BCG

REPORT

GLOBAL PAYMENTS 2011

Winning After the Storm

THE BOSTON CONSULTING GROUP

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Global Payments 2011

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Contents

Executive Summary

The Boston Consulting Group's tenth comprehensive study since 1995 of the worldwide payments landscape appears at a time when unprecedented changes are sweeping the payments industry. Amid growing competition and price pressure, increasing regulatory constraints and scrutiny, rising macroeconomic volatility, changing demographic patterns, and shifting customer demands, only those institutions that are able to adapt, transform, and optimally link their business and operating models will prosper and seize a greater share of revenues and profits over the next decade. The size of the prize is too large not to take action: we estimate that the global payments market will be worth $782 trillion in noncash transaction value and $492 billion in transaction revenues by 2020.

In our last report, Weathering the Storm: Global Payments 2009, *we concentrated on the actions that financial institutions needed to take to withstand the global financial crisis and emerge from the downturn in a strong position. In this report, we focus on developing optimal business models (target customer segments, product portfolios, regions, and channels) and operating models (target processes, IT, sourcing, and organization) that will drive successful and sustainable growth strategies in payments and transaction banking "after the storm."*

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-third to one-half of most banks' revenues. We define* transaction banking *as products and services related to payments, such as cash management services for corporate clients.*

Despite the fundamental strength of payments-related businesses, some of these businesses have showed weaknesses in recent years. Global transaction volumes and revenues have slumped, and checking-account balances have slipped in certain customer segments. The relatively cyclical credit-card business, traditionally a powerful revenue engine in certain markets, has taken an extraordinary hit—especially in the U.S., where high losses have been linked to rising unemployment.

- Payments businesses are generally recovering today despite widespread macroeconomic uncertainty. But some financial institutions have yet to recoup sizable chunks of income lost through regulatory disruption. Global payments revenues fell at a compound annual rate of 7 percent from year-end 2008 through 2010. But overall volumes and values (up 5 percent and 3 percent on a compound annual basis, respectively, over the same period) are back to precrisis levels in most countries.

- Payments players wishing to fully capture the resurgence must scrutinize their business and operating models and determine whether current models are well suited to shifting industry dynamics. In the process, they will face the daunting challenge of meeting essential segment, product, and country requirements while minimizing operational complexity.

In Europe, average annual retail-payments values and volumes remained relatively flat from year-end 2008 through 2010 at roughly $10 trillion and 70 billion

transactions, respectively, but with ample variation by market. Retail transaction revenues slipped from $62 billion in 2008 to $60 billion in 2010.

- Payments market dynamics vary widely among the northern, central, and southern regions of Western Europe, as well as among the countries of Central and Eastern Europe (CEE). In order for European payments players to forge clear and far-reaching strategies, they must thoroughly understand these structural and regional differences.

- Given Western Europe's highly evolved infrastructure, product mix, and bedrock of well-established business models—as well as significant margin pressure—the next developmental stage in the region's payments market will be focused on refining operating models. By contrast, in the CEE countries, where infrastructure is less sophisticated and payments efficiency is still relatively nascent, forging winning business models will be the key success factor.

- The Single Euro Payments Area (SEPA) has been a work in progress for many years. Today, although acceptance of certain SEPA instruments (such as credit transfers) has been steadily increasing, a number of the original objectives of SEPA—let alone a full replacement of fragmented national payments systems—do not seem achievable without further regulatory intervention.

In the U.S., the payments industry has undergone considerable disruption. From year-end 2008 through 2010, total payments revenues fell at a compound annual rate of 4 percent despite steady payments values and a 3 percent annual rise in volumes driven by steady growth in automated clearing-house (ACH) and debit card transactions. Total revenues are expected to grow in 2011 but will remain about 6 percent below the 2007 peak level of $162 billion—a level not likely to be surpassed for another few years.

- New financial regulations such as the Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009, the Durbin Amendment (within the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010), and modifications to Regulation E will have a dramatic effect on U.S. payments businesses. As much as $25 billion in annual retail-transaction revenues—about 29 percent of total retail-transaction revenues—will be "regulated away" from U.S. financial institutions as the new guidelines take effect.

- As a result, banks and other institutions active in the payments industry must rethink their business models and develop new value propositions. Three specific initiatives are most important: transforming credit card businesses, moving beyond the checking account to deepen client relationships, and staying smart in the digital financial-services game.

In Asia-Pacific, payments and transaction banking are primed for growth. Banks will have to tailor their business and operating models in order to balance growth aspirations with efficiency goals. Key success factors for mature markets in the region will differ considerably from those for emerging markets.

- In the mature Asia-Pacific countries, much as in North American and Western European markets, growth discussions focus on existing customers—more specifically, on opportunities to increase share of wallet by improving the convenience of payment solutions for consumers and merchants.

- In emerging Asia-Pacific markets, by contrast, growth will be generated by the gradual financial inclusion of unbanked consumers and the rapidly expanding footprint of the electronic-payments infrastructure. Shifts in spending behavior and payment preferences, especially on the part of the emerging digital generation and those consumers moving from rural to urban areas, will also be a prime factor.

The financial crisis has highlighted the attractiveness of wholesale transaction banking. Although businesses such as deposit and payment services, cash management, and trade services were not unscathed by the downturn, they fared relatively well. Over the full economic cycle, these businesses often provide reliable fee and spread revenues, rich deposit volumes, and high profitability. Return on equity is typically above 40 percent for best-practice institutions.

- In the postcrisis era, transaction banking will remain a significant opportunity for financial institutions. Wholesale payments volume is expected to grow at a compound annual rate of 9 percent globally from year-end 2010 through 2020, and total wholesale payments revenues are expected to increase from $169 billion to $471 billion. Leading global institutions are assigning more importance to transaction banking from an organizational perspective.

- Despite the strengths of transaction-banking businesses, there are hurdles to overcome. Getting different silos within the bank—such as the corporate-banking sales force, cash-management and trade-service specialists, and operations and IT groups—to align around making transaction banking a top priority can be a tall order. Some institutions struggle in defining their core target markets (from both a segment and a regional perspective) and in smoothing out uneven customer experiences across channels and regions.

- Price pressure is becoming more severe as competition for market share and scale heats up—a dynamic complicated by the tightening regulatory climate. Traditional operating models are being tested as wholesale banks face increasing tradeoffs between efficiency and standardization on the one hand and service excellence and customization—both across borders and across segments—on the other.

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A Time of Transition

Since the global financial crisis first unfolded several years ago, leading banks have increasingly recognized the importance of their payments and transaction-banking businesses. In the short term, these businesses serve as a relatively stable source of revenues; in the long term, they provide a solid platform on which to build customer loyalty and increase share of wallet. In addition, with the exception of credit cards, these businesses typically possess structural advantages that include consistent, predictable volumes and relatively low (non-capital-intensive) risk factors. They also serve as a low-cost source of funding.

In 2009 and 2010, however, some payments-related businesses showed glaring weaknesses. Global transaction volumes and revenues slumped, and balances in demand deposit accounts (DDAs) slipped in certain customer segments. The relatively more cyclical credit-card business—traditionally a powerful revenue engine in certain markets—took an extraordinary hit, especially in the U.S., where high losses were linked to rising unemployment. Also, structural cracks appeared in the underlying economics of credit cards and DDAs in the U.S. market as new regulations began to whittle away historically strong profit levers.

In Europe, Single Euro Payments Area (SEPA) legislation has forced banks to rethink their operating models, especially in regard to their IT architecture. Banks are struggling with the key issue of whether—from both a functionality and a profitability outlook—one IT platform for payments across Europe would be preferable to using multiple local IT platforms.

In general, payments businesses are recovering today despite widespread macroeconomic uncertainty. Some financial institutions have yet to recoup sizable chunks of income lost through regulatory disruption. Indeed, global payments revenues fell at a compound annual rate of 7 percent from year-end 2008 through 2010. But overall volumes and values (up 5 percent and 3 percent on a compound annual basis, respectively, over the same period) are back to precrisis levels in most countries.[1]

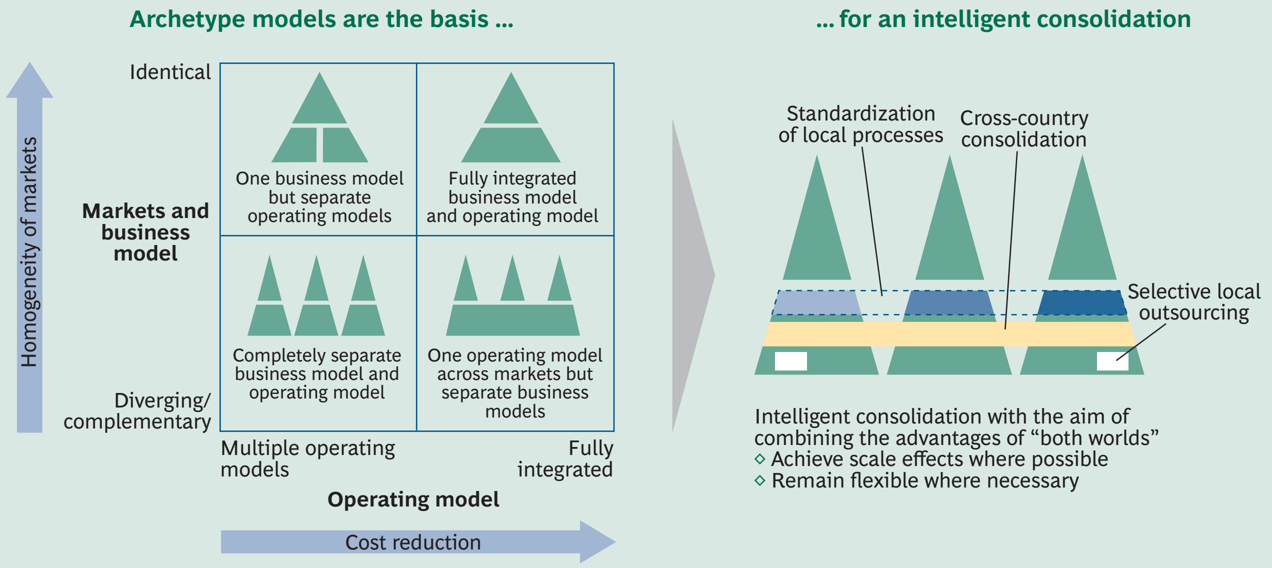
Payments players wishing to fully capture this recent resurgence must scrutinize their business and operating models and determine whether present models are well suited for shifting industry dynamics. In the process, they will face the daunting challenge of meeting essential segment, product, and country requirements while minimizing operational complexity.

Indeed, striking the optimal balance between standardization and customization has become a top priority. Banks must be more intelligent than ever both in designing the right business models and in identifying which elements of core operating models can (and cannot) be consolidated and used efficiently across different markets, customer segments, and products. (See Exhibit 1.)

The question of how payments players strike this balance hinges on another critical dimension of the global landscape: whether the target market is a mature or transitioning one. Broadly speaking, transitioning markets are characterized by a high percentage of unbanked consumers, above-average real-income growth, and relatively young and fast-growing populations; mature markets tend to have the opposite characteristics. (See Exhibit 2.)

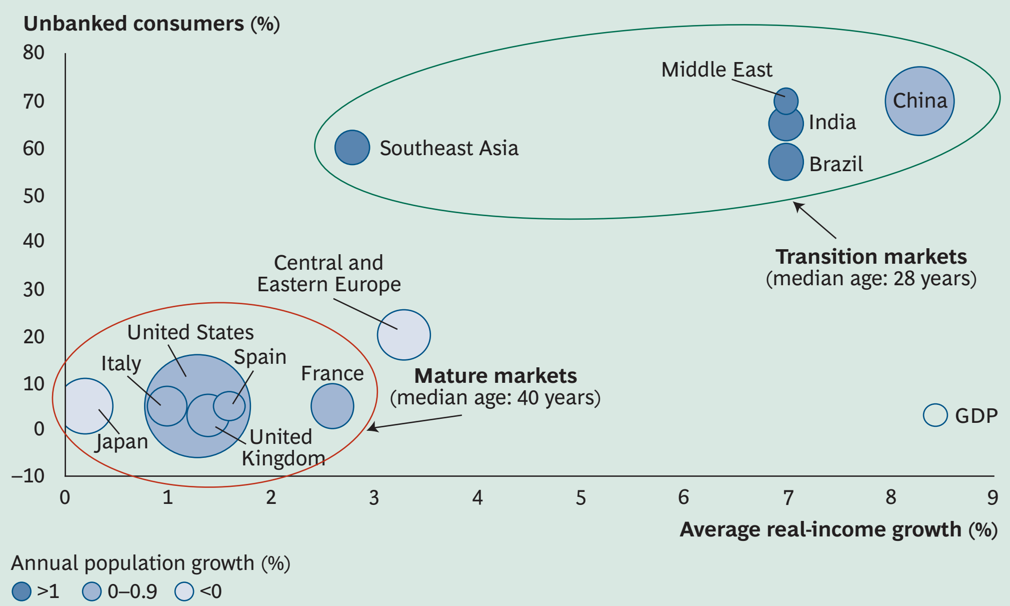
1. In 2010, BCG updated its global payments database to incorporate additional data and adjust its forecast models; data from previous reports may have been revised accordingly.

Exhibit 1. Intelligent Combinations of Business and Operating Models Will Be Required Across Markets



Source: BCG analysis.

Exhibit 2. Mature and Transitioning Markets Have Fundamental Differences That Affect Payments Businesses



Sources: Euromonitor International; World Bank, *World Development Report 2009;* BCG analysis.
Note: Growth rates are calculated for 2008 through 2013.

In addition, transitioning markets are typically poised for developments such as migration from cash to card-based or mobile payments, unbanked-consumer acquisition, payment-method innovation, and the entry of new types of players.

What's more, mature and transitioning markets usually have different development paths. For example, in mature markets such as the U.S. and Western Europe, barriers to entry are high, large players can leverage their advantaged scale positions, product penetration is deep, and margins are thinner. Such markets are typically ripe for operational improvements and cost cutting as well as revenue growth through relationship banking and increasing share of wallet.

By contrast, in transitioning markets such as Latin America and most of Asia-Pacific, the infrastructure is expanding and products and target customer segments are still in flux. For example, sizable opportunities still exist in e-payments and mobile payments as well as in highly populous unbanked and underbanked customer segments. As a result, business model design (that is, addressing which products and which segments to target) is often at the top of the agenda, ahead of operating-model design. Obviously, financial institutions cannot pursue all products and segments in emerging markets because the required infrastructure investments are too high. This constraint is leading to operating models that involve more partnerships than typically exist in mature markets. For example, in transitioning markets, financial institutions are more likely to partner with telecommunications companies, whereas in mature markets, telcos are seen as a potential threat. Of course, as we have seen, regulatory disruption can trigger dramatic transformations in either type of market.

Overall, the winning financial institutions will be those that analyze the distinct characteristics and development paths of their different markets (and customer segments) and make wise choices about how to approach them over the long term. (See the sidebar below.) Accordingly, given

Key Factors in Assessing Payments Markets

There are a number of characteristics that can affect the development paths of payments markets in different regions.

Macro/socioeconomic Factors:

- *Demographics.* A higher proportion of young people in the regional or national population could lead to faster adoption of new payment methods (such as m-payments).
- *"Unbanked" Population.* A high proportion of consumers with no formal banking relationship will also lead to a rapid uptake of new payment methods (such as prepaid cards) and channels.
- *GDP Growth.* Rapidly growing economies generate a greater number of new market entrants and faster adoption of new types of payment methods.
- *Average Real-Income Growth.* Markets with relatively high real-income growth foster increases in average payments values and favorable returns on investments in payments innovation.
- *Export-Import Balance.* Cross-border trade growth leads to greater opportunities for high-margin payments products (but also heightens competition).
- *Regulatory Outlook.* Rigorous government regulation can have a dramatic impact on payments economics, sometimes necessitating strategic transformations. Such regulation is currently having a major effect on the U.S. market and a substantial (but lesser) effect on the Western European market. These two markets each accounted for about 25 percent of global payments revenues in 2010.
- *Infrastructure.* Active government involvement in building payments infrastructure can have large implications on the pace of market evolution and potential profit pools. Poor, stagnant infrastructure can lead to faster adoption of next-generation payment vehicles.

Industry Factors:

- *Mix of Payments Instruments.* Greater use of cash and checks can generate high potential to capture new payments flows (from the migration away from cash and checks toward card and e-payments), resulting in new market entrants and the likelihood of more innovation.
- *Efficiency Level.* In inefficient markets with a low degree of operational excellence, new market entrants are more likely to excel.

the diverse nature of current payments markets—and their likely development paths over the next decade—we have structured this report by region. We will first address the challenges and opportunities facing institutions that are active in retail payments in Europe, the Americas, and Asia-Pacific, respectively, focusing on issues most pertinent to each market. We will then look at the global wholesale transaction-banking market. As will become evident, creative and innovative strategies will be needed in order for banks and other payments players to gain and maintain competitive advantage.

Retail Payments: Europe

This section of the report provides an overview of the European retail-payments market, examines structural differences among subregions (as defined in the Appendix), addresses the critical question of balancing scale and complexity in operating models, and takes a quick look at the ongoing SEPA initiative.

In Europe, average annual retail-payments values and volumes remained relatively flat from year-end 2008 through 2010 at roughly $10 trillion and 70 billion transactions, respectively, but with ample variation by market. Western European countries showed fairly similar trends in payments values, with the two-year compound annual growth rate (CAGR) in payments values ranging from –3 percent to 1 percent in most countries. In Central and Eastern Europe (CEE), there was wider variation by country. Russia, with a two-year CAGR of 8 percent in payments values, showed the strongest growth—followed by Poland with a two-year CAGR of 4 percent. In the Baltic countries, however, the two-year CAGR was –11 percent.

Payments revenues from transactions and accounts told a different story, however. Retail payments revenues fell dramatically in Europe, from $173 billion in 2008 to $136 billion in 2010. The dynamics were somewhat similar in both Western Europe and the CEE countries, with two-year CAGRs in revenues of –12 percent in the former and –10 percent in the latter. The majority of the decline occurred in account revenues, with a CAGR in spreads of –17.5 percent from year-end 2008 through 2010.

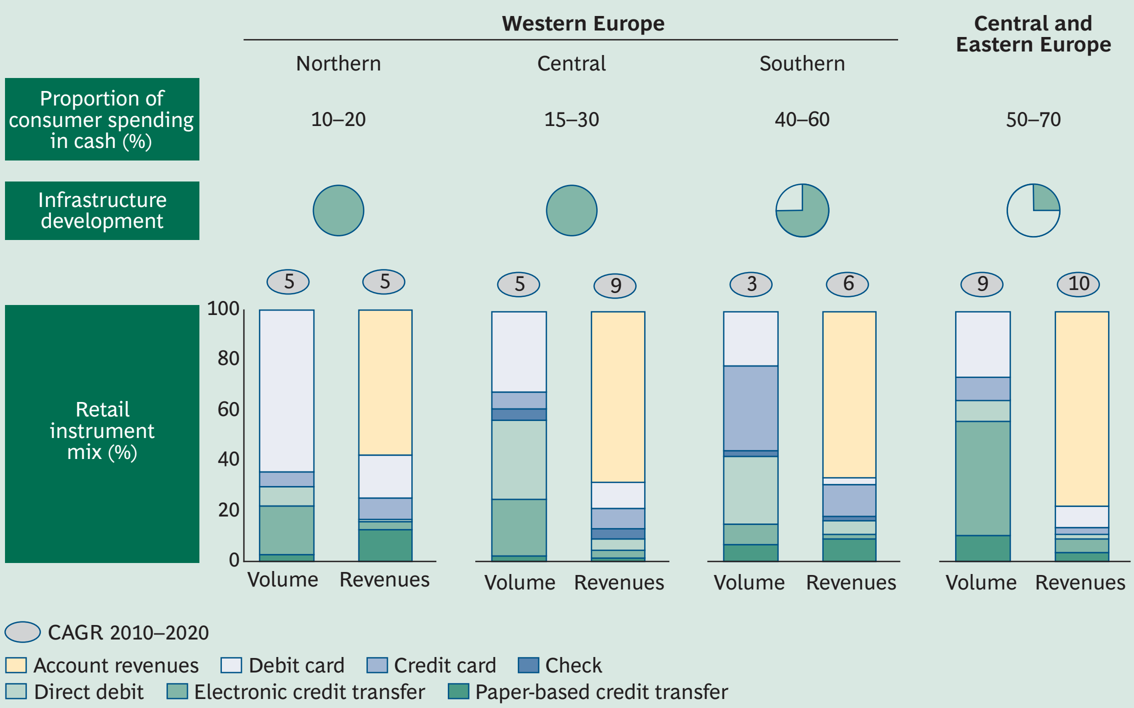
From year-end 2010 through 2020, we expect wide variation among the payments markets in Western Europe and those of the CEE countries. We estimate that payments values in Western Europe will rise at a CAGR of about 5 percent, with CAGRs for most countries in the 4 to 5 percent range. Such growth would lead to an annual payments value of around $155 trillion by 2020. The CEE region should show a significantly higher CAGR—about 11 percent—which will be somewhat evenly distributed by country. But the driving force of growth will continue to be Russia, with a CAGR of about 12 percent. By 2020, the CEE payments market will reach an estimated annual value of roughly $53 trillion.

On the payments revenue side, we estimate CAGRs of about 7 percent in Western Europe and 9 percent in the CEE region from year-end 2010 through 2020. We also expect the revenue mix to change. Transaction revenues in Europe will likely be flat at best, owing to competitive pressure on prices, the progress of SEPA, and government restrictions on float income. Although account (interest spread) revenues in Europe have been hurting for the past few years, we expect them to recover once interest rates start rising again—and to post a CAGR of about 10 percent from year-end 2010 through 2020.

Structural Differences in European Payments Markets

In order for European payments players to forge clear and far-reaching strategies, they must understand structural and regional differences thoroughly. To aid this effort, we have divided the European payments market into four areas: the northern, central, and southern regions of Western Europe, and Central and Eastern Europe. Overall, these regional markets show wide variations that will affect banks and other market participants differently. (See Exhibit 3.)

Exhibit 3. In Europe, Regional Payments Markets Show Wide Variation



Source: BCG analysis.

The Northern Region: A Highly Mature Payments Market. The northern region of Western Europe is characterized by an affinity for noncash payments, especially electronic credit transfers and debit cards. This trend is illustrated by the high annual rate of debit card transactions per capita—roughly 170, compared with about 40 in the rest of Western Europe—and the fact that value-add services such as drawing money from debit cards in supermarkets are routinely offered. Given the northern region's strong payments infrastructure, we do not expect mobile payments or other potential innovations to have a great impact in the coming years.

The Central Region: A Mature Market with Legacy Card Issues. Like the northern region, the central part of Western Europe is also a mature market characterized by the high use of electronic credit transfers—although cash usage is somewhat higher than in the north. The main difference is on the card side. In the northern region, the ratio of debit-card to credit-card payment values is about 90 to 10, whereas in the central region it is closer to 75 to 25. Also, the share of debit cards versus credit cards is more varied among countries in the central region, and direct debits play a more significant role.

In the future, we expect structural changes in this region to be minimal. There may, however, be further movement away from credit cards toward debit cards. With interest spreads extremely low in the central region owing to the current low-interest policy of the European Central Bank (ECB), account revenues are at a relatively low level. They should rise again once interest rates pick up, and we expect a CAGR in account revenues of roughly 12 percent from year-end 2010 through 2020. Transaction revenues, by contrast, will likely fall at a compound annual rate of about 1 percent over this period—and the transaction-revenue share of total revenues could decrease from 41 percent to 18 percent.

The Southern Region: Still Maturing Amid High Prices. The southern region is the least mature market in Western Europe in terms of the use of cash, checks, and paper-based credit transfers. There is also more variation among countries in terms of product mix. That said, the infrastructure necessary to bring the market to the level of the central and northern regions is largely in place.

Average revenues per transaction in 2010, at $1.70, were significantly higher than elsewhere in Western Europe—$0.72 in the north and $0.50 in the central region—as well as in the CEE region ($0.83). Direct-debit and electronic credit transfers in the southern region yield revenues per transaction that are twice as high as elsewhere in Western Europe. Revenue growth is driven by Italy, which accounts for 60 percent of total payment revenues from the southern region (but only 29 percent of payment volumes).

In Western Europe, the next stage will be focused on refining operating models.

Overall, southern Europe is still a very high-margin region, and should remain so in the near to medium term. We believe that the Western European payments market will continue to evolve toward a highly efficient, account-centered, homogeneous state.

CEE: High Growth Potential but Young Infrastructure. The product split in the CEE countries is far more diverse than in the northern and central regions of Western Europe, and the use of cash is even higher than in the southern region. In 2010, the CEE countries averaged about 26 noncash transactions per capita, compared with 191 in Western Europe. This gap will likely narrow somewhat to a ratio of about 63 to 212 by 2020. Advanced payments infrastructure is nonexistent in CEE, so innovative products such as mobile payments may end up playing a significant role, and product mixes will be less predictable than in Western Europe. Also, growth potential will be significantly higher.

Scale Versus Complexity

Given Western Europe's highly evolved infrastructure, product mix, and bedrock of well-established business models—as well as significant margin pressure—the next developmental stage in the region's payments market will be focused on refining operating models. By contrast, in the CEE region, where infrastructure is less sophisticated and payments efficiency is still relatively nascent, forging winning business models will be the key success factor, although operating models are nonetheless important.

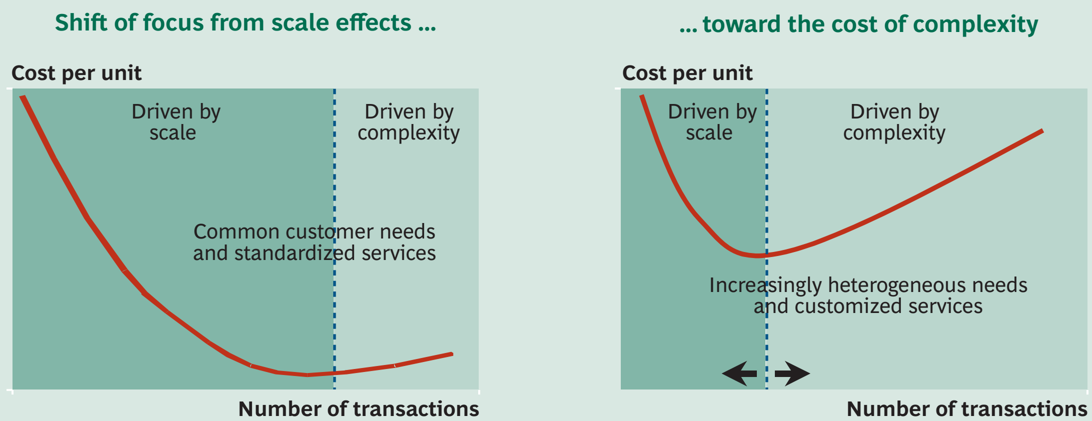
In our view, the operating model of the future must be both cost-efficient and flexible. In order to achieve this, we believe that reducing complexity—a side effect that many payments players have long underestimated when multiple business and operating models come into play—is a key success factor. Indeed, the cost of complexity can easily offset scale advantages. (See Exhibit 4.)

As major banks in Europe have expanded into new regions in search of revenue growth and greater scale in recent years, the effort to use one operating model across countries has become increasingly problematic. Trying to serve too many customer segments (with their varying product needs), as well as dealing with diverse regulatory regimes in different countries, has rendered operating models less efficient—hurting scale and pushing unit costs upward.

Specifically, we believe in the following key design principles for the operating model of the future in Europe:

- Operate primarily in-house (with minimal outsourcing), if sufficient scale is available, in order to control core differentiation criteria.
- For functions that are subscale and nonstrategic, seek partnerships or outsource (provided the vendor is not a competitor).
- Physically consolidate across countries, with as few processing centers as possible, in order to increase "actual" scale.
- Drive maximum standardization of products and processes in order to increase "virtual" scale.
- Strengthen the product line on a group level, but maintain a country perspective as well.
- Carve out activities and functions and bundle them within separate legal entities (with their own service-level agreements) in order to ease governance issues and reduce payroll costs.
- Implement the right end-to-end governance model in order to sustainably embed design-to-cost principles.

Exhibit 4. The Cost of Complexity Can Offset Scale Advantages



Singular focus on scale neglects rising complexity
- Underestimation of the cost of complexity
- Overlooked impact of market expansion (such as cross-border issues) and new customer needs

Focus on complexity as a significant cost driver
- Cost of complexity quickly offsets scale advantages
- Scrutiny of how customer scope and product/service customization affect unit cost

Segregating operating models may even reduce cost

Source: BCG case experience.

SEPA: An Update

The Single Euro Payments Area has been a work in progress for many years. Today, although acceptance of certain SEPA instruments (such as credit transfers) has been steadily increasing, a number of SEPA's original objectives—let alone a full replacement of fragmented national payments systems—do not seem achievable without further regulatory intervention.

The slow pace of SEPA's progress led the European Commission and the ECB to call for the first meeting (held in June 2010) of the recently created SEPA Council. This meeting brought together the demand and supply sides of the European payments market. The main issues discussed were the conditions necessary both for establishing SEPA migration deadlines and for planning a SEPA for payment cards.

SEPA credit transfers, following rapid growth over the previous two years, accounted for 8.8 percent of total credit-transfer volume in the euro zone in June 2010. The number of SEPA direct-debit transactions remained insignificant, however, with a 0.05 percent share of total direct-debit volume in the euro zone. Clearly, high conversion costs have deterred many financial institutions from committing to total migration to the SEPA scheme.

Overall, it is becoming increasingly clear that SEPA should not be the key principle for banks in designing their end-to-end operating models. The first priority should be country-specific customer demands, with SEPA compliance a second priority.

Retail Payments: The Americas

In analyzing the Americas, we will dedicate most of our discussion to the U.S. market. It is the world's largest, with an annual payments value of $87 trillion in 2010 (representing 26 percent of the global total and 75 percent of the Americas total). The second-largest market in the region is Brazil, with an annual payments value of $11 trillion in 2010.

The U.S. market has undergone considerable disruption in recent years. From year-end 2008 through 2010, payments revenues fell at a compound annual rate of 4 percent, despite steady payments values and a 3 percent annual rise in volumes driven by growth in automated clearinghouse (ACH) and debit card transactions. Total revenues are expected to grow in 2011 but will remain about 6 percent below the 2007 peak level of $162 billion—a level they are not likely to surpass for another few years. Retail yields (revenues relative to transaction values) will likely remain below the 2008 level of 54 basis points until 2016.

In the longer term, we expect a general recovery. From year-end 2010 through 2020, payments revenues are expected to post a CAGR of 5 percent—with payments values and volumes posting CAGRs of 4 percent and 6 percent, respectively. Moreover, the stability of the U.S. payments industry has been tested not only by the Great Recession but also by significant regulatory developments—which we refer to as the "Great Regulations." Among these new regulations are the following:

- The Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009, which was aimed at curbing excessive interest-rate hikes and hidden fees.
- Regulation E: older legislation that was recently modified to require customers to "opt in" for debit point-of-sale (POS) and ATM overdraft protection on their demand-deposit accounts.
- The Durbin Amendment (within the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010), which authorizes the U.S. Federal Reserve to set limits on debit-card interchange rates and eliminate network exclusivity. This act also creates an independent Bureau of Consumer Financial Protection, whose wide mandate can directly affect how payments products are created, priced, and managed.

According to our estimates, as much as $25 billion in annual retail-transaction revenues—about 29 percent of total retail-transaction revenues—will be "regulated away" from U.S. financial institutions as the new guidelines take effect. As a result, banks and other institutions active in the payments industry must rethink their business models and develop new value propositions. In our view, three specific initiatives are most important: transforming credit card businesses, moving beyond the checking account to deepen client relationships, and staying smart in the digital financial-services game.

Transforming the Credit Card Business

The credit card business continues to be plagued by above-average charge-offs, the effects of the CARD Act, and shifts in consumer behavior. Income before loss provisions was down by an estimated 18 percent in 2010.

Unfortunately, better days do not seem to be near. Although the level of charge-offs is declining slowly, persistently high unemployment—which is not expected to fall from its current levels until 2013 at the earliest—will hinder rapid improvement. In addition, the impact of the CARD Act is expected to be long lasting, which will intensify competition for a shrinking group of attractive customers. Lower-value customers will face limited access to credit.

What's more, the Durbin Amendment establishes a regulatory precedent and the threat of a material reduction in credit-card interchange revenues as well—which would further erode profits and trigger significant industry restructuring. The likely consequences could include reduced investment in product innovation, lower rewards values on card purchases, higher annual fees, and the inability to serve certain customer segments.

Banks will need to ensure a superior customer experience across all channels.

Compounding these structural developments is a U.S. consumer trend toward lower debt accumulation. This trend is adding momentum to the shift from credit cards (with revolving credit lines) to debit cards. Also, we expect to see the rise of newer products such as prepaid cards, delayed-debit cards, and charge cards. Meanwhile, the migration from paper to electronic payment vehicles will continue. As a result of these and other factors, credit card profitability is unlikely to return to its precrisis levels over the next several years.

Indeed, in our view, the credit card industry has arrived at an inflection point that will require banks to rigorously rethink their business and operating models. In order to overcome significant near-term tactical challenges and develop long-term sustainable strategies, card issuers need to excel in the following areas: product bundling and pricing, product innovation, channel management, risk management, analytics, and cost management.

Product Bundling and Pricing. Retail banks have a wealth of insight into the transaction behavior and preferences of their checking-account customers that can be leveraged to develop attractive product combinations. Institutions with large retail-customer bases have the potential to become leaders in the new environment if they can successfully use this knowledge to develop product bundles that include flexible pricing and payment options.

Bundling will be particularly important given the significant decline in overdraft and interchange fees. Many customers will be profitable only if they have active credit and debit cards (which will often carry annual fees to help offset lower interchange), a checking account (possibly with a monthly fee), and perhaps loan products as well. To succeed at bundling, however, banks must develop effective internal incentives, as well as revenue- and cost-sharing policies across business units and product silos. The most successful bundling efforts will merge product functionality with new value propositions.

One particular credit-card product—the cobranded reward card—will undergo major attrition over the next decade. Amid eroding profit margins, only large programs such as those linked to major airlines and hotel chains will likely survive. Moreover, in the new era of a stronger focus on customer relationships, some issuers will want to build their own brands. Their objective will not be to save on reward costs, which will remain the same as with cobranding deals (75 to 100 basis points), but to more tightly link the card offering to other products in order to gain a higher share of wallet.

Product Innovation. Innovation will help lead to new pricing structures. It will also lead to bundles that include both deposit and credit offerings, as well as creative combinations of revolving and nonrevolving credit products. Innovation will extend to information delivery as well. Banks will send alerts to customers on their mobile phones to notify them of low account balances, funds transfer options, and retail purchase opportunities (based on the customer's known preferences and geographic location) in real time. Whatever the innovation, banks should focus primarily on easing "pain points" in their customers' daily lives.

Channel Management. Better channel management will be increasingly important to support product innovation, new customer-acquisition strategies, and low-cost operations. As the direct-mail universe shrinks, card issuers need to develop effective e-mail, Internet, and branch-acquisition approaches—including multichannel promotions (such as a credit card invitation that, if fulfilled online, offers larger sign-up rewards). Banks will also need to ensure a superior customer experience across all channels, and efficiently serve low-value, single-product accounts through low-cost channels. Regardless of the channel, however, the highest-value customers should receive the highest-priority service, much as business-class airline travelers wait in shorter queues and have access to superior departure lounges.

Risk Management. Given the regulatory impact on credit card economics, it is essential for issuers to improve their risk-management skills. First, they must identify the right pricing structure and credit-line size at the outset of the customer relationship. As issuers use additional variables that are based on the analysis of DDA flows, risk management capabilities are expected to improve.

Analytics. Banks also need to lift their performance in customer analytics, particularly when it comes to understanding the drivers of product selection and usage. The Internet will be an increasingly important platform for segmentation, rapid product testing, and multichannel management. We also expect advanced analytics (coupled with new channel technology) to support highly targeted, merchant-funded rewards. Such rewards will be geared toward increasing spending on a given issuer's card (as opposed to other cards or using other payment vehicles).

Cost Management. Given fundamental changes in revenue drivers, issuers will have to lower their costs in order to improve their return on assets. Operating models will have to be reexamined and restructured. Many banks will discover that they need to right-size through some degree of outsourcing, offshoring, and forging new partnerships.

Ultimately, over the next decade, issuers will differentiate themselves by their performance on the above initiatives. The winners will be those that move beyond the product-silo and mass-market approach toward building profitable, multiproduct relationships. Some institutions are already merging their credit-card business with their deposit and debit-card businesses, gaining an advantage over slower-moving rivals.

Beyond the Checking Account: Deepening Client Relationships

Similar to the credit card business, the checking-account domain is also undergoing a major upheaval in the U.S. In recent years, fee revenues for overdrafts and nonsufficient funds have topped $35 billion annually, enabling U.S. banks to offer free checking and to subsidize a majority of customers—those who did not generate appreciable fees or high spread income. Growing debit interchange revenues (which totaled $16 billion in 2009) also supported these subsidies.

But Regulation E modifications and the Durbin Amendment will permanently alter DDA economics. (See Exhibit 5.) As much as $10 billion of annual industry revenues will be lost owing to Regulation E. This translates to roughly 23 percent of all DDA net revenue or 38 percent of DDA pretax profits. Moreover, up to $9 billion of debit interchange revenues could be lost as a result of the Durbin Amendment. Generally speaking, these dynamics will signal the end of free checking and lead to greater emphasis on using other means (such as credit products) to expand share of wallet.

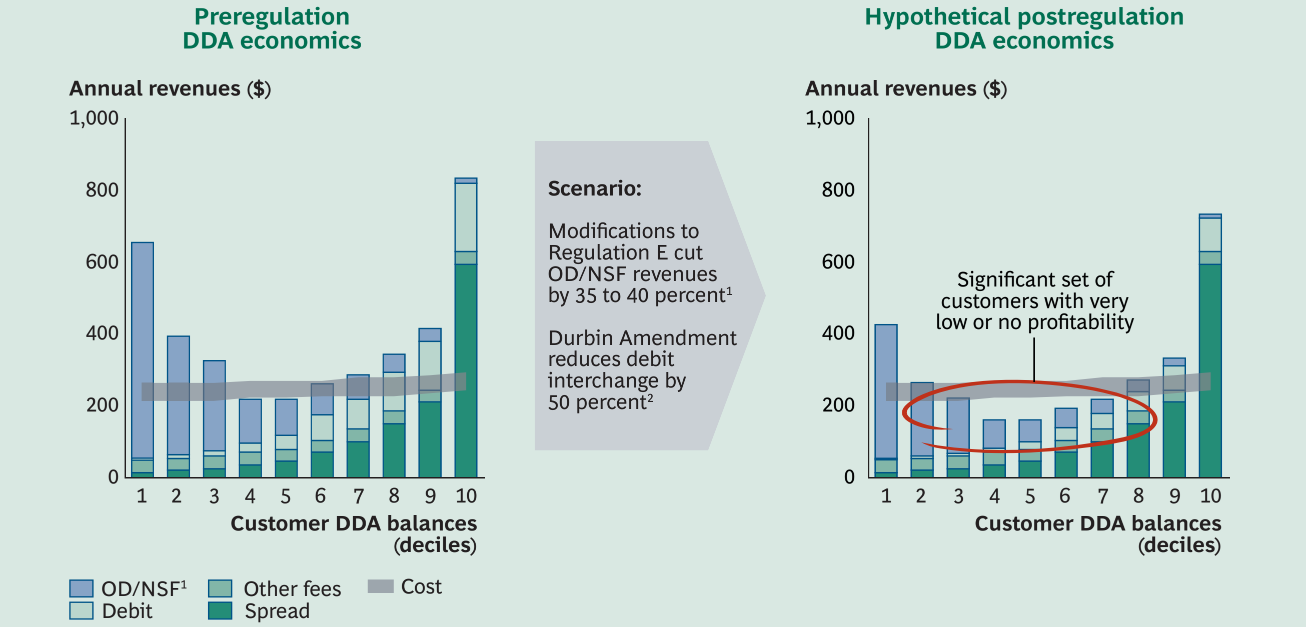
Banks will react by rethinking parts of their overall business models. Indeed, many leading institutions are steadily shifting from a product-centric model to a relationship-based model by focusing on segment needs and by developing product bundles that cut across silos.

In order to rebuild revenue streams, banks will need to undertake both tactical and strategic initiatives. We are likely to see more-sophisticated product bundling, true relationship-based pricing, next-generation data analytics and segmentation, a greater focus on targeting profitable segments, and a drive to better understand fully allocated and marginal costs by segment. Competition for high-income, high-balance customers will intensify, with banks offering generous incentives for customers to consolidate their banking relationships. At the other end of the spectrum, single-product, low-balance customers will see less-favorable pricing and reduced service levels. Such customers may eventually lose their access to traditional accounts.

Clearly, if fixed costs are fully allocated, a relatively high percentage of customers will be classified as unprofitable, causing banks to rationalize them through pricing or service restrictions (such as Internet-only accounts). More specifically, most banks are reinstituting monthly maintenance fees, even at the risk of some customer attrition, in order to improve profitability.

However, banks will have to be watchful to avoid losing customers who are incrementally profitable—those who

Exhibit 5. Regulation E Modifications and the Durbin Amendment Will Permanently Alter DDA Economics



Source: BCG case experience (sanitized); FDIC.
[1]OD/NSF = overdraft/nonsufficient funds; assumes debit/ATM OD is ~70 percent of total OD and a ~55 percent reduction in OD items.
[2]After banks have undertaken mitigating actions such as monthly or annual fees (estimated).

would become attractive if, for example, they added another product or increased their card-transaction volume. To be sure, competition for these "near profitable" customers will intensify as low-cost providers (possessing different cost structures) take advantage of pricing disruptions and customer churn to capture share.

Generally speaking, different approaches for different customer segments will be critical. For *mass-market customers* (average DDA balances of $500 to $3,000), truly free checking is essentially dead—although *qualified* free checking will still encourage profitable relationship building. Simply put, banks will move to a new revenue model that includes "free" checking provided other revenue-generating or cost-to-serve qualifications are met. Potential requirements will include minimum DDA balances combined with online bill payment or an active credit card (or other potential product combinations).

Beyond qualified free checking, many banks will try to develop products and services that help shift the relationship dynamic toward more of a *partnership* than a "who's getting the best of the deal" construct. Overall trust can be improved, for example, by helping customers achieve prudent financial planning. Creating this new spirit, along with a broader value proposition, will require working across product silos—not an easy task, but one that is attainable if a bank grasps the following key success factors:

- Understand total-household profitability, not just account profitability.
- Leverage all internal (transaction-level) and external (credit bureau) customer data.
- Stay in frequent touch with customers and develop a thorough understanding of their financial needs.
- Ensure early and active internal cross-silo engagement.
- Innovate and try new approaches (even if they may have short-term negative aspects).
- Monitor competitor moves.

- Closely coordinate internal and external communications.
- Ensure senior leadership commitment.

For *low-balance customers,* banks can provide alternative products that generate sustainable profits. Potential programs include the following:

- *Low-Line Credit Card.* Credit card competition in the subprime space has understandably declined. Nonetheless, some providers will profitably serve this segment by enhancing their pricing capabilities, risk analytics, and ability to determine optimal credit lines. Banks that provide DDAs to the subprime segment have income and transaction data to incorporate into the analytics but may prefer to focus their resources on prime customers.
- *Delayed-Debit or Charge Card.* Another means of improving the profit of DDA customers is to offer a delayed-debit card or charge card that is paid off (either automatically or by the customer) on a bimonthly or monthly basis (as is commonly offered in Europe). Such cards emphasize the control aspect of debit cards but can provide the issuer with interchange rates that are higher than those on debit cards. The interchange gap, if not eventually regulated away, is sufficiently large to warrant product innovation and to offer DDA customers incentives to use this type of vehicle. Furthermore, there are tools that provide control features on traditional credit cards through which customers can choose which charges must be paid out of their DDA immediately following the transaction (such as all charges under $25).
- *Prepaid Card.* With this type of card, fees would be a function of average balances and transaction volume (to maximize spread and interchange revenue) and could include an option to migrate to a limited DDA (such as an Internet-only account with only a debit capability and no checks). Such a card, combined with online bill payment, could provide a transaction-like account without the branch costs while earning higher than debit-card interchange revenues.
- *No-Frills Account.* This is a no-minimum-balance, online-only account with multiple aspects (such as prepaid or debit cards as well as a savings-account option). The offering could include financial-management tools available online or by mobile phone in addition to online rewards (such as iTunes) aimed at a younger customer segment.

For *high-balance customers,* banks need to be creative in promoting cross-selling and increasing product stickiness. Online bill payment, for example, has been highly successful for many institutions in achieving both aims. Other possibilities include relationship rewards that provide incentives for customer use, selective fee waivers (based on total balances), and reward points or cash-back programs.

In addition, accounts with bundled, nontraditional services (such as ID theft protection, roadside assistance, travel insurance, and special call-center support) can be offered with fees waived in return for a greater share of the customer's wallet. Credit products (such as auto loans, mortgages, and home equity loans) can be incorporated into the bundle. Banks can also leverage their ability to analyze customers' transaction flows in order to refine interest-rate levels on the basis of better credit-risk insight. Successful banks will continue to innovate with regard to how various products interact so that the customer will benefit from both a price and a functionality standpoint.

Staying Smart in the Digital Financial-Services Game

As banks and other payments institutions react to the challenges caused by the new regulatory environment, they must also look ahead to the next wave of digital innovation. The online channel is already the preferred U.S. banking channel (based on the number of transactions), and people are using a growing number of features. Moreover, mobile banking should come increasingly to the fore, playing a vital role in building transaction volumes, lowering cost-to-serve, and opening new opportunities to win market share.

Mobile banking is not merely about transferring online banking to a small, smartphone screen. It is about linking banking services with everything that mobile-phone applications and location-based technology have to offer. Possibilities for customers include receiving real-time text alerts about bills that are due, being able to snap a picture of a check for remote deposit, and receiving directions to find a bank branch or a merchant that offers rewards on their cards. If banks can provide both customers and merchants with the right incentives and functionality—and market mobile capabilities clearly and effectively—mobile payments will flow strongly into the payments mainstream in the U.S. over the next decade.

Banks in the U.S. must therefore invest prudently to stay in touch with digital advancements and consumer habits, developing products that will meet their customers' evolving needs. Part of this process will involve simply being where the customers are—such as on Facebook and Twitter. Banks that do not keep pace with the growing presence of digital products in everyday life risk losing the customer relationship to nonbanks that have already established digital beachheads.

While it may be difficult to imagine people having their monthly paychecks deposited directly to Apple, it is easy to see iTunes intermediating between customers and their financial institutions for many online transactions. Like PayPal, both iTunes and Amazon simplify the purchase process and provide value-adds such as reviews of consumer goods. And as PayPal has proved by its strong growth both on and off eBay, "simple" is good business. Both Mint.com and Intuit, which acquired Mint, know this as well.

Although it is clear that banks and payment networks must make progress in the world of mobile payments, navigating a smart path and prudently pursuing initiatives that have the greatest chance of success is a tall order. And because capturing value may be elusive in the early stages, a "relationship banking" approach will again prove critical to profitability.

Banks can most effectively motivate merchant acceptance and consumer use of mobile payments through pricing and reward incentives. Banks are in a stronger position than mobile-telecommunications carriers, which cannot provide FDIC insurance and are unlikely to extend credit or be holders of large deposit balances. Also, while mobile carriers may own the SIM card, they do not own the merchant or customer relationship. But they do know where their customers are all day long—extremely valuable information if they use it intelligently.

In particular, banks should monitor opportunities in the e-wallet space and leverage their ability to link products, act as an aggregator, and provide a general-purpose payment service—for example, a virtual wallet coupled with a reward card. Ultimately, the prize will be not only a greater share of the steadily growing e-payment transaction volume—as consumers migrate away from using cash and checks—but also an opportunity to influence the migration itself.

In this area, more than most, how one lives inside the payments ecosystem will be critical for success. As banks build out their own applications, other entities are moving aggressively into the mobile space. Players include both the payment networks (Visa, MasterCard, Discover, and American Express) and the carrier networks (AT&T, Verizon, T-Mobile, and Sprint) along with handset manufacturers and operating systems (such as Google's Droid). Knowing where your strengths lie in the value chain, as well as how to successfully partner and extract value, will be the key.

Brazil: From Disruption to Innovation

Brazil is by far the largest payments market in Latin America. In 2010, total noncash payments in Brazil were valued at $11 trillion, representing 52 percent of total payments value in the region. Payments revenues were $43 billion, of which $19 billion came from transaction revenues.

A central theme in Brazil today is the transformation of the card market, a shift that is having a significant effect on the country's overall financial-services industry. And the stakes are high. Unlike mature markets, in which the battle for credit and debit card share is waged in terms of basis points, the fight in Brazil is for percentage points—gains that will lead to a solid platform for growth.

The market has recently undergone considerable disruption, most of it centered on the acquiring and network businesses—with collateral impact on the issuing business. Merchant acquiring has long been a very profitable and fast-growing activity in Brazil, with EBITDA of 60 to 70 percent of revenue and annual growth of 25 percent. In July 2010, however, regulatory pressure opened up the acquiring market, eliminating a structure in which each acquirer was affiliated with a single card network. This development is likely to put pressure on merchant discount rates (MDRs) as well as on point-of-sale terminal rental margins (which currently account for roughly 20 percent of acquirer revenues). It has already brought in new players, and we expect others to enter the market over the next few years.

One example is the joint venture between Banco Santander Brasil and GetNet (a Brazilian IT products and services provider specializing in electronic payment transactions), which is competing in the acquiring business. Meanwhile, Santander Brasil is offering discounts on POS terminals and account service fees, incentives to open new accounts, higher working-capital and prepayment lines, and concessions on overdrafts.

Payment margins in Brazil are attractive and are likely to remain that way.

Credicard, a wholly owned subsidiary of Citigroup, and Elavon, a wholly owned subsidiary of U.S. Bancorp and a leading global payments provider, have also announced their entry into the acquiring business. They have signed a binding agreement to establish a joint-venture merchant-services company that will offer a full suite of payment solutions in the Brazilian market.

New entrants will have to compete with two strong incumbents, Cielo and Redecard. These established players were started by—and are still closely associated with—the leading Brazilian banks. They have become publicly listed companies and are among the largest acquirers globally in terms of market capitalization.

Despite the increased competition, however, payment margins in Brazil are attractive and are likely to remain that way compared with those in other countries—enabling local payments players to continue investing in marketing, distribution, infrastructure, operating efficiencies, and, above all, innovation. Indeed, the Brazilian payments market has some distinct characteristics that make it ripe for innovation-driven strategies:

- High cash use (some 50 percent of transaction volume)
- A relatively young, steadily growing population
- Relatively strong household-income growth
- A central bank and regulators eager to migrate transactions from cash and checks to cards and e-payments, as well as to bring banking services to the unbanked

One recent example of innovation has been the move by three top Brazilian banks—Banco Bradesco, Banco do Brasil, and Caixa (the latter two government controlled)—to form a new card network called Elo. This development illustrates how established players can restructure and extend their market reach and at the same time fend off new entrants such as nonbank players. Elo also demonstrates how traditional banks can cooperate to form a useful new utility. The Elo network will target the low-income segment—typically underbanked or unbanked consumers—which represents a vast opportunity with double-digit growth potential, particularly in migrating government benefits to Elo prepaid cards.

Beyond the card business, Brazilian banks are cooperating and innovating in e-payments. In October 2009, Brazil's Interbank Payment Clearing-house (CIP), which is owned by 42 banks, launched the direct-debit account—a full electronic bill presentation and payment (EBPP) service. Unlike the U.S. market, in which there are competing third-party EBPP networks, Brazil is forming a single utility that enables banks to accelerate the network effect and scale benefits. The direct-debit account system already has 3 million payees registered, out of a potential 34 million Internet-banking clients.

Another highly useful (and differentiating) feature is that the system has no preferences with regard to the particular bank. Payers register using a taxpayer identification number and are then able to access the service from any account at any participating bank. (In Brazil, consumers often have checking accounts at multiple banks.) Currently, payers are not charged to use the direct-debit account. Instead, banks charge payees for registration and then for clearing and settlement.

Developments in Brazil demonstrate how established players and new entrants can respond to market disruption with innovations aimed at securing share in a rapidly growing region. Payments providers in other transitioning markets in which the government is a key player (such as India and China) should monitor Brazil's evolution over the next five years.

Retail Payments: Asia-Pacific

Asia-Pacific remains a growth area for payments and transaction banking. In 2010, both total volume (up 11 percent from 2009) and the total value of transactions (up 13 percent) grew significantly. Moreover, this growth is expected to continue as large pools of unbanked consumers gradually enter the market—and as some of the largest economies in the region, including China and India, invest heavily in their national payments infrastructures.

Overall, Asia-Pacific is a highly diverse region that presents a unique set of challenges for financial institutions. Banks will have to tailor their business and operating models in order to balance growth aspirations with efficiency goals. Generally speaking, there are two sets of markets:

- Mature markets, such as Japan, Australia, Singapore, and Hong Kong, which are characterized by well-developed payments infrastructures and regulatory environments

- Emerging markets, such as China and India (as well as some Southeast Asian countries), where consumers still make payments primarily in cash but where the reach of electronic payments systems is dramatically increasing and mobile-payment models are beginning to gain traction

In the mature Asia-Pacific countries, much as in the North American and Western European markets, growth discussions focus on existing customers—more specifically, on opportunities to increase share of wallet by improving the convenience of payment solutions for consumers and merchants.

In Hong Kong, for example, the Octopus card—a "contactless" smart card that was first introduced in 1997 as a simple prepaid card for public transport—has now been enhanced with top-up facilities and links to credit card accounts. Now widely accepted at convenience stores, food shops, and retailers, Octopus has become a market leader in terms of consumer and merchant adoption. What's more, it offers additional utility to consumers by functioning as a means of entry into secured buildings.

Similarly, in Australia, contactless cards are seen as one of the next frontiers in electronic payments, having the potential to displace cash for small purchases at the point of sale. The market potential is significant, with more than 60 percent of purchases in some categories (such as takeout food) still paid for in cash. Some banks have begun to invest in contactless-card and terminal solutions and are promoting their use through consumer education campaigns. Such banks could potentially gain ground by targeting consumers and merchants of financial institutions that do not offer contactless solutions. Such a strategy is not without its challenges, however. To be successful, contactless solutions must provide benefits across the value chain from merchant to consumer. In particular, consumers must have incentives to use these cards.

In *emerging* Asia-Pacific markets, by contrast, growth will be generated by the gradual financial inclusion of unbanked consumers and the rapidly expanding footprint of the electronic-payments infrastructure. Shifts in spending behaviors and payment preferences, especially on the part of the emerging digital generation and those consumers moving from rural to urban areas, will also be a prime factor.

In India, for example, the government has started an ambitious and successful rural employment program called the Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA). Under the program, small payments to rural manual laborers are made through direct credit into "no frills" bank accounts held by the workers. Another parallel initiative, Unique Identification Authority of India (UIDAI), is attempting to allot a unique ID number to each resident of India. This project could make "know your customer" initiatives much easier and ensure more rapid inclusion of the large portion of the population that is still unbanked.

In emerging markets, telecom providers have pushed ahead to offer payments solutions.

In China, personal credit cards are growing rapidly in popularity. By the end of 2009, there were around 185 million cards in circulation, a gain of 30 percent over the previous year. Transaction volumes and values are increasing at similar rates. Large Chinese banks continue to aggressively expand their card bases by offering incentives such as annual-fee waivers or welcome gifts. In addition, some banks have launched innovative products such as "combo" cards that offer convenient payment solutions by combining credit, debit, and IC/RFID (integrated circuit/radio frequency identification) functions into a single card. At the same time, banks and other payment companies are rapidly rolling out POS terminals. Finally, the public-transport sector is contributing to the growth in electronic payments by actively implementing and promoting prepaid products.

The differences between mature and emerging markets are further illustrated by the way in which banks view telecommunications companies. In mature markets, electronic payment systems enjoy geographically wide coverage and operational stability. Interactions between participants—banks, network providers, merchants, and, ultimately, consumers—are well established. Any perceived disruption to this well-functioning ecosystem is likely to trigger a protective response from established players. Indeed, although telecommunications providers in these markets may have an attractive offer for consumers—such as payments via near-field communication (NFC) technology at the point of sale—they are not viewed as absolutely critical partners.

In emerging markets, by contrast, telecommunications companies have a significant value-add proposition for payments ecosystems that are still constrained by limited physical and electronic infrastructures. In addition, governments, central banks, and regulatory bodies have a vested interest in the migration from cash to electronic payments and therefore are key stakeholders—influencing payment infrastructure development and potentially even pricing. Hence, there is a strong rationale for collaboration among banks, telcos, governments, and other nonbank players to increase financial inclusion and drive electronic-payments growth. In India, the central bank has recently taken steps to allow banks greater leeway in using nonbanks (including telcos) as "business correspondents" to facilitate transactions in remote places using hand-held devices and mobile phones.

Back in 2003, mobile provider China Mobile and the card network China UnionPay established UMPay to try to capture the nascent domestic mobile-payments opportunity. More recently, in 2010, China Mobile purchased 20 percent of Shanghai Pudong Development Bank, with which it is expected to jointly develop mobile-payments services. Separately, China UnionPay has formed an alliance with commercial banks, mobile operators, phone manufacturers, and other industry players to establish specifications and business models for the overall mobile-payments industry.

In some cases, telecommunications providers in developing economies have pushed ahead on their own to fill gaps in the market. For example, India's largest mobile player, Bharti Airtel, recently obtained a payment-service provider license that will allow the company to offer semiclosed-loop payment solutions to customers.

When it comes to regulation of the payments industry in Asia-Pacific, the climate also differs between mature and emerging markets. In the former, the principal aim of regulators is to enable efficient payment mechanisms and to maintain a competitive market structure. In emerging markets, the focus is much more on creating the basic framework for the payments business—as well as on fostering a thriving market. For example, National Payments Corporation of India (NPCI), a new organization promoted by banks, is building infrastructure to facilitate better interbank connectivity. In addition, Indian regulators have mandated free customer access to the ATMs of all banks. The ATM switch operated by NPCI has facilitated this fundamental shift in India's payment ecosystem. As a next step, NPCI has been charged with developing a domestic card network called RuPay (originally announced as IndiaPay) as an Indian alternative to international card offerings.

The divergent market characteristics in the Asia-Pacific region provide an interesting set of challenges for banks with both local and regional aspirations. A clear view of regional and segment priorities will be required in order to guide investments. Most local banks will concentrate on opportunities in their domestic markets. That said, some large players are starting to build out their franchises to support cross-border payment flows. But regardless of whether the geographic focus is domestic or regional, banks need to think through their operating models—especially concerning possible cooperation with other banks and nonbank players—as well as explore opportunities to leverage payments systems across markets and segments.

The Global Wholesale Transaction-Banking Market

The global financial crisis has highlighted the attractiveness of transaction banking. Although businesses such as deposit and payment services, cash management, and trade services were not unscathed by the downturn, they fared relatively well. Over the full economic cycle, these businesses often provide reliable fee and spread revenues, rich deposit volumes, and high profitability. Return on equity is typically above 40 percent for best-practice institutions. Moreover, BCG's Corporate Banking Benchmarking Survey has shown that "transaction champion" business models—those that generate a diversified mix of credit, treasury, cash-management, and payment revenues as opposed to those dominated by credit-related revenues—can be pivotal in gaining competitive advantage across customer segments.

In the postcrisis era, transaction banking will remain a significant opportunity for financial institutions. Wholesale-payments volume is expected to post a CAGR of 9 percent globally from year-end 2010 through 2020, and total wholesale payments revenues are expected to increase from $169 billion to $471 billion. Moreover, leading global institutions are elevating transaction banking from an organizational perspective. They are refocusing sales efforts and making significant investments in improving overall capabilities, client coverage, and regional scope. They are taking these steps in the belief that an increasing emphasis on transaction banking will bring long-term benefits. Let's explore some of the reasons for this belief.

Why Transaction Champions Outperform

Our benchmarking demonstrates that transaction champions have continued to outperform other types of banks despite adverse trends such as narrowing deposit spreads and lower volumes. The reason is a relatively resilient revenue mix consisting of spreads earned on deposit balances and fee income earned on transaction and value-added services. In 2009, among banks focused on serving midsize corporations (those with between $25 million and $250 million in annual sales revenues), transaction champions posted revenues per risk-weighted assets of 600 basis points, compared with only 250 basis points for credit-heavy corporate banks—and their return on regulatory capital was 31 percent, versus 8 percent for credit-heavy banks.[2] Since 2007, return on equity has risen for most transaction champions and has fallen for all credit-heavy banks in our benchmarking survey.

What are the dynamics behind these trends? Generally speaking, transaction champions exhibit a comprehensive approach to building their franchises along dimensions such as the following:

- *Organization.* Commercial-, corporate-, and investment-banking businesses are fully aligned and have transaction-banking objectives. Cross-silo product development, pricing, and bundling (such as FX risk hedging) are encouraged and supported. In addition, a collaborative model exists between the front office (the business units) and the back office (IT and operations).

- *Relationship Management.* A distinct coverage model exists, including appropriate incentives, that enables effective teaming between relationship managers and specialists in treasury and other product areas. Strong emphasis is placed on fully understanding customers'

2. Based on the worst three-year average of actual or expected loan losses.

present and future needs. When serving large corporations and MNCs (multinational corporations), global product groups team with relationship managers as well.

- *Product Capabilities.* Excellence in the core products and services needed by target clients is provided, ultimately enabling clients to optimize their working capital. Cutting-edge pricing models, superior bundled-service packages, and the ability to offer short-term credit (such as supply chain financing) is the norm. The greatest challenge is in serving MNCs, which require sophisticated, integrated, cross-border payment services.

- *Customer Service and Product Delivery.* Both on-site and remote support is robust, enabling swift problem resolution. Online cash-management and treasury services are user-friendly and efficient. The execution of transactions is automated, accurate, and fast. We have observed that banks with relatively deep online-portal penetration rates tend to have higher transaction-banking revenues.

- *Infrastructure.* Core systems are reliable, secure, scalable, and easily integrated with customers' systems. In addition to having a sophisticated online treasury-management platform, transaction champions serving large corporations and MNCs must be able to offer their clients access to the bank's treasury and payments applications via the clients' own enterprise-resource-planning (ERP) and treasury systems.

The above attributes contribute to transaction champions' frequent ability to gather more deposits and generate more revenues than banks whose focus lies elsewhere. Yet the sales forces of transaction champions are not necessarily larger, nor are their overall product ranges always wider. Their secret lies simply in achieving the virtuous circle of cross-selling: sell more transaction services, increase deposit balances, and win more cash-management mandates. As account revenues gradually become more important, an increasing share of a client's deposits will be a critical revenue driver.

Most banks, however, are not transaction champions. Our benchmarking has revealed that a majority of banks are leaving potential revenues on the table, with only a small minority exploiting the transaction-banking possibilities presented by their deposit and loan clients. (See Exhibit 6.) Moreover, even those banks that excel at transaction banking can improve their performance. But in order for all banks to raise their games in this area, they need to review—and potentially retool—their business and operating models.

Transaction champions achieve the virtuous circle of cross-selling.

Building a Transaction Champion

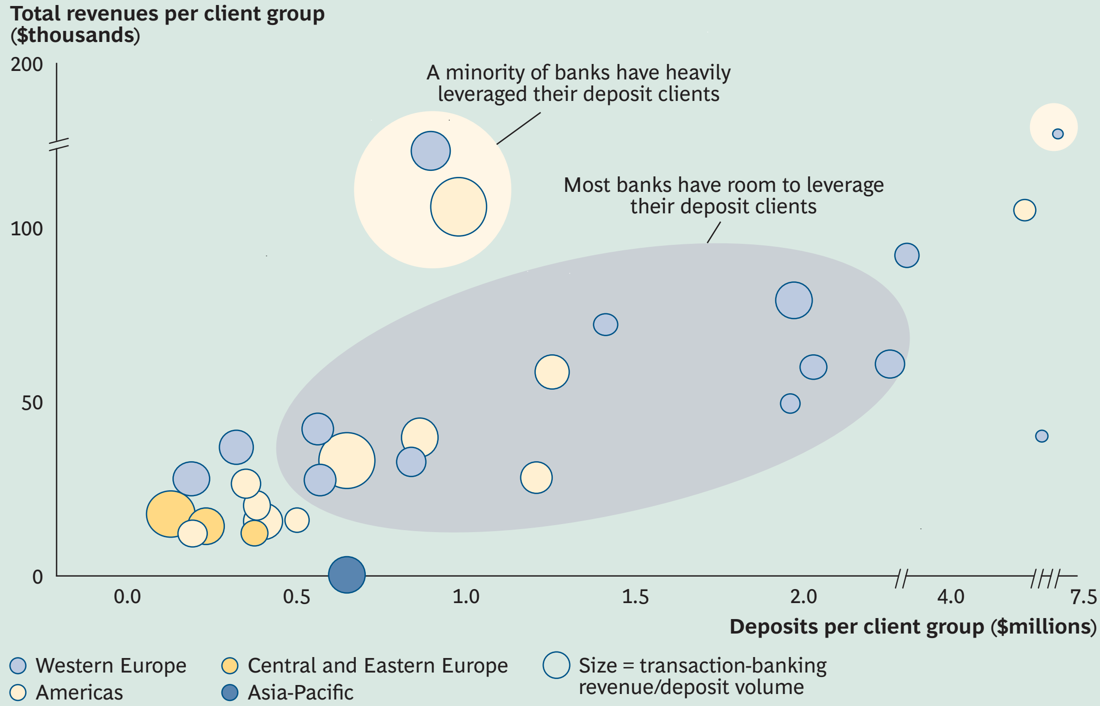
Despite the strengths of transaction-banking businesses, there are multiple challenges to be overcome before the full opportunity can be captured. For instance, getting different silos within the bank—such as the corporate-banking sales force, the cash-management and trade-service specialists, and the operations and IT groups—to align around making transaction banking a top priority can be a tall order.

What's more, some institutions struggle in defining their core target markets (both from a segment and geographic perspective) and in smoothing out uneven customer experiences across channels and regions. A winning strategy in North America or Western Europe, for example, might not be optimal in Asia. (See the sidebar "Transaction Banking in Asia: Forging a Sustainable Franchise.")

In addition, price pressure is becoming more severe as the competition for market share and scale heats up—a dynamic complicated by the tightening regulatory climate. Traditional operating models are being tested as wholesale banks face increasing tradeoffs between efficiency and standardization on the one hand and service excellence and customization—both across borders and across segments—on the other.

In our work with clients, we have observed that building a transaction champion depends on making the right decisions and investments along multiple dimensions. These dimensions include geographic footprint, product breadth, product quality, product and service innovation, distribution infrastructure, customer service and support, and credit capacity (along with the related risk appetite). For example, banks aspiring to be transaction champions

Exhibit 6. Most Banks Do Not Achieve the Full Potential of Their Transaction-Banking Business



Sources: BCG Corporate Banking Benchmarking Database, mid-cap segment (data are from 2009); BCG analysis.

for small to midsize corporations (as opposed to large-caps or MNCs) should focus on getting product breadth, distribution, and customer support right, as well as assuring that sufficient credit capacity is available.

As for product breadth, many banks have pursued an "everything to everybody" strategy. As a result, they are supporting an unwieldy range of products, some of which are subscale, negative- to low-profit products. Yet our benchmarking shows that banks can achieve above-average cross-selling (measured by revenues per client) without a full product set—and that other factors are important drivers. (See Exhibit 7.)

In our view, banks should home in on core, profitable products, ensuring that their offering remains competitive, while jettisoning or "white labeling" (using generic versions of) noncore, low-profit products. White labeling has become an increasingly viable proposition as top-tier banks build multibank product platforms and offer interesting terms. Our recent discussions with banks reveal that many see partnering in global transaction banking as an increasingly important part of their growth strategy.

Regarding distribution, most banks have room for improvement in achieving a collaborative organization structure between relationship managers and transaction-product specialists, with a commensurate opportunity to increase their share of customer wallet. A useful place to start is to undertake a "wallet sizing" exercise. Such an initiative should be aimed at understanding each client's revenue composition, current product use, and future potential with regard to client segment, region, product, and relationship manager. Wallet-sizing methodologies tend to vary by segment.

Customer service and support is another critical area. Indeed, poor customer service is the root of most attrition. If a bank is to maximize the lifetime value of its customers, sharp distribution infrastructure must be coupled with customer service excellence. Best-practice players are developing centers of excellence to support specific products and services and ensure that service-level agreements are met and improved upon. Such institutions establish delivery teams (both physical and virtual) to assure quick customer onboarding, and they designate client-specific support teams for the largest, most profitable customers.

Of course, banks must be willing and able to provide capital-intensive products, including corporate loans, lines of credit, and (to a lesser degree) trade finance. For the latter, a bank may find that partnering with another bank is optimal. The ability to provide credit is critical to maximizing transaction-banking revenues from midsize to large corporations. As one of our clients said, "It is impossible to divorce the conversation about credit from cash management." The reverse is true as well. Transaction champions often will not renew a line of credit for credit-only customers unless the customer shifts some of its transaction-banking business to the bank. As Basel III capital requirements adversely affect the return earned on credit products, cross-selling to credit clients will become critical to improving performance.

Although crisp execution along the above dimensions requires a sizable commitment in terms of financial and

Transaction Banking in Asia

Forging a Sustainable Franchise

For major payments players, making the most of transaction-banking growth opportunities in Asia is largely a matter of focusing on three segments: Western multinational corporations (MNCs) that are evolving in the region, Asian MNCs with expanding cross-border needs, and midsize Asian corporations (which tend to be underserved).

In building up a competitive overall offering, a new entrant can often use tailored trade solutions as a door opener, with a heavy focus on structuring, cross-selling, and differentiating the bank's offering from those of purely local banks. Product capabilities can be advanced gradually to capture new flow businesses. Regional e-banking can be used to enhance visibility, with progressive expansion into full regional cash-management offerings.

More specifically, in order to excel at serving Western MNCs, banks need to understand how an MNC is organized globally and have a strong relationship with its headquarters—be it in Europe or the Americas—as well as with its regional divisions in Asia. Although regional divisions may take their lead from the home office in seeking out transaction-banking products and credit facilities, the bank's relationship with the MNC's Asian division or affiliate needs to be managed locally—"on the ground"—in order to truly capture and meet the full range of local needs. Moreover, in order to sell transaction-banking services, credit lines must be available at the local level.

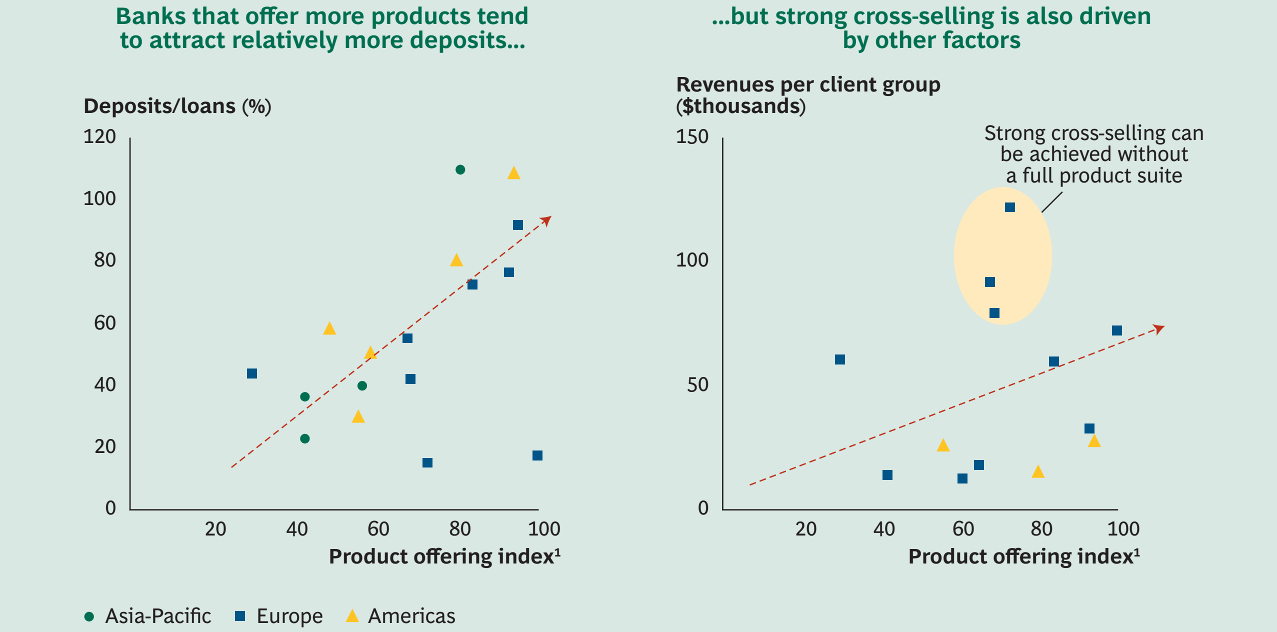
But nonlocal banks will have to beef up their local knowledge and capabilities if they hope to succeed with Asian operations of Western MNCs. They must be able to develop—either directly or through partnerships—a complete and sophisticated set of local offerings, backed by products and services tailored to specific Asian markets.

When it comes to serving leading Asian MNCs, banks must be especially thoughtful in choosing target companies and countries. They must also establish regional coverage teams to serve their targets, as many Asian MNCs have significant transaction-banking and credit needs outside their home markets. Initial attention should be placed on Asian MNCs' divisions in rapidly growing economies such as China and India. Often, a banking relationship can be built up by offering credit lines in non-home markets, which can then enable the bank to win cash management mandates. Such mandates, in turn, can enable the bank to provide lucrative treasury services.

As for midsize Asian corporations, which tend to be underserved, vast potential exists for meeting their transaction-banking needs. This opportunity can bring significant rewards. As with the other two segments, however, winning requires a high level of local knowledge and an ability to provide sufficient credit facilities. In addition, banks that can offer differentiated trade services in rapidly developing economies will capture market share. Trading companies, in particular, are an attractive segment to serve, but they require relatively large credit facilities and a corresponding risk appetite. Banks with limited risk tolerances can target Asian companies that have a multicountry presence by offering regional and interregional cash-management services.

Even though the investment required to be a winner in Asia is large, it can be made incrementally—and either directly or through partnerships. But there is no time to lose, as many leading global banks have been ramping up their Asian investments during the downturn.

Exhibit 7. A Broad Product Range Attracts More Deposits but Is Not Mandatory for Strong Cross-Selling



Sources: BCG Corporate Banking Benchmarking Database, mid-cap segment (data are from 2009); BCG analysis.
[1]The product offering index indicates the number of products offered out of a list of 18 key products (each is weighted equally); an index value of 100 means that all 18 products are offered.

human resources, the investment will likely result in a sustainable business model and profitable growth. Not only do transaction champions increase customer retention through superior service and credit offerings but they also tend to attract the best customers of other banks as well.

Finally, a transaction champion must be able to design and implement appropriate business and operating models for its target segments. This task often involves balancing a "design to cost" perspective for the small and midsize segments with a "service excellence" perspective for large corporations and MNCs. A bank must have a flexible operating model that allows it to achieve scale and low costs within an infrastructure that supports all client segments. At the same time, the model must support the separate platforms required to deliver customized services to MNCs. Banks that achieve this balance will have not only a sustainable cost (and pricing) advantage but also a service advantage. These benefits will be the growth drivers of the future.

Appendix

An Overview of Volumes, Values, and Revenues in the Payments Marketplace, 2010–2020

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 evolution from 2010 through 2020.

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 2010, BCG updated its global payments model to incorporate additional data, add new countries (now 55), adjust the forecast models to account for the global recession, and extend the forecasts to 2020. Data from previous BCG reports may have been revised accordingly.

Worldwide Payments, 2010 and 2020

2010

	North America	Latin America	Western Europe	Central and Eastern Europe	Asia-Pacific	Middle East and North Africa	Rest of world	Total
Volume (millions)	116,700	29,000	78,000	11,900	65,400	4,000	1,200	306,300
Value ($millions)	95,595,100	20,841,600	98,739,100	18,647,000	90,913,100	5,314,600	1,323,200	331,373,700
Total revenues ($millions)	159,900	71,200	146,600	40,300	140,400	29,200	2,400	589,900

2020

	North America	Latin America	Western Europe	Central and Eastern Europe	Asia-Pacific	Middle East and North Africa	Rest of world	Total
Volume (millions)	206,700	109,000	125,200	30,400	212,500	37,500	28,500	749,800
Value ($millions)	137,480,600	71,254,100	154,780,000	52,909,400	301,147,200	34,751,600	29,682,800	782,005,700
Total revenues ($millions)	284,500	195,200	276,200	97,400	533,800	132,300	60,000	1,579,400

Source: BCG Global Payments database, 2010.

Volume of Payments

Region/country	2010	2020	CAGR, 2010–2020 (%)
Units: millions of transactions			
Americas	**145,800**	**315,700**	**8**
North America	116,700	206,700	6
Canada	9,500	15,800	5
United States	107,200	190,900	6
Latin America	29,000	109,000	14
Brazil	18,900	67,900	14
Mexico	3,500	8,500	9
Other Latin America	6,600	32,600	17
Europe	**90,000**	**155,600**	**6**
Western Europe	78,100	125,200	5
France	14,300	21,500	4
Germany	18,800	33,200	6
Italy	3,600	4,100	1
Netherlands	4,500	7,600	5
Spain	4,800	5,700	2
United Kingdom	14,400	24,100	5
Other Western Europe	17,600	29,000	5
Central and Eastern Europe	11,900	30,400	10
Czech Republic	1,800	3,200	6
Poland	1,900	3,900	7
Russia	2,800	9,200	13
Other CEE	5,400	14,100	10
Asia-Pacific	**65,400**	**212,500**	**13**
Japan	7,600	9,800	3
Australia	5,200	11,900	9
New Zealand	2,000	3,600	6
China	22,400	105,200	17
Taiwan	800	1,100	4
Hong Kong	800	1,200	3
Singapore	2,600	4,600	6
South Korea	11,000	20,800	7
Indonesia	2,400	7,800	13
Malaysia	1,400	2,400	6
Philippines	3,600	14,000	15
Thailand	1,200	3,000	10
India	2,900	19,400	21
Other Asia-Pacific	1,700	7,700	16
Middle East and North Africa	**4,000**	**37,500**	**25**
Rest of world	**1,200**	**28,500**	**37**
World	**306,300**	**749,800**	**9**

Source: BCG Global Payments database, 2010.

Volume of Retail and Wholesale Domestic and Cross-Border Payments

Region/payment type	2010	2020	CAGR, 2010–2020 (%)
Units: millions of transactions			
North America	**116,700**	**206,700**	**6**
Retail domestic	94,800	172,500	6
Retail cross-border	1,700	3,700	8
Wholesale domestic	20,000	29,800	4
Wholesale cross-border	300	600	7
Latin America	**29,000**	**109,000**	**14**
Retail domestic	20,400	83,000	15
Retail cross-border	400	1,200	12
Wholesale domestic	8,100	24,700	12
Wholesale cross-border	30	200	21
Western Europe	**78,100**	**125,200**	**5**
Retail domestic	63,100	102,100	5
Retail cross-border	1,600	2,600	5
Wholesale domestic	13,300	20,100	4
Wholesale cross-border	200	300	4
Central and Eastern Europe	**11,900**	**30,400**	**10**
Retail domestic	9,200	23,700	10
Retail cross-border	200	400	7
Wholesale domestic	2,400	6,000	10
Wholesale cross-border	100	400	15
Asia-Pacific	**65,400**	**212,500**	**13**
Retail domestic	42,600	132,500	12
Retail cross-border	2,800	14,400	18
Wholesale domestic	19,700	64,600	13
Wholesale cross-border	300	1,000	13
Middle East and North Africa	**4,000**	**37,500**	**25**
Retail domestic	3,300	33,300	26
Retail cross-border	100	500	17
Wholesale domestic	600	3,600	20
Wholesale cross-border	10	30	12
Rest of world	**1,200**	**28,500**	**37**
Retail domestic	900	21,600	37
Retail cross-border	30	900	41
Wholesale domestic	300	5,900	35
Wholesale cross-border	4	100	38
World	**306,300**	**749,800**	**9**

Source: BCG Global Payments database, 2010.

Value of Payments

Region/country	2010	2020	CAGR, 2010–2020 (%)
Units: $millions			
Americas	**116,436,700**	**208,734,700**	**6**
North America	95,595,100	137,480,600	4
Canada	8,100,500	13,755,800	5
United States	87,494,600	123,724,800	4
Latin America	20,841,600	71,254,100	13
Brazil	10,961,900	34,585,400	12
Mexico	3,096,500	9,933,900	12
Other Latin America	6,783,100	26,734,800	15
Europe	**117,386,200**	**207,689,400**	**6**
Western Europe	98,739,100	154,780,000	5
France	16,594,300	24,827,600	4
Germany	22,563,000	35,291,400	5
Italy	9,927,000	14,135,400	4
Netherlands	4,664,800	7,273,100	5
Spain	8,685,700	13,091,700	4
United Kingdom	14,462,800	23,363,000	5
Other Western Europe	21,841,400	36,797,800	5
Central and Eastern Europe	18,647,000	52,909,400	11
Czech Republic	1,025,500	2,084,100	7
Poland	2,203,000	4,703,300	8
Russia	8,026,800	25,023,100	12
Other CEE	7,391,600	21,098,900	11
Asia-Pacific	**90,913,100**	**301,147,200**	**13**
Japan	21,045,700	27,234,100	3
Australia	3,009,700	5,002,000	5
New Zealand	763,400	1,585,600	8
China	43,975,500	181,964,500	15
Taiwan	2,409,600	5,543,600	9
Hong Kong	1,500,300	2,982,500	7
Singapore	734,500	1,882,300	10
South Korea	6,503,000	14,555,200	8
Indonesia	1,304,500	5,950,500	16
Malaysia	982,900	2,479,300	10
Philippines	1,355,500	5,283,000	15
Thailand	845,300	2,447,100	11
India	4,468,800	35,265,100	23
Other Asia-Pacific	2,014,400	8,972,400	16
Middle East and North Africa	**5,314,600**	**34,751,600**	**21**
Rest of world	**1,323,200**	**29,682,800**	**36**
World	**331,373,700**	**782,005,700**	**9**

Source: BCG Global Payments database, 2010.

Value of Retail and Wholesale Domestic and Cross-Border Payments

Region/payment type Units: $millions	2010	2020	CAGR, 2010–2020 (%)
North America	**95,595,100**	**137,480,600**	**4**
Retail domestic	16,056,700	20,720,400	3
Retail cross-border	108,700	198,800	6
Wholesale domestic	77,496,500	112,650,600	4
Wholesale cross-border	1,933,300	3,910,800	7
Latin America	**20,841,600**	**71,254,100**	**13**
Retail domestic	1,969,600	6,542,800	13
Retail cross-border	44,300	111,600	10
Wholesale domestic	18,107,200	60,372,000	13
Wholesale cross-border	720,400	4,227,700	19
Western Europe	**98,739,100**	**154,780,000**	**5**
Retail domestic	8,633,500	13,719,900	5
Retail cross-border	188,600	321,400	5
Wholesale domestic	85,061,200	130,764,900	4
Wholesale cross-border	4,855,700	9,973,800	7
Central and Eastern Europe	**18,647,000**	**52,909,400**	**11**
Retail domestic	1,336,300	3,906,000	11
Retail cross-border	18,500	46,100	10
Wholesale domestic	16,234,700	44,722,800	11
Wholesale cross-border	1,057,500	4,234,500	15
Asia-Pacific	**90,913,100**	**301,147,200**	**13**
Retail domestic	5,833,400	21,331,200	14
Retail cross-border	329,400	1,666,400	18
Wholesale domestic	79,674,000	253,561,200	12
Wholesale cross-border	5,076,300	24,588,500	17
Middle East and North Africa	**5,314,600**	**34,751,600**	**21**
Retail domestic	508,200	4,969,000	26
Retail cross-border	10,100	49,800	17
Wholesale domestic	4,253,600	27,624,500	21
Wholesale cross-border	542,600	2,108,300	15
Rest of world	**1,323,200**	**29,682,800**	**36**
Retail domestic	137,700	2,809,100	35
Retail cross-border	2,800	94,500	42
Wholesale domestic	1,125,900	24,843,900	36
Wholesale cross-border	56,900	1,935,300	42
World	**331,373,700**	**782,005,700**	**9**

Source: BCG Global Payments database, 2010.

Total Revenues (Account and Transaction Revenues)

Region Units: $millions	2010	2020	CAGR, 2010–2020 (%)
North America	159,900	284,500	6
Latin America	71,200	195,200	11
Western Europe	146,600	276,200	7
Central and Eastern Europe	40,300	97,400	9
Asia-Pacific	140,400	533,800	14
Middle East and North Africa	29,200	132,300	16
Rest of world	2,400	60,000	38
World	**589,900**	**1,579,400**	**10**

Source: BCG Global Payments database, 2010.

Revenues per Transaction (Based on Transaction Revenues Only)

Region Units: $	2010	2020	CAGR, 2010–2020 (%)
North America	0.89	0.75	–2
Latin America	1.06	0.77	–3
Western Europe	0.58	0.29	–7
Central and Eastern Europe	0.83	0.50	–5
Asia-Pacific	0.89	0.67	–3
Middle East and North Africa	1.40	1.09	–2
World (includes rest of world)	**0.83**	**0.66**	**–2**

Source: BCG Global Payments database, 2010.

Domestic Transaction Revenues

Region	2010		2020		CAGR, 2010–2020 (%)	
Units: $millions/$	Total	Per transaction	Total	Per transaction	Total	Per transaction
North America	96,400	0.84	142,200	0.70	4	–2
Latin America	28,900	1.01	79,800	0.74	11	–3
Western Europe	39,400	0.52	27,600	0.23	–3	–8
Central and Eastern Europe	8,700	0.75	12,700	0.43	4	–5
Asia-Pacific	45,500	0.73	98,600	0.50	8	–4
Middle East and North Africa	4,900	1.28	38,100	1.03	23	–2
World (includes rest of world)	**224,700**	**0.75**	**414,700**	**0.57**	**6**	**–3**

Source: BCG Global Payments database, 2010.

Cross-Border Transaction Revenues

Region	2010		2020		CAGR, 2010–2020 (%)	
Units: $millions/$	Total	Per transaction	Total	Per transaction	Total	Per transaction
North America	6,700	3.48	12,200	2.79	6	–2
Latin America	1,300	2.67	3,900	2.92	12	1
Western Europe	5,600	3.23	8,600	2.93	4	–1
Central and Eastern Europe	1,100	3.96	2,500	3.29	9	–2
Asia-Pacific	12,400	3.97	44,300	2.88	14	–3
Middle East and North Africa	600	5.65	2,900	5.23	17	–1
World (includes rest of world)	**27,800**	**3.62**	**77,400**	**2.93**	**11**	**–2**

Source: BCG Global Payments database, 2010.

For Further Reading

The Boston Consulting Group publishes other reports and articles that may be of interest to senior financial executives. Recent examples are listed here.

Global Retail Banking 2010/2011: The Road to Excellence
A report by The Boston Consulting Group, December 2010

The Solvency II Challenge: Anticipating the Far-Ranging Impact on Business Strategy
A White Paper by The Boston Consulting Group, October 2010

Leveling the Playing Field: Upgrading the Wealth Management Experience for Women
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Note to the Reader

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2/11

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