

Business models in a consolidated and converging payments world

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ABSTRACT

The payments business is undergoing a significant transformation: markets are integrating regionally across Europe; processors are consolidating scale; bulk and urgent payments are

converging; regulators are questioning the traditional economic framework; and retailers and mobile operators are on the verge of becoming payment service providers. These developments in the European payments landscape could become the inflection point for a payments end-game beyond Europe. This paper examines the forces shaping the payments landscape, analyses the building blocks of the emerging end-game, and examines five successful business models to enable payment institutions to be in position for this outcome.

Keywords: *payments strategy, payment volumes, business models, SEPA and PSD, cards, cash displacement, financial supply chain management*

INTRODUCTION

The payments business is quite sizeable. Across the globe, consumers, governments and corporations send approximately 270 billion non-cash payments per year through cheques, credit transfers, direct debits or cards (see Figure 1). The payments business is large not only in terms of volume, but also in terms of revenues for banks. In Europe, the 74 billion non-cash payments equate to transactional and float revenue of approximately €75bn, one-tenth of the total banking revenue pool.¹ This does not include derived revenue, such as interest on current or liquidity accounts. The role

Region	Non-cash payments (billions of transactions)
North America (United States, Canada)	107
Europe (EU-27)	74
Asia-Pacific	55
Latin America	27
Rest of world	9
Total	272

Source: Central bank data, A.T. Kearney analysis

Figure 1 Global non-cash payment volumes

of payments as a liquidity ‘engine’ has proved to have value beyond the income of mere fees, particularly since the 2008 inter-bank market crisis.

During troubled market circumstances, the payments business also stands out in comparison with other fee businesses: Not only does it require little equity compared with other banking businesses, it is also a fairly stable and predictable income stream. Non-cash payments have grown at an annual rate of around 6 per cent since 2000,² more than the average price erosion of roughly 4–5 per cent per year.

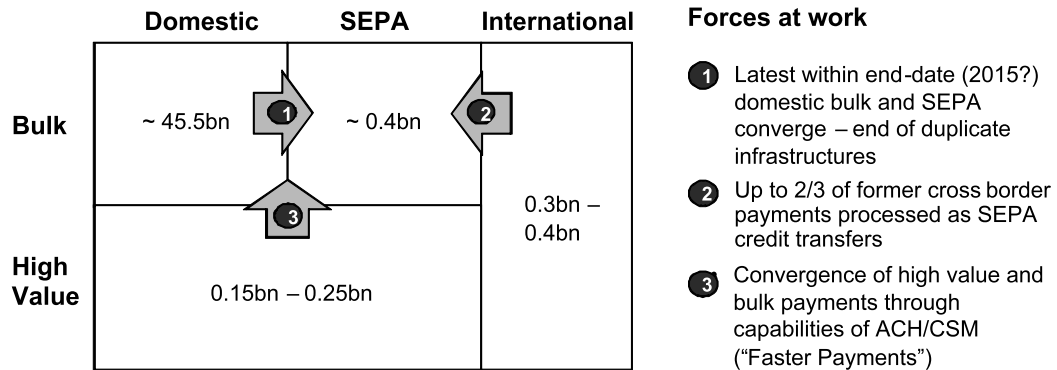
Perhaps most importantly, non-cash payment volumes have proved fairly resilient to crisis. During the 2001–2003 downturn, for example, European non-cash payment volumes stagnated in terms of credit transfers and direct debit volumes; however, overall payment volumes grew at the normal pace, with card payments increasing above average. Obviously, the magnitude of the 2008 financial troubles and the current world economic crisis might lead to shrinking payment volumes. Observations from the fourth quarter of 2008 and the first quarter of 2009, for instance, already point to a changing pattern in card

payments: volumes are growing, but the payments are of lower value. However, even if there is a dip in volumes, that drop is very unlikely to be anywhere as steep as those among asset management, custody, lending or brokerage businesses, where revenue drops of up to 40 per cent could be seen.

Furthermore, the payments business is far from having exploited its fullest potential. Globalisation will drive growth in commercial payment volumes. The remittance business is growing at a double-digit rate and constitutes a volume in excess of US\$320bn (2007 estimates).³ Personal travel will, despite taking a dip during the downturn, continue to stimulate card usage across borders. Cash displacement will continue to show significant potential — between 60 and 90 per cent of payments in Europe are still made in cash, meaning there is plenty of room for payment providers to improve in this area. The role of cash displacement will actually increase in coming years, as card revenue models evolve from traditional *ad valorem* fees to per-click fees, as already observed in many Nordic and Benelux markets.

But does this relative stability in revenues during downturns justify a

Figure 2 Payment convergence in Europe (billion transactions)



‘business as usual’ approach? Certainly not.

NO CUSHION TO REST

Significant forces of change are at work in payments — globally, yet even more so in Europe, where a lot of regulatory and market integration activity is taking place (see Figure 2). Europe illustrates how some formerly highly attractive payment areas are gradually becoming a commodity, with lower revenues:

- *Cross-border to European:* The Single Euro Payments Area (SEPA) has rendered approximately two-thirds of what were once considered international payments simply ‘domestic’ European. This applies to all payments which are below €50,000 between citizens in member states of the European Union, and where the International Bank Account Number (IBAN) and Bank International Code (BIC) are used. Actually, companies are already splitting payments to stay below the ceiling in order to benefit from the low cost of SEPA payments. Apart from a limit on fees for those payments (they cannot exceed those of domestic ones), a European format for credit transfers (called SEPA

Credit Transfer) was implemented as of 30th January, 2008. A SEPA Direct Debit scheme is expected to come in the next year.⁴ Banks will have to pay to invest in these new formats and product schemes, but more importantly, they will lose important fee income on top of the lost scale for the remaining international payments.

- *Domestic to European:* Gradually, domestic formats in Europe will be phased out and replaced by the SEPA product schemes. In some countries, this may lead to a loss of revenue, as former pricing differentials in different countries can no longer be justified by major product alterations. Though the idea is that payment institutions provide value-added services, the core products will most likely become very similar, as bulk payments are typical in each market today. Current expectations are that the European Union will set an end date of about 2015 for these legacy formats.
- *Bulk-urgent convergence:* A major revenue threat is coming from the functional upgrade of bulk payment systems. The UK, with its ‘Faster Payments’ initiative run by VocaLink, was leading the way, and other clearing and settlement mechanisms (CSMs)⁵ are following suit.

Providers such as Equens on the European continent run clearing cycles every 30 minutes, meaning that there is a lower need for treasurers to go to urgent payment systems such as EBA or TARGET for many of their payments. While companies will benefit from improved liquidity management, banks could suffer significantly from an accelerated shift from urgent to bulk payments, which are charged at a fraction of the cost.

- *Float reduction:* The Payment Services Directive is reducing float income significantly. According to A.T. Kearney's estimates, around one-third of float income will be lost for banks, as it is no longer allowed on incoming payments. While banks will revisit their pricing arrangements with cash management customers, it is clear that overall this eliminates some pricing leeway.

Internationally, similar developments are under way. The recent International Payments Framework (IPF) initiative, which includes the Federal Reserve Bank, some European CSMs and banks from both sides of the Atlantic, is set to mimic the SEPA integration model for cross-border payments. Members of the IPF will be able to exchange payments in a standardised form between each other. Initially, this refers to dollar and euro payments, which will be processed based on standards similar to those chosen for SEPA product schemes (ISO 20022).⁶ While this initiative is certainly creating consumer welfare through lowered costs for international payments (and supposedly increased speed in clearing and settlement), it will probably reduce overall revenues in the main international payment corridors. Unlike the SEPA introduction, this service, if well implemented, could also be priced at a premium, as speed and finality of payments will improve. The overall direction is clear: more and more

international payments will be treated in an ACH-type way rather than in a 'wire' manner, and this integration will span the Atlantic and most likely include the US, Europe and the Middle East.

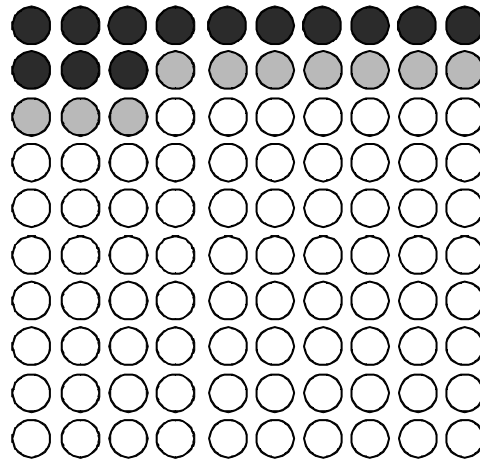
So what can one take from this discussion? While payment volumes are fairly resilient to downturns, thanks to continued trends toward non-cash payments and the underlying drivers for increased global connectivity, structural changes in payments are actually undermining current revenue streams and business models. Europe proves the point, with up to 400 million formerly high-margin international payments migrating to low-margin SEPA payments. Additionally, bulk and high-value convergence endangers a significant part of urgent (high-value) payment revenues. Payment institutions therefore cannot stand still — they must find new ways to counter this revenue and margin pressure.

CONSOLIDATION AND TIERING

In times of shrinking revenue pools and mounting cost, two effects can be observed: tiering and consolidation.

Tiering is familiar to financial institutions. Particularly in transaction banking, which is characterised by a high share of IT cost and by the need for absolute reliability, scale is a prerequisite to play. In times of shrinking margins, scale becomes an even bigger requirement for success. This was evident some years ago in the custody business and among stock exchanges. The cash management business is another example, where even large banks are now relying on 'white-label' offerings, as investment in captive platforms has become prohibitively expensive. Corporate treasurers are demanding more sophisticated functionality, which requires a broad geographical reach, refined reporting services and strong payment ex-

Figure 3 Retail payment pattern in Europe



● Card payment
 ● Non-cash payments (credit transfer, direct debit, cheque)
 ○ Cash payments
 Source: A.T. Kearney analysis

- Significant need
 - ~1,000 yearly payments per adult
 - 60-80% paid in cash
 - Every second transaction is low value
- Key role for debit
 - Everyday spending
 - Low cost
 - Fast check through/check-out
- ... likely through contactless or mobile payments

ecution. Only a handful of global banks are able to play in the first tier and offer the most enhanced services spanning many geographies. Others either retreat to commodity offerings confined to local or regional markets, or white-label one of the top offerings. The providers of these solutions increase their relative share and advantage over the other banks.

In order to ensure sufficient volumes in this game, even leaders are forced to pursue cross-border consolidation. Looking at Europe, a handful of card and payment providers are able to reach 10 billion transactions per year — including VocaLink (UK), GSIT (France), Equens (Dutch–German–Italian), Visa Europe and some other candidates such as Deutsche Postbank's BCB or First Data, to name a few. These players have a cost per transaction that is one-tenth or less of larger European banks, according to the 2007 A.T. Kearney Payments Benchmark.⁷ If volumes matter, it is inevitable to pursue consolidation. Only three countries in the EU 27 make more than ten billion transac-

tions a year: the UK, France and Germany. The next group of three countries is below seven billion, another three below 2.5 billion, and the remaining 18 are below one billion.⁸ Clearly, cross-border consolidation is the only choice if a player wants even the minimum efficiency of scale and is based outside the US, the UK, Japan, France, Germany and probably China.

What can payment institutions do beyond or in addition to consolidation and tiering?

AVENUES FOR GROWTH

Payment providers will have to develop new avenues for growth to survive. In general, growth can come from more transactions, more revenue per transaction or new services beyond the traditional payments value chain.

Cash displacement

Replacing cash with non-cash payments is a key area for transaction growth. While some estimates claim that half or more of

US payments are made by card or other non-cash payment means, this ratio in Europe is much lower — as low as 10 per cent in Italy, for instance. The typical European adult pays for something around 1,000 times a year — be it for a coffee, a new shirt or to pay a bill, and only a fraction of these are paid through banks or cards. On average, Europe has around 200 non-cash payments per capita, with around 50–60 of these on cards. The ‘best practice’ is above 150 in Sweden on cards alone. This situation only illustrates the vast potential for payment institutions to capture the opportunity in cash displacement (see Figure 3).

Cash displacement is not limited to cards. Electronic bill payment and presentment solutions might play an increasing role also in Europe, with e-invoicing being standardised within the SEPA initiative and gaining ground in the corporate area. Examining e-commerce and mobile payments, alternatives to card payments might also play a role: The Dutch iDeal scheme is one example of a direct-debit-based solution. In fact, in the future it may become less important how the payment is initiated and more important what mode and how certain the payment is. How quickly is the payment executed? Is it guaranteed? How many consumers can be reached by a certain payment method? How costly is it to merchants and consumers?

Credit transfer and direct debit will be the backbone of this in terms of a ‘push and a pull’ payment method (cheque payments for retail customers have been phased out in most countries for being largely inefficient and not fraud-proof, although the US and France remain exceptions). But different means of originating the payment — cards, bank portals, point-of-sale terminals, automated teller machines (ATMs), e-invoices — will emerge with added functionality.

One might in fact see more sorts of payments catering for convenience aspects. For example, in one European country, each police ticket carries an identifier that allows it to be paid from an ATM using a customer’s card and the identifier. A number of providers have specialised in bill payments at the point of sale in which a bar code on a utility bill can be scanned for payment. A combination of payment guarantee, reliable execution times and convenience aspects should allow payment institutions also to ensure attractive pricing on these new offerings.

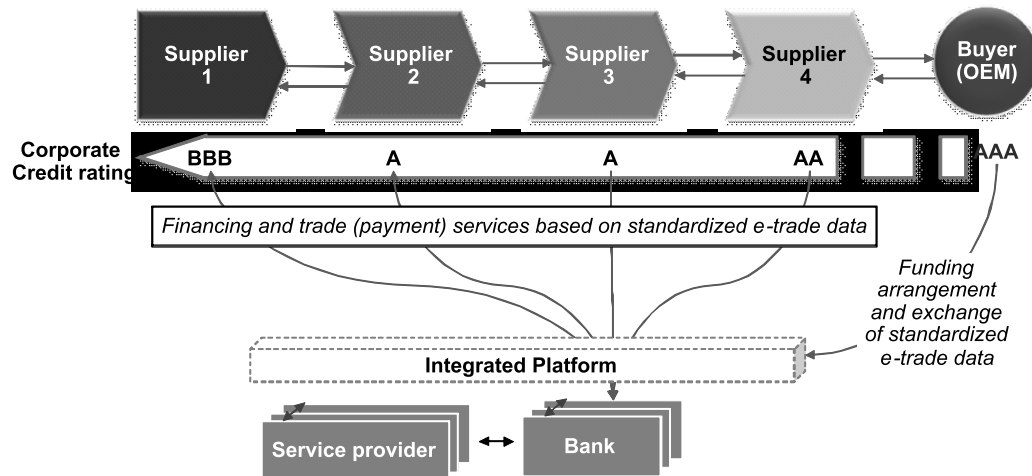
More revenue per transaction

A large part of the payments discussion is still focused around costs rather than revenues. This might be an artefact of the history of payment divisions being run as cost centres somewhere between the IT and operations areas. However, in the current market environment, the top line aspects of payments have become more transparent and more important. Payment institutions that are only active in the bulk processing of payment items are subject to the ongoing cost decrease, the quest for scale and the resulting margin squeeze. Therefore, payment institutions will have to find ways to earn more on each payment.

One strategy to escape this cost-driven paradigm is the bundling of payments with ancillary and value-adding services offered to companies, merchants and customers. Non-bank examples show the way:

- Invoicing and collection agencies relieve the finance departments of companies from these activities, including factoring services. With unpaid invoices reaching 4–5 per cent not only in mass market services such as mobile providers, but also even for lawyers in some countries, the benefit of such services goes beyond the administrative

Figure 4 Financial supply chain management (illustrative)



costs of invoicing, collections and payment execution.

- Secure purchasing environments, such as e-commerce payment providers PayPal or Google Checkout, are primarily offering trust to both parties in a goods purchase, and the option of insurance against delivery issues and non-payment. The payment aspect and its cost are becoming secondary, which allows for improved pricing models.
- Convenience payments, such as those by mobile operators, related payment schemes including Mobipay and NTT Docomo, and 0900 numbers, are linking service delivery to an integrated payment transaction. Downloading content for mobile phones and simply paying for it on the mobile phone bill, sometimes with additional SMS traffic, is so convenient that no discussion about the cost of the payment occurs. In actuality, the cost per click to users is significantly higher than in a bank-offered payment.

Banks and payment institutions have started looking at some of the above. The overall theme is to move away from competing for the cheapest payment

execution and towards the value of collecting receivables. In this area, payment institutions could certainly benefit from the mobile industry and its thinking: What services cater for additional revenues for some time before becoming a commodity?

Broader services: Financial supply chain management

Supporting a service offering beyond the narrow area of payments execution is the idea behind holistic financial supply chain management. This entails the end-to-end steps in financial processes that take place in a commercial transaction, starting with the purchase order and concluding with the post-settlement reconciliation between the buyer's accounts payable system and the seller's accounts receivable system. Through sophisticated payments and e-invoicing, banks allow buyers to link up with their suppliers so that all can benefit from the credit rating of the buyer (see Figure 4). While somewhat complex to implement — it requires high levels of collaboration and shared IT infrastructure to facilitate the flow of information and improve supply chain visibility, such services have become almost critical to

some suppliers since the banking crisis hit in September 2008, when credit default swaps skyrocketed and widened spreads between rating classes. E-invoices and payments provide the glue for a financial supply chain management service.

There are multiple benefits to this. There are reduced cost of funding for suppliers, leading to reduced cost of goods and higher supplier financial strength — both important to buyers or Original Equipment Manufacturers (OEMs). E-invoicing and the related payments flow also reduce handling costs, improve working capital management and related supplier risk management, just to name some important benefits. Treasurer interest in financial supply chain management has increased significantly since the 2008 financial market crisis, and more leading banks are starting to offer parts of the solution.

POSITIONING FOR THE END-GAME

Will taking these avenues to growth protect against the cost and scale pressures outlined earlier? They probably can for some of the players, but only with a dedication to payment innovation, access to a corporate customer base (for financial supply chain management, for instance) and efficient processing. In that sense, they can actually help those companies that are benefiting from the ‘tiering’ and ‘consolidation’ trends already observed in this industry. The magnitude of change in the payments business suggests that it might actually be moving from one relatively steady state to another: the break-up of geographical markets through SEPA and the PSD in Europe, and possible beyond through the IPF; the entry of non-traditional players from the mobile or retail industries in the consumer payments area; and the global challenge to traditional economic models, for example

around interchange in the cards business.

If this is the planning assumption, it actually means that the challenge is not only about being cost-competitive while developing new avenues to growth. Moreover, it poses a challenge to revisit the business models in the payments area.

Following are five business models for the future of the payments business. The first four appear the most viable, with the fifth model providing more help in the interim:

- *Retail payment providers*: This model caters to the bulk payments market and typically serves a large retail customer base. Payments are an integral part of their account services, are reliable and offer access to major European and international bulk payment mechanisms. Their advantage is cost efficiency, as their cost for an electronic payment is below 0.5 euro-cents. Scale is important, with somewhere between three and five billion non-cash payments per year, simply for that fact these will typically be large retail banks, sometimes across borders.
- *End-to-end premium providers*: Cash management specialists catering to the most demanding segment of payment users — multinational companies — enhance their functionality into financial supply chain management, offer sophisticated IT integration capabilities and invest into innovation such as the IPF or invoice handling. Only very few banks will have the required volumes to do so on their own, so this may lead to further alliances in this field and new white-label services. Their services will have to be all-inclusive, so that their platforms can combine bulk and high-value, domestic and international, and bank and card payments; they might use processors for some of those,

but keep a strong payments expertise in house for innovation purposes. The bundling with foreign exchange and money market (FX/MM), factoring and risk management solutions will make it hard for non-banks to play in this area.

- *Point-of-sale providers:* Merchants need more than payment execution. They not only want payment guarantees and quick collections, but also new revenue streams. Specialised providers will play an increasing role in this business, developing new functionality from bill payments, mobile top-ups and remittances to point-of-sale loans. Beyond payments, they provide additional frequency to merchant locations, and new commission revenues. Already today, acquirers are starting to upgrade their point-of-sale services, and non-bank terminals play a stand-alone role in some markets, including Portugal or Poland, to name two examples.
- *Pan-domestic processors:* Payment processors and CSMs will play a much bigger role in the future, particularly in the commodities segment of bulk payments. They provide cost-efficient processing for mid-sized and larger banks, including access to major European and international bulk payment mechanisms. They also focus on electronic payments and only provide value-added services in areas where they find significant demand. Scale economies are at the core of their DNA, but they will move into more specialised areas such as data analytics, where size and magnitude of data matter in terms of generating information. The winning processing players will handle more than 10 billion transactions per year, and they will consolidate volumes across borders, but they will not necessarily integrate card and other payments processing for the time being.
- *Mobile and online payment providers:* Specialist providers will continue to serve the mobile and online payments area, which are still characterised by a pace of innovation and a level of risk different from other segments in payments. With the Internet and mobile payments gaining ground, however, payment services will be provided by either traditional players or the network providers themselves. Clearly, there are network effects (for example, from serving both merchants and consumers, and building a credit history for both sides) which drive scale, and as soon as a leading technology in the mobile or online payments area emerges, this will become an area where size and reach matter most. Currently, some of the incumbent players are already engaged in acquiring specialist players — a clear indication of how important it is becoming for traditional payment players to keep a foothold in this growing area.

Many of the current payment providers do not fit into one of the models above. This is particularly the case for domestic-only processors, and for mid-sized banks.

- A large number of domestic processors are still found in many countries. In the future, they will either be swallowed up or will have to expand across borders. Their traditional governance models will need to be transformed from former association-type processors into more of a business process outsourcing model, with a strong economic interest and the ability to fund outsourcing deals. In Europe, this transformation is already under way both for cards and for non-card payments.
- Mid-sized banks will almost be forced to confine themselves to retail payments; ambitions in the cash management area will be increasingly difficult

to maintain, unless through white-label solutions. More mid-sized banks will rely on processors in order to be cost-competitive.

PREPARING FOR THE FUTURE

Strategically, payment providers should have these models in mind when launching new initiatives on the cost or the growth side. It is without doubt that the SEPA project will be mirrored in other regions and conclude in a transatlantic service. While part of the traditional cross-border and wire revenues will disappear, new transactions stemming from increased global trade, migration and travel, and cash displacement in general will fuel future growth. Payments is an important business and resilient to crisis, which offers significant potential for future growth. But commoditisation and payments convergence is leading to more tiering and consolidation among providers, and not all current payment providers are prepared to play in the upcoming end-game. Any transition, however, is a huge opportunity as well.

Nobody in this game should act without properly setting their direction. Changes in the payments business take a long time, and the SEPA initiative is just a recent example: While it was launched in 2001, the new SEPA products will probably not replace all the domestic legacy products until 2015 or later. Movements in the payments business, as seen there, are slow but forceful. It matters more to pick the right direction for an institution than to move hastily down a path that could prove fruitless. After setting the right direction, a plan should be executed with clarity, persistence and direction in order to build a stable position for the payments end-game.

NOTES AND REFERENCES

- (1) See A. T. Kearney (2008) 'The Sepa Shake-Out', A. T. Kearney, Chicago, IL, pp. 1f.
- (2) Compound Annual Growth Rate in the European EU-27 countries between 2000 and 2007 based on European Central Bank (2009) 'Blue Book', available at <http://www.ecb.int/paym/market/blue/html/index.en.html>
- (3) See Worldbank (2008) 'Migration and Remittance Factbook', available at <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:21352016~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html>
- (4) Originally planned for November 2009 (see European Payments Council (4th May, 2009) on [http://www.europeanpaymentscouncil.eu/content.cfm?page=sepa_direct_debit_\(sdd\)](http://www.europeanpaymentscouncil.eu/content.cfm?page=sepa_direct_debit_(sdd))), the launch might get delayed; see for example French Banking Federation (2009) 29th April, 'Le prélèvement SEPA sera disponible en France à partir de novembre 2010', available at [http://www.fbf.fr/Web/internet/content_presse.nsf/\(WebPageList\)/Le+prelevement+SEPA+sera+disponible+en+France+a+partir+de+novembre+2010+?Open](http://www.fbf.fr/Web/internet/content_presse.nsf/(WebPageList)/Le+prelevement+SEPA+sera+disponible+en+France+a+partir+de+novembre+2010+?Open)
- (5) Clearing and settlement mechanisms ensure the exchange of payments. They can be organised in a central way (Automated Clearing Houses) or in other topologies, ie multilateral or bilateral exchange of payments.
- (6) <http://www.internationalpaymentsframework.org/docs/IPF2009.pdf>
- (7) Source: A.T. Kearney Payments Benchmark 2007; this analyses unit cost across 16 payment and card processes across more than 40 banks from 13 European countries; data is confidential to participants; see also A.T. Kearney, ref. 1, above pp. 8f.
- (8) Source: European Central Bank, ref. 1, above, 4th May.