



Winning in the new payments landscape: A global outlook

In relative terms, the global payments industry came through the financial crisis in good shape. In 2009, payments revenues in most regions declined less severely than those for banking overall. However, this performance is not an argument for the status quo. There have been enormous shifts in the sources of payments revenues and profits.

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Incumbents across the globe now face challenges that were unimaginable just two years ago. Business models in many sectors will need to be reinvented – retail current accounts in Europe, corporate transaction banking in Asia and credit cards in the U.S. are a few examples. To add to the pressures, continued turmoil in the global banking industry is creating opportunities for new players to build beachheads in the payments market.

To answer these challenges, banks and other payments players must develop strategies to drive the profitability of large, existing payments franchises. They must make bold choices about their portfolio of products; build fee-based revenue models and make step-change reductions in costs. Banks must also go further and integrate payments and broader banking propositions, and empower leadership to mobilize the institution to deliver value to customers.

The post-crisis payments landscape

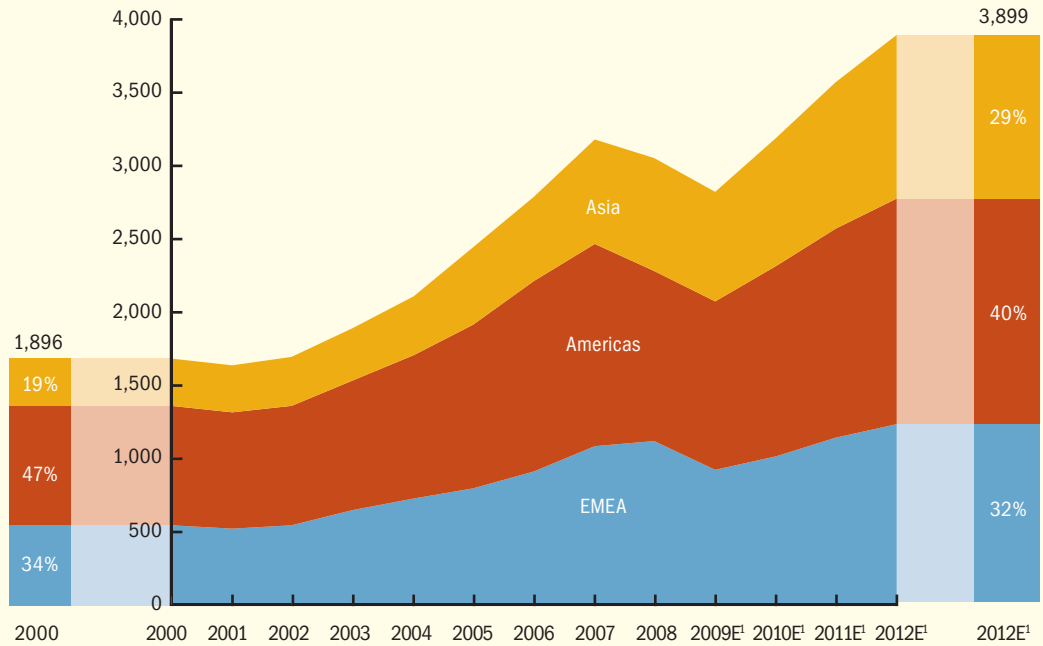
Global banking revenues (after risk costs) declined by more than 10 percent from

2007 to 2009 (Exhibit 1, page 4). Payments revenues fared somewhat better, falling by single digits overall, with some geographical pockets of stronger performance. Both banking and payments revenues are expected to resume steady growth in 2010, with notable exceptions such as the U.S., where continued credit card struggles and new regulations impacting DDA will drive another year of declines prior to recovery (see sidebar, “The transformation of the U.S. consumer payments market”).

In Europe, payments revenues after risk costs tumbled from €182 billion in 2008 to an estimated €141 billion in 2009, largely driven by a €31 billion collapse in net interest income (NII). The interest rate environment weighed more heavily in Europe than in the U.S., where earnings on balances comprise a smaller share of the revenue equation. Conversely, increased losses on card balances played a larger role in the U.S., and accounted for significantly more erosion than the €4 billion increase seen in Europe.

Exhibit 1
The banking crisis has exacerbated the shift in revenue balance across regions

Total revenue after risk cost
 U.S.\$ billions, percent



¹ Baseline scenario
 Source: McKinsey Global Banking Pools

Across Asia broadly, there was a similar decline in NII, and an increase in credit costs that ranged from contained (in markets such as Hong Kong) to severe (e.g., India). In Latin America, the greatest impact was felt in Mexico’s credit card market, which relies heavily on revolving balances and experienced high rates of delinquency. Other markets in the region were more resilient. Brazil and Chile, for instance, both fared well through the crisis: deep penetration of card usage (more than 20 percent for both countries) resulted in high transactional revenues. Card growth in Brazil was a particular bright spot for payments: spending on credit and debit cards increased 19 percent and 21 percent, respectively.¹

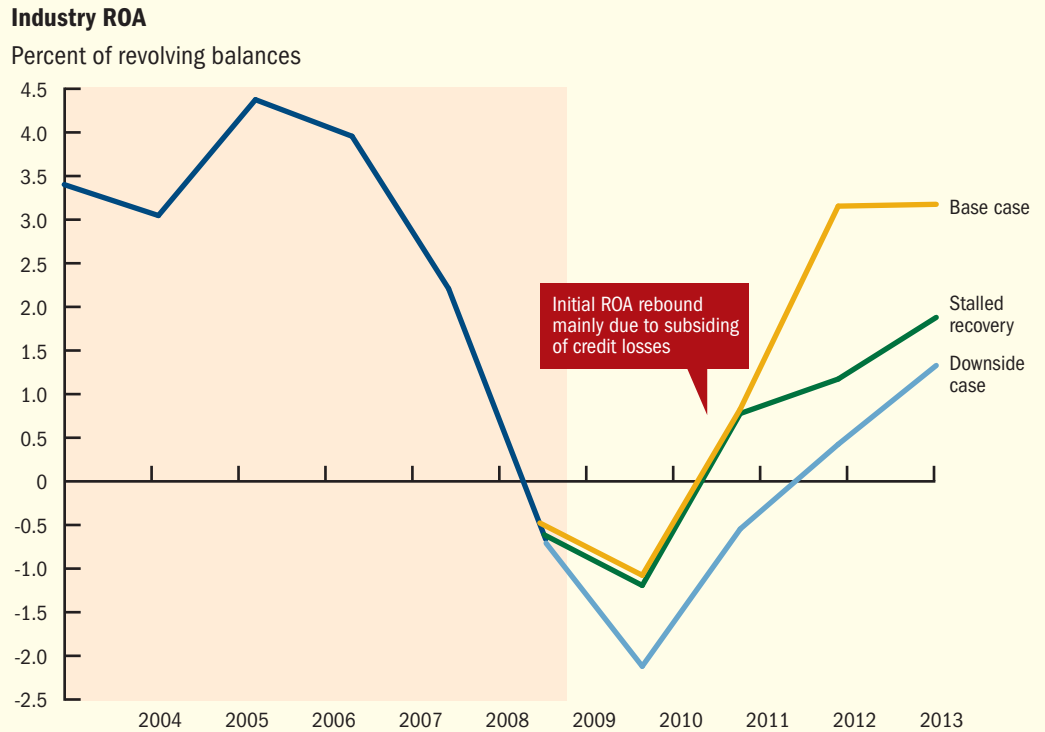
These numbers only tell part of the global payments story. Structural shifts in the economic cycle (historically low interest rates, constrained credit/lending), regulatory changes, evolving customer behavior, and a redrawn competitive landscape have combined to alter some of the sources of payments revenues and profits.

In the U.S., fee income (for delinquency, service, et al) is driving credit product profitability, whereas spread-based income (revenue derived from charging interest on balances) used to be the dominant profit driver. In fact, the existing credit card business model in both the U.S. and U.K. may no longer be sustainable.

Credit cards in the U.S. are unlikely to return to profit this year, unless there is a dramatic drop in unemployment (Exhibit 2). The Credit Card Accountability, Responsibility, and Disclosure Act hampers card issuers’ ability to generate profit by recalibrating balances from low-rate teaser offers. Overall, we expect aggregate credit lines will be reduced by 20 to 30 percent, and that balances will drop 12 to 15 percent from their 2008 peak of \$717 billion, before growing again. When the industry does regain its footing, profits will only rebound to a 2 to 3 percent pretax return on assets, compared to 3.5 to 5 percent over the 15 years prior to the crisis.

¹ Association of Brazilian Credit Cards & Services Companies (Abecs)

Exhibit 2
U.S. credit card industry losses are likely to continue through at least 2010



Transaction revenues are a continued focus in the U.S. As a byproduct of the financial crisis the share of point-of-sale dollar spend executed by card has temporarily plateaued at roughly 50 percent, even as the mix of debit and credit use shifts. We project that U.S. consumer point-of-sale debit spend will match credit spend in 2010, a significant change from as recently as 2005 when credit comprised over 60 percent of card spend (see Exhibit B, page 7). Debit card spending continues to show healthy growth throughout this period, and as the economy improves the share of overall card spend should resume its upward trajectory.

U.S. banks are also struggling to address how to make a profit on demand deposit accounts, given the Federal Reserve’s changes to overdraft rules. Changes to Regulation E will allow consumers to opt in or out of overdraft protection for debit card and ATM transactions, which could have a substantial impact. We estimate that courtesy overdraft fees constitute the majority of the

\$29 billion in penalty fees that U.S. banks charged in 2009, nearly a third of consumer DDA revenues.

In the U.K., ongoing reduction in interchange, consumer deleveraging and regulatory changes that have dampened cross-sell rates for services such as protection insurance, could halve card profits. At the same time, competitive and regulatory changes in the way current account fees are charged – combined with the reduction in interest margins – have radically compressed current account margins.

In Europe and in Asia, the credit card challenge is less dramatic. Across many markets in these regions, credit cards account for less than 10 percent of payments revenues (versus nearly 40 percent in the U.S. and 25 percent in the U.K.). Instead, the big challenge across much of the two regions is falling interest rates, which have eroded interest margins on retail and corporate current accounts by about \$68 billion over the last two years – greater than

The transformation of the U.S. consumer payments market

U.S. payments revenues totaled \$277 billion in 2008 – or around 30 percent of the global payments pool – and appear to have fallen to roughly \$260 billion in 2009. As the broader economy has suffered, so has the U.S. payments industry. Given the current headwinds facing the U.S. market, we do not expect payments revenues to regain their 2007 high of more than \$280 billion until 2012.

Today’s challenges stem largely from the severe recession. Consumers have been spending less, and spending less frequently. Transaction fees, which grew at roughly 8 percent annually between 2003 and 2008, slowed to less than 5 percent growth in 2007–08, and appear to have fallen again in 2008–09. Consumers have increased their deposits, but historically low interest rates and a reluctance to lend have compressed net interest margins.

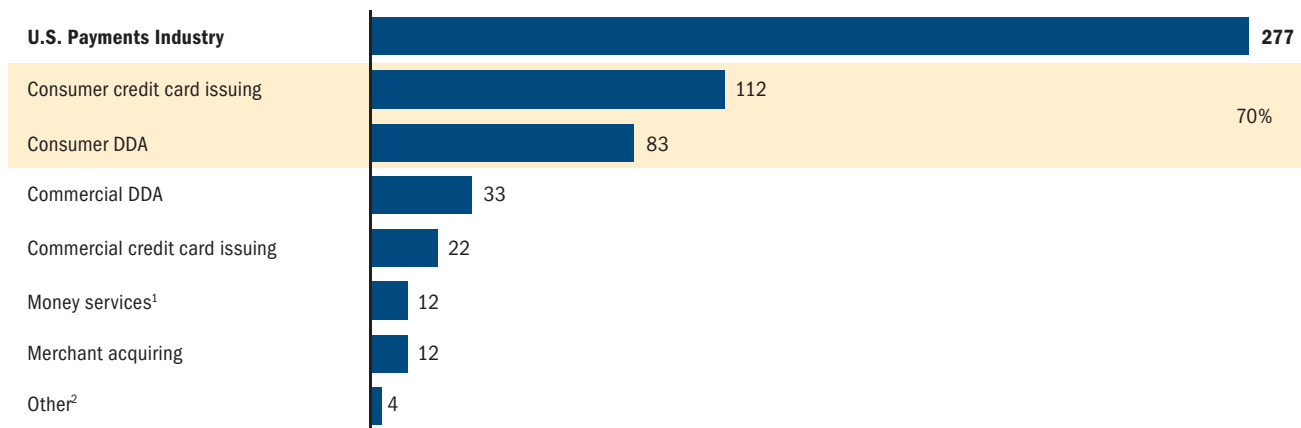
In 2008, U.S. consumer credit card issuing and consumer DDA (*current accounts* in Europe) generated 70 percent of U.S. payments revenues (Exhibit A) – and more than 20 percent of global payments revenues.

Now, however, these two business lines face significant headwinds. Consumer consumption and savings behavior has changed coming out of recession. Credit card issuers themselves are recovering from record losses. And to add to the pressures, new regulations constrain growth in both DDA and card issuing. The result will be a transformation in consumer payments over the next few years.

Consumers are deleveraging, both voluntarily and involuntarily. U.S. consumer revolving debt, for example, declined from 2008 to 2009 for the first time on record. *Voluntary deleveraging* reflects both consumers’ battered confidence and their desire to spend more responsibly. McKinsey’s quarterly Consumer Financial Life Survey has found that only one in five U.S. households is comfortable with its level of debt, and that the percentage of households that has significantly reduced consumption increased from 26 percent in Q1 2009 to 29 percent in Q3 2009. *Involuntary deleveraging* occurs as card issuers reduce the supply of credit in response to recessionary forces and new regulations that restrict their ability to selectively price for risk. The net effect has been a rapid acceleration of the inflection point between credit and debit card spending: U.S. consumers will spend more on debit cards than credit cards this year and this trend will continue through at least 2013 (Exhibit B).

Exhibit A

2008 U.S. payments industry revenues U.S.\$ billions



¹ Includes prepaid cards, EMT, non-bank check cashing and money orders

² Includes armored transport, check verification/guarantee, travelers checks and ISO ATMs

Source: McKinsey U.S. Payments Map, release Q4-09

The growth of debit cards has coincided with growth in overdraft fee income. This has not gone unnoticed by regulators and lawmakers. Changes by the Federal Reserve to Regulations DD and E go into effect this year, and seek to increase consumer awareness of the overdraft fees they pay, and require that consumers actively opt-in to fee-based overdraft protection for most debit card and ATM transactions. At the time of publication, bills in both houses of Congress are proposing more stringent regulation of overdraft practices than has already been enacted by the Federal Reserve.

Together, the pressures on the two largest payments businesses will likely mean that revenues will fall in 2009-10. This is leading to a new focus on cross-sell efforts and channel integration. It has also invigorated the hunt for new consumer value propositions. Already, several offerings cater to consumers' desire for control and more responsible spending:

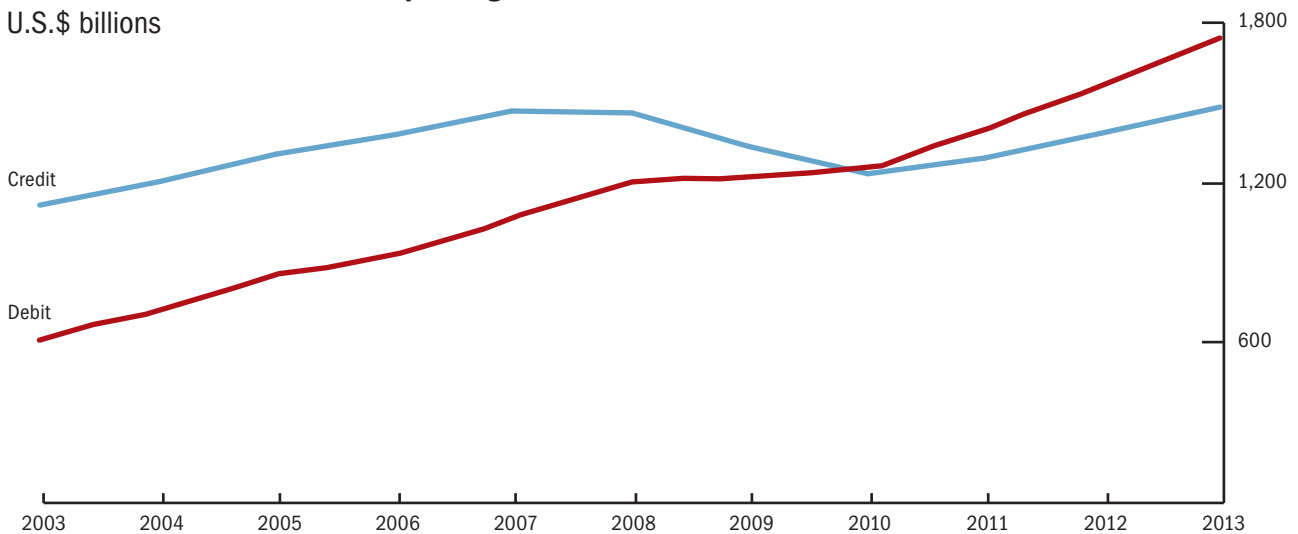
- Chase's Blueprint card platform allows online users to choose which credit card charges (or categories of charges) they will pay off now versus later.
- PNC's Virtual Wallet uses a calendar to help consumers manage cash flow and savings goals better.
- Citi's Forward card offers APR reductions as a reward for staying under the credit line and timely payment of three consecutive billing periods.
- Discover's Current card is targeted at teens but marketed to parents. It includes spending limits and the ability to restrict particular types of merchants.

We anticipate further innovations ranging from creative relationship-based product pricing to more structural redesigns that challenge the prevailing wisdom on how credit cards or checking accounts work. To enable these innovations and protect against future losses, banks are building universal underwriting tools to manage risk exposure to a given customer across all products. Increasingly, banks will find product innovation (and the attendant investment in technology) necessary as they strive to gain their share of a smaller pie and create new profit opportunities in payments.

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Exhibit B

U.S. consumer debit and credit spending
U.S.\$ billions



Source: McKinsey U.S. Payments Map, release Q4-09

10 percent of total payments revenues (and more than 50 percent of estimated total payments profits).

Interest margin revenues have been partially replaced, however, by transaction and fee-based revenues, which continue to grow at a steady pace. European transaction revenues are expected to continue to grow at about 5 percent, and Asia is growing even faster. This continued growth combined with future improvements in interest margins provide longer-term growth potential for banks in the payments market.

In Latin America, cards are something of a success story, continuing their overall growth in revenues. Perhaps the most significant development for the region will be an increase in regulations related to the card market. In Brazil, for instance, there is robust growth, but also increasing pressure on interest rates and penalty fees, and movement toward introducing more competition into the market. Regulators in several Latin American countries are closely following the developments in the U.S. and Europe and are likely to introduce similar changes in consumer protection and transparency. Payments players in the region will need to develop new ways to drive revenues and differentiate in a more competitive market.

Recent structural shifts require that financial institutions clearly stake positions on the payments value chain and rapidly refocus revenue models and products.

How to move forward

Payments remain a large and resilient source of profits. Recent structural shifts, however, require that financial institutions clearly stake positions on the payments value chain and rapidly refocus revenue models and products. For large financial institutions, this is not just a question of redirecting the payments business. To

maintain flexibility and navigate in an evolving market, firms need to change their mindset and integrate payments into the overall business. (For more on coordinating payments strategy across an organization, see sidebar, “Putting payments center stage.”)

We see five feasible strategies for success in the new payments environment, applied individually or in conjunction.

1. Plot the portfolio. Payments companies should decide which businesses to be in and which to exit. This is particularly critical for diverse institutions operating across multiple regions. Taking a lead from the private equity sector, they need to focus on high-growth, high-margin businesses and divest slower-growth businesses. We see this at work in Eastern Europe, where banks are exiting monoline credit card-issuing businesses to focus on in-footprint, relationship-based cross-selling of cards. And in Asia, financial institutions are extending corporate cash management and international payments capabilities.

Where exiting a business entirely is not possible – for example, where a slow-growth checking business is core to the retail bank – the bank should focus on maximizing value, building market share in scale-intensive parts of the business, and setting stringent limits on the capital it commits. This could entail more aggressive actions such as outsourcing check processing or ATM management, to improve the return on equity of the overall business.

Portfolio cuts can be made by product, geography (down to micro-levels) and customer segments, and can include decisions on where to grow, maintain, slim down or divest. For retained portfolios, marketing spend targets need to be closely aligned with portfolio dynamics; for instance, they should be stress-tested against changes in regulation, customer base and profitability levels.

Banks should develop a portfolio/product optimization framework to inform their business strategy, and ensure that such optimiza-

tion takes into account economic recovery scenarios, regulatory scenarios and the resulting consumer behavior outcomes. The result will be a clear comparison between portfolios/products that have consistently underperformed and those that have underperformed only during periods of extreme stress.

Changes in profitability and anticipated growth will mean that business models for some products will need to be reinvented.

A portfolio approach also means being more explicit about future investments, going far beyond near-term marketing. Rather than following the annual budget process, whereby all businesses receive increases within a set range, it is more effective to cut the budgets of unattractive businesses and reinvest the capital in higher-growth businesses.

2. *Reinvent broken business models.* Changes in profitability and anticipated growth will mean that business models for some products will need to be reinvented. A prime example is consumer credit cards in the U.S. and U.K. We believe that success in these markets will take one of the following three forms:

- **The financial institution relationship-based model.** In this model, products such as credit cards become a more integral part of the retail banking product suite, either through cross-sell or product bundling. Product innovation could come in the form of universal lines of credit or integrated bank loyalty programs. Regional banks would no longer be at a disadvantage to national issuers, although they might require new agent/bank models (e.g., asset-light offerings). Financial institutions could leverage the capabilities of scale players for risk, operations and technology – and take on their customers' credit risk, leveraging their balance sheet. Others might favor pure distribution and not take on credit risk for all customers, or

play only in certain segments or geographies. Banks will need to develop current account products that deliver value to customers in order to justify fees, or create bundled product propositions such as those emerging in current accounts and mortgages in the U.K.

- **The new partnership model.** Banks taking this path would work with strategic partners to develop distinctive value propositions or use partners' low-cost acquisition channels. Winners will differentiate themselves by using partner data in new ways (e.g., using shopping data for risk evaluation), while remaining sensitive to privacy fears. Banks could build on customer data to enhance the value proposition, for instance with new digital products or customer sales alerts for frequented retail stores. Using data from multiple products, financial institutions could cater to payments behaviors (e.g., alter bill-pay cycle based on deposit behavior, offer forbearance programs for missing payments based on spend data) in addition to meeting customer purchasing needs.
 - **The new direct model.** In this third model, banks would enhance the customer experience and strip out costs through new digital technologies. A direct model could eliminate 30 to 40 percent of operations costs, and at the same time create differentiated experiences for each customer segment, based on needs and overall profitability. These banks could market and enable account opening through entirely digital channels, with mid- and back-office fulfillment almost fully digitized. Statements and direct billing tied to linked deposit accounts would all be electronic. This model could work for multiple accounts for each customer, driving incremental cost savings.
3. *Ruthlessly remove costs.* To boost profitability, banks need to reduce payments expenses on multiple tracks, including:
- **Going lean.** Banks can target rapid cost optimization through comprehensive im-

improvements in payments processes. Financial institutions can reduce their overall expense base by 10 to 30 percent by running a comprehensive lean program across most common payments processes (for more, see “The time is right for lean in payments,” *McKinsey on Payments*, June 2009).

- **Consolidating payments utilities.** Banks can selectively consolidate payments utilities within and across regions, and across retail, corporate and wholesale businesses, to make operations more efficient. Changing core utility processes is a complex challenge, but new approaches to creating shared payments capabilities either in front of or behind core booking systems can save significant costs. Further, banks can deliver capabilities to clients through shared payments layers that provide distinctive services (e.g., real-time integrated payments tracking tools for corporate clients). In addition, we also see opportunities for banks to create shared utilities for highly commoditized activities, driving costs down even further.
- **Moving to lower-cost labor.** Banks that have developed a single payments exception processing platform can move the majority of operations resources focused on the task to near-shore (and potentially offshore) low-cost labor locations.

Putting payments center stage

To successfully confront the new payments landscape, banks must also rethink the organizational processes that drive change. Payments should be at the top of the CEO agenda, and firms should have coordinating bodies that can focus on institution-wide opportunities. There are three current models for coordination.

In the first, which could be termed *Let a thousand flowers bloom*, individual business units set their own strategy with minimal coordination. This can leave managers empowered to grow sizeable, but largely independent, business units. However, the model is not capable of capturing the complex payments opportunities likely to drive the next wave of growth in the industry.

The second model is the *payments operating unit*, which combines all payments businesses into a single or a few operating units. While this increases coordination it is often impractical and can create other inefficiencies (e.g., separating consumer payments from consumer lending). A few U.S. institutions have tried to combine front-office assets (US Bank has a payments business unit and American Express recently formed a payments division), but institutions that have combined front offices have rarely reaped the benefits they anticipated. European banks such as Barclays have had some success combining processing, infrastructure and operations units (e.g., check and card processing, cash management operations) into a single business unit to improve costs.

Finally, there are coordinating mechanisms such as *payments councils* or payments “czars,” which are empowered to set strategy and pursue opportunities that cut across business units. While the effectiveness of councils has been mixed thus far, we believe this model is the best way to ensure that payments stay a core part of a bank’s strategy.

Payments councils are common in large banks, but vary in size and in the type of role they play and their degree of responsibility. They can be divided into three basic types:

- **Educators.** This is a collection of experts tasked with spreading the payments word throughout an organization. They do valuable work, but commonly run into one or both of two main barriers in their quest to set payments strategy: a lack of authority to hold people and lines of business accountable, and a lack of recognition as a strategy-setting body.
- **Coordinators.** Coordinating councils are jacks-of-all-trades, tasked with coordinating competing business lines. They are similar to educators, but are seen as mediators, while educators are not. Neither are considered drivers of payments strategy.
- **Strategists.** Strategist councils are empowered to set the strategic direction of payments within an institution. To this end, they must have the authority to hold people and lines of business accountable for executing that strategy.

4. Develop integrated value propositions.

Banks need to think beyond their own direct customer relationships and focus on how they can add value by augmenting commercial customers' own offerings. In one approach, a bank could provide all of a customer's payment and collection needs, and develop industry-specific solutions (e.g., telecom, property management). A bank might integrate payments and broader deposit-raising capabilities to increase the deposit base. The growth in supply-chain financing solutions is a perfect example: Banks are developing transaction platforms to integrate buyers and sellers along a supply chain and bundle financing services along with payments and invoice present-

ment. On the retail side banks could develop more needs-based current account/payments propositions to grow transaction volumes and, perhaps more importantly in today's environment, liquidity.

5. *Innovate and invest in disruptive plays.* Banks have at times been slow to spot new opportunities. They exited the merchant acquiring business just as it took off, and ceded the C2C market to PayPal. There are several emerging areas where banks could be more active and regain momentum:

- Banks should stake out an ownership position in *mobile commerce* before telecom providers take the lead. At the very least, they should take part in shaping the land-

To be effective, any payments council must have the following characteristics, grouped under three themes: *organization, mandate and tools*.

1. *Organization.* In this context *organization* refers to a set of principles that govern how an institution thinks about their council. These principles should always include:

- Strong support of senior management, and the authority to make critical decisions (e.g., to reprioritize investments or redistribute P&L)
- Flexibility to incorporate additional participants in council efforts
- Lean but effective staff to support council operations

2. *Mandate.* When a payments council fails, it is often due to the lack of a focused mandate. To avoid creating tenuous situations for a council, the mandate should be defined around a finite set of guiding principles:

- Emphasis on action, not just discussion
- Focus on important issues with clear bottom-line impact
- Select initiatives the council is uniquely capable of driving
- Realistic ambition

3. *Tools.* To succeed, a payments council requires a suite of tools to provide insights into an institution's payments business. The resources in an effective council's arsenal typically include:

- Payments P&L
- Industry research and analysis
- Ad hoc workgroups and workshops
- Portfolio of initiatives

Finally, a payments council should be led by a seasoned executive capable of moving the organization, working across silos and marshalling resources for high-value initiatives.

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scape to ensure a seat at the table. Banks should be a part of industry associations or utilities to define standards or create shared platforms.

- Banks should develop solutions and services for the *electronification of the entire B2B purchase-to-pay value chain*. Processes for purchase orders, invoices and bills of lading are still remarkably slow, error-prone and costly. Banks are well-positioned to address these issues and provide related services such as supplier financial risk management and AR/AP management. If banks do not do so, there are companies outside the financial industry ready to step in.
- Banks should strategically invest to redefine how consumers, businesses and governments interact. As an example, health care payments and other paper-intensive areas are markets in need of innovative solutions.

The foregoing five strategies represent, we believe, the most viable, promising and sustainable paths forward for banks and other payments players.

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The global payments industry is emerging from a period of unprecedented change and turmoil. As the dust clears, there are great opportunities and, inevitably, threats. Smart banks and payments players will now make bold decisions on where and how they do business. They will reinvent broken business models, make step-change cost reductions, and, as always, execute with discipline. Those that succeed will shape, and profit from, the new payments landscape.

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