable and fee-based. Payments services lengthen the life of a relationship, reducing attrition and generating long-term cash flows for investors.
- *Capital efficient*: Unlike the credit business, the bank acts as an intermediary, not a principal. Risk exposures are significantly lower. Furthermore, the payments business generates attractive earnings multiples, providing a trading currency with which banks can make acquisitions.

The payments business is profitable

Many treasury services businesses offer attractive scale dynamics. Even the wholesale lockbox business, once driven by variable costs, is now a scale business. While scale dynamics are creating pricing pressure, they are enabling the largest providers to widen margins through incremental volume. In the cost curve shown in Figure 3, it is apparent that even banks with moderate wire transfer scale enjoy significant cost advantages.

In addition to processing scale, the payments business generates additional scale dynamics.

- *Information*: Large payments processors see significant deal flow, enabling them to mine data for targeted prospecting, enhanced pricing or macroeconomic value. For example, by mining wire transfer data, banks can identify where, with whom and how their customers are investing outside the bank.

- *Leverageable competencies*: Large payments processors can invest in and leverage core competencies. These competencies may include expertise in a functional value chain (such as AP) or in a specific industry vertical (such as large healthcare systems). Or the expertise could lie in operational areas such as workflow modelling and capacity management, enabling a bank to drive down costs or offer more flexible, customised solutions to clients.
- *Marketing*: Large payments processors can brand their services and develop a significant share of customer mind.

In addition to scale benefits, the payments business creates profit by generating stable balances and ancillary foreign exchange (FX) revenue. Many clients estimate that FX spread revenue is two to three times processing revenues for cross-border transactions. Foreign exchange and balance activity associated with payments is valuable because these transactional activities have a high convenience component, reducing price sensitivity. Deposit balances tend to be frictional monies that customers either are unable to manage actively or which they prefer to leave in operating accounts to avoid liquidity disruptions. These long-term price insensitive balances resemble low-risk, long-term money.

Banks place a value on deposits known as funds transfer price (FTP). By modelling the price sensitivity and duration of balances, the Treasury group (or asset liability management group) within a bank determines a synthetic asset to offset deposit balances for purposes of calculating net interest revenue. Banks with a high FTP receive a credit on their deposits that can approach the rate of five-year money. Some banks fail to recognise the term, stable nature of transaction balances. As shown in Figure 4, Bank 8 gives deposit balances a short-term FTP, essentially treating these deposits as 'hot' overnight money. Unsurprisingly, this valuation treatment is a self-fulfilling prophecy for Bank 8. Constrained by a weak FTP, the business unit's pricing strategy fails to attract stable deposits.

Conversely, best in class providers enjoy sufficient FTP flexibility to target pricing strategies that maximise the stability of the balances. An FTP that reflects business dynamics enables these banks to optimise rates relative to the competition, customer elasticity and the general economic environment. Getting FTP and balance pricing right is critical — the spread revenue from balances can represent 40–67 per cent of total treasury services revenue and as much as 90 per cent of total profit.

The payments business is stable

Many would argue that the classic relationship-banking model is dead. Sophisticated risk models that disaggregate asset volatility from stock market prices can encourage a 'trading desk' mentality within the credit business. What is an acceptable credit one week can become an untenable exposure the next. While the credit business may no longer be characterised by deep, long-lasting relationships, the treasury services business has proven to be a 'sticky' relationship. These services embed the bank in clients' processes, control practices and information architecture. Replacing a provider is difficult and fraught with risk.

Through client work, the impact of

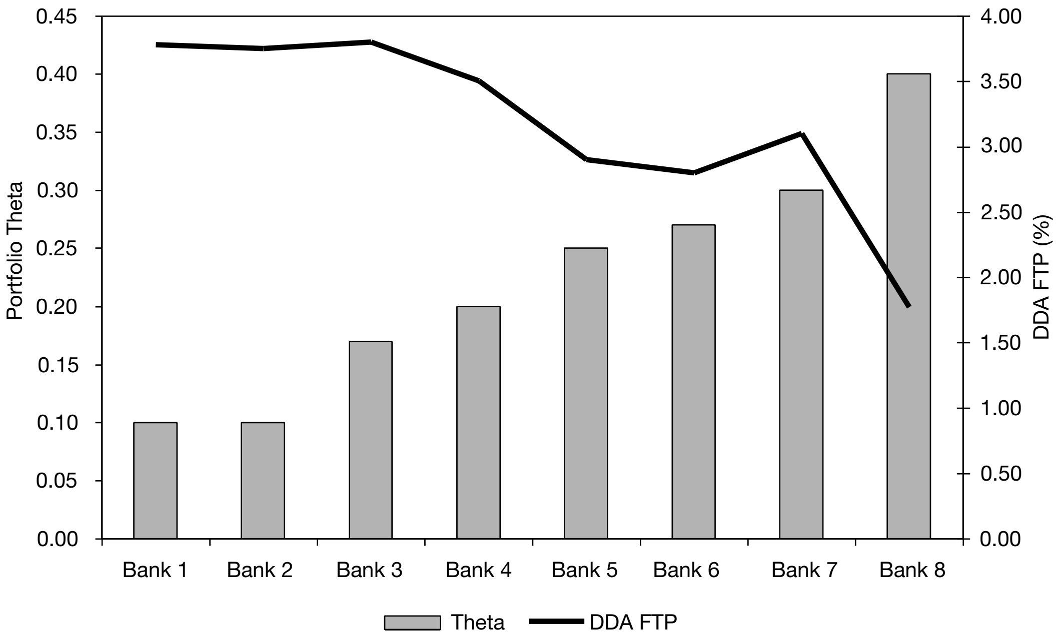


Figure 4 Portfolio stability and FTP

Notes: Theta is a measure of portfolio volatility; a low Theta represents a stable portfolio of long-term, price-insensitive funds.
Source: Treasury Strategies time series analysis of eight global and regional banks (2005)

a treasury services relationship was analysed, and it was determined that a treasury services relationship adds two years or more onto the life of a typical credit relationship (see Figure 5). Consider, for example, how many significant treasury services relationships Mellon has retained, despite its exit from the credit business. For example, in Treasury Strategies' 2005 Corporate Treasury Research Program, Mellon ranked No. 7 in cash management, with 12 per cent of corporate treasurers citing Mellon as a provider of cash management services.

The payments business is capital efficient

Payments businesses generate a higher price-earnings multiple than traditional banking businesses. An examination of the price-earnings multiple of non-bank technology firms and processors and banks showed a clear value dynamic. Universal banks are largely plagued with low price-to-earnings multiples. Those banks with a focus on processing earn higher multiples, and those non-banks in the payments space enjoy significantly higher multiples. Figure 6 illustrates this dynamic.

BASEL II capital requirements may offer treasury services executives significant ammunition in making the case for value. Currently, some banks lack a return on equity (ROE) for the treasury services business, and those that do have an ROE for the business often find that this return is not believed. Economic capital methodology often produces treasury services ROEs that range from 40 per cent to 400 per cent, inviting scepticism. BASEL II will require a more consistent level of rigour in capitalising the treasury services business and this will, in turn, improve the credibility of ROEs. As a result, treasury services executives

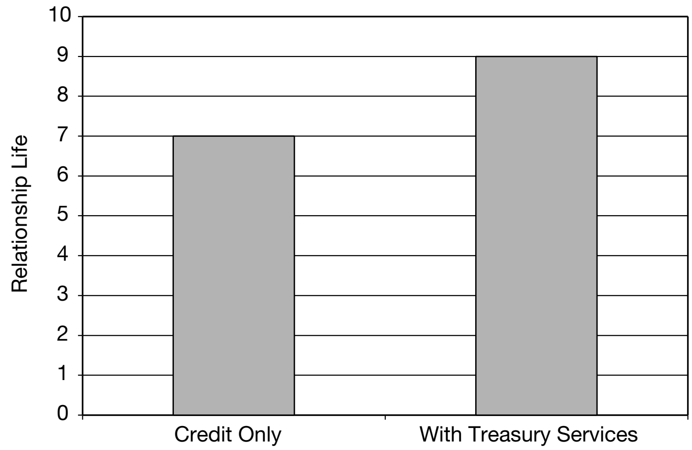


Figure 5 Impact of treasury services on relationship life

Source: Treasury Strategies time-series analysis

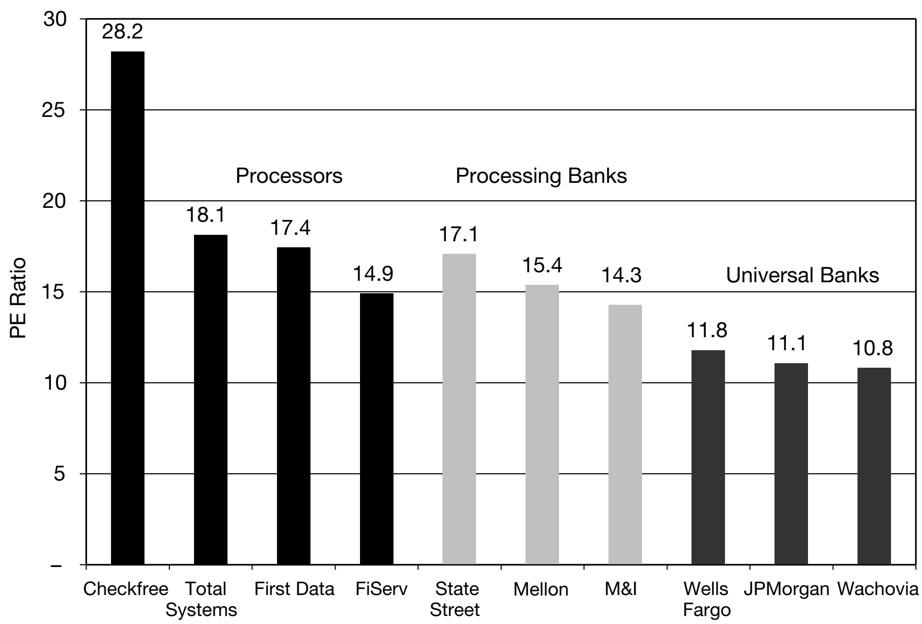


Figure 6 Price to earnings multiples and company type

Notes: P/E ratio based on 4/6/06 share price and forward consensus earnings estimate for 2007

will be able to position their growth opportunities more effectively within the total portfolio framework of investments that CEOs can make.

WHY IS THE PAYMENTS BUSINESS UNABLE TO GET ANY RESPECT?

Given the growth opportunities and tremendous value resident in the payments business, why are non-banks investing heavily and banks largely sitting on the sidelines? The author believes the reasons have to do with the way that banks define and measure payments businesses as well as a pervasive mythology that non-credit businesses are merely an add-on to credit relationships. In sum, these businesses are buried in the financials such that neither senior management nor the investment community fully understands their strategic and financial contribution.

Few banks report treasury services as a distinct business unit in their public financials

The 10-Ks/annual reports and stock fundamentals of all banks with over US$2bn in revenue listed on a public US stock exchange were reviewed (35 institutions in all, including ten Canadian/European/Asian banks with ADRs). In the vast majority of cases, business segments were broken down by customer groupings or were limited to traditional product monolines such as credit card and mortgages.

There are some exceptions to the rule, which suggest that select executives are beginning to understand the power of the payments business.

- Large global banks, including ABN, Citibank, and Deutsche Bank, include treasury services within a business unit called, 'Transaction Banking' or 'Global Transaction Bank'. Only Citibank, however, provides detailed financial information on this unit in their public financials.
- JPMorgan includes treasury services under a business unit called, 'Treasury & Securities Services' and provides public financial information on this unit.
- Mellon Financial includes treasury services within 'Payment Solutions and Investors Services' and provides a P&L for this unit.
- Royal Bank of Canada provides public financials on a business unit called 'Cards and Payment Solutions'.
- USBank provides relatively strong detail on non-interest income for a variety of payments lines of business and attributes net interest income to the 'Payments Services' line of business.

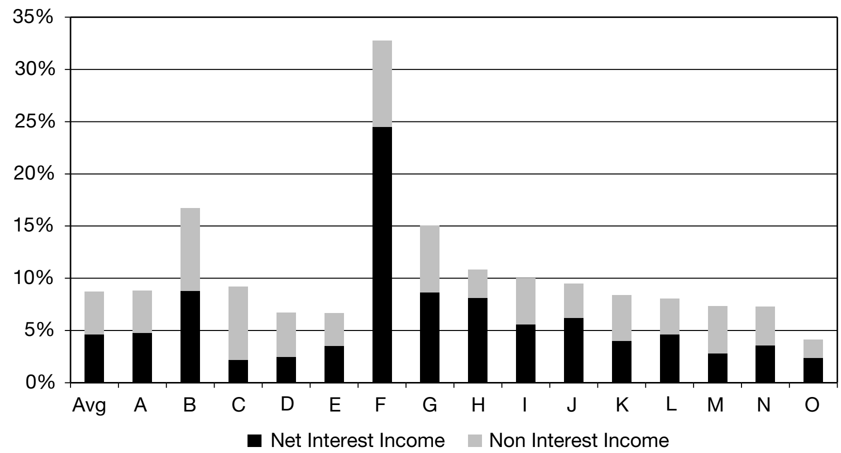
The treasury services line of business is often 'zeroed-out' at the GL level, showing up as net fees and non-interest expense

As shown above, few banks provide a P&L for a payments line of business. How then should an investor assess the size and growth of a bank's treasury services business? If they turn to the 10-K, they will often end up misled or confused. Generally, the only vestige of the payments business in revenue shows up under 'Non Interest Revenue' as 'service charges on deposits', sometimes accompanied by 'interchange fees' or 'card fees'. The line item entry for service charges on deposits is, however, a confusing figure at best.

In the US, corporations can pay for treasury services by placing balances in non-interest-bearing accounts that earn compensating credit. The figure reported in 10-Ks as 'service charges on deposits' is the net 'hard dollar' amount paid by corporations after their balance credits have been exhausted. This amount is generally 33–60 per cent of total fee equivalent revenues, thus drastically understating the magnitude of the treasury services business. And while fee equivalent revenues are stable, the composition of these revenues is volatile, driven by interest rate changes. Thus, an investor reviewing the 10-K would see a small, volatile source of income. In fact, research suggests that the deposit spread and fee income from the treasury services business comprises 9 per cent of total bank revenue on average, and that one in three banks earns more than 10 per cent of total bank revenues from the treasury services business (see Figure 7). This 10 per cent level is critical, as this is the threshold where equity analysts begin to consider a business unit's growth and profit dynamics as part of their valuation of the overall institution.

Today, treasury services is a rounding

Figure 7 Treasury services revenue as a percentage of total bank revenue



Source: Treasury Strategies benchmarking analysis of the profitability of the treasury services business for 15 of top 20 North American treasury services banks.

error at most banks. Properly illustrated to the street, it could form the basis for a higher valuation, providing a bank with greater access to capital for growth and acquisitions.

Even experienced equity analysts and institutional investors are not familiar with the business and its economic contribution

Few equity analysts specialising in banking are familiar with the treasury services business. Because this business line has been submerged in the strategy and public financials of the bank, executives and analysts have not been exposed to its dynamics and contribution. In fact, it has been found that, within banks, the Investor Relations group and many members of the executive team do not understand the business. As a result of this disconnect, a person who had a few dollars for every bank executive who was caught unaware by the impact of rising rates on the composition of the treasury services P&L would be very wealthy.

Improved literacy around the payments business is now being seen, together with some movement within the investor community to explore the value dynamics of this business.

- Lehman Brothers recently held a regional bank investor meeting focused on Check 21.
- Bear Stearns attempted to measure the payments revenue of each bank. While this exercise was laudable, it was severely constrained by the lack of consistently good information produced by banks.
- Brad Hintz, a five star equity analyst with Sanford C. Bernstein & Co., conducted a groundbreaking assessment of JPMorgan's Treasury and Securities Services business unit. In his analysis, he measured the unit's contribution to share price, and he valued Heidi Miller's growth plans at US$2 per share — or US$7bn! Notably, even though JPMorgan had broken out payments as a significant business unit, Brad had to create pro-forma views to capture fully all of the payments-related activities that were not included in the Treasury & Securities Services business P&L.

The payments business is incorrectly valued by Byzantine and ineffective internal cost and valuation methods

No two banks seem to count widgets in the same way. Cost allocations at banks are often a circular maze of formulas that bear little resemblance to how costs actually behave at the margin. In consulting engagements, one often sees an individual cost category that has been allocated multiple times as one loaded cost is allocated into another cost that is again allocated throughout the organisation, only to be loaded yet again into another cost that is further allocated. It is no surprise that one of the most frustrating acts a bank executive can undertake is to attempt to understand the bank's cost base.

As a business unit with relatively low organisational power, treasury services is often the dumping ground for costs. Overly complex and confusing costing methodology leads to either paralysis or bad decisions. For example, one has observed banks exit product lines on the basis of allocated costs, only to see significant unit cost increases absorbed by other areas, such as the retail bank. Conversely, one has also seen banks fail to make necessary decisions — such as a move to outsourcing — because of an inability to understand which costs will remain and which will truly go away.

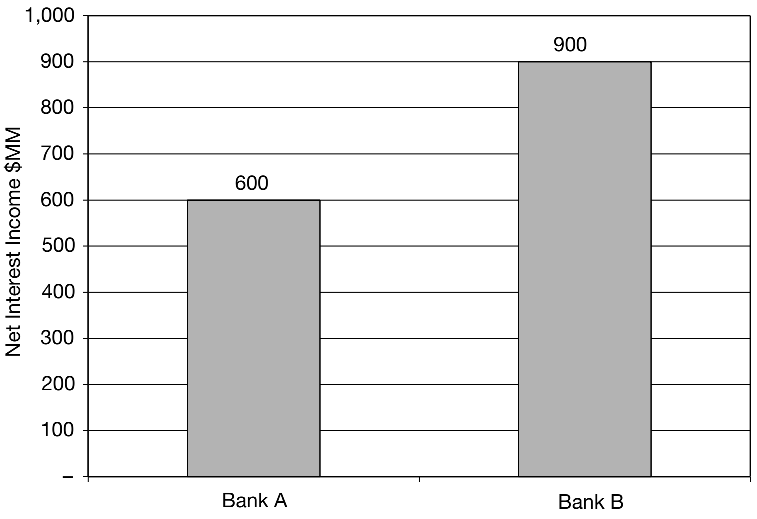
The most complex — and frequently erroneous — financial allocation methodology surrounds the valuation of balances. Because balance profit represents more than 80 per cent of total treasury services profitability for most banks, one would think this would be one area that banks would 'get right'. Balance valuation, however, is frequently a kind of Frankenstein monster — a bad mix of theoretical science and pragmatic political trade-offs. The treasury group (or asset liability management group) within the bank typically takes a purely theoretical approach to the valuation of balances, and this methodology is often complex and difficult to decipher. In the end, horse-trading takes place, and a compromise is derived that is neither scientifically valid nor reflective of business dynamics.

Getting the valuation of deposits right is critical. Banks that can understand customer demand, competitive dynamics and the impact of the macroeconomic environment on deposit and investment levels can go to market with optimal pricing decisions. In survey and engagement work, one finds great variance in deposit valuation levels — and frequently little rational basis for these variances. As shown in Figure 8, two banks can vary in their deposit valuation by as much as 150 basis points. If both banks have US$20bn in deposits, this difference would produce a swing in profit and revenue of US$300m. While some might argue that this valuation is used only for internal managemant information systems (MIS), one must consider that this MIS may not only affect pricing decisions but also the decision of the CEO as to the allocation of marginal resources among business units.

The payments business may be subordinated to lower ROE businesses such as credit

At some institutions, the treasury services business lacks a senior profile. While several institutions have recognised the value of the business and elevated it within the organisation, at many banks, the treasury services business is seen as the annoying little brother that tags along after the credit bankers. Credit is viewed as the primary driver of the business — a myth that will be addressed later. As a result, the credit footprint and the role of the credit banker as gatekeeper to the

Figure 8 Impact of variances in deposit valuation methodologies



Notes: Bank A: US$20bn in commercial deposits; FTP = 3.00 per cent (20th percentile in market). Bank B: US$20bn in deposits; FTP = 4.50 per cent (80th percentile in market). FTP = funds transfer price, the implied interest income yielded on deposits.
Source: Treasury Strategies sweep survey.

market significantly constrain the strategy of the treasury services business.

Strategy defines the identity of a business — the target market/client, product scope, pricing framework and basis of competitive differentiation. These strategy elements are interrelated, so that a constraint placed on any single element has a powerful ripple effect on other business options. In particular, the constraints the credit business places on the target market end up severely limiting the strategic options of the treasury services business.

Consider, for example, a frequent complaint of operations executives with regard to treasury services. Many clients bemoan a lack of discipline in pursuing business. Executives will complain that sales personnel bring in 'dirty' work that does not fit the operating model of the bank or that sales teams are prospecting for clients that do not fit the target profile. The sales personnel at banks are not irrational, however: they are merely trying to succeed within the boundaries they have been given. Because a typical bank might enjoy, at best, a 20–25 per cent share of their local credit market, many banks have literally shrunk their market radically before they even market their first piece of business. It is little wonder that, with credit relationships as a gatekeeper, treasury sales officers may be desperate to bring in any kind of deal possible.

Contrast the situation of credit-driven banks with that of the few banks that actively target market, prospect and sell treasury services relationships outside their credit footprint — or which pursue credit relationships based on a primary driver of selling high ROE non-credit services. At these banks, Product and Operations can collaborate to define their target client characteristic and can deploy disciplined pricing strategies that attract certain kinds of work and penalise or avoid other types of work. In control of their own destiny, these treasury services businesses have a degree of strategic flexibility that enables them to out-compete their peers.

While some customers make non-credit purchasing decisions based on, or heavily

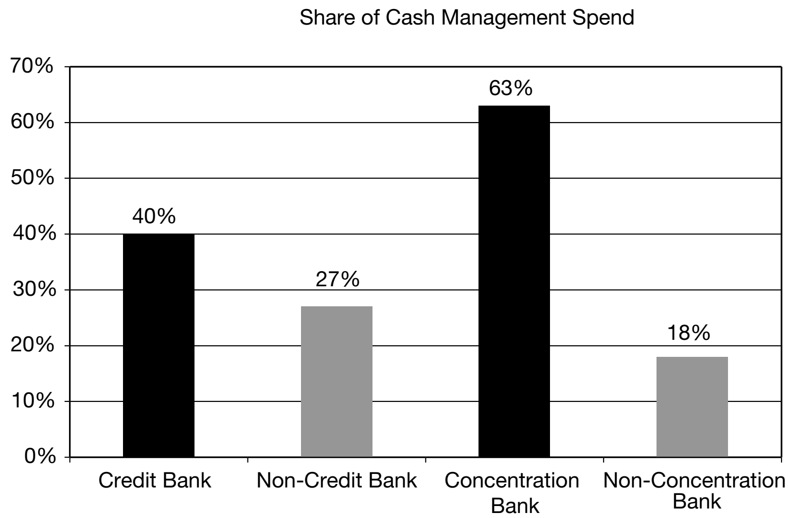


Figure 9 Customer buying behaviour

Source: Treasury Strategies US corporate research programmes

influenced by, credit relationships, a significant portion of the market does not use banks as a primary credit provider or does not link non-credit decisions to credit relationships. Figure 9 shows that, though a credit position helps gather share of treasury services business, a typical non-credit provider is also capturing a significant share of customer wallet. Furthermore, the most powerful driver of cash management wallet is not credit position, but concentration position — how deeply a bank's transaction services are integrated into its customers' core and strategic processes.

WHAT CAN BE DONE?

Given the opportunity facing banks and the obstacles payments executives face, what can be done? Treasury Strategies is aggressively advising client banks to ensure the business is correctly valued and that organisations make optimal decisions on strategic priorities and investment. Three primary steps must be taken.

(i) *Valuation*: The business must be valued correctly. Payments executives must be sure that costing and valuation methodologies support growth plans. Areas of particular concern include: (a) valuation of deposits; and (b) ensuring the bank is positioned to understand marginal cost dynamics.

(ii) *Visibility*: The value of the business must be promoted both internally and externally. Payments executives must begin to think of their mandate as driving share price — not merely adding marginal improvement to the bottom line. The impact of growth plans on EPS and share price should be measured as part of a compelling growth story.

(iii) *Leadership*: The business must take on greater leadership in the strategic direction of the organisation. The days of taking a back seat to the credit business are over. Payments executives should look broadly at their target market and explore multiple distribution channels. The banking sales channel should be viewed as a distribution channel and — rather than being taken for granted — should be actively sold on the benefits of the payments business.

Getting the valuation of the payments business right and gaining access to capital for growth is critical to a bank's long-term success. Banks with a clear and compelling growth strategy for the payments business will merit stronger PE multiples, positioning them to be acquirers. This cannot happen, however, if the value of the payments business is buried in a bank's financials and strategy. Given the long-term fate of banks with low PE multiples — investor pressure, vulnerability to acquisition, and CEO turnover — bank executives would be well positioned to highlight the payments business rather than bury it in the financial results of low PE businesses such as commercial or retail banking.

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