The Boston Consulting Group

Global Payments 2013

Getting Business Models and Execution Right

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INTRODUCTION

The payments and transaction-banking businesses represent an increasingly critical element of the banking industry and the global financial-services landscape. Their importance as key generators of stable revenue streams and as the linchpin of customer relationships—and therefore long-term customer loyalty—will only gain momentum throughout the rest of the decade. Institutions that are active in these businesses need to take stock of their capabilities and performance, sharpen their strategies, and lift their execution skills.

In our previous reports on the global payments industry, we have typically taken a regional approach, looking separately at the state of play in the Americas, Europe, and Asia-Pacific. Last year, in a departure from tradition, we published *The Transaction Banking Advantage: The Path to Profitable Growth,* a collection of four articles that addressed key transaction-banking topics: operating models in wholesale transaction banking; the rise of the Asia-Pacific region and global trade flows; mobile payments; and payments opportunities in emerging markets.

This year, in our eleventh Global Payments report, we return to our traditional format and present updated data on payments trends. As part of this update, we have worked with SWIFT, the global provider of secure financial-messaging services.

Rather than take a regional perspective as we have in the past, we first offer a global overview of the industry landscape, then concentrate on three high-stakes topics: key success factors in wholesale transaction banking, the impact of digital technology on acquirers and payment service providers, and the state of the global cards business.

We define payments revenues as direct and indirect revenues generated by a payment service. These include transaction-specific revenues, card and account maintenance fees, and spread income generated from current accounts, also known as checking or demand-deposit accounts (DDAs). Fees for overdrafts and nonsufficient funds are considered transaction-specific revenue. (See the Appendix for details.) Given this definition, payments make up approximately one-quarter of total global-banking revenues. We define transaction banking as products and services related to payments, such as cash management services for corporate clients.

Our aim in *Global Payments 2013: Getting Business Models and Execution Right* is to provide institutions that are active in the payments and transaction-banking businesses with provocative food for thought about where the industry is going. We also offer recommendations on which specific steps should be taken by different types of players in order to achieve or maintain leadership positions. In today's hyper-competitive "new new normal" environment, five years after the depths of the global financial crisis, few institutions can afford to maintain the status quo. The payments industry is in flux, and its basic economics—notably the shift from account-based revenues to fee-based revenues—is changing the landscape. The winners throughout the remainder of the decade will be those institutions that effectively adapt their business models and sharpen their execution capabilities in the changing environment.

OVERVIEW

ADAPTING TO THE "NEW NEW NORMAL"

In the years following the 2008–2009 financial crisis, the payments and transaction-banking businesses have been vital revenue generators for banks. In 2012, these businesses generated $301 billion in transaction-specific revenues (including monthly and annual card fees) as well as $223 billion in account-related revenues (including account maintenance fees and spread revenues). The total represented roughly one-quarter of overall global-banking revenues. Banks handled $377 trillion in noncash transactions in 2012, more than five times the amount of global GDP.

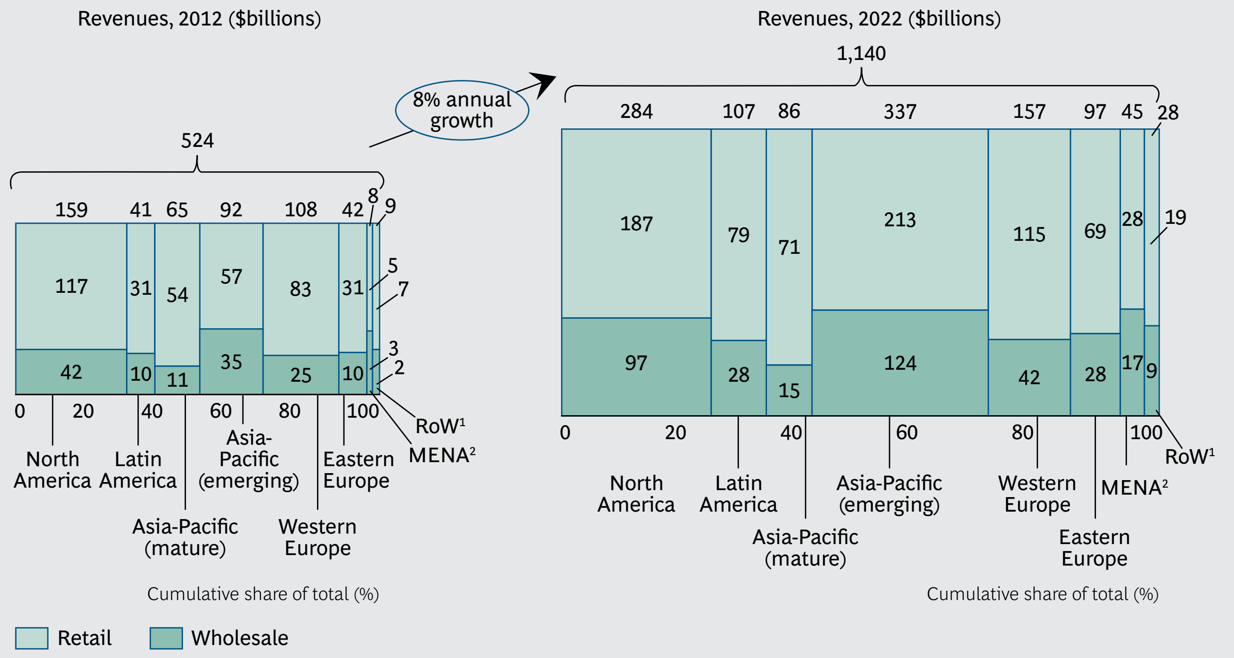
And business keeps growing steadily. By 2022, payments and transaction-banking revenues will reach an estimated $1.1 trillion, a compound annual growth rate (CAGR) of 8 percent. (See Exhibit 1.) The revenue mix is expected to shift toward account-related revenues as yield curves steepen and as pressure on transaction fees persists. The value of noncash transactions will reach an estimated $712 trillion by 2022, a CAGR of nearly 7 percent.

Overall, payments-related businesses have continued to serve as a relatively stable source of income for banks, providing a solid platform on which to build customer loyalty and increase share of wallet. Moreover, with the exception of credit cards, payments businesses still possess structural advantages such as consistent, predictable volumes and relatively low (non-capital-intensive) risk factors. These businesses have helped banks considerably by providing a low-cost source of funding and liquidity.

At the same time, payments-related businesses continue to face challenges on multiple fronts. Regulatory pressures stemming not only from the implementation of the Single Euro Payments Area (SEPA) but also from interchange fee legislation, along with intensifying competition and disruption by new entrants, are taking a toll. In addition, the attributes of payments businesses have attracted nonbank providers in key areas such as mobile payments and related deals and offerings on the retail side, and in supply chain financing on the wholesale side. The cumulative impact of these forces is evident. The average per-transaction fees earned by banks are broadly poised to decline, particularly in mature markets. (See Exhibit 2.)

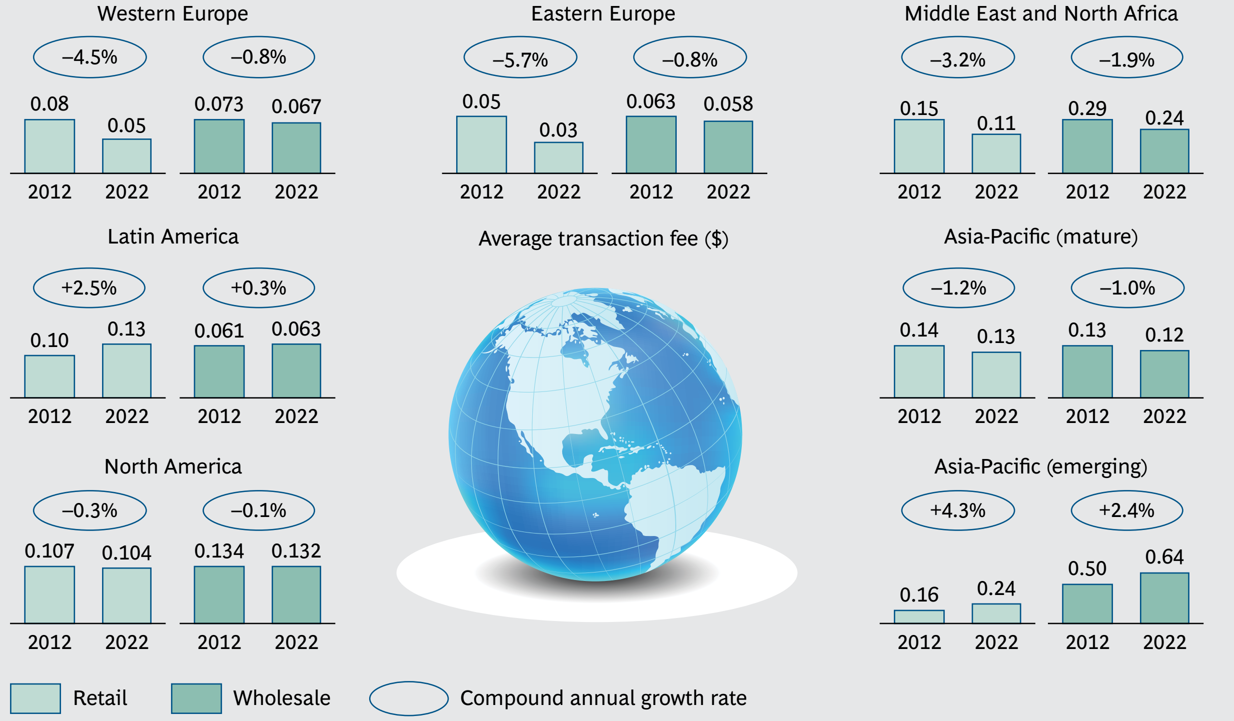
Given the size of the revenue pools at stake, banks will have to adapt to this "new new normal" climate and sharpen their business and operating models accordingly. Particularly in mature markets, higher levels of customer-centricity and a greater emphasis on execution excellence will be key success factors in winning share from competitors. Crisper pricing strategies, along with more-efficient processes and systems, will become core

EXHIBIT 1 | Payments and Transaction-Banking Revenues Combined Will Reach an Estimated $1.1 Trillion by 2022



Sources: BCG Global Payments Model, 2013; BCG analysis.
[1]Rest of world.
[2]Middle East and North Africa.

EXHIBIT 2 | Average Fees per Transaction Will Decline in Mature Markets and Increase in Some Emerging Markets



Sources: BCG Global Payments Model, 2013; BCG analysis.

capabilities for maintaining margins and, even more important, for cross-selling.

The Two-Speed World

While payments activity is increasing in all regions, there are widening gaps between how the industry is evolving in mature economies and its evolution in rapidly developing economies (RDEs), in line with what has become known as the two-speed world. From 2012 to 2022, payment values and volumes alike are projected to grow at a CAGR of 11 percent in RDEs, compared with 4 percent and 5 percent, respectively, in the developed markets. Similarly, RDEs will generate stronger revenue growth—a projected CAGR of 12 percent in total payments-related revenues—than the developed markets, where revenues have a projected CAGR of 5 percent.

Underlying this dichotomy are numerous socioeconomic factors and industry drivers. Mature markets are challenged by thin margins, modest economic growth, generally older populations, and legacy payments infrastructures that are expensive to replace or remodel. Compounding the systemic trends, the sluggish economic recovery in the developed markets since the depths of the financial crisis has slowed new business growth and investment. Because few greenfield opportunities exist in these markets, payments growth must be achieved by capturing a greater share of wallet. Banks have the opportunity to ease some of these pressures and reverse the revenue slide if they succeed in three core dimensions: improving their go-to-market capabilities, creating stronger links between their payments business and other banking services, and making their operations more efficient. (Operational efficiency is also discussed in *The Road to Excellence: Global Retail Banking 2010/2011,* a BCG report, December 2010.)

These levers will need to be used differently in various regions and countries. In continental Europe, for example, profits will primarily come indirectly through improved cross-selling. In North America and the U.K., there are still new revenues to be earned directly, especially from the credit card business, and also from cross-selling initiatives.

In RDEs, by contrast, greenfield opportunities remain bountiful. RDEs are benefiting from rapid GDP and income growth, more-active government involvement in building new payments infrastructures, and relatively young populations that help drive the adoption of new technology. A further catalyst is the fact that many domestic corporations in RDEs tend be in strong growth phases, with some rising to displace established corporations among the top 500 global companies.

Moreover, some RDE market characteristics that can be seen as disadvantages from a public-policy and economic-efficiency standpoint—such as the high use of cash and a high level of unbanked households—present clear opportunities for payments players. The migration of cash to cards and e-payments, along with initiatives to improve financial inclusion, will open numerous paths for new payments growth.

> The migration of cash to cards and e-payments will open new paths for growth.

Alternatives to credit cards (such as debit cards) as well as online and mobile payments have already played a critical role in revenue growth in RDEs because they serve as entry and retention vehicles for one of the most lucrative offerings in retail banking: the savings account. Evidence shows that customers who use alternative payments methods tend to keep more funds in their accounts for longer periods of time than do customers who withdraw cash at ATMs. The use of these alternative products also helps deepen customer loyalty.

In our work with clients, we have observed that the frequent use of alternative payments products—at relatively high spending levels—can lead to savings account balances that are 50 percent higher across income segments, gender, and age. This lever is even more powerful in RDEs than in mature markets, where savings and loan spreads are much wider. The spread on savings accounts in India, for example, is around 3.5 percent. It is therefore imperative for banks in RDEs to develop innovative alternative-payment channels in order to attract new customers. Banks in RDEs will also need to have highly segmented business models in order to effectively target those customers who are most likely to generate account balances.

There will likely be continued double-digit growth in card payments in Latin America.

In Africa and in the emerging markets of the Asia-Pacific region, growth will be achieved chiefly through greater financial inclusion. Mobile payment and mobile bill-pay products will enable banks to reach outlying areas where formal banking and the Internet have not yet penetrated deeply. In Latin America, several countries are well along the path of migrating cash to cards and e-payments—and have witnessed rising rates of financial inclusion. As a result, both the volume and the value of payments in Latin America are projected to grow at a CAGR of 7.5 percent from 2012 to 2022 (excluding Brazil, where the projected CAGR is 9 percent). Payments-related revenues across the region are growing at a CAGR of 10 percent. In particular, both credit and debit card transactions at the point of sale are growing at CAGRs of 20 to 25 percent in value and 10 to 15 percent in volume in Latin America (excluding Brazil).

In the coming years, we are likely to see continuing double-digit growth in card payments in Latin America. Regulation will put pressure on margins, but fee-based businesses will remain attractive. Also, we will likely witness the expansion of e-commerce (with more gateways and e-wallets), the launch of mobile payments solutions (including mobile-based point-of-sale technologies and mobile wallets), and the proliferation of micromerchant and micropayment solutions.

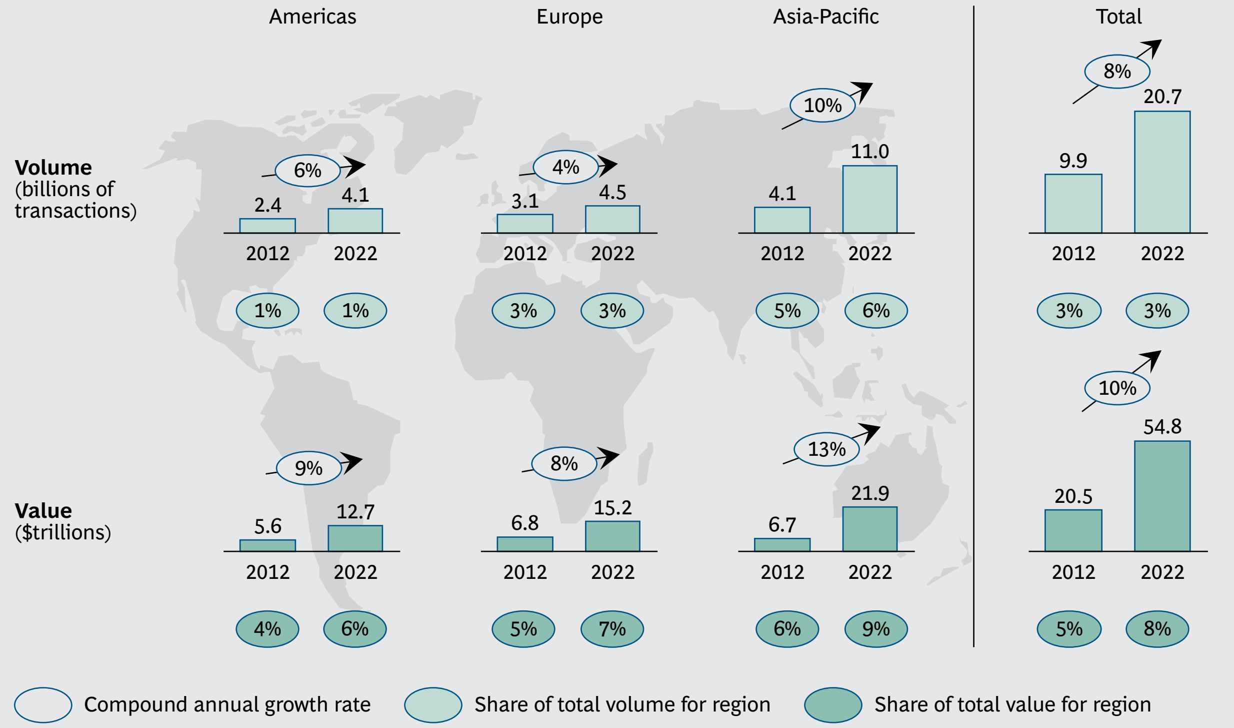
Although growth opportunities are abundant in RDEs, banks still need to foster a culture of innovation and rethink their organizational models for payments if they hope to take a leadership position in new businesses—prepaid cards being just one example. New ideas will be required in order to win market share because many consumers are averse to changing financial institutions once they have constructed a solid and reliable banking relationship for payments products.

Indeed, some innovative banks in RDEs are already challenging established lending-heavy banks to become the "house bank" for companies—the bank that handles a company's commercial payments. In India, for example, public-sector banks (which currently hold about 70 percent of all banking assets) are losing share as private-sector banks develop inventive, successful house-bank propositions. Over the next few years, public-sector banks are expected to show a CAGR of 15 percent in payments-related revenues, compared with 25 percent for private-sector institutions. Some of the latter group are adopting business models similar to those built by transaction-banking leaders in developed countries.

Strong Trade Growth and Cross-Border Payments

In addition to benefiting from strong economic growth drivers in RDEs, payments players have a sizable opportunity to ride another growth wave: the increasing demand for cross-border payments and related services, driven by rising trade flows worldwide. Globally, the volume of cross-border transactions will rise at a projected CAGR of 8 percent from 2012 to 2022. (See Exhibit 3.) Underpinning these increases is the vigorous growth in trade, which has been expanding at twice the rate of global GDP, as well as the easterly shifts in trade flows that have contributed to the exceptionally strong growth of payments businesses in the Asia-Pacific region. (See also "Profiting from Asia's Rise and from New Global Trade Flows," a BCG article, October 2012.) Asia-Pacific's share of global trade jumped from 22 percent in 2001 to 30 percent in 2010 and is expected to rise to 35 percent by 2020. One consequence will be ongoing new payments opportunities, particularly in the six markets forecast to rank

Exhibit 3 | The Volume and Value of Cross-Border Payments Transactions Are Growing Steadily



Sources: BCG Global Payments Model, 2013; BCG analysis.
Note: Cross-border payments transactions include all payment types.

among the world's top ten trading centers in 2020: China, Japan, India, South Korea, Singapore, and Hong Kong.

More broadly, banks in both RDEs and the mature markets must scrutinize their business and operating models if they hope to capture growth opportunities and minimize the adverse consequences of price pressures.

Ultimately, the "new new normal" climate in the payments industry is bringing both threats and opportunities. The name of the game will be customer-centricity, integrated business models, and execution excellence. With significant revenue pools at stake and pockets of strong growth obtainable, the winners will reap high returns on their investments.

THE WHOLESALE TRANSACTION-BANKING IMPERATIVE

Current market dynamics are pointing increasingly to wholesale transaction banking as a key lever for improving return on equity in the global banking industry. In 2012, wholesale transaction-banking revenues were about $220 billion, or roughly 15 percent of the total corporate-banking revenue pool. Nearly $140 billion was from transaction-specific fees and current-account-related revenues (shown in Exhibit 1), and another $80 billion was from value-added services, such as information reporting and trade-related services. Transaction fees and account revenues combined are projected to grow at a CAGR of 10 percent through 2022, reaching more than $350 billion. This expansion will be driven by modest but steady growth in the developed economies, continued strong growth in RDEs, and margin improvements as the yield curve rises and steepens.

Indeed, especially in developed markets, the combination of deleveraging and a higher cost of funding has led banks to focus increasingly on attracting stable transaction deposits from their wholesale clients. At the same time, a depressed return on equity is emphasizing the need for improved fee-business and deposit generation—as well as greater liquidity—to compensate for reduced trading and sales revenues.

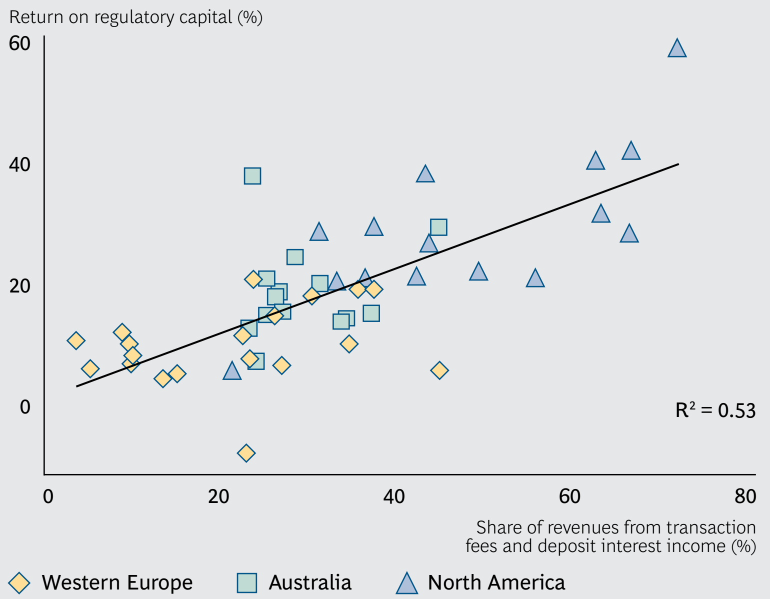
Banks that excel at wholesale transaction banking—institutions that we refer to as *transaction-banking champions*—have been able to gain a significant advantage over their peers in this environment. They generate higher profits, form deeper client relationships, leverage pricing to their advantage, and seize growth opportunities rapidly. (See Exhibit 4.) Most important, they have created a stable, reliable business.

These banks have also achieved better loan-to-deposit ratios (under 125 percent) and a lower cost of funding. Their diversified revenue mix, with more than 40 percent of revenue originating from noncredit businesses, has allowed them to achieve a significantly higher return on equity. The strong transaction relationships that these banks have developed with their clients have also opened significant possibilities for additional fee-product penetration beyond transaction banking, such as FX and trade-related products.

True transaction-banking champions possess a clear sense of their strategic strengths and boundaries, as well as a relentless focus on execution excellence. Roughly 25 percent of global revenue pools in wholesale transaction banking are linked to large multinationals and financial institutions. This is the realm of a select number of global banks that combine universal reach with continuous product innovation and a high level of customization.

EXHIBIT 4 | Transaction-Banking Champions Are More Profitable and Have Stronger Client Relationships

Profitability



Client relationships

- **Stickier client relationships:** Banks with deeper multiproduct relationships often have transaction services embedded in their clients' business processes.
- **Advantaged pricing:** Banks with strong multiproduct relationships generate better risk-adjusted loan margins than lending-heavy banks.
- **Additional growth opportunities:** Core transaction relationships create possibilities for additional fee-product penetration, including foreign exchange, international products, advanced liquidity solutions, and industry-specific payment platforms.

Sources: BCG Corporate Banking Benchmarking database; BCG analysis.
Note: Loan losses are normalized to 50 basis points for all participants to control for country and credit-cycle differences.

Nonetheless, 75 percent of revenues are concentrated in cash management products and services for small to midsize corporations in the banks' home markets. Tapping these revenue pools does not require sophisticated value propositions with global access and highly innovative products, but rather an obsessive focus on execution: how to sell, how to price, and how to organize the servicing model.

Making the Sales Machine Hum

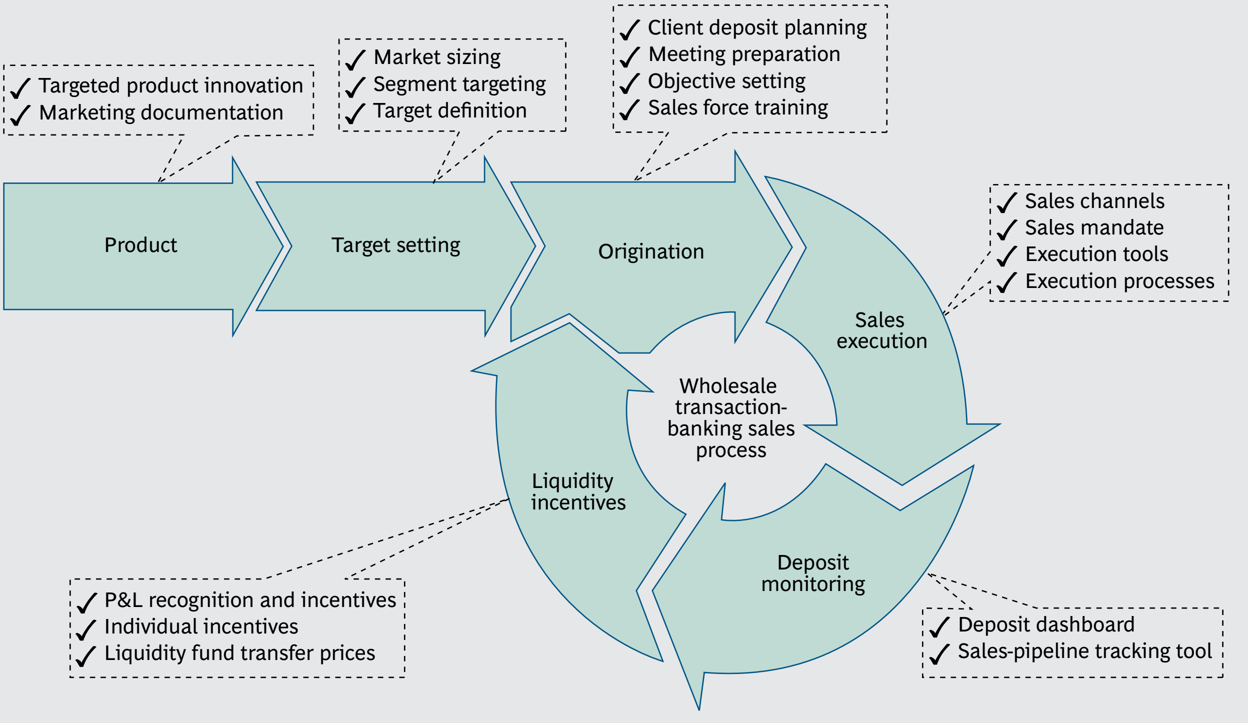
Leading transaction banks have realized that best-in-class sales processes still make the difference in the market. They focus on identifying high-potential clients and maximizing contact with them. They are highly analytical in the way they uncover pockets of opportunity.

There is no silver bullet for excelling in sales. But the leading banks seem to be highly disciplined at aligning and executing all elements of the sales cycle, cutting across traditional silos. They focus efficiently and effectively on product development, target setting, origination, sales execution, deposit monitoring, and liquidity incentives. (See Exhibit 5.)

Product Development. The importance of product innovation differs significantly among segments. For high-end corporate clients, there is clear value in tailored solutions and innovative products. For midmarket clients, the emphasis should instead be on how products are assembled and brought to market. Robust and user-friendly interfaces will remain a key lever for locking in clients and broadening share of wallet. Improved channel offerings that include new tools for assisting client decision-making will increasingly allow customers to self-select their best product solutions. Finally, for the smallest clients whose individual value typically does not merit the intervention of product specialists, leading banks are increasingly bundling products into more standardized solutions in order to enable generalist relationship managers to cross-sell more efficiently.

Target Setting. Transaction-banking potential is not equally distributed among clients, and sales resources are scarce and expensive. Yet many banks still use only basic client segmentations. The most advanced transaction banks use powerful analytics to differentiate their approach as a function of

EXHIBIT 5 | The Wholesale Transaction-Banking Sales Process Is Multifaceted



Source: BCG case experience and analysis.

client needs and the client's full potential for bank products beyond cash management. They are able to translate the results of sophisticated wallet-sizing models into simple metrics that are easy for the sales force to understand and use. They allocate resources and set targets in line with sales potential. We often see this process result in specific commercial strategies based on industry verticals (such as retailers and traders) and client size.

Origination and Sales Execution. Client coverage matters, but there is no single best way to organize the coverage model, which is highly dependent on each bank's specific situation with regard to targeted segments, market share, and penetration. What sets transaction-banking champions apart is the *clarity* of their coverage model, which enables the sales force to focus entirely on execution. The roles of both product specialists and relationship managers in the sales process are clearly defined, with a strong emphasis on collaboration across silos. Product specialists are assigned to specific client segments, reinforcing the focus on pockets of untapped potential. For example, many leading transaction banks are creating separate roles for "hunters" and "farmers" in their product-specialist teams, with portfolios kept as homogeneous as possible.

Deposit Monitoring. Few would disagree that granular monitoring of volumes and margins is critical to managing the transaction-banking business. Yet it is often the operational difficulties in consolidating information from multiple sources that prove to be the biggest hurdle to transparent reporting. The transaction-banking champions that we have observed have succeeded in combining internal and external information into highly actionable dashboards, providing granular volume and margin evolution, flagging important deviations at the client level, and using this information to manage risk and understand client needs. For example, account activity can reveal seasonal sales trends, predict client borrowing requirements, and help banks monitor specific loan covenants.

Liquidity Incentives. Depending on their specific context and business strategy, banks will vary the ways in which client deposits are recognized on the P&L and how incentives are set up internally. Some will focus on maintaining margins above all else, and others will set up mechanisms for enabling tactical pricing on key deals. Yet product specialists and relationship managers should be measured in the same way if true collaboration across silos is to be achieved. It is particularly important that in setting transfer prices, treasury departments properly balance the funding profile of the bank with the regulatory treatment of operating-account balances. Specific deposit strategies will emerge from this interaction.

Seven Best Practices in Pricing

It is easy to see why many wholesale banks have not yet capitalized on the pricing opportunity when their clients are typically large, sophisticated buyers with stringent procurement processes. Nevertheless, as difficult as it may be to reprice spread-based products (including FX), pricing initiatives can bring excellent results in fee-based products for which the long-term relationship is key. This is especially true with smaller customers for which the bank may be a primary provider.

Based on our research, transaction-banking champions respect seven best practices in the way they price their cash-management products.

Full-Cost Pricing. Banks with high fixed costs focus on incremental revenue to defray those costs. Nonetheless, if the incremental revenue covers only marginal costs, banks can accumulate a large number of clients that do not meet overall margin thresholds. Hence, banks need to set prices on the basis of fully loaded costs in order to avoid margin dilution.

Deliberate De-averaging. Wholesale contracts allow individual clients to be priced according to their competitive intensity and bargaining power. In order to do this effectively, banks must robustly segment clients on the basis of size, stickiness, bargaining power, and the like—and also effectively classify them by revenue contribution (such as gold, silver, and bronze levels) and offer commensurate service.

Smart Bundling. Bundled pricing tends to help cross-sell more products. But poorly structured bundling can cause the provider to lose substantially, such as when clients stop buying the more profitable products but the "bundle price" is maintained on the other products. Control of a client's primary operating account allows the opportunity for credit-offset pricing models in which customer balances can be used to pay for other banking services.

Reversible Volume Discounts. Discounts are a valuable tool for expanding share of wallet, but they should be tiered according to volume ranges—and volumes should be closely tracked. Any declines in volume over time should be met with corresponding adjustments in the pricing structure.

Full Charges. It is common to see "service creep"—higher levels of service with no extra revenue. As much as 50 percent of revenue can be lost due to leakage (not billing for billable services rendered) and slippage (not charging at all for certain services). Service levels must be carefully monitored and managed in sync with price realization.

If incremental revenue covers only marginal costs, banks can accumulate clients that do not meet overall margin thresholds.

Updated Pricing. For the banks that we have observed, almost 20 percent of client contracts were more than 10 years old, with some contracts dating back 20 years. On the basis of inflation alone, prices—and costs—may have risen sharply over those periods. It is important to review all contracts on a regular basis and build in indexation clauses where possible.

Margin-Based Incentives. Including pricing or margin criteria in sales incentives avoids the pursuit of market share at the expense of lower prices (and therefore lower margins).

The Service Model as a Differentiator

Transaction-banking champions have turned the service model into a commercial weapon. There are many ways to optimize the model, but leading banks consistently improve their front-to-back processes, cutting across silos and explicitly considering links between the retail and wholesale franchises of the bank (such as payments and trade finance). They deliberately design customer service models to free sales time—and solicit customer feedback that can be used to enhance products or enrich commercial discussions.

On the one hand, this allows differentiated service levels that are explicitly linked to pricing policies. On the other, efficient delivery models avoid squandering product specialists' valuable time on basic servicing tasks.

More broadly, as critical as it is to become a transaction-banking champion in today's wholesale-banking environment, the goal cannot be reached simply through deposit gathering or prompt service. Building a best-in-class transaction bank takes time and stamina. Most of the leading banks that we have observed have charted a clear road map and spent years fine-tuning their business, operating, and service models.

THE CHANGING WORLD OF MERCHANT PAYMENT REQUIREMENTS

The digital revolution is having a dramatic impact on retail commerce and how consumers make purchases. The e-commerce market continues to grow rapidly. Estimated at $1.1 trillion globally in 2013, up from $0.5 trillion in 2002, it is expected to grow by 15 percent per year even in mature economies such as the U.S. and the U.K. And few product categories are "store advantaged"—just about anything that can be bought in a shop can also be bought online, and often far more conveniently for consumers.

In this environment, merchants with a brick-and-mortar presence are seeking to defend their market positions from purely online retailers by using their physical assets to create differentiated cross-channel offerings. Their aim is to merge digital elements with their physical stores. In its simplest form, this can mean allowing customers to buy online for in-store pickup or order in-store for delivery at home. Leading retailers are taking things further by means such as sending targeted offers to customers' mobile phones and streamlining the checkout experience with tablet-based systems at the point of sale.

In order to facilitate the creation of an enhanced multichannel experience, many merchants are revamping their back-office systems to break down existing silos. They aim to create broad inventory visibility across their stores and e-commerce sites. In the same spirit, more retailers are looking to work with a single payments provider across all channels. All of these dynamics are fostering new opportunities for payments players—and generating new revenue pools.

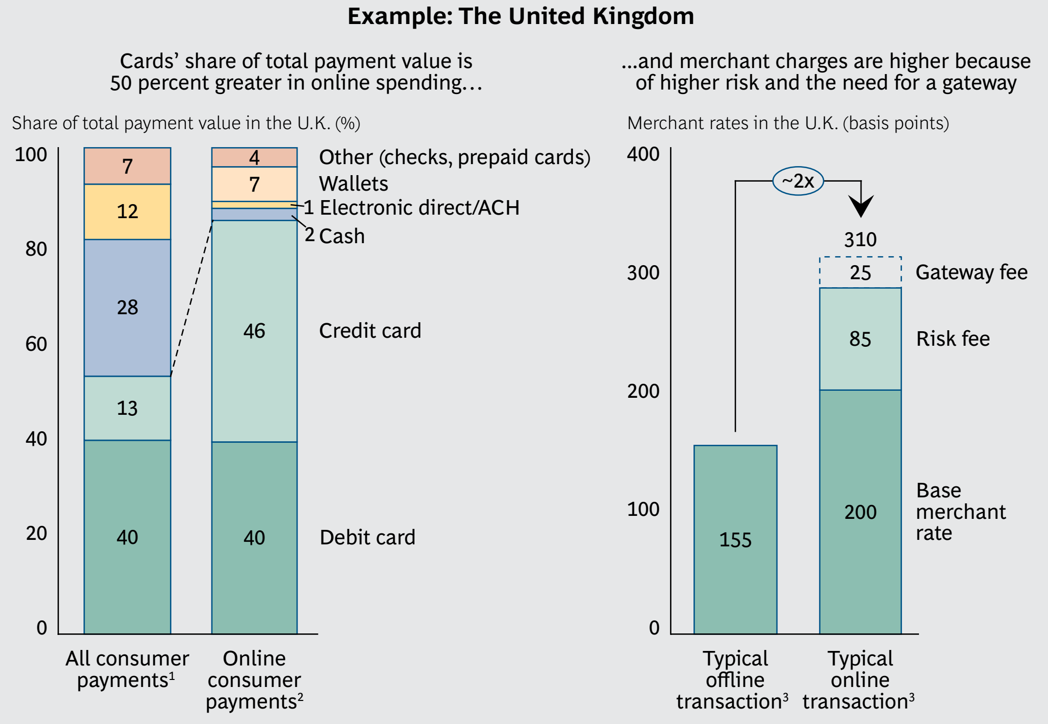
New Revenue Pools

Relative to offline transactions, online spending typically generates two to three times more revenue for payments providers. (See Exhibit 6.) This higher revenue is due both to the payment mix—because cards rather than cash or checks dominate online—and to the additional services, such as fraud management, associated with each transaction.

The global evolution toward more online payments is therefore playing a central role in driving growth in payments-industry revenue pools. In Europe, the revenue pool for payment service providers alone is expected to reach around $1.5 billion by 2016, compared with about $0.8 billion in 2012.

While intensifying competition among payments players will certainly create pricing pressure, higher revenue pools will be supported both by greater complexity in the industry and by merchants' willingness to pay for ways to avoid that complexity. For example, merchants are willing to pay for features such as closer integration into their back-

Exhibit 6 | Online Spending Generates More Revenue Because of Greater Card Share and Higher Merchant Rates



Sources: Euromonitor; Datamonitor; Barclays website; BCG analysis.
[1]2012 Euromonitor data.
[2]2009 Datamonitor data.
[3]BCG estimate for typical small to medium-sized corporate offering.

office systems, multichannel tokenization capabilities, and support for mobile-payment application program interfaces (APIs). International merchants, for their part, require currency conversion capability, greater fraud prevention, and access to local payments schemes and networks of acquirers (which process card transactions for merchants).

Also, particularly in Europe, acquirers are taking advantage of new online-payment capabilities to help merchants overcome the challenges they face in their physical stores. For example, some acquirers are beginning to offer cross-European solutions with consistent reporting and smart transaction-switching.

Intensifying Competition

As payments players look to defend their current positions or build new ones, they are pursuing M&A opportunities. Activity has been heavy in recent years, with the major payments schemes, acquirers, and providers of terminals all buying payment service providers (PSPs). In addition to these moves across the value chain, there has been regional consolidation at each individual step.

We expect to see significant M&A activity continuing as the industry moves toward a new equilibrium structure. Indeed, institutions all along the value chain will need to explore acquisitions, partnerships, and organic investments in order to gain the capabilities they need to thrive in a world increasingly composed of open payments ecosystems. Our overall belief is that there will ultimately be a small number of business models.

For example, small acquirers will need to partner with regional service providers such as traditional hardware suppliers and standalone PSPs in order to gain the capabilities that they will require. These banks will be unable to justify investments in multiple areas—such as in new technology and fraud protection—to develop the necessary capabilities in-house. Moreover, the importance of achieving scale on core technology platforms will mean that only a few regional and global service providers will survive to serve the small acquirers. These providers will also have the opportunity to partner directly with the largest merchants, especially the cross-border ones.

By contrast, large acquirers will be able to afford the heavy investments needed to develop key capabilities in-house, either organically or through M&A. More than a few large banks will likely take this route. Our view, however, is that relatively few will do so successfully. In the end, the winners will have to create the organizational structure needed to achieve multiple tasks: enable innovation, reach the volumes required to justify large investments, deliver a differentiated product to merchants, and extract value from merchants outside of the pure payments-processing relationship.

Moreover, small independent PSPs will survive in two niches. The first is in serving the higher-risk, primarily online-only segment (such as digital-goods or online-gambling concerns) in which they have specific expertise and strong customer relationships. This segment is not of interest to mainstream acquirers. The second niche is in offering a highly differentiated product to a specific set of merchant segments—for example, by offering strong integration with specific enterprise resource planning (ERP) software or focusing on a specific industry.

The Need to Act Now

In order to thrive in the new environment, all types of players will need to adapt—to sharpen their strategies, build scale, and continue to drive improvement in their offerings and operations. Acquirers will need to make the most changes. And while the steps that each must take will depend on their current market positions and capabilities, we see four no-regrets moves.

- *Develop a clear strategic plan for where to build in-house versus where to partner.* This principle holds both for go-to-market matters—local acquirers still have very strong merchant relationships, for instance—and for technological capabilities such as fraud-management solutions. A clear strategy is particularly important for banks that are reinvesting in acquiring as an anchor point for broader corporate-banking relationships. Some will look to build capabilities in-house and drive differentiation, such as one Asia-Pacific bank that has invested heavily in PSP and mobile-based point-of-sale systems. For many, however, particularly those that lack scale, partnerships with existing PSPs and systems integrators will be the best option.

- *Carefully identify the customer segments in which you want to win—and offer the services needed to do so.* Merchant requirements are becoming increasingly diverse, which implies the need to tailor and differentiate in order to deliver optimal solutions. Players may need to make moves along the value chain in order to control key elements of the customer experience. An example might be a PSP taking increased financial risk to improve control of the on-boarding process.

- *Build the IT organization and capabilities needed to work within an open, evolving ecosystem.* Institutions may need to create distinct teams to allow a flexible, iterative, developmental approach for the "consumer" IT experience. At the same time, they will need to ensure strong continuity in core IT skills such as speed, security, and stability. Technical capabilities, such as those needed to create APIs that allow third-party developers to integrate easily, will also be critical.

- *Focus on improving the retailer and cardholder customer experience.* There is much to learn from new market entrants. For example, while we are skeptical about the economics of microacquiring (processing transactions for micromerchants), especially in an EMV world, we believe that microacquirers have changed the game in terms of simplifying and speeding up the merchant setup process.

THE DYNAMICS OF CARDS

THE CARD INDUSTRY HAS emerged from the financial crisis with many challenges to address but also numerous opportunities to capture. The challenges have been brought about by decreased consumer spending, lower receivables (both smaller and fewer), tighter regulation, and intensified competition. The opportunities include new revenue streams that leverage evolving technologies and approaches (such as those related to mobile wallets and big data), new and disruptive business models (such as those created by partnerships across the value chain), and underserved customer segments that are ripe for innovation. A key goal is lowering the cost-to-serve while at the same time improving value propositions, such as for underbanked and unprofitably banked consumers.

To be sure, the retail payments business is once again showing strong growth potential. We forecast that transaction-related revenues generated by consumer-initiated (retail) payments will increase from $249 billion worldwide to $460 billion from 2012 to 2022, a projected CAGR of 6 percent. North America and Asia-Pacific will be the strongest regions, with RDEs in the latter posting the most robust growth. (See Exhibit 7.) In addition, account-related revenues will grow from $138 billion to $321 billion, a projected CAGR of 9 percent.

In order to seize this growth potential, banks must take stock of where they are and where the industry is headed, identify their largest opportunities, and take action on a number of fronts.

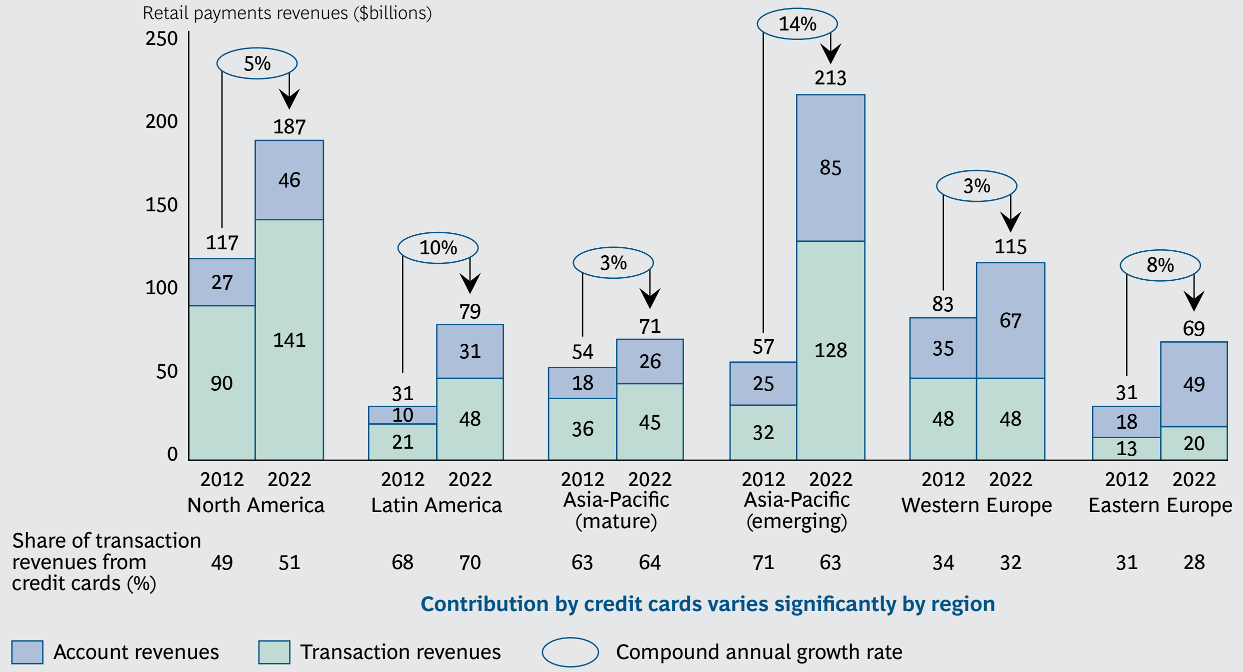
Key Trends in the Issuer Space

The four key trends for card issuers revolve around macroeconomic changes, industry structure and regulation, new technology, and heightened competition in key customer segments.

Macroeconomic Changes. On the transaction side of card revenue streams, slow GDP growth and the sluggish recovery in consumer spending since the depths of the financial crisis have translated into tepid growth in interchange revenues (the fees that card issuers charge merchants). The revolving-credit side of card revenue is also facing challenges. Ongoing consumer deleveraging, regulatory pressure in many countries, a greater number of delinquencies, slow interest-revenue growth, and higher loss provisions have all taken a toll. We expect this difficult new environment to persist as the global economy continues to struggle. Issuers will need to take steps to stay on the right trajectory.

Industry Structure and Regulation. The rollout of new regulations has obviously posed big challenges for issuers. For example, there have been three sets of onerous regula-

Exhibit 7 | Retail Payments Revenues Will Post Strong Growth, with RDEs Leading the Way



Sources: BCG Global Payments Model, 2013; BCG analysis.
Note: Not shown: Middle East and North Africa, rest of world (see Appendix for data).

tions in the United States: the CARD Act, aimed at curbing excessive interest-rate hikes and hidden fees; a modification to Regulation E that requires customers to "opt in" for debit point-of-sale and ATM overdraft protection; and the Durbin Amendment (within the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010), which established limits on debit card interchange rates, eliminated network exclusivity, and created a new oversight entity called the Consumer Financial Protection Bureau.

The impact on card issuers has been significant, and will not abate. We are seeing lower revenues, changing customer-service models and higher servicing costs, higher compliance costs (particularly in terms of the number of full-time-equivalent employees), rising legal fees, tighter scrutiny, and changing power dynamics among industry stakeholders. That said, as regulation continues to be implemented across corporate and investment banks—further depressing their returns—the relatively strong performance of cards could put them back on the front lines of bank profitability.

In addition, over the past decade, we have witnessed the demise of monoline issuers as card businesses have become parts of larger banking entities. This change has allowed issuers to leverage their other assets, such as branches (for sales channels) and data sources (for improving underwriting analysis and customer targeting).

There are many implications from this consolidation. For example, current-account data will help issuers lower their underwriting cutoffs on consumer credit scores. Indeed, we have already seen cutoffs drop by up to 20 points. Brand consolidation on the merchant side coupled with well-capitalized issuers will intensify the already-fierce competition for the best cobranded portfolios.

New Technology. The proliferation of technological innovations—such as those involving digital and mobile wallets and the possibility of automated clearinghouse interfaces at the physical point of sale—has led to the introduction of new payment products and credit-card form factors. Also, the ability to leverage big data to understand and influence customer behavior has fostered more-powerful marketing tools. While experimentation is necessary to drive innovation forward, we do not believe that new products, form factors, and tools will have a significant impact on the industry in the short term. Rather, it will take several years before new value propositions are strong enough to prompt a change in consumer behavior.

Heightened Competition in Key Customer Segments. Standard business models are being disrupted as different types of players make moves to capture diverse segments such as affluent consumers, small businesses, and low-income consumers. In fact, competition in all customer segments is forcing issuers to offer more rewards, thereby eroding net interchange revenues. We estimate that just over 50 percent of total interchange revenue is returned to customers through rewards, and that card fees and spreads make up more than 75 percent of issuers' income.

> Innovation in serving underbanked segments will continue to spawn new offerings.

These dynamics will continue to lead to consequences such as increasing costs for rewards and high-touch service for the affluent segment, the growing importance of cash advances for small businesses, and the evolution of new point-of-sale financing models to address the subprime space. In addition, innovation in serving underbanked segments will continue to spawn new prepaid, mobile-checking, and retail-credit offerings. Finally, ongoing globalization by acquirers and payments networks will lead to a further push to explore new regions and expand card usage.

Identifying and Capturing Pockets of Growth

Given the above trends, it is becoming increasingly important to identify and capture available pockets of growth. Looking ahead, card issuers will battle over product features and pricing in their search for higher market share and the most profitable customers. By taking the following five steps, issuers can quickly put themselves on an advantaged path.

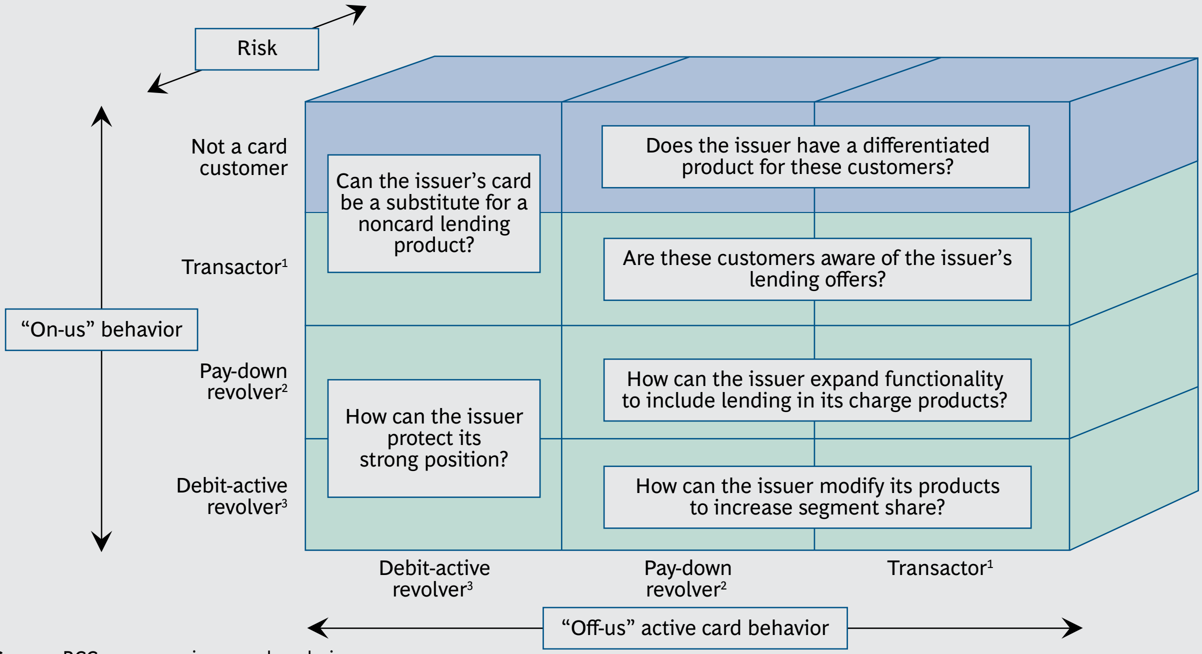
- Segment customers in a way that reveals where the greatest growth opportunities are available.
- Initiate customer discovery through interviews and surveys in order to understand true customer needs.
- Deconstruct competitors' value propositions and their appeal to consumers.
- Design specific product features for each customer segment.
- Clearly align marketing, servicing, risk, and fraud functions in order to ensure a consistent customer experience in the early defining days.

We have developed a "cube" model for segmenting consumers that examines "off-us" card behavior (activity on competitors' cards) and "on-us" card behavior (activity on a bank's own cards) to determine which customer segments will yield the greatest growth opportunities. (See Exhibit 8.) In mature markets with little greenfield opportunity, such as North America, Western Europe, and parts of Asia-Pacific (including Japan, South Korea, and Australia), an issuer has two primary growth routes: win share from competitors and increase business from current cardholders. Understanding the cube model is critical to these initiatives. If "off-us" spending is more active, the issuer must develop a value proposition that will trigger a migration to its own credit card. For example, an airline-branded card issuer could find growth opportunities in the airline's hub city by targeting competitors' cardholders who have no-rewards credit cards—and who could therefore earn more miles and other perks with the branded card.

More specifically, in order to benefit from the cube model, banks need to analyze three types of data:

- *Internal data for "on-us" transactions*, although these data alone are not sufficient to achieve full customer understanding
- *Credit-bureau data for "off-us" transactions,* which are an important addition—provid-

EXHIBIT 8 | The "Cube" Model Helps Reveal Where the Greatest Opportunities Lie



Source: BCG case experience and analysis.
Note: "On-us" behavior is activity on a bank's own cards; "off-us" behavior is activity on competitors' cards.
[1]Consistently pays down balances each month.
[2]Makes large purchase and pays down balance over time.
[3]Consistently carries balances, making payments and incremental transactions.

ing insight into cardholders' credit lines, risk profiles, and balances—but which do not indicate payment behavior regarding, for example, whether the cardholder typically pays the minimum balance, revolves a small portion, or pays the full balance every month

- *Third-party data based on card-issuer data sets,* which help provide a more complete picture on not only the payment history but also the type of interest being paid (such as promotional or indexed rates) and the type of card being used (such as cash-back, generic reward points, or branded reward points)

Analyzing and leveraging the cube model constitutes the critical first step in the journey toward effectively expanding a credit card portfolio. Once this step has been completed, the issuer is well positioned to undertake the next step—customer discovery—which delves into the functional, technical, and emotional dimensions of target client segments. The offerings that are eventually developed can include a single product (such as a new card) or a multiproduct, commingled value proposition, such as making mortgage payments from an issuer-provided current account in return for credit card reward points.

Customer-Relationship University

As banks explore the optimal value propositions for their new product offerings, it is worth taking a quick refresher course at what we call Customer-Relationship University. There are a number of different levels of value to consider—starting with mastering the task of cross-selling credit cards to current-account customers, and ending with determining which customer needs are best served when different products are combined to forge new value propositions.

Level One: Mastering the Standard Cross-Sell. Banks obviously wish to sell multiple products to their customers. Level-one initiatives can include not only direct mail credit-card offerings to current-account customers but also sales efforts in bank branches to leverage multiproduct interactions. For example, a bank could use current-account transaction data to underwrite higher-risk credit-card applicants. The pitch to customers might be that by linking their credit card to their current account and automatically paying at least the minimum balance on their card bill, they will never again pay a late fee.

In addition, card issuers can capture incremental growth by actively converting their telephone-service interactions into sales occasions. Having just resolved a customer problem, service reps have earned a measure of trust and are well positioned to suggest new or better products—ideally aided by a powerful analytics engine to enable real-time customer segmentation so that customers are offered appropriate products.

Level Two: Leveraging Transaction and Demographic Data to Generate Thoughtful Offerings. A bank should know its own customers better than its competitors do because of copious internal-transaction data that provide insight into its customers' behavior. For example, a bank can readily determine who is using revolving credit, who is paying balances in full every month, and who typically spends how much on different types of products and services. Credit-bureau and third-party data on *competitors'* customers also provide visibility into customers' credit usage and their preferred providers for products such as mortgages, personal loans, and credit cards. Level-two initiatives involve developing better, more innovative offerings in order to encourage customer migration.

Level Three: Creating Product Bundles Targeted at Specific Segments. By level three, banks have moved beyond customer lists and leveraging basic data to providing suites of products aimed at specific customer segments—on the basis of a segment's wealth, wallet size, and current product portfolio. One example might be a "student pack" involving price discounts tied to a student's product usage.

Level Four: Collecting Data on "Trigger" Events and Offering Relevant Products as Customer Needs Change. Banks at level four pay close attention to what each one of its customers is doing and make highly targeted offers. Changes in select customer data can signal a "trigger" event—such as a job change, a marriage or divorce, the birth of a child, or a young adult heading off to college—and provide an opportunity to keep up with the customer's evolving needs. The bank knows when a customer is in the market for additional products and reaches out in a timely manner.

Card issuers can also harness their understanding of customer spending patterns and life events to build a highly targeted advertising and promotion program along the lines of merchant-funded rewards. These programs can be developed in-house or in partnership with a growing number of rewards platforms. Designing a differentiated customer experience is critical so that customers receive the right offers at the right time and are not inundated with spam.

Level Five: Combining Products, Linking Rewards, and Using Special Tools to Forge New Value Propositions. Although it is the most challenging stage, level five—which might be thought of as graduate school at Customer-Relationship University—reaps the greatest customer value. Leading retail banks have moved beyond creating basic product bundles coupled with price discounts to developing integrated product-reward bundles. By linking products and offering flexible reward options, these banks generate a value proposition that is greater than the sum of its parts. For example, one bank has developed a special program that combines current and savings accounts with debit and credit cards—along with tools to help the customer save, and incentives and rewards for customers who achieve their savings goals. The customer maximizes the value proposition by having all four products.

IN the "new new normal" climate, banks need to become more innovative across the value chain of retail payments—from data analysis, customer segmentation, and product development all the way to product and rewards bundling. The reality is that banks can no longer merely sell products. Rather, they must offer workable and cost-effective solutions to meet customers' needs with regard to all types of payments—and, more broadly, all types of financial management.

APPENDIX

AN OVERVIEW OF VOLUMES, VALUES, AND REVENUES IN THE PAYMENTS MARKETPLACE, 2012–2022

The vitality of the global payments marketplace is measured by volume (the number of noncash transactions), value (the monetary amount of noncash transactions), and revenue (the amount of income generated for banks and other market participants by noncash transactions). This Appendix provides a detailed forecast of the payments marketplace from 2012 through 2022.

We define *payments revenues* as direct and indirect revenues generated by a payment service. These include transaction-specific revenues, card and account maintenance fees, and spread income generated from current accounts—also known as checking or demand-deposit accounts (DDAs). Fees for overdrafts and nonsufficient funds are considered transaction-specific revenue. We define *transaction banking* as payments-related products and services, such as cash management services for corporate clients. All numbers in the Appendix are for noncash payments. In the tables that follow, total revenues are the sum of account revenues and transaction revenues. (Numbers may not add exactly to totals because of rounding.) In 2012, BCG updated its global payments model to incorporate additional data, adjust the forecast models to account for the global recession, and extend the forecasts to 2022. Data from previous BCG reports may have been revised accordingly.

Worldwide Payments, 2012

	North America	Latin America	Asia-Pacific (mature)	Asia-Pacific (emerging)	Western Europe	Eastern Europe	Middle East and North Africa	Rest of world	Total
Volume (millions)	133,964	35,086	46,932	34,666	77,713	24,916	4,713	6,368	364,358
Value ($millions)	101,622,897	29,703,800	52,448,202	55,322,327	98,634,051	27,022,625	5,561,226	6,586,989	376,902,118
Total revenues ($millions)	158,932	41,388	65,025	92,336	107,925	41,572	8,101	9,166	524,444

Source: BCG Global Payments Model, 2013.
Note: Data are for noncash payments. Total revenues include transaction and account revenues. Any minor discrepancies in totals are due to rounding.

Worldwide Payments, 2022

	North America	Latin America	Asia-Pacific (mature)	Asia-Pacific (emerging)	Western Europe	Eastern Europe	Middle East and North Africa	Rest of world	Total
Volume (millions)	253,453	78,794	64,656	108,609	103,591	54,747	40,773	17,836	722,459
Value ($millions)	152,209,305	68,708,080	70,715,767	167,594,928	140,693,003	66,009,368	28,558,305	17,579,833	712,068,589
Total revenues ($millions)	283,847	107,048	85,711	336,564	156,551	96,694	45,189	28,138	1,139,742

Source: BCG Global Payments Model, 2013.
Note: Data are for noncash payments. Total revenues include transaction and account revenues. Any minor discrepancies in totals are due to rounding.

Volume of Retail and Wholesale Payments

Region/payment type (Units: millions of transactions)	2012	2022	Compound annual growth rate (%)
North America	**133,964**	**253,453**	**7**
Retail	101,750	196,064	7
Wholesale	32,214	57,389	6
Latin America	**35,086**	**78,794**	**8**
Retail	24,891	54,543	8
Wholesale	10,195	24,251	9
Asia-Pacific (mature)	**46,932**	**64,656**	**3**
Retail	41,072	56,011	3
Wholesale	5,860	8,645	4
Asia-Pacific (emerging)	**34,666**	**108,609**	**12**
Retail	30,230	96,492	12
Wholesale	4,436	12,117	11
Western Europe	**77,713**	**103,591**	**3**
Retail	63,260	84,526	3
Wholesale	14,453	19,065	3
Eastern Europe	**24,916**	**54,747**	**8**
Retail	19,381	42,089	8
Wholesale	5,535	12,657	9
Middle East and North Africa	**4,713**	**40,773**	**24**
Retail	4,094	35,845	24
Wholesale	619	4,928	23
Rest of world	**6,368**	**17,836**	**11**
Retail	5,064	14,316	11
Wholesale	1,304	3,520	10
World	**364,358**	**722,459**	**7**

Source: BCG Global Payments Model, 2013.
Note: Any minor discrepancies in totals or subtotals are due to rounding.

Value of Retail and Wholesale Payments

Region/payment type (Units: $millions)	2012	2022	Compound annual growth rate (%)
North America	**101,622,897**	**152,209,305**	**4**
Retail	15,445,548	22,230,283	4
Wholesale	86,177,350	129,979,021	4
Latin America	**29,703,800**	**68,708,080**	**9**
Retail	2,662,930	5,435,553	7
Wholesale	27,040,871	63,272,527	9
Asia-Pacific (mature)	**52,448,202**	**70,715,767**	**3**
Retail	4,054,953	5,307,473	3
Wholesale	48,393,250	65,408,294	3
Asia-Pacific (emerging)	**55,322,327**	**167,594,928**	**12**
Retail	4,622,215	17,089,883	14
Wholesale	50,700,112	150,505,044	11
Western Europe	**98,634,051**	**140,693,003**	**4**
Retail	8,919,978	12,497,727	3
Wholesale	89,714,073	128,195,276	4
Eastern Europe	**27,022,625**	**66,009,368**	**9**
Retail	1,684,573	4,001,154	9
Wholesale	25,338,052	62,008,215	9
Middle East and North Africa	**5,561,226**	**28,558,305**	**18**
Retail	744,469	4,207,823	19
Wholesale	4,816,757	24,350,483	18
Rest of world	**6,586,989**	**17,579,833**	**10**
Retail	678,321	1,791,423	10
Wholesale	5,908,667	15,788,410	10
World	**376,902,118**	**712,068,589**	**7**

Source: BCG Global Payments Model, 2013.
Note: Any minor discrepancies in totals or subtotals are due to rounding.

Total Revenues (Account and Transaction Revenues)

Region (Units: $millions)	2012	2022	Compound annual growth rate (%)
North America	158,932	283,847	6
Latin America	41,388	107,048	10
Asia-Pacific (mature)	65,025	85,711	3
Asia-Pacific (emerging)	92,336	336,564	14
Western Europe	107,925	156,551	4
Eastern Europe	41,572	96,694	9
Middle East and North Africa	8,101	45,189	19
Rest of world	9,166	28,138	12
World	**524,444**	**1,139,742**	**8**

Source: BCG Global Payments Model, 2013.
Note: Any minor discrepancies in totals are due to rounding.

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A report by The Boston Consulting Group in partnership with SWIFT, October 2012

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An article by The Boston Consulting Group, June 2012

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