Finding new cost efficiencies in European card processing

Cost efficiency has long been an area of focus for payments processors in the European card market, and a number of trends are driving banks and specialist processors to redouble their efforts. Traditionally, processors have depended on building scale as a cost-control lever, but overcapacity in today's market makes this approach untenable. Processors are therefore in search of new ways to control costs.

Vaibhav Dayal

Tobias Lundberg

Massimiliano Merlini

A few leading players are already achieving savings and productivity gains by targeting specific processing steps or elements of the value chain. However, the biggest savings—up to 25 percent of the total cost base—are likely to come from programs that approach cost reduction in a holistic manner. To make this approach work, processors first need to identify where on the card processing value chain they can improve.

Mounting pressure on costs

Three trends are intensifying the focus on capturing cost efficiencies. First, the structure of the market is changing. New entrants are providing innovative offerings in such areas as mobile point-of-sale (mPOS) payments and acceptance, information-based business models, remote payments and new currencies, and business-to-business payments and e-invoicing. Where these innovations overlap with established models, some new entrants have chosen to expand the value chain by building on existing infrastructures. Although this strategy may pose a risk of commercial disintermediation for traditional players, it does leave some revenues on the table. For instance, PayPal has built direct relationships with online merchants but continues to operate on traditional credit and debit card architectures.

Meanwhile, commoditization of traditional processing services, combined with an excess of capacity, is putting price pressure on processors during contract renegotiations and renewals. Between 2004 and 2012, processing costs in Europe dropped 27 percent, driven by commoditization (Exhibit 1, page 28).

These price cuts are also reducing the attractiveness of disintermediation for new market entrants; as long as processing prices remain low, they have little incentive to develop platforms that might put traditional processors out of the game.

In the past, falling prices have been offset by the increase in transaction volumes. Between 2004 and 2012, the average processing cost per transaction fell by a compounded annual rate of about 4 percent, while transaction volumes rose at a compound annual rate of 9 percent. This trend, however, is unlikely to continue. Long-term processing contracts are being renewed at discounts as high as 30 percent, while projections for 2013 to 2017 indicate that the rise in transaction volumes is slowing to 5 to 6 percent per year CAGR. In the absence of new value-added services to mitigate this margin erosion, banks and specialist processors are struggling to maintain their profitability and prepare to compete with digital challengers.

The second key trend driving cost efficiencies is the loss of momentum in outsourcing. McKinsey estimates suggests that, in the past few years, banks have started to bring their issuing transactions back in house; between 2004 and 2010 the share of outsourced volumes fell from 45 to 32 percent. Over the same period, outsourced volumes on the acquiring side shrank marginally, from 40 to 39 percent of total transactions. With outsourcing no longer on the rise, the prospect of a card processor building enough volume to move along the scale curve is remote.

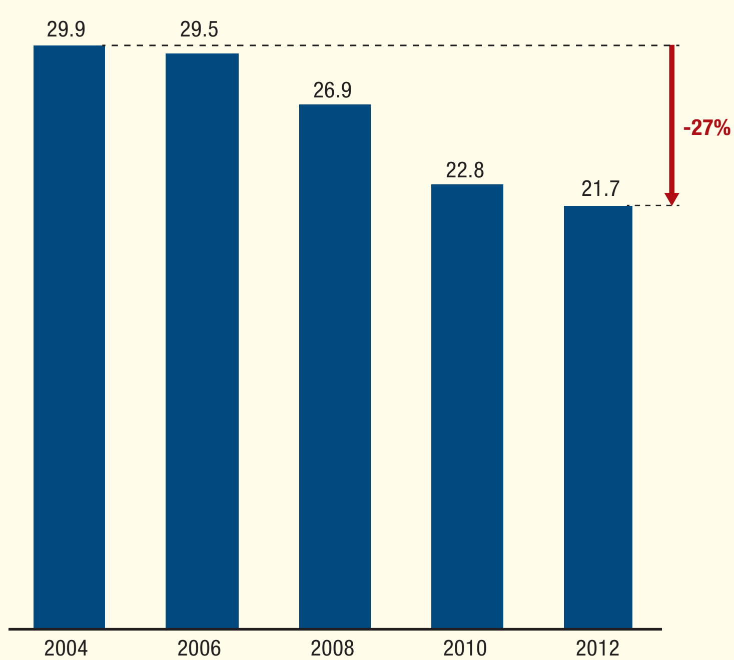
Third, integration among European processors has been slow to take off. Early consoli-

Exhibit 1

Commoditization and competition are reducing card processing costs

Evolution of card processing costs

Euro cents per transaction



Source: McKinsey Card Processing Cost Benchmark dation moves triggered by the establishment of the Single European Payments Area failed to gather pace and the market remains fragmented, with the top 10 processors handling only about two-thirds of card transactions. This market fragmentation is exacerbated by fragmentation at the level of individual players. Most processors still operate multiple legacy platforms and have yet to develop a single integrated platform capable of exploiting economies of scale.

Together, these trends are pressuring processors' margins. Their traditional response has been to build scale to reduce costs. However, in a market characterized by excess capacity, reaching critical scale is no longer a realistic option for the majority of players.

McKinsey analysis indicates that holistic implementation programs that tackle multiple efficiency opportunities at once can capture savings worth up to 25 percent of a card processor's total cost base.

What can processors do?

Unable to rely on scale to drive cost efficiencies, card processors are exploring other options. They are looking at the structure of their operations, their sourcing models, the complexity cost of dealing with multiple countries and currencies, and the IT infrastructures that underpin their platforms. A few examples illustrate the range of approaches:

- After mapping key processes in its administrative department, a payments processor identified considerable scope for improving efficiency by automating or offshoring some transaction processes, managing demand more rigorously and streamlining its organization.
- In partnership with the issuer, a processor analyzed card usage by different customer segments, established rates of return on investment for each segment, and launched initiatives to encourage higher usage among the most profitable segments. The processor targeted a potential profit uplift of more than 40 percent, driven by a combination of cost savings and targeted income initiatives.
- Another card processor identified opportunities to apply lean methods to improve the output of its IT application development by more than 50 percent. By implementing the change in waves, the processor was able to capture early savings from its initial moves and use them to fund improvements in the next wave of initiatives.
- Having reviewed its indirect procurement costs, another player unlocked savings by consolidating its facility to eliminate redundant desk space and by addressing staff travel expenses through the introduction of new booking policies, price-based vendor selection, and negotiations for rebates on high-volume routes. These types of initiatives can generate cost reductions of between 10 and 20 percent.

Initiatives like these can deliver valuable benefits, but when developed as part of a comprehensive approach they offer even greater potential. McKinsey analysis indicates that holistic implementation programs that tackle multiple efficiency opportunities at once can capture savings worth up to 25

McKinsey's card processing benchmark

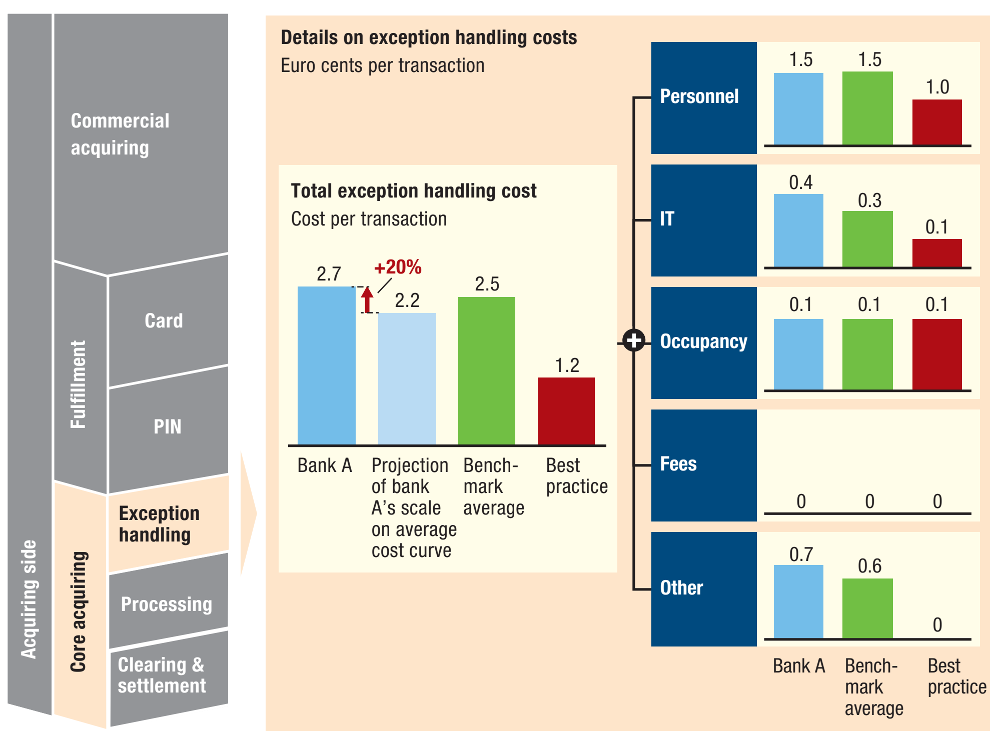
McKinsey's Card Processing Benchmark extends across the entire processing cost base for credit cards and international and domestic debit cards. The data in the benchmark accounts for half of the entire outsourced card market in Western Europe. In 2012 it covered the processing of some 205 million issued cards and 9 billion acquiring transactions across 28 dedicated platforms in 14 countries.

The benchmark covers all activities in *issuing* (commercial issuing, fulfillment, processing, exception handling, clearing and settlement, and value-added services) and *acquiring* (POS commercial acquiring, POS fulfillment, ATM fulfillment, acquiring processing, exception handling, clearing and settlement, and value-added services), as well as all cost categories (personnel, hardware, software, occupancy, fees and central functions).

For each step in the value chain, the benchmark produces a granular breakdown on cost drivers. The exhibit illustrates an example deep dive into the cost of exception handling across a processor's core cost driver components. The benchmark provides comparisons with best practices as well as the benchmark average to reveal the full scale of opportunities for cost savings across products, regions and steps in the value chain.

To discuss a full diagnostic on your organization's current level of efficiency, please contact one of the authors:
Vaibhav Dayal (vaibhav_dayal@mckinsey.com) or
Tobias Lundberg (tobias_lundberg@mckinsey.com).

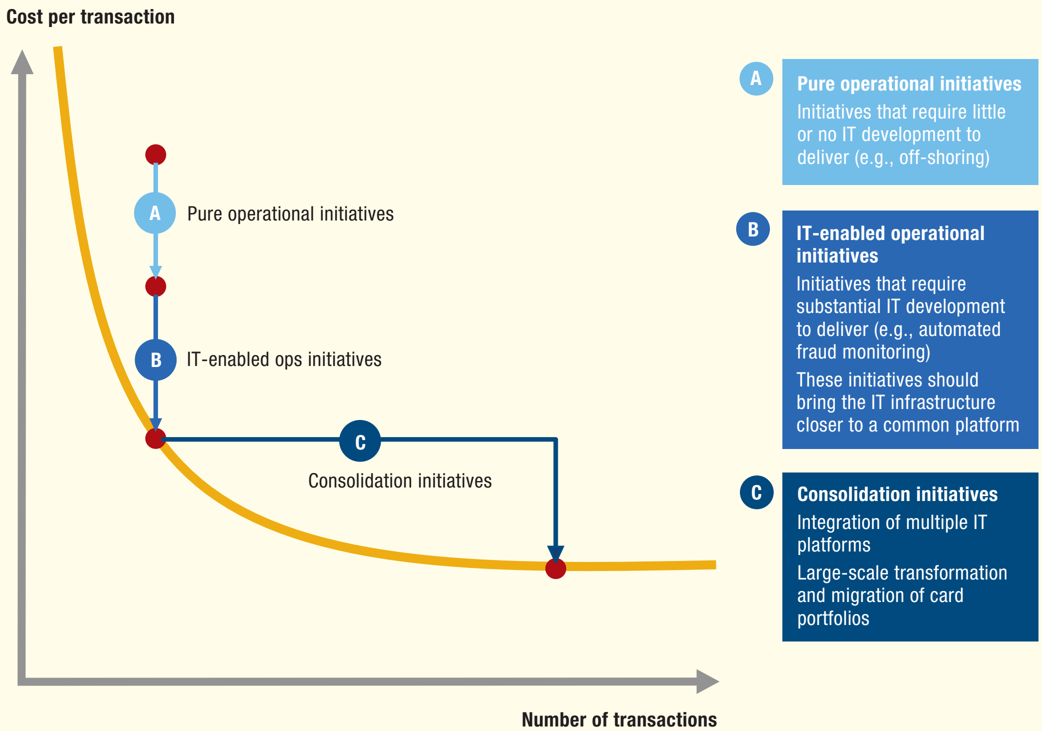
A deep dive into a specific cost area uncovers opportunities for efficiencies



Source: McKinsey Card Processing Cost Benchmark

Exhibit 2

Grouping initiatives in waves enables smarter implementation and early delivery of benefits



Source: McKinsey Card Processing Cost Benchmark

percent of a card processor's total cost base. At the same time, these programs help organizations improve their focus on customers and performance.

A comprehensive approach

To diagnose their current situation and design and implement a comprehensive improvement plan tailored to their needs, card processors will need to focus on three key imperatives:

1. **Ensure transparency so the organization can benchmark costs.** The first step is to map costs along the value chain so that unitary costs can be compared with the industry average for players of similar scale. The company can then explore initiatives using activity process mapping, lean diagnostics and a review of spend areas.
2. **Adopt a pragmatic approach to implementation planning.** To avoid long, complex and costly platform consolidation programs, organizations should evaluate cost/benefit calculations against time-to-implement to find the right trade-offs and balances. By implementing initiatives in progressive waves—first purely operational initiatives, then IT-enabled initiatives, and finally business consolidation initiatives—they can reduce risk and capture a significant portion of the cost savings at an early stage in the process (Exhibit 2); for many players the focus will be to move down the internal cost curve, not to gain scale.

3. **Set up a value assurance program** to ensure that the desired impact will be captured on time and on budget. Many projects suffer cost overruns due to insufficient rigor in project management and a lack of attention to cultural aspects of change. Value assurance should focus on managing strategy and stakeholders, excelling in project management, mastering technology and content and building team and capabilities.

* * *

Banks and commercial processors seeking to unlock value from cost efficiencies need to first understand their current cost position and how it compares with that of other players handling comparable transaction volumes. To be actionable, this comparison must be granular, allowing the processor to clearly map where the inefficiencies are clustered. Armed with these insights, a card processor can then take practical steps to eliminate waste. These steps might include consolidating platforms, increasing automation, outsourcing and offshoring selected activities, or adopting lean management methods in operations, IT and sales. With the improvement initiatives in place, the company can then assess its potential to improve costs, evaluate the capabilities of its organization to implement the changes, and draw up a road map and implementation plan to capture maximum impact.

Vaibhav Dayal *is a senior analyst in McKinsey's Gurgaon office,* **Tobias Lundberg** *is a consultant in the Stockholm office, and* **Massimiliano Merlini** *is an alumnus of the Milan office.*