EMERGING PAYMENTS ASSOCIATION

# INNOVATION IN INTERNATIONAL TRADE

## Report from the EPA's Project Futures Workshop

December 2018

Sponsored by

FICO Decisions

## The purpose of Project Futures is to provide members of the Emerging Payments Association with insight and thought leadership on: new innovations and technological developments, emerging market trends, and the prospective future regulatory landscape in payments.

The Project Futures workshop in December 2018 focused on the innovations and technologies that are opening up opportunities for international trade and its transformational impact upon the new payments landscape.

The focus of the discussion was to explore the disruptive innovations and technologies that are or will be relevant in shaping international trade finance and global commerce, the impact that these innovations will have upon the payments ecosystem, and the social and commercial drivers which will enable these innovations to flourish. Our discussions were scoped to consider payments product developments and enabling technologies that are already visible or emerging, and which therefore have potential to offer tangible benefits at scale over a 3-5-year horizon and beyond.

**The half-day workshop was structured around three sessions on:**

- Evolving business models and the role of regulation in international trade finance
- The role of disruptive innovation in identity & standards for enabling international trade
- The impact of increasingly international trade upon consumers, SMEs and society

This report is one of a series of four produced by the Emerging Payments Association in 2018.

It highlights the content of the discussion, the insights derived and the conclusions drawn.

These conclusions highlight the direction of travel for the payments industry as it develops and how the ecosystem will fundamentally change in light of new technologies and innovations.

Thank you to the Benefactor behind this project, FICO, the facilitators, EFT Associates, the report author and EPA member, Huntswood, and the workshop participants. ■

# Technology & Regulation

The UK is world-leading in financial services, and in fintech innovation. The payments industry has grown at a rapid pace and continues to innovate digital payment services that enables consumers to pay quickly, effortlessly, and conveniently. The UK is also at an advantage in its regulatory framework; widely viewed as creating a hospitable environment for entrepreneurs and payments innovators to succeed. After all, regulation should not be seen as a business inhibitor and the FCA regulatory sandbox is a good example of this.

The emerging global standard for payments messaging is ISO20022 and the UK is firmly on-board with this as demonstrated by the Bank of England's RTGS Renewal programme[1]. For SMEs there is an opportunity for new technologies to be adopted more easily as they are built around this international standard, rather than having to adapt legacy systems to fulfil this standardisation. Whilst SMEs can be seen as being better placed for this transition, legacy infrastructure shouldn't always necessarily be seen as being prohibitive. Organisations worldwide are trying to get agreement on standards and generate solutions that are viable for their respective markets. The regulatory system is fragmented, with variance of trust between international markets, each country having its own approach to risk and AML standards. Globally, it can be a challenge for an organisation to keep up with the changing regulatory environment; as one set of regulatory standards gets adopted and integrated, another set comes forward. By contrast, technology advances at such a pace that it can be difficult for regulators to catch-up.

The UK's payments infrastructure and hospitable regulation in domestic markets is world-leading but is often found lacking in terms of integration with payments systems for international trade. This domestic focus discourages SMEs from investing in cross-border or international markets. However, this is likely to change and will be driven by the adoption of the ISO 20022 standard, facilitated by a commercial framework. The adoption of ISO 20022, which is already used for SEPA payments, should mean that there will be sufficient information incorporated into the messaging to be able to review the credibility or potential fraud within a transaction.

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This will be a step towards solving some of the trust issues. One problem is that if you add more data into financial messaging, then there will be more latency and the speed at which payments are transferred and settled may be reduced. Conversely, each part of the chain has to carry out its own due diligence, yet intermediaries are not getting all the necessary detailed information, due to batching and aggregation.

Identity and real time verification will have a big impact on how trade finance and international payments are made. However, there is no all-encompassing global provider for this and it instead requires the adoption of various service providers to get the information required.

One of the solutions to this is a better and more effective means of sharing data. The EPA and its members are looking to deliver upon this through the EPA's Project Financial Crime to support sector-wide activity to determine the level and extent of information that can be shared by government, law enforcement, and payments companies for mutual benefit, through the use of a common platform and commercial model. Another is the adoption of common standards in Digital Identity, which is discussed in the next section.

There is a need to connect and integrate various capabilities together when looking at large institutions. For the major banks, their identity and verification capabilities sit separate from their payments system. Similarly, credit and debit sit within different parts of the bank.

By having this delineation and separation, it drives inefficiencies for communication and creates the opportunity for information and data to become siloed. Furthermore, these separations also result in competition between them and thereby drive institutional attitudes that do not engender collaboration and information sharing. These traits are, however, not seen among the newer market entrants. Challenger banks now have the capability to view and connect the entirety of their departments. However, the reality is that these challenger and neo-banks have a far smaller user base to focus on and address in comparison to the larger financial institutions.

SMEs are using the regulatory infrastructure to open-up opportunities and drive innovation. SMEs also typically use alternate platforms to the traditional platforms to enable business, such as using marketplaces like eBay and Amazon.

However, as discussed in the previous Project Futures report, is there a benefit for SMEs to move away from these marketplaces or does the level of data analytics, brand value, and security encourage SMEs to remain?

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International Trade is the biggest area of opportunity for business growth and development, but it is easier for large corporates to realise these opportunities than SMEs, where the volumes are smaller as a proportion of overall activity. As well as the difference in regulatory approaches internationally, there is also fragmentation in providers of ACH (push payment) services across Europe. All these factors make it difficult to justify investment in this area for SMEs.

New generations of vendors are creating middleware that enables businesses to manage data more effectively and with the ability to use a multitude of authentication processes based upon your preferences and needs.

## Digital identity

The industry is also creating innovative products and services to keep customers safe and to ensure payments are made securely. However, there continues to be weak points within the transaction process that enables consumers being victims of financial crime or identity abuse. Much of the problem lies in onboarding the customer in the first place. A potential solution to this would be the creation and adoption of a digital identity scheme. However, in the UK, the idea of a nationwide digital identity service has had a stop-start lifecycle. GOV.UK Verify, a government scheme that sought to provide a single trusted login across all UK government digital services, has to date ceased further development but it has not been abandoned entirely. The UK in its limited and fragmented approach to digital identity risks falling behind Nordic and BeNeLux countries where national digital identity services are either established or at an advanced stage.

There is the potential to have a centralised database that would allow the sharing of information. However, should the onus be on consumers to opt into such a service or do we need a centralised repository that is government mandated or industry-led via the banks?

The reality is that there are different agendas and risk profiles between the platform providers, the incumbent banks and the smaller entities. Furthermore, there are different capabilities between them due to extant legacy systems versus the more recently developed payments infrastructure. It would therefore be challenging to create a unique standard and the reality is that it will be a 'mish-mash' of different elements. The concept of a centralised repository was noted as having a strong capability for both businesses and consumers alike, but the question remains as to what type of data should it capture. Biometrics enable the opportunity to have a unique means of verification for each individual.


However, should this data become breached or hacked from such a centralised repository of data, there is no means of 're-issuing' when financial criminal activity starts to become apparent. The utilisation of a mobile proxy, such as PayM, was highlighted but it had been noted that there are challenges with this system as well. The biggest challenge around the creation of a centralised repository remains its business model. Who would have the responsibility to fund its development? There is the potential for Pay.UK, the UK's payments infrastructure, to take a role in acting as a centralised data repository due to its role in overseeing and regulating retail payments. However, its scope and remit does not include card-initiated payments.

With the problem of identifying real people behind accounts,

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especially amongst social media platforms, solving the identity issue must be seen as a priority. The UK has a long way to go before successfully implementing a national digital identity scheme, but these challenges are not technology-led. The UK has the capability to create an innovative digital identity scheme, but the barriers that inhibit its development are structural, organisational and cultural. Until these barriers are overcome, digital identity will not truly be embraced and developed. Thankfully, the Midas Alliance has created and is sponsoring PAS499[2] which will standardise the various components from Enrolment to Authentication, that make up a Digital Identity service. Providers of identity services adhering to this standard will be better protected against evolving fraud techniques and ensure their systems are optimised for usability.

## Tokenisation

In general, for capital markets, capital is required to cover risk, including counterparty risk, principal risk and other types, which also incurs a cost, including the cost to the market of requiring a central counterparty to manage risk. Reducing the settlement timeframe to 1 trade day or even in real-time will reduce this risk. Blockchain and distributed ledger technologies may have a role to play in enabling organisations to more effectively explore B2B international trade opportunities. They have the potential to reduce the cost to transact, to maintain capital within capital markets, and to reduce reconciliation and data management costs in the post-trade cycle.


The cost to transact includes the cost of depositories to keep records of ownership, intermediaries and multiple back offices, interconnected by complex electronic messaging protocols, but each with their own version of the truth. In having synchronized records of security ownership, which is shared and recognised by all the participating stakeholders, it would be possible to both automate and simplify the processes involved and reduce the need of reconciliation.

The inherent downside is that, under current rules and regulations, a market regulator has no oversight and are therefore reluctant to embrace this approach. However, both regulators and central banks are increasingly looking at the role that distributed ledger technologies could play within infrastructure and there may also be some appetite when the 5th Anti Money Laundering Directive (5AMLD) comes into force to cover virtual currencies. Whilst such technologies have the capability to reduce organisational costs and thereby have a greater potential to enter new markets, there are potential implications and costs to the adoption of such technologies. Implementing blockchain components wholesale would require the decommissioning of large parts of the back-office infrastructure and key operational processes for organisation – particularly for industry utilities – and thereby profoundly impacting cost dynamics[3].

Furthermore, a disadvantage of the tokenisation approach is that it is a nascent technology. A number of tokens have had technological failings or have had ICOs which have collapsed. There are also questions regarding the scalability of such tokens. At present, such tokens have specific capacities per block size that enable them to process a few transactions at a time. However, to be adopted mainstream by large corporates and banks, it would require the need to process hundreds of thousands of transactions per second to ensure the economy could keep moving without massive delays for consumers and businesses. Whilst tokenisation has a lot of unrealised potential, it is an immature technology.

Financial Institutions are experimenting with utility settlement coins, which act as a tokenisation of data. These utility settlement coins are faster than wire transfers and are leapfrogging the payments rails in terms of its development. It allows regulators to see the movement of money and these utility settlement coins have an auditability – a highly desirable trait from the perspective of a regulator. However, whilst these utility settlement coins have these benefits and are also cheaper than other methodologies, these tokens are currently used almost exclusively by larger organisations and may not necessarily be an inclusive solution to the problem.

Furthermore, the problem with DLT and blockchain is also one of its strengths. The record is permanent. If the record is incorrect, then the question remains as to how you correct it and who is liable for any decision based on this information.

Whilst services like Experian credit records are not immutable, blockchain technology is. This immutability also creates a concern for money laundering if the proceeds of financial crime are permanently legitimised through incorrect records. ■

**Footnotes:**

1 A new messaging standard for UK payments: ISO20022 [Bank of England] 2018

2 https://midasalliance.org/what-is-pas499/

3 Banking on Blockchain: A Value Analysis for Investment Banks (Accenture, 2018)

# Barriers to International Trade

From the perspective of international trade there are potential weak points globally that enable opportunities for financial crime. By the scope and size of the nature of international trade finance, it is simply not possible to oversee the full value chain. For many corporates, this is a challenge and raises the question of how an organisation accommodates for this.

The cost of KYC ('Know Your Customer') provides one layer of monitoring at the on-boarding stage, but then there is a further AML (Anti Money Laundering) approach that overlays this for the transactions. These services may originate from different providers, and so there is a cost and a complexity.

Whilst organisations are focused on protecting themselves and avoiding any fraud or criminal attacks upon their organisation, there has to be a balance between protection and its associated cost. This is not only the cost of implementing technologies that prevent financial crime, but the potential cost of losing a customer due to a clunky or prohibitive customer experience when making a payment. On this latter point, customers do not understand, or rather recognise, when a barrier in a transaction is a KYC or AML check.

In fact, certain customers may perceive these protections as a potential 'scam' that prevents them from accessing or utilising their money. Due to the rapid adoption of digital and frictionless payments, consumers expect to make instant payments. Furthermore, consumers also expect that a business knows that they aren't a money mule – based on their financial behaviour and their history of transacting with the business. If a consumer feels disenfranchised by the transaction process, there is the potential for the consumer to switch to a different provider of service (whether a bank or a merchant).

Organisations must recognise that the cost of a disenfranchised customer switching away may also incur the 'penalty' of reputational damage – the proliferation of customer review sites and other platforms means it is easy for a customer complaint to get wide awareness and traction.

As such, there is a need for industry, both the payments and FS industry and for corporates/ merchants, to provide consumer education on the benefits of friction within the payments process, especially in preparation for PSD2 Strong Customer Authentication

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requirements coming into force September 2019.

Further to this, there is a need for consistency from PSPs regarding their processes, including the adoption of pre-authorisation checks. Primarily, this stems from the complexity of the relationships between players within the payments ecosystem. With regards to authentication, PSD2 puts the responsibility of authentication primarily upon issuers – with some elements of responsibility for authentication being put upon the merchants and acquirers as well. The latest version of 3-D Secure is welcomed as it allows the merchant and their PSP to perform their own risk analysis decisions whilst still passing rich data to the issuer, however the scope is limited to card payments.

It may also be problematic for B2B or corporate environments where there is not one single account holder, unlike consumer models. In addition, there is a need for a globally-recognised common interpretation of SCA (Strong Customer Authentication) that is built upon the current definition.

This is paramount from an international trade perspective as, for a cross-border payment, a merchant may not trust the interpretation of SCA from a payer based within another country. SCA must also be mindful of social and physiological characteristics of the consumer in order to be inclusive, even if it ends up involving manual checks.

The workshop recognises that merchants could take on more responsibility within the authentication process. Merchants fundamentally know their customer and their behaviour better than other payments players. It could also be argued that there is a dissonance between regulation on liability between issuers and merchants, particularly on the subject regarding who incurs the cost for compliance. Bringing KYC in-house can be advantageous as you have all the data in one place, so this should be recognised by organisations as part of the cost/benefit analysis, which can take time to show a return.

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It could ultimately be argued that the cost will fall upon the price the customer pays, but an increase in the price charged to a customer may result in the organisation losing that customer. This has often meant that organisations hide the costs of compliance and authentication elsewhere. However, the argument can be made that if you an organisation is transparent with its costs and that this is tied in with consumer-led education on financial crime and the cost of combatting it, it becomes more accepted by the customer. Schemes have the capability to run authentication oversight across payment transactions, but they are not within public control. Oversight bodies, such as the Open Banking Implementation Entity, do not have the legislative capability to prevent participants, nor do such entities have the statutory powers to do this. Further to this, whilst the payment schemes can take responsibility for monitoring transactions, the regulatory oversight must sit within the hands of the regulators and it is paramount that regulators globally work together.

In addition, if the payment schemes do take on this responsibility then there is a question on what should be their focus. Domestic schemes must operate within the best interests of individuals within their country, and not in their interests of their own agenda. This is a challenge for commercial organisations who are also answerable to their shareholders, causing a conflict of interest.

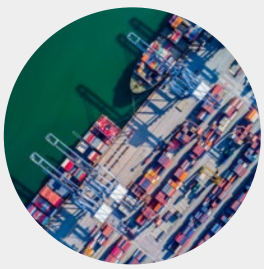
There also remains the challenge of how these domestic schemes work together with other schemes internationally. From a regulatory

perspective, there would need to be a regulatory body that monitors the entirety of an international transaction but it is highly improbable to have a singular regulatory entity capable of regulating this and would require a pan-European collaboration. One thing to consider is the success of UnionPay being precisely because they are closely monitored by their national regulator.

There also needs to be consistency regarding how enforcement is implemented across entities within the payments space, as it could be argued that regulated entities are penalised over unregulated entities.

Penalties at present have not been tied to the consumer losses, but rather to due to incomplete compliance, which can lead to organisations treating fines as purely a cost of doing business, if the cost to remedy is greater than the penalty incurred. Greater penalisation may discourage organisations from becoming licensed but there is an argument to say that pre-emptive punitive measures may prevent larger more serious problems occurring in the first place, in the same way that motorists are fined for not having insurance, regardless of whether injury or damage has been caused. This may stem from regulators lacking the knowledge and depth of resources to effectively manage and exercise fines upon organisations that are truly committing global fraud and evading regulatory adherence. There is a need for greater internal communication between departments in large institutions. An organisation may track potential money laundering or financial crime threats on the acquiring side of the business, but this same threat may not be spotted by the banking side of the organisation.

This is not so much a problem for SMEs as, due to their size, they are capable of seeing transactions across all programmes. It is paramount that organisations create a policy of information sharing both internally and externally – whether with competitors, regulatory bodies, or government/oversight bodies. This would alleviate a significant number of problems relating to financial crime and would be a step towards allowing 'bad players' to be recognised in advance of financial criminal activity taking place. Current regulation does not prevent this, for instance GDPR allows data sharing for the purposes of addressing financial crime. However, this is not widely recognised due to a lack of a common interpretation regarding the practicalities of the regulation. ■



# Collaboration & New Opportunity

Collaboration is integral to driving technological innovation in international trade. This is evident in EMVCo, a cross-scheme and cross-market collaborative approach which has evolved to fit market needs. The same evolution should be possible with ISO20022. However, whilst collaboration on technical standards can enable innovation, organisations may lose their competitive edge and have to consider – institutionally – how such collaboration will be commercially realised.

Innovation through legislation and regulation, such as the Payment Services Directives 1 & 2, have focused on the consumer perspective for payments, but it has been acknowledged that little focus has been applied to the corporate perspective.

In the Netherlands, the major banks have come together to collaborate and encourage smaller organisations to flourish. Similarly, in Germany, commercial banks and state banks are collaborating on digital onboarding.

This collaboration has been driven by the realisation that they are lagging behind their peers on international trade finance. We are seeing stronger reconciliation in banks between card and non-card payments.

Visa and Mastercard are also exploring opportunities within corporate payments. However, these opportunities are also being explored because they can become a threat to the status quo as PSD2 is seen as a threat to interchange income for issuers. If they do not embrace these opportunities, then another competitor will. The move away from corporate cards to instant payments stems from the fact that quicker payments is a win-win for B2B payments as it enables quicker settlement which means lower risk – although there is a difference in liabilities between an instant payment and a corporate card payment, where the liability is being funded in part from interchange revenue. Finally, direct transfers aid in reconciliation activities.

There are 22 domestic peer-to-peer schemes in Europe, but we are starting to see a progression towards peer-to-merchant. The peer-to-merchant approach is affording new, exciting opportunities in driving international trade. Peer-to-merchant schemes are predominantly mobile-based and have added the benefit of utilising GPS data to track locations. There is a potential progression for merchants and retailers to create closed-loop ecosystems.

A number of large-scale merchants have started to pioneer in this space, such as Starbucks offering a closed-looped digital payment capability. For the consumer, closed loop payments systems offer a wide variety of potential benefits, including loyalty incentives, the capability to pre-order goods and faster time to check-out. In essence, closed loop systems can provide a more convenient experience for the customer. Merchants have the opportunity to embrace payments and, in certain cases, have the ability to leverage their data sets – such as the utilisation of level 3 information by the airline and travel industry.

## Market Competition: Taking the first step

At its core, exploring the opportunities afforded by international trade will only be realised by those who move first and gain the competitive advantage without the fear of sunk costs. This requires a drive for internal support to explore these opportunities and to change the internal risk appetite. By having a customer-centric approach and enhancing the benefits for the customer, an organisation will realise a greater level of customer onboarding and increase its revenue. Organisations that are first in this regard often become the standard bearer, but the incentive to make this investment is hindered as retail banking does not make as much revenue for the banks as the corporate side.

As Brexit approaches mired in uncertainty, numerous questions remain about the UK's position and how it will impact international trade finance. Payments is core to enabling seamless international trade, and it is up to the payments ecosystem to find the opportunity surrounding international trade finance post-Brexit. With technological advancements, we are now seeing corporate banking moving towards digitisation. The challenge however is driving an increased focus on payments among corporates and merchants, and encouraging them to explore the benefits of adopting new PayTech innovation.

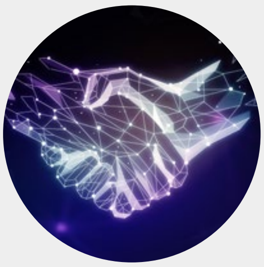
Merchants and corporates do not have a primary focus on payments, with very few large retailers having individuals with strict responsibility for payments. By tapping into the benefits of new technologies, removing this complacent approach to PayTech and prioritising payments, companies will benefit from a reduction in inefficiencies and operational costs that are currently associated with payments. The benefits of this approach at an international scale will enable these benefits to be realised at a greater scale, but companies need to make an investment just to make that initial evaluation.

With corporate prepaid cards less in demand, corporates will be looking at how they can retain customers in light of this change in behaviour. For consumers, the trend has moved towards instant payments. There is a huge appetite for instant payments as it creates a huge cost reduction that benefits both B2B and B2C transactions. Furthermore, they can also incentivise its utilisation – as evidenced through examples like WeChat. The adoption of new payment systems that offer instant payments, that fit consumer needs, has become an increasing trend globally and the UK should look to successful implementations in new markets. The Netherlands iDEAL payments system provides merchants with a real-time payment method (publicised as low-cost and virtually risk-free) for online payments. Its adoption by merchants has been widespread and now accounts for ~54% of all Dutch online payments.

Further to this, corporates and SMEs are all looking at liquidity, finding ways of reducing costs, and how they can tap into new markets. It is estimated that there are over 45 FinTech hubs internationally; fostering innovation that will enable organisations to enter new markets more effectively, create a competitive edge, and find a commercial strength solution.

These new payments innovations can offer a myriad of potential benefits including enhanced efficiency, greater customer stickiness, an increase in customer adoption, and ultimately increased revenue. However, the adoption of these new technologies also comes at a cost and requires a business case for how these are deployed. For instance, more effective utilisation of AI across a business will require the need to train people or deploy specialist staff who can clean data and train the model. The adoption of new innovation requires the investment of both finance and time, and cannot simply be viewed as a quick fix. For many players, it can also be a challenge to 'see the wood for the trees' due to the myriad of new payments innovations available and to understand which offering will provide the most benefit based on their organisational need. In many instances, a corporate will utilise the technology from the brand that they recognise and know rather than adopting the technology of a newer or lesser known player.

Getting FinTech innovation into the mainstream is a large-scale challenge and requires a significant investment in marketing and PR. This continues to be apparent as the established banks still get credit for innovations started by FinTechs and challengers. ■

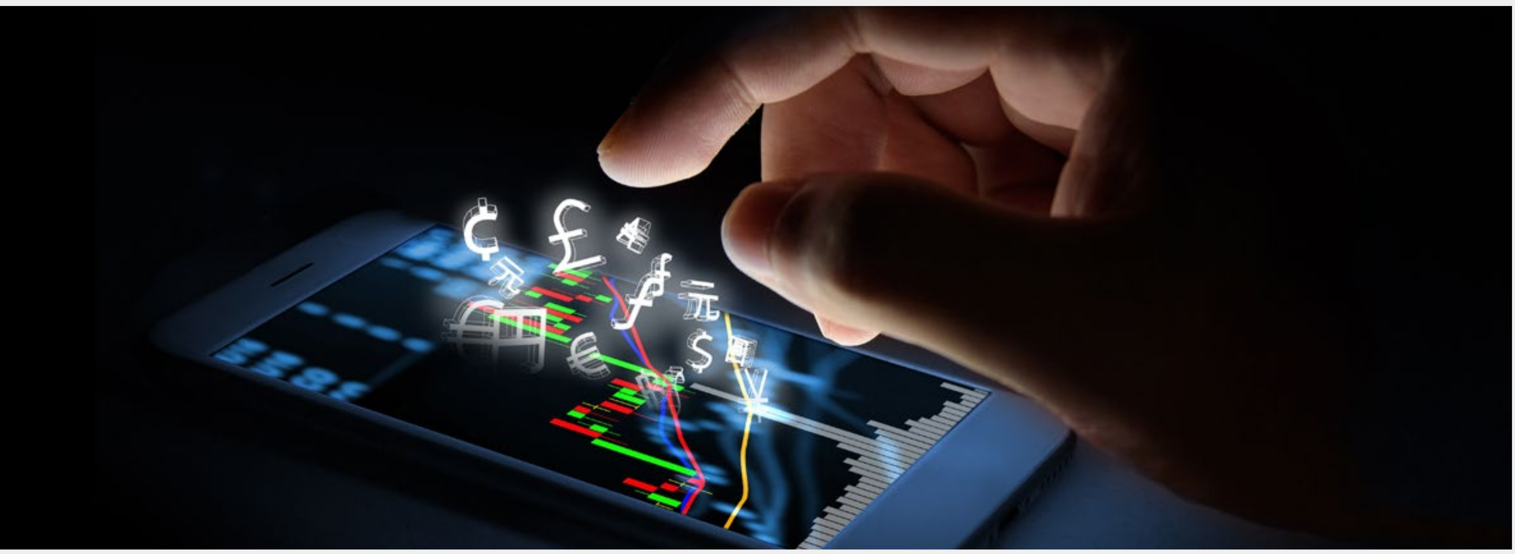


# The digital economy and its impact

The increasing digitisation of payments in the wider economy has meant that trade has become increasingly international. E-commerce has created opportunities for small-to-medium sized enterprises internationally and for consumers as well. Consumers have become more willing to purchase goods and services internationally, albeit with a conscious that it can result in 'buyers' remorse' when said goods do not reflect their descriptions.

The rise of online marketplaces and E-commerce has afforded consumers an ever-expanding amount of choice but has also resulted in increased consumer vulnerability. Consumer rights for online purchases differ from those made in physical stores; the Consumer Contracts Regulations covering the former, and the Consumer Rights Act for the latter, at least in the UK. Consumers purchasing from online marketplaces may not be aware which jurisdiction the retailer is in and therefore which laws apply, in spite of efforts from the card schemes.  From a B2B perspective, there is not this same level of choice available. However, there is opportunity available for businesses to challenge the status quo and to identify how they can partner with newer entrants. Businesses are increasingly looking at how they can partner with non-banks, who are trusted parties, to facilitate and make transactions directly from supplier to consumer, bypassing the retailer. Similarly, some organisations are evaluating opportunities in which they can disintermediate from the existing card schemes and partner directly with FX providers. It can be stated that whilst the landscape is fragmented and nascent, there is opportunity for businesses, but the risk of downtime must also be taken into consideration, when single solutions are dependent on multiple entities.

Customer retention can be a challenge for many large incumbents who have the challenge of finding ways of retaining customers but also the need to find new opportunities to increase revenue. The rise of challenger banks and non-bank PSPs has led to consumers switching away from the larger financial institutions, as these new entrants can provide innovate value-added services that are not presently offered by many of the larger players. For these new players, this means that they now have new avenues to create revenue for international trade finance, but there still needs to be a value proposition, rather innovation for innovations sake. ■

# About FICO, Benefactor of Project Futures

FICO (NYSE: FICO) is a leading analytics software company, helping businesses in 90+ countries make better decisions that drive higher levels of growth, profitability and customer satisfaction. The company's ground-breaking use of Big Data and mathematical algorithms to predict consumer behaviour has transformed entire industries. FICO provides analytics software and tools used across multiple industries to manage risk, fight fraud, build more profitable customer relationships, optimize operations and meet strict government regulations.


## With thanks

- To the EPA Benefactor of Project Futures, FICO
- To the Project Lead of Project Futures, David Core at Bacs
- To the facilitator of the workshop, Parag Shah at EFT Associates
- To the co-author of this bulletin, Neil Turner at Huntswood
- To the participants of this workshop listed below

David Core (Bacs) is Project Lead of Project Futures. The workshop was facilitated by Parag Shah at EFT Associates. This report was produced by Neil Turner from Huntswood and Thomas Connelly from EPA.

The EPA would like to thank the Benefactor of Project Futures, FICO, for their backing of the project, its workshops, and in helping identify technology and future innovations that will spark a dynamic change for both businesses and consumers


## To work with us to create a better payments industry in future...

To join our Project Futures (members only) contact:
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## Organisations represented

- AKCE Group
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