Treasury 3.0℠ Services

Challenges and Solutions

Treasury Strategies

The Power of Experience®

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From Past to Future

Historical Perspective

The Treasury Services marketplace is undergoing fundamental changes and in ten years will look quite different than what we see around us today. To understand where the industry is headed and how financial institutions can adapt to the changes, it's useful to know where we've been. There have been two important phases of growth and innovation for bank-provided treasury services prior to the emergence of today's Treasury 3.0℠ Services — the next phase of change.

Treasury 1.0 Services

Treasury 1.0 Services began in the late 1940s and lasted until about 1971. During this period, commercial banks provided business services to their corporate clients at no cost. The services were mostly client accommodations, extra tasks that banks performed to endear themselves to customers and to maintain the credit relationship. The treasury services industry grew rapidly during this era in number and scope of services, but this was basically cost-center activity — little to no revenue was generated.

Treasury 2.0 Services

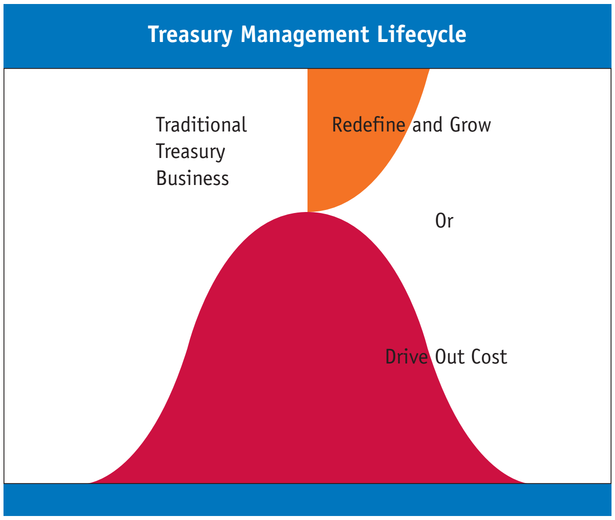
The second phase, Treasury 2.0 Services, began in 1971 and has more or less continued to the present. In this stage, the cash management/treasury management business we're familiar with took shape. Industry revenues grew from nothing to between $70 billion and $100 billion by 2005, clearly a formidable business.

Phase 2.0 was triggered in 1971 when the world moved off of the gold standard, precipitating two important changes. First, corporate liquidity drained out of the banking system. Most of the balances that companies had been keeping on deposit at the banks — which banks had earned interest on and which paid for treasury services — were drawn down. There wasn't enough left over to compensate the banks for what they were doing.

Second, interest rates rose astronomically, making the value of cash management services in a high-rate environment much more important to corporations. Consequently, banks decided to charge for these services. Treasury services fees became much more expensive and ultimately grew to about $100 billion.

Treasury 3.0℠ Services

In 2005, Treasury Strategies issued a white paper called *The Next Generation of the Treasury Services Business* documenting that Phase 2.0 was ending and arguing that banks needed to adapt to new market conditions. The array of cash management services that banks were offering had reached maturity and, in some cases, were in decline. Business had become a zero-sum game —



gains made by one bank usually came at the expense of another. Currently we are in the early phase of Treasury 3.0SM Services.

Viewed in terms of product life-cycle change, the treasury services business today is at a crossroads. Banks must choose whether to redefine the business to develop sustainable new sources of growth, or maximize the value of the existing franchise by milking it through its declining phase.

In fact, banks are moving in both of these directions. Some of the larger banks clearly see themselves as leading players in 3.0 and are making the necessary investments, while others are trying to maximize the profits of existing business as it declines.

The innovators are replacing traditional cash management services and repackaging them into more comprehensive payment and liquidity solutions. This third phase will be about payment and liquidity solutions offered by *banks*, as opposed to specific product sets put together by *companies*.

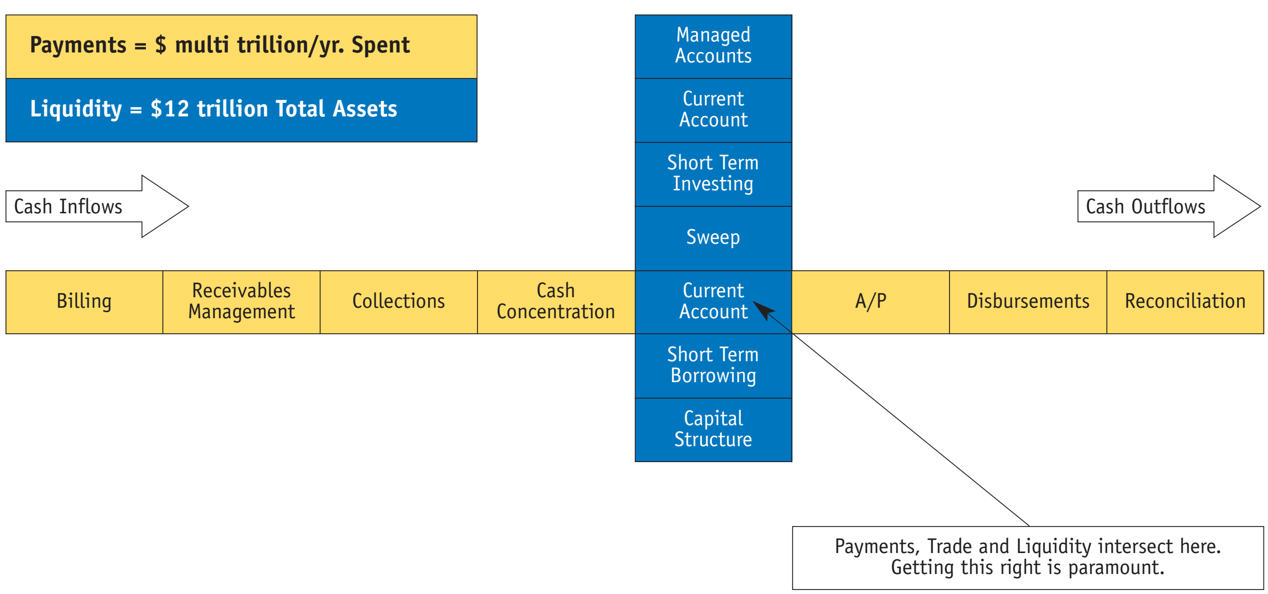
The Potential of Treasury Services

Current Industry Structure

Today, at the cusp of Phase 3.0, there are five banks globally who have much larger shares of the overall treasury services market than the remaining players: Bank of America, Citibank, Deutsche Bank, HSBC, and JPMorgan. Large as these five organizations are, they have less than 50% of the total market. The treasury services business is still highly fragmented, even though it is 60 years old.

In addition to the five leading players, there are a number of less global, but strong competitors in each geographic region around the world, plus a number of capable industry segment players.

Because the market remains highly competitive, it's far too early to predict who the key players are going to be 10 years into the future. It is possible, however, to see what comprehensive payment and liquidity solutions will look like in 3.0, because solutions are already beginning to appear.



Components of a Comprehensive Solution

The components of a comprehensive Treasury 3.0℠ Services solution can be seen by visualizing a "corporate payments" horizontal axis and a "corporate liquidity" vertical axis. The two axes intersect at a company's operating accounts.

The horizontal axis represents the entire process of a company managing its working capital, from billing and accounts receivable management to cash mobilization and accounts payable management.

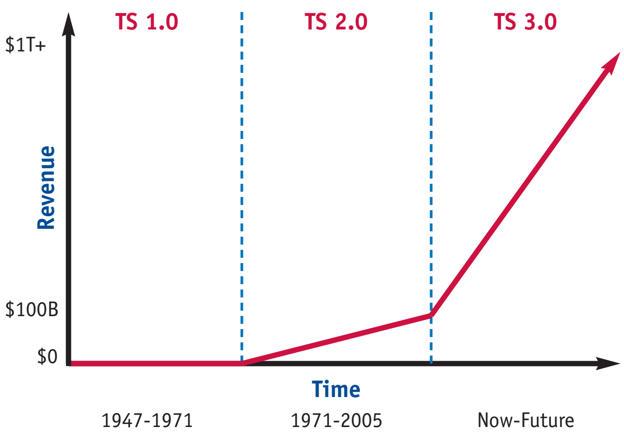
There's a lot of activity along the working capital axis. Treasury Strategies estimates that companies spend well over $1 trillion annually conducting their working capital activities. Of that figure, only about $100 billion — less than a 10% market share — is spent with banks, even though they have a monopoly on financial settlement. The rest of the spending is done either internally or through outsource providers or software providers. In 3.0, banks are going to take some parts of this value chain and convert them to solutions for their corporate customers, prompting explosive revenue growth.

The same process is underway along the liquidity vertical axis. Today, corporate liquidity totals approximately $12 trillion. Banks control less than one-quarter of that through direct deposit accounts, current accounts, sweep, and interest-bearing accounts. The greater part of the liquidity, however, is placed into money market funds or the secondary markets directly by corporate Treasurers or through nonbank intermediaries directed by Treasurers. In 3.0, banks will develop liquidity solutions that go further along the axis, both above and below the intersection point, to capture more of the revenue stream.

Explosive Potential

Capturing the revenues inherent in both axes is a huge opportunity that is far more significant than any revenue gains previously seen in the industry. As has been noted, the most dramatic growth in treasury services occurred in the 2.0 phase from 1971 to 2005. Revenues rose from nothing to $100 billion. In absolute terms, that growth will seem insubstantial compared to the $1 trillion-plus in revenues that banks can ultimately capture as Phase 3.0 proceeds.

Treasury Services Timeline



Choice-Driven Strategies

While 3.0 offers exceptional opportunities, competition will be fierce and the divergent nature of the opportunities will require sharper strategic focus. Banks will have to make three critical decisions in order to capitalize on new opportunities. The decisions have to do with the product life cycle, business drivers, and customer value propositions.

The Life Cycle Decision

In competitive markets, when products reach maturity — as treasury services offerings have — organizations must make a basic choice: either reinvent the product for a new phase of growth, or harvest its profits as revenues decline. This is the life cycle decision faced by treasury services groups. Banks that opt for treasury services innovation and growth will focus on combining separate services into integrated payment and liquidity solutions.

The alternative choice, harvesting, means retaining paper-based payments, regional lockboxes and similar traditional features, and seeking profits by aggressively driving out costs. But maximizing short-run profits without reinvesting will ultimately lead to exiting the business. The treasury services life cycle decision — reinvent/reinvest and grow, or harvest and exit — is a binary decision. A bank must choose one or the other. It cannot choose both.

The Primary Business Driver Decision

The second critical decision for providers of Treasury 3.0SM Services is the choice between two fundamental business drivers, scale and scope.

The decision to pursue *scale* involves selectively growing volumes within particular product lines and aggressively driving out cost, particularly marginal cost, in order to become, or remain, a major low-price player. This is a Wal-Mart type of strategy. Customers pay very low prices and receive little to no service, which is a very efficient solution and aligned to customer buying behavior for a certain segment of the population.

Focusing on *scope*, on the other hand, involves broadening the product line and becoming more of a relationship player, as opposed to operating as a high-volume “factory”. Scope players will provide broader solutions that offer more feature choices, seamless cross-product solutions and deeper integration into customer workflows and technology environments.

Each of these drivers — scale and scope — has its own benefits and trade-offs. Either is appropriate, depending on how a bank views its capabilities, client base, and competitors. The choice of these drivers is not necessarily determined by a bank’s size. Scale or scope decisions can be made by regional banks as well as by global banks.

Like the life cycle decision, the primary business driver decision is binary. A bank’s strategy cannot be based on both scale and scope. It’s impossible to offer low fees, high service levels, and customized solutions simultaneously. For many banks, particularly large ones, choosing between these drivers is the most difficult decision they make. Not even the largest bank in the world can do everything. Focus is essential in 3.0, not only because competition is so strong, but also because the opportunities are so vast — the global economy is creating a much larger, more diverse marketplace that requires a careful, strategic approach.

The Customer Proposition Decision

The third set of strategic decisions revolves around a bank’s customer proposition(s). These are the customer-segmentation decisions that banks make based on what they believe is their value proposition to customers. What are they best at? Within the treasury services business, there are many different value propositions in the 3.0 marketplace. The propositions aren’t mutually exclusive, so banks don’t have to choose just one, but banks with multiple customer propositions should make sure they can actually provide distinct value for specific segments.

(1) The first customer proposition focuses on *commercial payments*. It involves a bank offering solutions where the underlying transaction, the transaction that gives rise to a particular payment, is an exchange of goods or services. Is customer A buying from, or selling to, B? That transaction gives rise to the need for funds to be transferred and settled and it also incorporates significant opportunities to deliver value by integrating the physical and financial supply value chains. Increasingly, banks will aggregate solutions for a customer’s supply chain, linking suppliers, buyers and the manufacturers who turn inputs into finished goods. Along that entire supply chain, there are both processing and financial transactions as well as

associated financing and logistics. Certain banks are beginning to focus on this segment.

(2) With the *financial settlements* proposition, in contrast, the underlying transaction is not a commercial one, but rather a financial one involving the purchase of a security or, perhaps, the transfer of funds between a regional collection bank and a concentration bank. No goods or services are being sold. The settlement of financial instruments represents a different set of factors from the standpoint of buyer and seller. These solutions require sophisticated management of risk and compliance concerns.

(3) The third proposition involves *liquidity*. That is, a bank offers treasury services (transaction services) and companies use those services to combine their cash pools so they can optimally either pay down debt or use those funds for investment in the short-term investment markets. Banks will focus their solution set around providing the best cash concentration and investment products available.

Within each of these propositions, banks will increasingly specialize by segment or industry. By becoming the lead bank for the key players in an industry, a bank will be able to offer solutions that are specific to, say, the chemical industry, the healthcare industry, the securities industry, or the agricultural products industry. Again, certain banks are already becoming key players in specific industries, developing sources of differentiation and enhanced insights into their targeted segments' needs and buying behavior.

Additional Challenges

While banks address critical decisions around the product life cycle, business drivers, and customer value propositions, they also need to deal with other challenges that make up the market environment. Increased *client sophistication* clearly puts a great deal of pressure on the current players in the business to perform well. Such pressure should be considered a positive, because client sophistication and high expectations will bring out the best in banks that are providing innovative products and services, and expedite the move up the curve in 3.0.

The growth of global businesses is clearly a fact of life, and research shows that companies are *centralizing their treasury departments* even as they expand and diversify their footprint around the world. So while a company's business is becoming more global, the actual financial control of that business is becoming more centralized. That seems like a contradiction, and in fact, it poses a challenge for financial institutions. Banks must provide a global presence for their clients, but also must facilitate oversight and control of local operations on a 24/7 basis.

Technological developments are expected to continue at a fast and furious rate, and financial institutions will need a framework to evaluate the rate at which they adopt these new technologies. Addressing the three critical decisions that were discussed above will help provide the mechanism for making appropriate technological decisions. Banks must not only expand the scope of their capabilities to meet their customers' needs for global solutions, but must also simultaneously integrate their infrastructure to deliver a consistent customer experience across the globe.

Changing market structure is an important factor in the 3.0 environment. Banks will need to respond to and address commoditization of basic treasury services, the impact of offshoring on business economics, the increased need for differentiation and new scale dynamics resulting from consolidation.

Regulation is becoming increasingly pervasive. SEPA, Basel II, Sarbanes-Oxley, HIPAA, the Patriot Act, IAS 39, and Check 21 affect how banks do business, often reducing revenues or increasing costs. Expectations about being "green" and environmentally conscious are strongest in Europe at present, but are increasing in other regions as well.

Finally, the intersection of *professional and social networking* is becoming more important, changing the selling process in a way that will impact how financial institutions market themselves. Services like LinkedIn or Plaxo encourage people to become more reliant on their networks for business referrals and information gathering. In the future, prospects may prefer to be reached through their networks and do business within their networks.

In 3.0, Size Matters, But So Do Other Factors

As in many other industries, advocates of economies of scale in the financial services market argue that in the future only the large will survive. They believe that, as globalization unifies the world's markets, the largest banks will use their expertise, efficiency, broad product line, extensive customer base, and access to capital to take share from smaller players. By extension, this line of thinking suggests the winners in Treasury 3.0℠ Services will be the global banks, who will siphon business at the expense of increasingly uncompetitive regional and small banks.

Treasury services professionals should view this notion skeptically. While size matters, it is by no means the only determinant of success. In fact, strategic thinking and focused execution are arguably more important competitive factors in Treasury 3.0℠ Services than market share. If size were all that mattered in life, dinosaurs would still be walking the earth. In the treasury services arena, regional and smaller banks that understand strategy and execute it nimbly will have abundant opportunities to grow.

Banks and other service providers not in the top 5 still have a number of potentially successful options to pursue. In order to be effective, there are four things all players in 3.0 will need to do well:

1. Know Your Identity
2. Focus on Industries
3. Partner Effectively
4. Know When to Manufacture

Know Your Identity

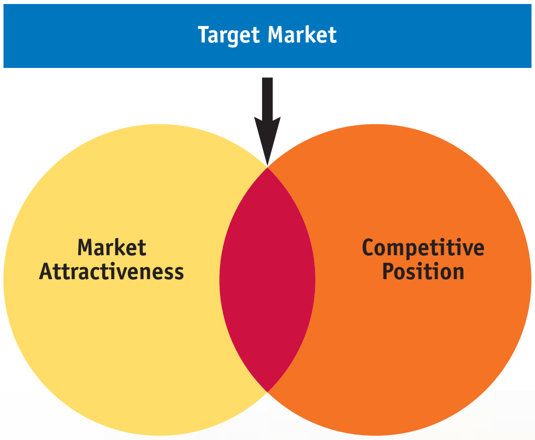
In 3.0, it is essential for treasury services groups to choose an identity. This involves analyzing the organization's strengths and weaknesses, understanding where it stands in the market, defining where and how it will compete, and communicating its strategy to employees and external audiences. A bank that continues business as usual — doing the same thing it's been doing, whether lowering prices or cutting costs — will not be successful over the long term. The need to manage an organization's identity is as compelling for small and regional banks as it is for larger banks.

Focus on Industries

Focusing on key industries is particularly appropriate for banks with limited treasury services resources that must compete with much larger banks. By focusing, banks can develop deeper knowledge of their customers and prospects, particularly their accounts payable and receivable chains. Knowledge about customer rules and regulations is another area where banks can differentiate themselves from competitors and reduce risk for themselves as well as their customers.

A bank's industry expertise should include ongoing monitoring of underlying trends, key metrics and market share, which can help the sales force focus on the most promising prospects. To be effective, a bank's knowledge should be extended throughout the organization. Knowledge cannot be useful if it's not communicated. Banks can extend their traditional intermediary role to the arena of best practices, trading partner networks, and industry-specific standards and solutions.

Many banks lack sufficient discipline in determining which industries to pursue. We recommend a classic fact-based evaluation of strategic options.



By developing unique competitive capabilities, banks can target and dominate specific industry verticals. The more granular the industry definition, the deeper the bank can differentiate itself by understanding each industry's unique needs, processes, technology environments, regulations and buying behaviors. In turn, banks can generate cross-industry scale by developing generic core competencies that can be leveraged in multiple industries. For example, one bank might target information-intensive industries by developing an enhanced ability to translate, process and deliver data. Another bank may target industries that generate or receive complex payments by developing a superior ability to deploy workflow tools through the web.

Partner Effectively

At regional and small banks, limited resources for developing proprietary technology means that treasury services groups must improve their ability to manage technology partners both strategically and tactically. That is to say, choosing the right partners and effectively incorporating their technology is a key element of success in 3.0.

The challenge of managing technology partnerships cannot be underestimated. Not only must partnered technology be incorporated into product development, but it also must be synchronized with treasury services IT, operations, legal, billing, pricing, customer service and new account setup. The customer experience with a bank should be seamless, whether the customer is dealing directly with the bank or an external, strategic partner.

Banks with inflexible internal processes and systems that cannot quickly and smoothly accommodate "plug and play" solutions will find that they have limited the number of technology partners with whom they can work. This will hamper their ability to assemble best-of-breed solutions for customers.

The IT and process architecture of a bank must not only be open to support partnering, but it must also enable cross-product integration and workflow across solutions delivered by multiple vendors. To achieve this level of integration effectively, banks must ensure interoperability by developing or deploying standards around key technology elements. Interoperability is critical in such areas as internal data networks, risk management, customer service, implementation, and — last but far from least — the web. Today few, if any, banks are properly structured to support this critical business mandate and most vendors do not offer solutions that support this emerging need.

Know When to Manufacture

For many regional and small banks, contracting with a larger bank or non-bank provider to handle manufacturing will be the appropriate strategy. Banks that want to continue manufacturing must have strong commitment, deep expertise, and outstanding staff. Without these elements, their prospects will be limited by increased competition from larger players both within and outside banking. Treasury Strategies observes that the low cost position in the industry is increasingly a fraction of the industry median cost structure. Banks that fail to aggressively manage their cost structures and align their cost structures to their business models will see dramatic declines in margins as Treasury 3.0SM Services advances.

Niche manufacturing, where treasury services groups can specialize in an area or activity that is too small to attract competition from larger competitors, is a good way to build expertise and market share. Doing a few things well rather than many things in a so-so fashion is a viable 3.0 strategy for both small and large banks. However, as banks become more nimble at consolidating generic functions and leveraging scale across the enterprise, it will be increasingly difficult for niche manufacturing strategies to succeed.

Seizing the Opportunities

Successful financial institutions in 3.0 will understand both the order-of-magnitude changes that are required and the significant revenue potential these changes represent. These organizations will not be afraid to make the three critical decisions — the life cycle decision, the business driver decision, and the value proposition decision. The cost of *not* making clear, firm decisions will rise in 3.0 as competition increases.

Banks will need to put in place sales organizations that understand solutions, the sweet spot of 3.0. Sales people and teams will become solution architects delivering high-value comprehensive products and services to meet the needs of the Treasurer.

Meeting the Treasurer's Agenda

2.0 was about products, 3.0 is about solutions

In Treasury 2.0 Services, banks and vendors sold products to Treasurers who then forged their own solutions. In 3.0, banks and vendors will sell and implement solutions.

To effectively sell treasury services to corporations, financial service providers must have a profound understanding of the motivations and concerns of Treasurers and working capital executives.

Increasingly, Treasurers and Comptrollers are establishing global support structures and operating procedures for all their priorities — banking, cash management, investments, working capital and debt. Simultaneously, they are working on strategic initiatives to optimize performance. Technology is the primary tool used to fulfill these objectives, giving treasury and working capital departments control over global operations, risks, staffing and costs.

Not only will treasury services groups need to understand the entire financial function of their customers — the horizontal financial supply chain as well as the vertical liquidity axis — but they'll also need to organize internally around delivering solutions rather than independent products. In 3.0, "silo-thinking" will be replaced by cross-departmental cooperation and solutions. Banks will increasingly work with technology partners and the IT departments of their customers. Currently, most banks operate along the vertical liquidity axis and horizontal working capital axis as siloed business units. In the future, banks will integrate product and sales teams across the full spectrum of products used by Treasurers. Banks will integrate products and sales delivery across Treasury Services, short-term credit, short-term investment, and the array of services companies use to manage capital structure and financial risk exposures.

A hallmark of successful 3.0 groups, no matter how they are organized, will be the ability to implement creativity and imagination to innovate for their clients. Can they make treasury workstations more user friendly for customers? Can they reduce the workload for Treasurers by automating decision-rules and executing them in-house? Can they mine the transaction information flowing through their databases to highlight useful trends? Can they manage third-party technology relationships? Creativity and flexibility will play important roles in crafting solutions.

Last but not least, banks will need to invest in technology and staff training if their goal is growth. Cutting costs and harvesting short-term profits are appropriate steps for banks that are deemphasizing treasury services, but they won't work for banks that want to remain competitive in treasury services in the long run. The prospects are excellent for significant growth and profitability in treasury services over the next decade, but only for banks that are willing to invest in and revitalize the way they operate.

As Treasurers' capabilities evolve, banks should enhance their own capabilities in order to better align them with changing corporate needs.

In theory, banks are ideally suited to support the tools and technical solutions that Treasurers are assembling. After all, most of the treasury inflows and outflows already go through banks, so banks and their partners can feed the information back to customers in various forms, ranging from raw data to high-value-added information that supplements what Treasurers are already getting from existing sources.

In 3.0, banks that manage technology partners effectively and understand and integrate into the Treasurer's IT environment — including common third-party systems — will be positioned to successfully meet the Treasurer's agenda.

Who We Are

Treasury Strategies, Inc. is the leading Treasury consulting firm working with corporations and financial institutions. Our experience and thought leadership in treasury management, working capital management, liquidity and payments, combined with our comprehensive view of the market, rewards you with a unique perspective, unparalleled insights and actionable solutions.

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