Optimising FX and cross-border payments

THE PAYMENTS BANK FOR THE NEW ECONOMY

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EXECUTIVE SUMMARY

For some time, European companies have expressed dissatisfaction with the costs and fees associated with Foreign Exchange (FX) and cross-border payments, to the extent that just under half of those we surveyed in 2020 have considered switching provider to find a better deal.

While competition from Non-Bank Financial Institutions (NBFIs) such as CurrencyFair, Wise, Revolut and others has improved the situation for clients over the last 20 years, there remains wide scope for FX and cross-border transactions strategies to be optimised to deliver significant cost savings and improve processes to reduce administration requirements and save time. This is where payments businesses and banks could play a pivotal role.

Foreign exchange:

- When determining their FX strategy, companies should ensure they have a thorough knowledge of all parties involved and how the FX process works (see Part One of this paper). Additionally, businesses should make sure they understand the fees and costs to which they are exposed and how these charges are applied.
- As part of that strategy, it is important to set priorities by recognising those currencies in which fluctuation could have a material impact on the business – and which are of less interest given lower transaction volumes/values in that currency.
- When engaging a third-party provider of FX services, businesses should develop a clear commercial agreement, including the benchmark exchange rates that will be used as part of that agreement.
- In addition to the above recommendations, in Part Two of this paper we explain that businesses should be aware of key risks such as unnecessary conversions (for instance, from British Pounds to Euros then to Danish Krone), as well as the risk of intermediaries routing transactions through a third currency when this is unnecessary.

Cross-border payments:

- Everyone involved in the process - from the bank or payments provider to the end client - should also be looking to reduce the number of intermediaries involved in the transaction process, eliminating unnecessary intermediaries where possible.
- When seeking a provider of cross-border services, businesses should be looking for that provider to have access to deep pools of liquidity to achieve optimal pricing. Additionally, the provider's systems should be cloud-based and feature modern, open and flexible APIs to enable faster and more efficient cross-border payments. Likewise, processes should be seamless and fully transparent when it comes to fees and costs.

INTRODUCTION

By now, it is widely appreciated that the digital revolution is opening up competition in banking and financial services. Perhaps less well understood, however, is the extent of dissatisfaction among Europe's small and medium-sized businesses with existing cross-border payments and foreign exchange (FX) services: at present a wide range of firms are looking to make improvements in their approach to moving funds and exchanging value across borders. This report examines the current situation in FX and cross-border payments and outlines strategies that companies - and their payments partners - can adopt to improve processes, reduce costs and speed up FX and cross-border transactions.

Scaling the problem

Our 2020 study into SME attitudes[1] to banking services revealed mid-sized companies across Europe frequently experienced challenges with FX and cross-border transactions. Some 25% of companies we surveyed reported experiencing poor value in the FX rates offered by their banking partner, while 42% said their bank's fees for cross-border transactions were too expensive, with more than one in three complaining that sending money between countries also took too long. In the worst cases (the Nordic markets and the Netherlands) this complaint about slow transaction times rose to almost two in five of those surveyed.

Given such dissatisfaction, it comes as no surprise to learn almost half (49.7%) of those surveyed have begun to use FinTechs and other NBFIs to fulfil their international currency and payments needs, rising to almost three in five in Nordic markets. Specifically, around one in three European SMEs said they were motivated to switch from their bank to a FinTech provider for better FX rates and faster, cheaper cross-border payments. As one interviewee put it in a follow-up study[2], "Even when we use SEPA [Single European Payments Area] services, the money transfer market is crazy long. And if you're transferring [less common currencies], it takes far too long."

The opportunity for payments providers with strong FX and cross-border payments partners is therefore clear.

"Even when we use SEPA services, the money transfer market is crazy long. And if you're transferring [less common currencies], it takes far too long."

European SME

[1] Banking Circle, 29 May 2020, "Mind the Gap": https://www.bankingcircle.com/whitepapers/how-payments-providers-fill-finance-gap-online-merchants
[2] Banking Circle, 26 January 2021, "Bounce-Back Banking": https://www.bankingcircle.com/whitepapers/bounce-back-banking-5-markers-for-success-in-delivering-sme-financial-services

PART ONE
FOREIGN EXCHANGE: LEARNING HOW TO GET A BETTER DEAL

When it comes to foreign exchange transactions, it is important to record that increased competition has, broadly speaking, led to better deals from a customer point of view. Overall, FX is cheaper and settlement faster than it was 20 years ago. This is mainly thanks to the rise of money transfer companies such as WorldFirst and Wise, which have grown exponentially by offering cheaper, faster transactions and improved transparency and visibility at every stage in the process.

Even though established banks have responded by offering better rates, a lack of transparency in costs and charges can still be a problem. This applies even for those organisations that employ experienced treasury professionals to manage currency exchange and settlement on a daily basis. For example, companies using corporate credit cards across borders may find it hard to understand how the card scheme applies exchange rates, especially in those cases where more than one currency pair (from British Pounds to Euros, then Euros to Swedish Kronor, for example) is used.

FLOATING VS FIXED:
HOW FOREIGN EXCHANGE RATES FUNCTION

Currency prices can be determined in two main ways: a floating rate or a fixed rate. A floating rate is determined by the open market through supply and demand on global currency markets. Therefore, if the demand for the currency is high, the value will increase. If demand is low, this will drive that currency price lower. Several technical and fundamental factors determine fair rates of exchange and these factors affect supply and demand for currencies.

Most major currencies were allowed to float freely following the collapse of the Bretton Woods system between 1968 and 1973. This means most exchange rates are determined by on-going trading activity in the world's currency markets, with supply and demand affecting these floating rates. How much demand there is in relation to supply of a currency will determine that currency's value in relation to another currency. For example, if the demand for U.S. Dollars by Europeans increases, the supply-demand relationship will cause an increase in the price of the U.S. Dollar in relation to the Euro. Common geopolitical and economic factors affecting floating rates include interest rate changes, unemployment rates, inflation reports, gross domestic product numbers, manufacturing data, and commodities.

A fixed or pegged rate is determined by the government through its central bank. The rate is set against another major world currency (such as the U.S. Dollar, Euro, or Japanese Yen). To maintain its exchange rate, the government will buy and sell its own currency against the currency to which it is pegged. Some countries that choose to peg their currencies to the U.S. Dollar include Panama, Qatar and Saudi Arabia.

THE FOREIGN EXCHANGE PROCESS

At its simplest, FX trading is similar to the currency exchange people undertake when travelling abroad. A trader buys one currency and sells another at a fluctuating exchange rate. A vast majority of trade activity in the FX market occurs between institutional traders working for banks, fund managers and multinational corporations. Not all FX trading seeks to move funds from one country to another, and may involve speculation for profit or hedging against future exchange rate fluctuations. For instance, a FX trader might buy U.S. Dollars and sell Euros if they believe the Dollar will strengthen in value. Meanwhile, a European company could hold Dollars as a hedge to protect the value of their funds in the event the Euro weakens.

There are three main ways to trade foreign exchange:

- **The spot market.** This is the primary FX market where those currency pairs are swapped and exchange rates are determined in real-time, based on supply and demand.
- **The forward market.** Instead of executing a trade now, FX traders can also enter into a binding (private) contract with another trader and lock in an exchange rate for an amount of currency on a future date.
- **The futures market.** Similarly, traders can opt for a standardised contract to buy or sell a predetermined amount of a currency at a specific exchange rate on a date in the future. This is done on an exchange rather than privately like the forward market.

In practical, everyday terms, businesses will incur FX charges when they accept payments using cards denominated in other currencies, or use their own cards to pay for goods and services between different currencies. Foreign exchange charges can also apply to credit transfers (CTs), direct debit arrangements between accounts, and other payments. As businesses expand beyond their home markets, they are increasingly likely to incur such fees.

Depending on where a business is located and the currencies involved for purchasing and settlement, companies need to be aware of a range of factors – which we outline on the next page – to make sure they get the best deal on their foreign exchange requirements, delivering transaction settlement as rapidly as possible and at the lowest risk and cost available.

IMPROVING THE FX PROCESS

Payments businesses and banks working with companies that have significant FX requirements can help them improve the process by understanding these key factors:

- **The actors involved in the process.** This includes the counterparty (e.g. a merchant), the counterparty's bank, any card schemes or non-card payment methods such as digital wallets involved and the brokers used by all involved. Doing so will help avoid unnecessary costs: for example, if a company insists that transactions take place in a particular currency, this could require further conversions and therefore incur higher costs.
- **Transaction settlement times and risk.** These can vary widely, especially outside Europe, North America and Asia. When it comes to risk, it is especially important to ensure that parties have sufficient funds to cover settlement. This applies even in developed markets like the UK, where the FCA expressed concern in 2021 that some Electronic Money Institutions (EMIs) failed to hold sufficient funds to cover inflows and outflows from their accounts for overnight settlement.

In addition, those undertaking FX regularly should:

- **Ensure there is a clear commercial agreement** with the financial counterparty regarding currency conversion (i.e. what margin the counterparty is charging).
- **Understand the benchmark/ exchange rate source** used to which these commercial terms will apply (for example a central bank rate, a Bloomberg rate at a specific time, etc.)
- **Set priorities for the FX strategy.** Movements in primary trading currencies can be material to a business. However, for currencies that are more peripheral to a business, it may be prudent to focus on the most efficient path to executing a trade and settlement, rather than being too particular about the price for peripheral currencies or one-off payments.
- **Understand delays caused by regulatory obligations (AML and KYC checks, among others).** By understanding exposure to these factors it is possible for payments businesses and banks to develop effective approaches to mitigate the impact of delays caused by regulatory checks and requirements that can slow transactions down.

PART TWO
CROSS-BORDER PAYMENTS

All cross-border transactions outside the Single European Payment Area (SEPA) will involve an element of foreign exchange, and as such many of the risks outlined in Part One of this document also apply to cross-border payments. In addition to these risks, we explain below some specific challenges in cross-border payments. On the next page we explain what businesses should be looking for and how payments providers and banks can help them optimise their approach to cross-border payments.

Risk 1: Paying for unnecessary double conversions

Banking intermediaries and card schemes can often introduce sub-optimal processes through which companies end up paying more than they should. In particular, card schemes may systematically transact from British Pounds into Euros or U.S. Dollars and then into a third currency (such as Swedish Kronor or Danish Kroner), when in reality a direct switch from Pounds to Kronor or Kroner would be more beneficial from a cost perspective. The usual argument for such processes is that it reduces the risk of exposure to currency fluctuation between the two national currencies. However, this risk can also be mitigated by paying a slightly larger conversion and/or interbank fee, which would still be cheaper – and potentially faster – than paying two sets of conversion fees.

Risk 2: Poor counterparty knowledge leads to extra cost

As outlined in Part One of this paper, it is important to understand all the parties connected to a transaction to avoid unnecessary costs and delays. One example of where better knowledge can cut costs lies in understanding where counterparties and their banks are located. For instance, a British company wants to send funds to a Danish company whose bank is based in Belgium. In this case, the bank may add a conversion from Pounds to Euros, then convert again to Danish Kroner – an unnecessary step. Alternatively, the Danish company could hold an account in Denmark denominated in British Pounds, making any currency conversion redundant, since a simple transfer in British Pounds would suffice. It all comes down to having the best possible understanding and knowledge of the counterparty's business and advisors.

In addition to these common risks, those transacting across borders can also be subject to long and complex settlement arrangements between banks and intermediaries involving regulatory obligations and checks related to KYC, AML and other issues. Companies, banks and payments providers involved in cross-border payments should seek to understand these obligations.

IMPROVING THE CROSS-BORDER PROCESS

Payments businesses and banks working with companies that have significant cross-border requirements can help them improve the process by understanding these key factors:

- As with FX, it is important to understand the process. This means understanding who is involved in the transaction and settlement, and how the process works. For instance, does the provider undertake unnecessary conversions into intermediary currencies such as Euros at additional cost to the business. Companies transacting across borders should look for a process that is as transparent and simple as possible.
- Look for short chains. Businesses should choose a partner that has as short a chain as possible between buyer and seller, avoiding unnecessary intermediaries and therefore reducing risk and cost.
- Know the infrastructure. Especially when it comes to higher-value payments, companies should understand the infrastructure being used to complete transactions, and the time taken for clearing and settlement. Doing so will reduce exposure to regulatory breach, including the risk of having insufficient funds retained to cover clearing and settlement, among others.
- Seek a transparent and seamless approach. Companies doing business across borders should engage with counterparties and encourage them to be as transparent as possible when it comes to fees, costs and processes. In a commoditised payments world, buyers should be looking for partners that add value through transparency around costs and fees.
- Use cloud-based services and modern, efficient Application Programming Interfaces (APIs). Working with partners that offer cloud-based services with modern and efficient APIs will enable easy dialogue and integration between the payments business or the bank's systems and the FX partner's technology stack. Flexible and open API environments will make for faster and more efficient FX and cross-border payments, especially if these happen in the cloud, which can make processing much faster than between systems hosted in-house.
- Consider access to liquidity. The chosen payments provider should have access to deep pools of liquidity as this creates a more stable market in which prices do not fluctuate drastically, helping to secure better pricing for transactions.
- Businesses should be aware of the time absorbed by regulatory requirements and the potential knock-on effects of slower settlement times. In particular, businesses should ensure both they and their intermediaries have sufficient funds to cover any exposures caused by slower-than-expected settlement.

PART THREE
WHAT HAPPENS NEXT IN CROSS-BORDER PAYMENTS AND FX

In what follows, we explain what businesses, banks and NBFIs can expect to see in the future when it comes to FX services and cross-border payments.

- Greater competition.
  Especially for higher-value and higher-volume corporate customers, businesses should expect to see more value-based offerings related to the volume and value of foreign exchange or payments transacted. Thanks to more powerful technology, it is possible to offer customised pricing based on a corporate customer's credit risk and their volumes of business, effectively creating individual markets for companies doing high volumes and values of cross-border business. We expect this practice to be extended to a wider range of corporate customers in the years ahead.

- Better services through Open Banking?
  As Open Banking becomes more prevalent, enabled by the EU's second Payment Services Directive (PSD2) and analogous legislation in the UK and Switzerland, businesses should expect to see faster FX and cross-border transactions. This is mainly due to new payment services like account-to-account (A2A) payments, instant payments and Request to Pay. However, these services will not reduce exposure to unnecessarily high FX fees and charges, so businesses should remain vigilant as this paper suggests. Furthermore, questions remain over how to regulate these new payment methods and how effective "instant settlement" payments will be, especially with higher-value transactions subject to AML and KYC checks. The lack of "trusted party" status in many cross-border transaction scenarios could also act as a blocker to instant payments.

- Blockchain to make slow progress.
  While there has been much hype surrounding the ability of blockchain-based payments to cut out intermediaries and speed up transactions, several challenges remain, especially if such transactions are executed using crypto. To start with, the inherent volatility of most cryptocurrencies may make intermediaries reluctant to take part. Secondly, interfacing between fiat currencies and crypto remains a complicated process. The advent of "stablecoins" such as USD Coin is beginning to enable blockchain-based transactions. However, until a secure and stable blockchain solution is widely available and accepted, businesses should focus on optimising their existing FX and cross-border payment arrangements.

As a leading provider of foreign exchange services with access to multiple pools of deep liquidity, Banking Circle can offer Payments providers and Banks optimal pricing for their customers FX and cross-border transactions. Our cloud-based systems feature modern, flexible and open API environments that are easy to integrate with internal payments software, and reduce the number of intermediaries needed. Our commitment to optimal FX pricing also extends to the maximum possible transparency regarding fees and pricing.

To find out more about how you can better manage risk and control costs when it comes to FX and cross-border payments, visit bankingcircle.com to get in touch with our team of specialists.

Banking Circle is a fully licenced next generation Payments Bank that is designed to meet the global banking and payments needs of Payments businesses, Banks and Marketplaces. Through our API, we deliver fast, low cost global payments and banking services by connecting to the world's clearing systems – enabling our clients to move liquidity in real-time for all major currencies securely and compliantly. Our solutions are powering the payments propositions of more than 200 regulated businesses, enabling them to gain the geographic reach and access to the markets in which their customers want to trade. We process over 6% of Europe's B2C e-commerce flows and in 2021 alone, we processed over 250 billion Euros in payments volumes.

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