The Practicalities of Cross-Border Payments in a Faster Payments World

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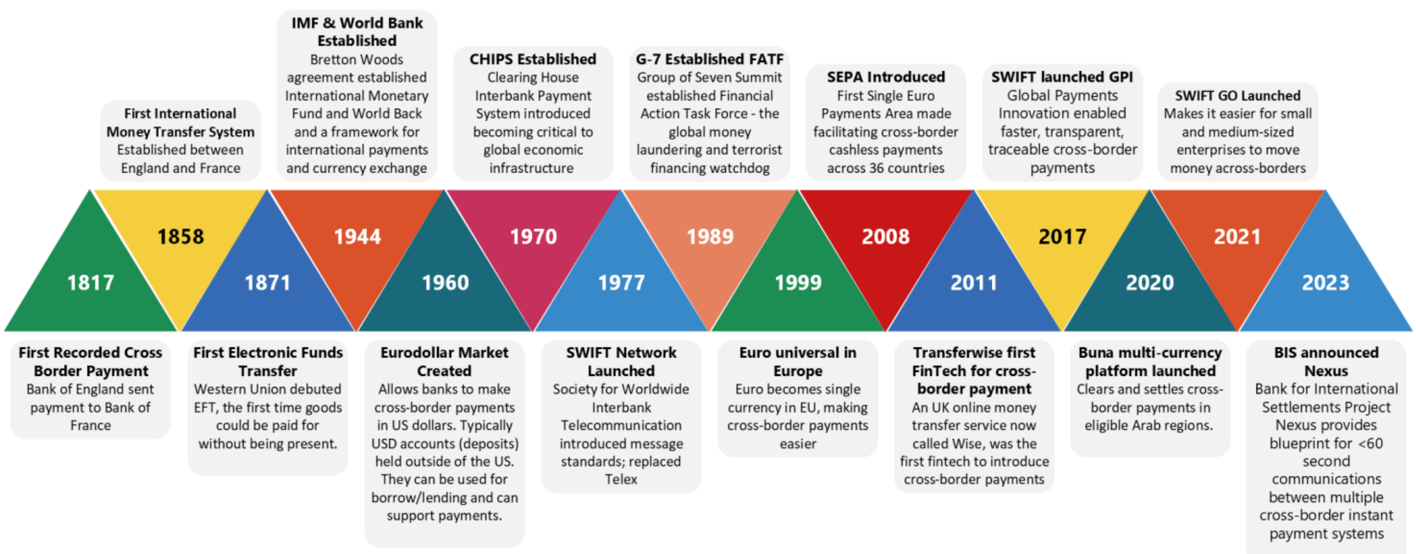
In June 2021, the Cross-Border Payments Work Group of the U.S. Faster Payments Council (FPC) published a whitepaper titled "Cross-Border Faster Payments."[1] The paper addressed use cases and user expectations for cross-border faster payments, particularly along the dimensions of speed, risk, ubiquity, transparency, and cost. The paper identified interoperability approaches, along with associated settlement schemes necessary to create a world-class cross-border payment system.

This report builds on those principles and explores the practicalities and realities of cross-border payments in a faster payments' world. This document is intended to look back at the history of correspondent banking and look forward to some of the considerations, challenges, and changes financial institutions are facing in the next 12 to 24 months in their faster payments implementations.

A Brief History of Cross-Border Payments

Cross-border commerce has been around for centuries, an example being the Silk Road[2], which was a network of trade routes that connected the East and West. This allowed merchants to exchange goods and services across vast distances. Cross-border payments have a rich history that dates to ancient times when different civilizations engaged in trade and commerce across borders. Below is a chart of some the key milestones in the history of cross-border payments highlighting some significant events in the journey to faster cross-border money movement:



In the modern era, cross-border payments have become more prominent as technology has advanced, and global trade has increased. Financial institutions have developed sophisticated systems to facilitate international payments, allowing businesses to send and receive money quickly and securely.

In recent years, the emergence of digital payments solutions offered by companies such as Apple, Mastercard, PayPal, TransferMate, Visa, and Wise, has made it even easier for businesses to transfer funds across-borders. These solutions make cross-border payments available to users who have registered with the service and successfully completed customer vetting. Additionally, many of these solutions offer low fees and competitive exchange rates, making them attractive options for businesses looking to save money on international payments.

In July of 2023, the Bank for International Settlements published their annual economic report. A special chapter details a blueprint for the future by rethinking the existing pillars of the current monetary system.[3]

According to the Bank for International Settlements Committee on Payments and Market Infrastructures it showed that over the last decade the volume and value of cross-border payments has increased by 61 percent and 37 percent, respectively, while the number of correspondent banking relationships has fallen by 29 percent.[4]

Correspondent Banking Explained

Correspondent banks play a vital role in cross-border payments, providing access to local banking systems and services. Correspondent banking is a type of banking relationship in which one bank (the correspondent bank) provides services for another bank (the respondent bank). Not all banks maintain accounts in all countries and all currencies. Respondent banks who do not have international relationships rely on correspondent banks who have such relationships to facilitate cross-border payments, as the correspondent bank can provide access to the local banking system in a country outside the respondent bank's country. The correspondent bank can also provide services such as currency conversion, liquidity management, and compliance with local regulations.

This type of banking relationship has been around since the late 19th century when banks began to establish relationships with other banks to facilitate the transfer of funds between them. The correspondent bank acts as an intermediary, allowing the respondent bank to transfer funds to and from other banks. It could also provide access to the global payments network, allowing the respondent bank to make payments to banks in different countries. The correspondent bank could also provide liquidity to the respondent bank, allowing it to make payments to other banks without having to hold large amounts of cash.

Large global banks, in addition to having correspondent banking relationships, have in-country branches used to connect to the local clearing and settlement systems to make payments on behalf of themselves and their customers.

The Challenges of Correspondent Banking and Cross-Border Payments

Today more than ever financial institutions face challenges in their correspondent banking relationships and cross-border payments.

- Regulatory Compliance: Correspondent banking and cross-border payments are subject to a variety of regulations, including anti-money laundering (AML) and know-your-customer (KYC) laws. Banks must ensure they are compliant with all applicable regulations, which can be a complex and time-consuming process. At the same time the BASEL III regulations mandate a standardized approach for operational risk determines a bank's operational risk capital requirements based on two components: (i) a measure of a bank's income; and (ii) a measure of a bank's historical losses.[5]

- Security: Cross-border payments involve transmitting sensitive financial information across-borders, which can be vulnerable to fraud and other security risks.

- Foreign Exchange Rate Risk: Exchange rate fluctuations can have a significant impact on the cost of cross-border payments. This can make it difficult to accurately predict the cost of a payment and can lead to unexpected gains and losses.

- Lack of transparency: Cross-border payments can be complex and opaque, making it difficult to track payments. Transparency ensures that payments are secure and that all parties are aware of the status of the payment. This helps to reduce the risk of fraud and other financial crimes. It also means the sender knows the cost of the transaction, including fees and foreign exchange expense before sending the transaction.

- High costs: Cross-border payments are typically costly due to expenses involved such as currency exchange costs, intermediary charges, and regulatory costs. In the World Bank's most recent review of remittance prices worldwide, banks remain the most expensive type of service provider, with an average cost of 12.10 percent vs. a global average of 6.25 percent.[6]

- Interoperability: Cross-border payments interoperability requires collaboration between payment systems, market infrastructures, networks, and financial institutions. It involves adopting common standards and protocols, improving infrastructure, and enhancing regulatory frameworks to ensure that cross-border payments are secure and efficient.

- Data Privacy: Several countries and states have stringent data protection laws to safeguard customers' sensitive information. The General Data Protection Regulation (GDPR) applicable in the EU and UK and the California Consumer Privacy Act (CCPA) are privacy policies that limit access and use of customer data. Financial institutions and payment systems need to ensure their businesses comply with these data laws for cross-border payments, making interoperability even more challenging.

- Rise of Fintech Payment Players: Multiple players have entered the field, including many fintechs, crowding the market with competitive offerings. These new players leverage innovative technologies and alternative approaches to move money across networks, servicing specific corridors or market verticals.

- Liquidity Management: Involves managing the flow of funds between countries and correspondents, ensuring payments are made in the correct currency and at the right time, managing the risk associated with foreign exchange fluctuations, and ensuring sufficient funds are available to cover forecasted and unforecasted payments.

- De-risking: De-risking, the method that allows banks to end their relationships with certain customers and banks to curb financial, compliance or criminal risks. Banks around the world are reducing their correspondent banking relationships, focusing on high-risk jurisdictions. Without access to traditional banking channels financial institutions and individuals may seek alternative channels which are less well regulated, and which may bring additional risks.

Many of these issues are exacerbated when trying to support faster payments on either side of the transaction. Faster payments can complicate many of these issues (regulatory compliance, AML, data privacy) while helping to address other issues (e.g., exchange rate risk, lack of visibility, etc.).

The Challenges of Fintechs and Cross-Border Payments

Fintech companies that operate in the cross-border payments space face several challenges due to the complexity and regulatory nature of international financial transactions.

- Regulatory Compliance: Fintech companies must navigate a complex web of international and local regulations, which can vary significantly from one country to another. Meeting compliance requirements for anti-money laundering (AML), know your customer (KYC), and sanctions screening is crucial, and failure to do so can result in significant legal and financial penalties.

- Security: Fintechs must establish secure payment infrastructure capable of handling diverse currencies and complying with various regulatory frameworks. Encryption, tokenization, and secure APIs play a critical role in securing payment gateways and ensuring the integrity of transactions.

- Foreign Exchange Rate Risk: Cross-border payments involve diverse currencies, multiple intermediaries, varying payment infrastructures, and different clearing systems. Finding competitive rates and minimizing fees for customers can be a challenge for fintechs. Fintechs need to create solutions that can seamlessly navigate these complexities to ensure timely and cost-effective transactions for their customers.

- Lack of Transparency: The lack of transparency can present significant challenges for fintechs involved in cross-border payments. Fintech's might find it challenging to provide real-time transaction tracking and visibility for cross-border payments and communicate potential delays or processing times transparently to customers.

- High Cost: Operating a cross-border payment platform requires significant infrastructure and operational costs. These costs can include maintaining customer support teams, fraud prevention measures, and cybersecurity to ensure the safety and reliability of the payment platform.

- Interoperability: Integrating with existing financial systems and establishing interoperability between different payment networks and platforms is a significant hurdle. Legacy systems and varying technological standards across countries can hinder the development of seamless cross-border payment solutions.

- Data Privacy: Fintechs are responsible for protecting sensitive customer data, and this responsibility becomes more complex in cross-border transactions. Operating across multiple jurisdictions means fintechs must navigate diverse legal landscapes, which can pose challenges in interpreting and adhering to different laws and regulations related to data protection, financial transactions, and cybersecurity. Compliance with various data protection laws, such as the General Data Protection Regulation (GDPR) in Europe and the California Consumer Privacy Act (CCPA), adds additional layers of complexity.

- Competition with Financial Institutions: Fintech companies have brought disruptive innovation to the financial industry, including in the realm of cross-border payments. Their agility, technological advancements, and customer-centric approaches have posed significant competition to traditional financial institutions.

- Liquidity Management: Managing liquidity across borders is a challenge for fintechs. Fluctuating currency values, settlement times, and the need to maintain adequate funds in different currencies pose liquidity management challenges, especially for smaller fintech firms.

Changes in the World of Cross-Border Payments

The last six years have seen an increase in the pace of change in the world of cross-border payments.

- In 2017, Swift introduced their Global Payments Initiative (gpi)[7]financial institutions are now sending and receiving funds quickly and securely to anyone, anywhere in the world, with full transparency over is the status of a payment at any given moment. SWIFT gpi dramatically improves cross-border payments, and for corporates, for example, for whom speed, certainty and seamless international payments experience is an absolute must.

- In March of 2023 after a long and circuitous journey the global rollout of the ISO 20022 payments and message standard became a reality for SWIFT member banks. This common standard enables more interoperability between market infrastructures and network participants dealing with both cross-border and domestic payments. Different countries have different ISO 20022 migration timelines. There is a coexistence phase until 2025 that supports a mix of old and new messaging standards while market infrastructures and financial institutions complete their migration to and adoption of ISO 20022.

- Distributed Ledger Technologies (DLT) is a type of technology that enables the secure and transparent sharing of data across a distributed network. It is used to facilitate cross-border payments by providing a secure and transparent platform for the transfer of funds. There are several DLT projects being explored that can help reduce the cost and time associated with international payments, as well as reduce the risk of fraud and money laundering. Additionally, DLT can help to improve the accuracy and speed of payments, as well as provide greater transparency and traceability. Project Cedar Phase II x Ubin+ (Cedar x Ubin+)[8] was a research project exploring potential improvements for multi-currency wholesale cross-border payments. The project examined whether wholesale central bank digital currencies (CBDC) developed using DLT could improve the efficiency and transparency of cross-border payments involving one or more vehicle currencies.[9] This collaboration brought together Project Cedar of the Federal Reserve Bank of New York's New York Innovation Center (NYIC), and Ubin+ of the Monetary Authority of Singapore (MAS).[10]

- Application Programming Interfaces (APIs) are a set of tools and protocols that allow applications to communicate with each other. They are used to facilitate the transfer of data between applications, allowing them to exchange information and perform tasks. API's can be used to facilitate the transfer of funds cross-border allowing for the secure transfer of data between banking systems. APIs are equipped to facilitate faster and more efficient cross-border payments as they reduce manual intervention and support a timelier data exchange across the payment chain. Payment service providers, financial institutions, and other entities in the payments ecosystem use application programming interfaces (APIs) to enhance efficiency, facilitate automation and extend payment functionality. For cross-border payments, API harmonization has the potential to improve transaction times and reduce costs (e.g., those associated with industry-wide standards).[11,12]

- Central Bank Digital Currencies (CBDCs) are digital versions of a country's fiat currency, issued and regulated by the country's central bank. CBDCs can be used for cross-border payments, allowing for faster, cheaper, and more secure payments than traditional methods. As of June 2023, the Atlantic Council was monitoring CBDC initiatives in 130 countries and currency unions.[13] This represents 98 percent of the global GDP. In July of 2023, a BIS survey showed 93 percent of Central Banks working on Digital Currencies.[14] Recently the FPC Cross-border Payments Work Group produced a series of bulletins exploring the current CBDC market landscape, the distinction of wholesale versus retail distribution of CBDCs, and how liquidity management is orchestrated in the CBDC world. The bulletins also examined a few of the recent CBDC pilots.[15] The potential for digital assets like digital currencies and tokenized assets to alter the global financial and cross-border payments landscape is immense. Digital currencies and tokenized assets have the potential to revolutionize the way money is transferred across-borders making it faster, cheaper, and more secure.

Conclusion

New transaction banking initiatives are changing traditional correspondent banking practices and payment processing paradigms. Innovated methods of payment and receipt, new currencies, and payments formats as well as the realities of 7x24x365 transaction processing are altering payment, compliance, and liquidity management policies, practices, and procedures. To keep pace with financial institutions, payments infrastructure must continuously adapt and change for new technologies, new industry initiatives, mandates, and regulatory and compliance directives. The pace of these changes has accelerated and will continue to do so. This requires constant review by all internal and external stakeholders responsible for ensuring a smooth and efficient payments workflow as well as an assessment of the impacts on the entire payments ecosystem.

In a faster payments world, cross-border payments can become more efficient and convenient due to the increased speed of transactions and advancements in financial technology while at the same time they become more seamless and accessible, benefiting both businesses and individuals. It is therefore important for every financial institution to stay informed about the specific features and requirements of the payment systems and applications they are using and to be aware of potential challenges to ensure successful cross-border transactions both for their customers and themselves. This report puts forth some practicalities and realities to consider when dealing with cross-border payments in a faster payments environment.

Acknowledgements

About the Faster Payments Council and the Cross-Border Payments Work Group

The Faster Payments Council (FPC) is an industry-led membership organization whose vision is a world-class payment system where Americans can safely and securely pay anyone, anywhere, at any time and with near-immediate funds availability. To further this vision, the Faster Payments Council established the Cross-Border Payments Work Group to cover global industry intiatives, gathering information on various models and use cases for real-time payments across borders with the long-term goal of cross-border interoperability.

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