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One Bank Oligopolies or open, collaborative networks?

Future of Payments

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One Bank oligopolies or open, collaborative networks? The future of cross-border payments

In the Annual Economic Report (June 26 2022) BIS released an interesting study on the monetary system and the future of cross-border payments. BIS predicts that the future technology, that could replace the current correspondent banking model, would be blockchain networks tokanizing regulated assets such as M0 (central bank money) or M1 (commercial bank money) and not crypto assets. They elaborate on how local RTGS systems can be connected by using CBDCs, enabling global real-time payments at low costs and eliminating the intermediaries in the form of correspondent banks. The CBDCs are now in the making, but mainly for retail use, while wholesale CBDCs for cross-border payments are more distant. Meanwhile, global commercial banks launch their tokens and networks, generally backed by cash deposits (M1). Regulators and politicians will likely be on the watch. However, the global banks' biggest challenge will not be regulators but the new DLT that can bring even small banks at par with the global behemoths by using open, collaborative, permission-based networks.

The existing system, sending cross-border payments via a chain of intermediaries (correspondent banks), is arguably the same infrastructure that has been used for decades despite the technological advancements in society. Attempts have been made to improve it (Swift GPI, new ISO standards, etc.), but ultimately the problem remains that there is no way of transferring value (risk) in real-time in the old system. Here comes the uniqueness of DLT that enables the creation of a digital asset (stable-coin) that can be transferred in real-time (hence eliminating counterparty risk) and enables money to be transferred 24/7 across the globe in real-time.

This has significant implications for how liquidity is managed. As the new technology enables companies to transfer funds 24/7 instantly, it provides predictability and comforts corporates and financial institutions in reducing cash buffers and local cash pools around the globe. There is no need to maintain extra cash in the subsidiary in Australia if there are no cut-off times, and money could instead be transferred instantaneously from the head office. This greatly impacts global cash management and will ultimately free up capital for both corporates and financial institutions. This would mean considerable savings for society, while the global cash management banks (normally the same institutions that dominate correspondent banking) would see significant drops in revenue.

Already, there are alternatives to the traditional correspondent banking infrastructure enabling instant, global payments. Most of the innovation is so far seen in retail and e-commerce-related flows. This is usually achieved through pre-funding to eliminate the value transfer risk. Fintechs are now offering real-time payouts in 70+ countries on the back of prefunding and are gaining market share from global banks. It is, however, more difficult to execute wholesale tickets as the pre-funding amounts limit the ticket size.

The global banks instead dominate developments in the wholesale markets. For global banks, this is urgent as their revenue model in transaction banking will come under pressure. They are now creating their own tokens in "one bank” solutions by utilizing their global footprint and large IT development resources. As long as both the sender and beneficiary are the bank's clients, the Global Bank can execute a real-time payment, as they do not need to worry about the value transfer risk. By doing this, they are locking in clients into their networks. It becomes difficult for smaller banks to compete with their traditional correspondent banking infrastructure model. There are, however many obstacles in the way for the global banks:

1. Politicians' strong resistance to having global banks create payment infrastructure oligopolies. This would not only be the case in China or India but remember the destiny of Facebook and the Libra in the EU. The EU is not interested in more foreign dominance in payments infrastructure.
2. The clients are not interested in dependence on “one bank" solutions. Most corporations need broad banking groups to support their liquidity needs over time, and giving too much business to one bank jeopardizes banking relations.
3. There are limitations in terms of geographical reach and liquidity. Even global banks are cutting their networks to reduce costs, meaning that they by no means can reach all markets. Real-time payments require liquidity at the source of the payment beneficiary, and one bank can only service a limited number of payouts for companies, particularly in smaller markets. It won't be easy to service global clients worldwide efficiently.

Nevertheless regulators and politicians should be cautious when they follow the developments of "one bank" solutions and actively counteract new oligopolies.

Fortunately, the new blockchain technology opens new opportunities for regional banks, particularly Fintechs, that are fast in adapting to the latest technology. As BIS points out in the report, new innovative and secure payment methods emerge by combining DLT and tokenized Central or Commercial Bank money. Banks can create decentralized networks where they collaborate and share each other's geographical reach and local liquidity. Thanks to the DLT and smart contracts, and time locks, counterparty risk can be eliminated. This gives “open bank networks” superior geographical reach and deeper liquidity than the global banks' "one bank" solutions. The geopolitical challenges are also much smaller if the network is built on a “peer to peer” governance model with participating banks from different parts of the world. The winner is ultimately the end client.

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Such a system would be much in line with the BIS thinking for the future. Centiglobe offers an open, collaborative network operating on a private, permission-based chain. Using tokenization, CBDCs can be synthetically created, enabling risk-free value transfers. This means that banks worldwide can instantly execute payments outside of the traditional correspondent banks around the globe. This creates a level playing field where regional banks and PSPs can compete with global banks and offer markets without a local presence to their clients. The biggest winners are the clients and society, as instant global payments free up liquidity and capital, releasing resources for new investments.

Please do not hesitate to contact Centiglobe if you have any comments or suggestions on the text or if you want to know more about the Centiglobe network.

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