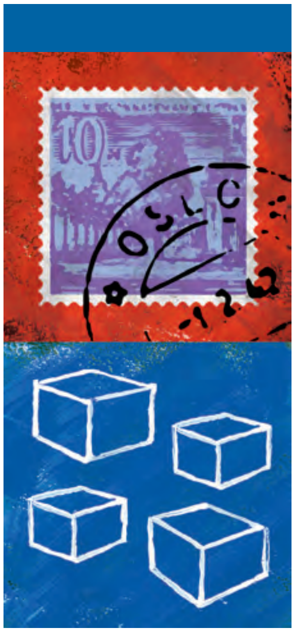

Payments strategies and opportunities for postal operators around the world

Although postal operators have traditionally played an important role in payments, strong forces are reshaping industry dynamics and profitability – often at their expense. To defend their payments franchise, postal operators must act quickly. If they do so, they may even be able to leverage payments as the foundation of an exciting new growth strategy.

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The importance of postal operators in payments

Postal operators have contributed significantly to the development of the payments system in many countries, with the neighborhood post office serving as the local focus of economic activity. From the 1950s to 1990s, postal operators provided the primary channel for disbursing government pension and benefit payments and offered customers a convenient way to pay utility bills and government fees – a natural product extension for a state-owned entity with a broad retail network. They also ensured nationwide access to cash through ubiquitous branch networks and secure transportation of coin and currency around the country. Over time postal operators supported national savings programs with the introduction of government-backed savings deposits – a legacy that continues today with more than $3 trillion in deposits managed by postal operators worldwide.

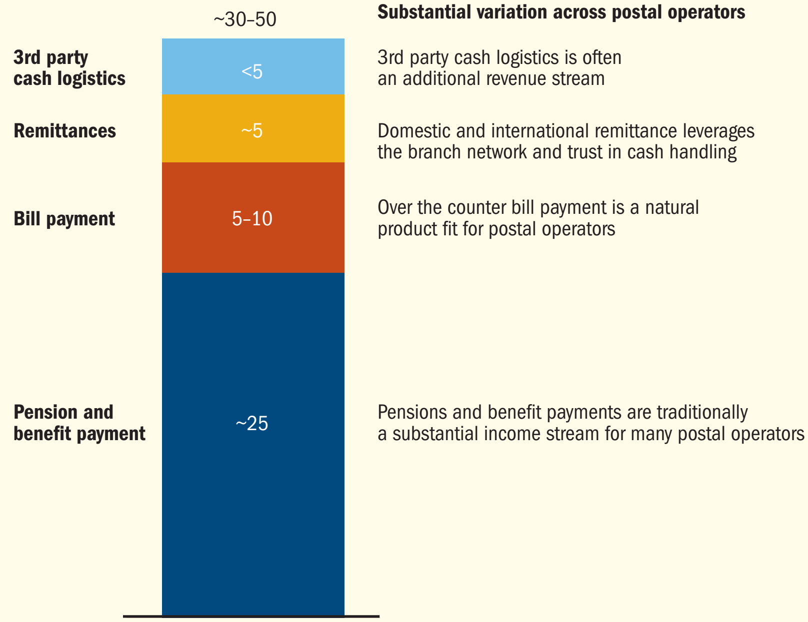
Importantly, in the 1960s and 1970s, when most banks focused exclusively on wealthy customers, postal operators in many regions introduced basic mass market banking and payment services (see “A brief history of postal payments and banking” on page 28), first through giro products offering transfers and bill payment, followed in many cases by mass market retail checking accounts. More recently, many postal operators have established domestic and international remittance products, and a broader range of financial services offered through their postal retail networks, sitting alongside their primary businesses of mails, express and logistics.

Postal operators, therefore, have served important functions through the global net-

Exhibit 1

Pensions and benefits payments have been a substantial source of income for many postal operators, alongside bill payment and remittance products

Illustrative share of income for a postal counter business unit
Percent



Source: McKinsey analysis

work of 660,000 postal establishments by providing access to pension and benefit payments, supporting bill payments and remittances, providing cash access, processing transactions to interconnect disparate parts of the financial system, and supporting social inclusion by bringing financial services to the mass market.

Payments has been a profitable business for postal operators – at its peak, fees and income from transactions could generate as much as half of the income to the postal counter business unit (Exhibit 1), with much of the remainder coming from sales of retail mail products and services.

Strong forces reshaping the payments landscape

In recent years, a combination of powerful forces – including government policy, intensifying competition and changing customer behavior – has gradually weakened the role of many postal operators in the payments business. Although the global payments business has grown rapidly to annual revenue of $900 billion – making it a larger industry than global airlines or pharmaceuticals, the share for postal operators has shrunk significantly, as declines in traditional payments income have outweighed new growth areas.

Many postal operators have seen a precipitous decline in government payments income and other transactional products such as fees and licenses. For example, in many countries there have been steep declines in income from pension and benefits payments, as governments have adopted automated channels to reduce transaction costs and increase security and fraud protection. Such changes have resulted in an income loss of as much as 40 percent for the postal counter business over a period of just a few years (see Exhibit 2 on page 29).

During the 1980s and 90s, postal operators faced increasing challenges from retail banks, which moved aggressively to compete for mass market customers with broader product offerings and more competitive pricing. More recently, competition

A brief history of postal payments and banking

The postal system in many countries has a long history of providing banking services. For example, the General Post Office in the U.K. established the Post Office Savings Bank in 1861, which brought rural areas and those with lower income access to savings. By the 1920s, a quarter of all Britons had postal savings accounts with nearly $0.5 billion in deposits. Similarly, in the U.S. the Postal Savings System was established in 1911 to provide convenient access to savings for the mass market. Savings boomed in the 1930s and again after WWII to peak at over $3 billion in 1947, before competition from mainstream banks and the rise of consumer spending led to the system's decline in the 1950s and closure in 1967.

In many other European countries, postal savings institutions were established in the early 20th century. They also focused on savings accounts for the mass market, capitalizing on the trusted brand of the postal operator, its extensive branch network, and deposit security through government ownership. Many operators added additional savings products over time, such as government bonds. They also built cash transit and payments systems, taking on roles such as cash payment of government pensions and benefits over postal office counters. Postal saving institutions played a critical role in the development of a "cash society" and the incorporation of broad segments of the population into the banking system. The Japan Post Bank is particularly noteworthy, as it grew to be the largest savings bank in the world (see "Evolution of payments and banking at Japan Post" on page 32).

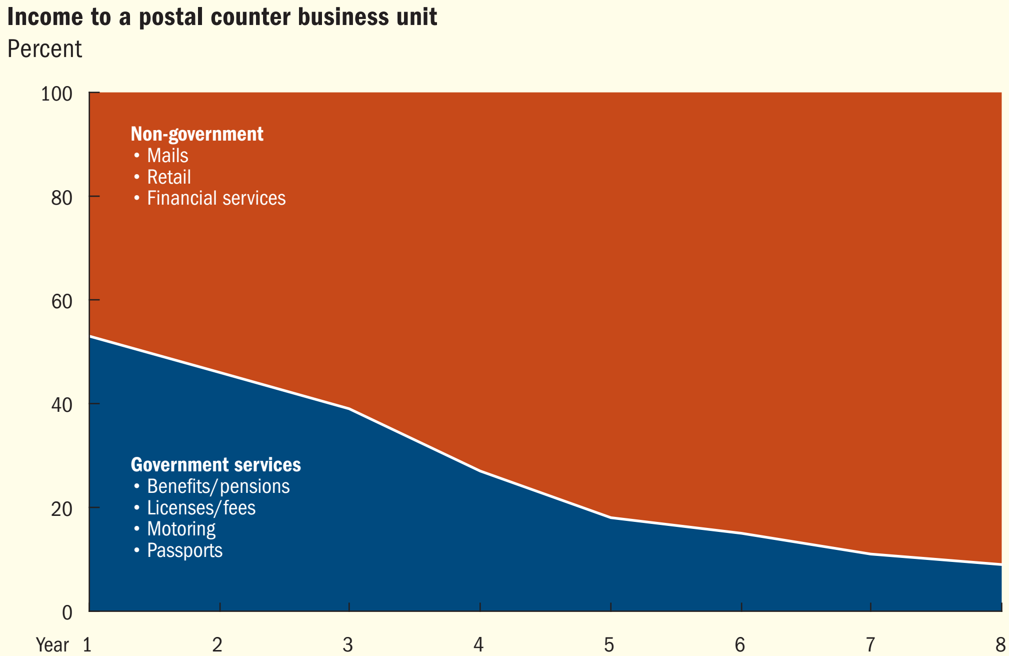
However, over time major retail banks expanded into the mass market with broader offerings including credit cards, loans, mortgages and insurance products. The traditional postal savings institutions, with their narrow product set, could not compete and some (as in the U.S.) went into decline and were closed; others were privatized and either competed through a focused savings strategy or became part of a broader banking institution.

The early 1990s brought a resurgence in postal banking. Some countries such as Germany and France have seen the emergence of the licensed postbank – in which the postal operator has obtained its own banking license, allowing it to offer a suite of payments, savings, insurance, and loan products. In other countries such as Belgium, Ireland, Spain and the U.K., postal operators have entered into strategic alliances with retail banks – postal operators bring their trusted brand, customer footfall and extensive network, while the banks bring financial products, license, and experience in retail banking, and often manage the back-book. In several countries, these postal banks have formed growth engines for postal operators.

Today, many postal operators are state-owned companies with dual objectives to increase their profitable commercial focus and continue to play a social role in the country. Some have become semi-autonomous – perhaps even pursuing privatization, while others, particularly in emerging economies, remain particularly close to national governments. Now, just as the global financial services sector has entered a period of massive restructuring, another wave of separation and privatization of postal banking businesses is underway. As postal banks mature and synergies with postal operators decrease, several postal banks are becoming independent institutions or being acquired by established financial groups, leaving some postal operators to once again focus on their core business.

Exhibit 2

Precipitous decline in government services as pension and benefits payments move to direct channels



Source: McKinsey analysis

has further intensified through rapid growth of low-cost terminal networks for bill payment and the proliferation of ATMs for cash access. One example is Payzone, which operates more than 240,000 terminals for bill payment and mobile telephone reloading across Europe. These competitors often beat the postal operator on price and convenience, as their terminal networks are typically low cost, located in high-traffic areas and available during extended hours.

Even international remittances, until recently a strong source of growth for postal operators, are now under attack. In major remittance corridors such as Germany–Turkey or Spain–Morocco mainstream banks have an estimated half to two-thirds of the market volume in remittances, and postal counters have a 10 to 20 percent share. One example of banks' keen interest in remittances is NatWest, which has developed a dedicated bank account to serve the 300,000 Polish-speakers working in the U.K. All services, including telephone and internet banking, leaflets and forms are available in Polish, and the account has a built-in "Money Transfer Account," which allows a nominated person to access funds via the cash machine network in Poland using an ATM card.

Furthermore, changing customer behavior – such as the adoption of online and automated payments and a reduced use of cash – have lessened the demand for core transactions at postal counters. Income from bill payment services has declined as billers have persuaded customers to enroll in automatic direct debit and have established electronic funds transfers directly from current accounts. The adoption of electronic bill presentment and payment (EBPP) platforms has strengthened this trend, for example in Nordic countries, where banking systems are relatively centralized and use of the internet is widespread. The need for cash has also declined due to the increased use of debit and credit cards for low-value point of sale purchases.

Challenge or opportunity?

On the face of it, the picture for a traditional postal operator in payments is gloomy – powerful forces are likely to continue attacking and eroding postal operators' traditional footing in the payments market. There is therefore little doubt that the traditional postal payments business is undergoing an inevitable decline in many countries. Our analyses, however, suggest that there are four potential building blocks of a winning strategy for postal operators: 1) defend the core franchise aggressively; 2) develop merchants as a natural niche segment; 3) identify and pioneer new technology trends with natural fit; and 4) leverage payments as a gateway to a broader financial services offering.

Cost reduction is an essential part of the defensive strategy as it positions postal operators to compete for payments contracts on price and on value.

1. Defend the core franchise aggressively

The first element of a successful payments strategy is for the postal operator to proactively defend its core payments business by fighting aggressively for important payment contracts such as high-profile electricity, gas and other utility bill payment services. Postal operators should compete strongly on price and, where possible, negotiate terms as exclusive provider.

Postal operators should also work closely with respective governments to preserve and enhance the close relationships they have for delivering government payments and transactions such as pensions and benefits. For example, an Eastern European postal operator has successfully negotiated with government to defend its position as the provider of pension payments. They did so by highlighting the critical social benefit they provide by offering pensioners the choice to receive their payments at home via the postman. Postal operators should also identify additional government-related payment services to mitigate the inevitable loss of counter-based transactions to direct channels.

Cost reduction is an essential part of the defensive strategy as it positions postal operators to compete for payments contracts on price and on value. Postal operators in many developed economies have sought to reduce costs by rationalizing their counter networks to offset the erosion of both payments-related income and the impact of competition and substitution in the core mail business. For example, postal operators in many countries including Austria, Denmark, Ireland, Portugal and the U.K. have seen substantial branch closure programs ranging from 15 to 30 percent in the past decade. In some countries this trend is slowing, as counter networks reach a minimum coverage required to serve the population; in others, further reductions are likely. Postal operators can also reduce costs through franchising their postal counters – typically to established retailers. For example in Holland, TNT is moving towards an almost exclusively agency-based postal network.

As volumes decline, another solution to manage unit cost is to boost volumes through "in-sourcing" activities. Deutsche Postbank, for example, processes payment transactions for other German banks, and Ireland's An Post processes payments and data, including tax returns, through its BillPost subsidiary. Low-cost operating models and automated terminals can also drive down transaction costs; for example the Payshop system underpins bill payment and prepaid mobile phone top-ups in all postal branches in Portugal and in several thousand small retailers.

Taken together, these actions can significantly reduce the overall cost base of the postal operator and enhance its ability to compete aggressively in the payments market.

2. Develop merchants as a natural niche segment

Merchants, especially small and medium-size retailers, require infrastructure support to accept and process customer payments and often seek to expand the payment serv-

Exhibit 3

Substantial opportunity to provide a tailored suite of products and services to support and reinforce the postal agency model

Examples of possible products and services with natural fit

Core customer transactions Drives footfall	**Additional products** Drives customer loyalty and value	**Agent services** Provides a compelling support proposition to the agent
Government payments Primarily pensions and benefits from central government	**Top-up e-cash and prepaid cards** Ability to top-up (and use) electronic cash and prepaid cards perhaps as store cards, gift cards or for travel	**Merchant acquiring service**
Remittance International and domestic money transfer	**Travel ticketing** Sales of important products in a secure environment	**Check processing and paper-based back-office** Back-office support and processing (e.g., check clearing or administrative support)
Bill payments Pre-pay and post-pay bills over the counter	**Foreign exchange** Provide international currency	**Business banking and cash** Business banking and cash delivery/collection services
Mobile telephone top-up Reload prepaid mobile telephone accounts	**Postal financial services & ATMs** Transactions (e.g., cash withdrawal) and other financial products (e.g., insurance)	**e-POS systems** Potential to provide simple electronic point of sale system, perhaps linked to merchant acquiring and banking services
Core mails offering Payments products sit alongside core mails offering		

ices offered to customers. This typically requires a multitude of contracts with different providers. As many postal operators have adopted agency franchise models, they already have close relationships with many of these merchants. This positions postal operators as the natural and potentially exclusive provider of a compelling suite of products and services for merchants. At the core of this strategic value proposition are products that drive footfall: government payments, foreign remittances, bill payment, mobile phone top-up, and the core mails offering. Additional products – including travel ticketing, foreign exchange, prepay cards, ATMs, and postal financial services – are important for securing customer loyalty. Bundled alongside this customer proposition could be a compelling support proposition for agent services such as merchant acquiring, check and paper processing services, business banking and cash logistics, and even point of sale terminal maintenance (Exhibit 3).

3. Identify and pioneer new technology trends with natural fit

New technology, regulation and changing customer demand will continue to drive change across the payments industry. Although new technology is often a threat to postal operators, it also offers areas of opportunity. Contactless payment systems can offer a top-up opportunity (much like prepay mobile phones), and the "dictator effect" can drive rapid customer adoption when, for example, a sole provider like the transit system introduces a new payment device. New charging schemes such as congestion charging, parking permits and fines, local taxes, and fees have the potential to increase payment transaction volume and revenue and are typically a natural fit for postal operators.

EBPP and electronic invoicing provide additional important opportunities for postal operators. As discussed in a prior article ("E-invoicing in Europe: Substantial value hiding in plain sight," *McKinsey on Payments*, June 2008) electronic invoicing could save businesses and consumers across Europe tens of billions of euros. Successful examples of electronic document services include: Canada Post's development of ePost, which allows customers to safely receive, manage and pay bills and other financial documents online; and

Denmark's secure electronic mailbox service, e-Boks (part-owned by Danish Post), which has enrolled well over 1 million users in recent years.

Trends in consumer behavior and adoption of new technologies are also opening up opportunities for postal operators as a trusted intermediary providing services such as secure electronic messaging, identity management and payment verification. For example Swiss Post's subsidiary SwissSign provides identification and authentication using digital ID and offers a digital signature service.

4. Leverage payments as a gateway to a broader financial services offering

In the past 10 to 15 years, many postal operators have successfully re-established their traditional role in mass market retail banking services, often by leveraging their existing payments franchise, customer base, and trusted brand as a gateway to broader financial services, placing them in direct competition with mainstream retail banks. This growth opportunity is particularly attractive at a time when the core mail business is coming under pressure from liberalization, competition and e-substitution, as it can provide an additional revenue stream to support the cost base.

Typically, this involves the postal operator providing a suite of transactional and relationship products, ranging from simple savings products to full banking and insurance offerings. At this time of financial turmoil, customers are mindful of the trustworthiness and security of depository institutions, and postal operators are benefiting from the perception of an implicit state guarantee, allowing them to attract substantial new deposits. There are opportunities for existing financial institutions to partner with the postal operator, combining the strong postal brand and established delivery channels with the bank's payments and banking expertise.

In many countries, particularly in emerging economies, postal operators have a unique

Evolution of payments and banking at Japan Post

With $1.8 trillion in deposits – or 12 percent of Japan's consumer deposits and a significant share of all postal bank deposits worldwide – Japan Post Bank (JPB) is one of the world's largest depositary institutions. Founded in 1875 to provide a safe place for consumers to hold cash reserves and promote a culture of saving, JPB is older than Japan's Central Bank. Today, as it transitions toward independence, JPB is expanding its payments offerings as part of a strategy to increase deposits and retain its strong liquidity position.

JPB built its initial deposit base through mass market savings programs for Japan's largely rural population, targeting farmers and elementary school students to encourage a savings culture. It also provided financing for the government as JPB invested the deposits into long-term government bonds.

During the period of high interest rates in the 1990s, JPB's deposits jumped, due primarily to its strong balance sheet, high fixed rates and government guarantee – which could not be matched by retail banks. More recently, as fixed rates have adjusted to current market conditions, deposits at JPB have declined.

Steps to privatize JPB began in 2007 and the company is moving towards independence and a public listing, putting it on a comparable footing with other retail banks. JPB is now focused on attracting deposits, improving product and service offerings, and optimizing its operations. It seeks to reduce cash usage and counter activity by issuing credit cards with e-money and bill payment capabilities. It has also opened its 26,000 ATMs to other banks. Through the network of 25,000 postal counters, JPB remains a powerful force in Japan's financial services sector, offering mutual funds, government bonds and deposit accounts as well as payment services including tax and bill payment and money transfer.

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opportunity to provide a mass market financial services offering to the unbanked population. This builds on the unrivaled reach, trusted brand and regular contact that postal operators already have through payments, benefits and remittance products. For example, in Kazakhstan, Brazil and South Africa, postal operators have established basic post accounts for receiving pension and salary payments, and for extending financial services to segments served poorly by retail banks. Even in developed countries such as Belgium, France and the U.K., postal operators play an important role in financial inclusion by providing convenient local access to basic banking services and cash.

There are real opportunities for postal operators to supplement their existing payments business and develop new ways to create value, both financially for the business and socially for their countries.

Furthermore, international collaboration among postal operators could leverage the global network of 660,000 postal establishments. Eurogiro, one of the first systems for cross-border exchange of automated clearing house payments, is a striking example of postal operators' leadership in payments innovation and now supports 3 million money order and credit transfer transactions per month. The new Postal Payment Service Agreement adopted by the Universal Postal Union last summer is expected to enable postal operators around the world to offer faster and more secure electronic money transfer services, which can be offered to unbanked populations and immigrant workers. Future online trends may also bring closer collaboration around hybrid mails, secure messaging and electronic document sharing to support additional payments business.

* * *

Trends in the payments market are impacting the traditional role of the postal operator, and there is little doubt that in many countries the long-term outlook is a decline in their core payments business. However, postal operators can develop new growth areas to offset this decline and reinforce their role within society. To do so, they need to be more proactive, and take a strong approach to defending their business. We also believe that there are real opportunities for postal operators to supplement their existing payments business and step further out and develop new ways to create value, both financially for the business and socially for their countries.

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