Future of **Payments**

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Dear reader,

Welcome to this, the inaugural edition of the Projective Group Institute's new Journal of Financial Services!

We're very excited to be launching our Journal at a time of immense challenge and change for the financial services industry, and we've drawn upon the deep subject matter expertise of the many renowned contributors to this edition of the Journal to bring you what we hope you'll find to be a highly stimulating series of articles.

We'll be publishing editions of the Journal on a regular basis, and each time we will be focusing on those topics our Advisory Board members, who are leading academics and executives, are telling us are of key strategic importance to them. And it's for that reason that we've chosen to focus this edition on the world of Payments.

Payments has gone from being an often-overlooked, quite slow-changing, typically back-office, function to becoming one of the most transformed - and transformative – functions in the financial services industry. And all of that has happened within the space of only a few years. Digitization, cloud native technology, financial crime and fraud, artificial intelligence, and many other recent developments, combined with ever-greater regulatory scrutiny and ever-increasing client expectations, have created the perfect storm for legacy Payments providers and have opened this area up to newer and more agile competitors.

We focus on the drivers of that transformation, the implications of those drivers for the various players in the Payments value-chain, and the key decision points firms will therefore soon face if they intend to remain leaders in this field.

I'm conscious that in creating the articles in this Journal, many individuals have spent many hours researching and writing, and I'm very grateful for their time and expertise!

I look forward to getting your feedback on our new Journal of Financial Services, and to speaking with you again soon.

Stefan Dierckx, Founder & CEO, Projective Group

Future of Payments

Impact of new technologies on the **cash management** competitive landscape

Koen Vierendeels,
Head of Transaction Banking, Belfius

Robert-Jan Wekking,
Group Practice Lead Payments,
Projective Group

ABSTRACT

Corporate treasurers already had enough on their plates before the recent geopolitical challenges made their jobs significantly more complicated and challenging. From trying to remain compliant with the numerous regulatory environments, to preventing fraud, keeping up with the latest technologies, and trying to find the best way to manage the funds of the enterprise, corporate treasurers already had quite a bit to deal with. However, the recent trade wars have made that task somewhat more complicated, with expectations that taxes could become even more complex to manage for globally diverse organizations. These challenges come at a time when, like most other functions, corporate treasuries were working on their digital transformation strategies, made somewhat more complicated, and exciting, by the AI revolution. Interestingly, these same new technologies can, and will, have a profound impact on how organizations manage their cash, and with whom they will partner going forward. In this article, we posit that these new technologies will make the corporate cash management market much more competitive, and allow regional and local banks to compete head-on with global players.

1. Introduction

Most people still view corporate treasury as the division that works hard at finding ways to keep the company's funds away from the taxman. Using offshore locations, and complex tax structures, they spend all day moving money around to minimize the company's tax obligations. Even those who study the subject at major universities are primarily taught about whether centralized or decentralized treasury structures are better at managing a multinational organization's taxes. And while it is true that corporate treasuries do work hard to help multinational companies minimize their global tax obligations, the job of a corporate treasurer is much more complicated than that.

At its core, treasury management is still about managing an organization's liquidity, using a myriad of instruments and relationships to help improve how that is done. Constantly monitoring cash inflows and outflows, identifying and hedging risks that emanate from currency and interest rate fluctuations, ensuring working capital is maintained and allocated efficiently, and managing investments and debt, to name a few, ensure that a company's liquidity position is optimized. But to ensure that optimization, corporate treasurers need to be constantly aware of regulatory changes within the markets in which they operate, specifically with regards to transfer pricing and taxation, how currencies might move, their implications for a company's liquidity across its regions, forecasting how both currency and liquidity needs might fluctuate, and obviously make informed decisions about how and where funds are allocated.

To put things in context, a typical corporate treasury of a multinational corporation needs to be cognizant of a large number of major global regulations when undertaking its liquidity management tasks, including the Sarbanes-Oxley Act (SOX), which requires companies that operate and publish accounts in the U.S. to ensure that their disclosures are accurate and free from fraud, resulting in significantly more work in documenting and testing; the Office of Foreign Assets Control (OFAC) sanctions list, which requires cross-border payments processed by the U.S. treasury to be screened against OFAC's Specially Designated Nationals (SDN) list, slowing the process down; and Basel III, which impacts how treasuries can allocate their cost of capital and how they invest their cash, including lending. This is by no means an exhaustive list, and does not include local regulations and restrictions, but does highlight some of the key regulatory challenges corporate treasurers face to remain compliant.

To manage some of these challenges, corporate treasurers are increasingly relying on advanced treasury management systems to help them improve efficiency, have access to better and more reliable data, and, consequently, make better financial decisions. They often also establish strong relationships with major legal and tax advisory firms, and major global banking organizations, who can help them navigate some of their liquidity challenges and provide cash management and advisory services. It is with the help of advanced internal, and third-party, cash management capabilities that corporate treasurers can track where liquidity is based, forecast where it needs to be, and take the necessary actions to make it happen in the most efficient manner possible. Maintaining control over where money is coming from and going to continues to be the main challenge facing the corporate treasury function.

Given the global nature of the operations of most major global corporations, this has typically meant establishing close relationships with a number of global banking organizations such as JPMorgan, Bank of America, Citi, HSBC, or Deutsche Bank. The result has been a highly concentrated corporate cash management market, where a handful of large global banking organizations have dominated.

In our view that is going to change. We firmly believe that with the advent of new technologies, in specific instant payments, which is more of a new capability than a technology but is increasingly becoming more prevalent, and Application Programming Interfaces (APIs), which allow services to be provided to third-party companies, regional players will be able to compete head-on with the more global players and make the market for cash pooling and management significantly more competitive.

2. Evolving nature of cash management

An important subset of treasury management is cash management, which is tasked with tracking, managing, and investing cash across the entire enterprise.

Cash management is responsible for both long-term issues such as how much and where excess cash should be invested, and short-term ones, such as ensuring there is enough cash to cover payroll and supplier invoices and making sure cash is collected on invoices that are outstanding. And all the while trying to minimize so-called idle cash and maximize the returns obtained.

How corporations managed their cash management, or their treasury, functions, was up for debate up to around a decade ago when, according PwC's Global Corporate Treasury Benchmarking Survey of 2017[1], 83% of the more than 200 corporates surveyed stated that they had established a dedicated central treasury department for the management of cash, foreign currencies, and other key financial matters.

This finding was interesting, since the trend in many multinationals corporations has been to decentralize their strategic and operational management so as to be more responsive to rapidly changing consumer needs.

Nevertheless, that trend has continued and most major global corporations have established a centralized treasury that acts almost as an in-house bank, with some such as BP even having their own market trading functions to improve their "Buying Power" (playing on the BP initials!) in financial markets. There are also corporate treasuries that provide retail and corporate financing, with some such as GE Capital having spun off those operations (in their case to create Synchrony Financial).

While the pros and cons of centralized and decentralized cash management, and treasury, functions is beyond the scope of this article, there a number of benefits of the former that we believe are valid and pertinent for the arguments made here. They include:

- **Centralized dashboard of cash positions**: centralized cash management operations allow corporations to have a clear view of their global cash positions, and anticipated inflows and outflows; helping them to make reliable forecasts about needs and, consequently, better manage their liquidity. By consolidating cash in a central location, organizations will also have better control over how liquidity is managed.
- **Increased efficiency**: pooling of liquidity can help reduce transaction fees and improve interest rates paid and received, and of course consolidating functions typically improves efficiency. Corporations are also able to benefit from having a small number of experts managing the treasury function centrally rather than a large number of less experienced individuals scattered across the group.[2]
- **Better investment management**: having a holistic view of the company's global cash positions allows firms to increase balances invested for the long-term, obtaining better investment returns, reducing borrowings or obtaining better rates, and minimizing idle cash across the entire enterprise. Idle cash management also benefits from diversification, meaning a smaller total is needed to maintain the minimum balances required across the group.
- **Improved risk and regulatory management**: being able to improve coordination across a group to manage financial and regulatory risk will help organizations to mitigate and better manage them. Hedging strategies also benefit from centralization, since not only is the treasury able to obtain better rates, it gains from diversification effects across the group.
- **Applying the latest technologies**: the complexities of today's treasury function demands that it applies the latest technologies, some of which are expensive and complicated. Having a centralized treasury function allows for the hiring of the most capable people, needed to implement, manage, and apply these new technologies, and to standardize the systems across the group. The treasury function requires access to real-time reporting and analytics to be able to effectuate its strategies, and that demands the most advanced technologies, capabilities, and personnel - things that are hard to decentralize.

To achieve its goal of improving control over the organization's cash positions and automate as much of their internal and external processes as

1. https://tinyurl.com/y245u5z6
2. Within centralized treasury functions, corporations often separate international treasury centers (ITCs), that deal with management of the corporation's finances, as discussed in section 2, from shared service centers (SSCs), which constitute the grouping of resources for standardized operational functions to improve efficiencies in HR, Finance, IT, etc.

possible, the cash management function also needs to apply the latest technologies. This is no mean feat, and forces most corporations to consider centralizing their cash/treasury management technological capabilities in order to achieve their objectives.

Automation of the treasury function will help reduce the costs of erroneous data being manually entered into the system, ensure compliance with the ever-growing list of regulations, and control fraud. It will also help in identifying errors and allowing for remedial action to be taken earlier in the process.

The AI revolution is expected to accelerate the process of automation, and have a transformational impact on the treasury function as well. In the specific case of cash management, AI's predictive capabilities will help organizations to speed up error detections and reconciliations, as well as use seasonal cash flow patterns and payment behaviors to drastically improve how much idle cash they need to keep across the group, making sure it goes to where it is needed most.

APIs, which allow different software applications to communicate and exchange data using a set of protocols, is another technological capability that is expected to have a profound impact on cash management.

APIs are expected to help organizations obtain real-time information across the different accounts and currencies they hold, no longer waiting for overnight processing cycles to end, automate data flow across different systems, streamline routine transactions to speed up processing, minimize manual errors, and have access up to date information from across the group.

By integrating APIs with the treasury's own banking application, rather than third-party solutions, organizations will be able to streamline their reconciliation processes and manage cash pools directly from their own enterprise resource planning (ERP) systems, eliminating the need to navigate multiple banking platforms.

2.1 Automation, instant payments, and pooling

Within the corporate treasury ecosystem, it is not just the treasury function that aims to automate as much of its processes as possible: the banks and payment providers companies deal with have also been working hard to automate their processes, one important manifestation of which is instant payments.

2.1.1 Instant payments

Instant payments, which are processed and settled in real time, avoid the need to wait days for them to clear. The funds move within seconds, 24 hours a day, 365 days a year. The immediacy of payments, while having many attractive features such as certainty of payment, rapid confirmations for sender and recipient, and enabling just-in-time working capital management, also means that once an instant payment is sent, the transaction is irrevocable and the recipient has immediate access to the funds. This means that the payment processing systems need to be designed to be as foolproof as possible, since mistakes are much harder to correct. Obviously, managing fraud is also an important issue that the treasury function needs to manage effectively.

Integrating real-time payments within legacy systems in the treasury function is also a challenge for many organizations, with most being forced to upgrade or modernize their systems. The cost-benefit analysis will, over time, tend to favor undertaking such a system modernization.

The fact of the matter is that a major challenge for treasurers is that they will now have to manage their funds and cash positions 24/7, as there is no end of day closing anymore. This is difficult, given different time zones and is something that is contrary to the notion of a centralized treasury function.

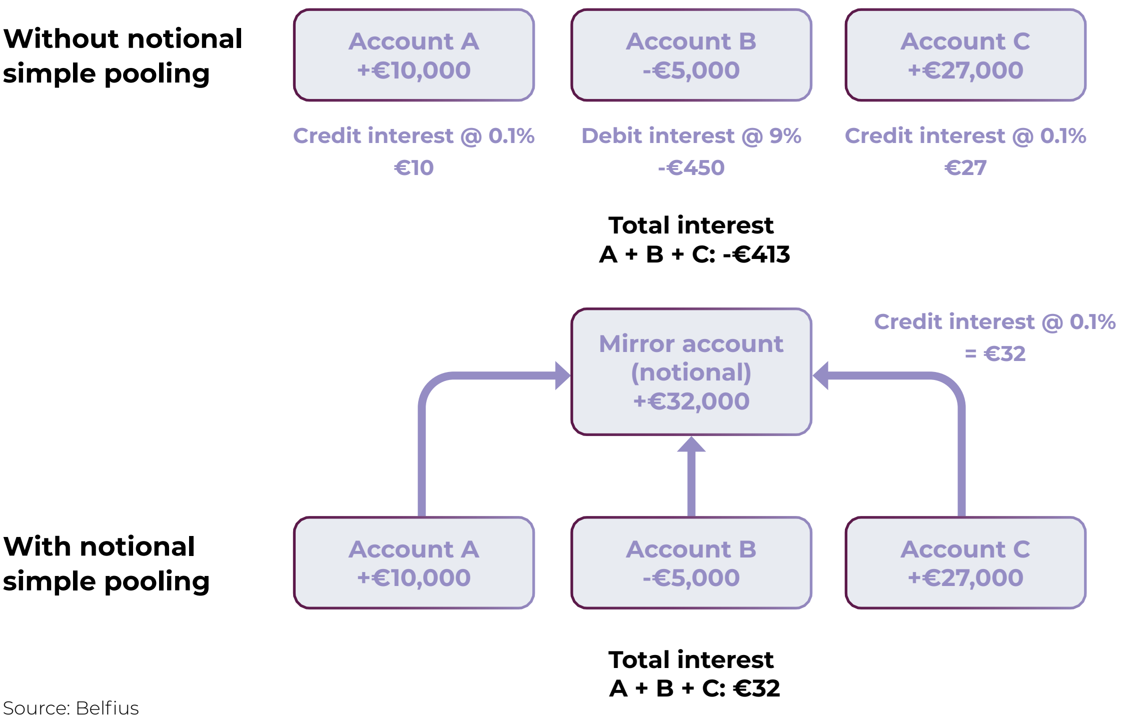
2.1.2 Cash pooling

Cash pooling, which optimizes liquidity by centralizing account balances, allows organizations to aggregate the cash sitting in various accounts into a single pool, making it possible to offset short-falls in one account with surpluses in another.

Cash pooling can either be physical (zero-balance account[3], where the funds are physically transferred at the end of each day so that sub-accounts are brought to zero and all excess cash is concentrated in a master account (Figure 1)), or notional (where balances are virtually consolidated without phys-

3. Alternative types of physical pooling exist, such as target balance accounts, where the subsidiaries maintain a target or fixed balance.

Figure 1: Simple pooling (merger of accounts)



Source: Belfius

ical transfer). In the case of the latter, the company's bank will calculate interest on the net aggregated balance of all accounts and treats them as one for interest and reporting purposes, even though each subsidiary's account remains separate.

Cash pooling adjustments (sweeps), which used to take place at the end of each day and where funds would move once daily to concentrate balances, have also been impacted by instant payments, making cash pooling timelier and more dynamic, and allowing treasuries to maintain near-zero latency in liquidity management.

Instant payments have also made it possible for the treasury function to undertake intraday pooling, since real-time transfers allow them to sweep balances a number of times a day, if not continuously throughout the day, permitting optimization of net positions immediately, including outside of normal working hours. Real-time pooling allows for monitoring of the consolidated cash position, helping to improve forecasting of short-term needs and reducing idle funds.

In response to these capabilities, a number of banks are offering to their clients API-driven real-time cash pooling services that allow intraday sweeps. Some are even offering these services for virtual account structures, which make it possible for treasury to have immediate centralization of cash with full visibility, without needing to make physical transfers for every single transaction.

3. The changing competitive landscape

Despite the aforementioned benefits that instant payments afford cash pooling strategies, treasuries will struggle to achieve real-time pooling across the entire enterprise should they have relationships with a number of banks, as is typically the case. They will, therefore, be forced to limit their banking relationships to only those banks that either support instant payments or are able to use overlay solutions that enable real-time transfers.

Ironically, the same capabilities that are forcing corporates to choose the more global of banking partners are also changing the market dynamics in the cash management ecosystem, creating opportunities for both local and regional banks to compete with the very biggest.

For example, while cash pooling (especially physical pooling or notional pooling) has traditionally meant that corporations were forced to hold accounts with a single global bank, with instant payment as the new normal, and a modern connectivity architecture such as APIs and ISO20022, this model is evolving.

Corporations are now able to establish in-house structures where subsidiaries transact via internal accounts, external payments and collections are routed through regional banks, and liquidity is managed via real-time or intraday transfers to the central pool.

Having the option to also partner with local and/or regional banks for their cash management needs means that corporations will now be free to choose the partners that best meet their specific requirements, rather than being forced to choose only the largest global players.

As with everything in life, there are pros and cons to choosing to partner with local and/or regional banks, as opposed to the large global banking giants, but new technologies have certainly made it possible for corporations to benefit from the ability to build a modern treasury model with them that is both agile and efficient.

By partnering with those local and/or regional banks, corporations will be able to benefit from greater local expertise and market access. They typically offer stronger local market knowledge and faster tailored support. They are also more knowledgeable about the local regulatory environment, which is very valuable in areas with complex financial regulations and growth potential.

Furthermore, by decentralizing banking relationships across multiple providers, corporations will be able to avoid having to pay the premium prices charged by global banks and negotiate better fees and FX spreads. They will certainly be in a stronger negotiating position because of the advent of local and regional banks in the provision of cash management services.

Finally, corporations will be able to mitigate the risk of being dependent on a single bank's infrastructure and/or credit risk – an issue that becomes more pertinent in times of crisis, when banks face liquidity or technological issues.

For corporations that are considering partnering with more local and/or regional banks for their cash management services, there is, however, a note of caution. And that is that while the aforementioned benefits are certainly real in markets that have developed technologically, there are still countries where instant payments are not as yet guaranteed. Where cross-border flows are required in countries that do not provide instant payments, it may be advisable to allocate this part of the cash flows to a single cash pooling bank.

Hence, treasurers and cash managers are typically managing a hybrid model by using a global player as the cash pool bank for all non-instant payment flows while using local/regional banks for the instant flows.

A potential benefit of such a model is that since global banks are well-versed in international regulations, and local/regional banks have a good understanding of local compliance requirements, corporations can take advantage of this dual expertise to navigate complex regulatory environments more effectively.

4. Conclusion

New technologies are changing every facet of our lives, and treasury and cash management is no exception. New technologies are creating a very different landscape in this industry than most corporations are used to.

Companies that manage cash across borders are now able to choose who manages that cash and how, be they global banks as was the case in the past or local/regional players as new technologies have made possible (or a hybrid of the two for markets that are still instituting these technologies). But change is the only constant in this environment.

New technologies such as APIs have even made it possible for treasurers to manage their cash pools directly from their ERP systems, eliminating the need to navigate multiple banking platforms. APIs can also automate routine tasks such as fund transfer, reconciliation and reporting, reducing the need for manual intervention and minimizing the risk of error. Furthermore, the new technologies come with enhanced security, ensuring that financial data is transmitted securely between systems. Their capabilities will further accentuate the ability of local and/or regional banks to even more aggressively compete in this market, since they will be able to leverage those capabilities to innovate and differentiate their offerings to rival with those of the global banks.

As those who are familiar with this market will be fully aware, modern treasury is about more than just pooling cash. It is about optimizing liquidity in real time by maintaining visibility across accounts (made possible by real-time reporting via APIs) and building a resilient banking model to optimize working capital across regions through real-time information and forecasts.

Regional banks such as Belfius can now offer specific added value by linking local banks to global pooling. The newcomers to the global marketplace realize that they will need to provide more than mere cash management services, and become true partners to their clients. Today's clients demand more, and thanks to the new technologies and the new competitive environment they have created, they might finally get what they demand and deserve.

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