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The future of European payments: Strategic choices for banks

November 2020

Executive summary

This paper is based on research and analysis undertaken by McKinsey & Company and the Euro Banking Association between November 2019 and November 2020.

Payments and accounts services are at the core of banks' offering to customers. They contributed about a third of European banks' total revenues in 2019, and represent banks' leading source of customer interactions.

Banks' payments revenues have grown steadily at about 3 percent per year over the past six years. However, some specialist payments providers—processors, acquirers, schemes, and others—have achieved double-digit growth rates over the same period. This suggests that banks' traditional role at the centre of the payments ecosystem may be coming under challenge.

High ambitions, significant challenges

Almost two-thirds of the executives and experts who were surveyed as part of the research for this paper believe that banks will continue to be the leading players in European payments over the next five years.

However, survey respondents and interviewees identified a number of challenges faced by banks. These included increasing competition (especially from tech companies and fintechs), the rise of technologies that could allow other payments providers to come between banks and their customer relationships, the lack of flexibility in banks' operating models, the constrained revenue environment, rising customer expectations, and the complex regulatory outlook. Executives also identified gaps in the capabilities and practices needed to grow their payments business, especially in technology, organisational agility, and monetisation models.

The effects of the pandemic

According to McKinsey's Global Payments Map, the COVID-19 pandemic is likely to cause a temporary fall of about 6 percent in European payments revenues in 2020, followed by a rebound. Fee-dependent revenues may recover more rapidly than interest-dependent revenues, although these had less room for decline given the long-term compression of net interest margins in Europe. Further fuel for a rebound may come from an acceleration in electronic payments in southern and eastern Europe as these regions catch up with digital migration in the north and west.

Many of the executives interviewed observed that the crisis had prompted them not to change the direction of their payments business but to reinforce their commitment to digitising customer journeys, introducing machine learning, and improving their technological and operational resilience.

Strengths and opportunities for banks

Interviewees noted that banks possess considerable strengths in payments, including access to large customer pools, control of current accounts and customer data, and balance sheets that allow them to provide liquidity for consumer lending, working-capital financing, and corporate transaction management. Interviewees also commented on banks' opportunities to accelerate growth in digital payments, use real-time payments infrastructure to offer fully digitised customer experiences, and improve the flexibility and cost of their operating models by using application programming interfaces (APIs), offering payments-as-a-service (PaaS), and setting up industry utilities to build scale.

Many of the executives interviewed spoke of efforts to upgrade customer value propositions and optimise operating models, and some identified a need to adapt business models to changing industry dynamics. Given the number and scale of the challenges, however, it remains to be seen whether banks' efforts will go far enough to enable them to capture emerging market opportunities and grow the value of their payments businesses.

The outlook for the payments sector

On the stock markets, payments specialists outperformed the overall European banking sector between January and November 2020, with a shallower decline and a bigger rebound. Interviewees noted that *banks* continue to be affected by mounting credit losses and low interest rates; *payments specialists* stand to gain from the shift to digital commerce and electronic payments; *fintechs* have opportunities to target a broader pool of customers and capitalise on their cost advantages, but are more exposed to structural factors because of the narrower focus of their customer relationships; and *big tech* companies have ample resources to invest but may come under increased scrutiny from governments and regulators.

Despite the uncertainties, the interviewees saw the outlook for payments as broadly positive. Most felt the crisis of 2020 would not damage their strategic position, and could even improve it.

The strategic choices facing banks

In defining their strategy for each customer segment and step in the payments value chain, banks can choose to lead, accelerate, follow, or reduce their payments footprint, depending on their wider aspirations and starting point.

Leading requires banks to set ambitious goals, capitalise on strong capabilities, and invest at scale in payments as a means of competitive differentiation. All the banks interviewed aspired to lead in at least one customer segment. *Accelerating* could involve making standalone investments; partnering to gain scale, expand customer access, and reduce time to market; or forming industry coalitions to address customer pain points and build new propositions. About half of the banks interviewed intended to accelerate in consumer payments. *Following* is an option for a bank seeking to provide payments products and services without investing substantial resources. Some banks are already tacitly following this strategy in segments that require high scale or are strongly contested by specialists and tech companies. *Reducing* the payments footprint can be achieved through the use of partners for selected activities and applications.

Banks have a range of opportunities to collaborate with other organisations to fill capability gaps, drive economies of scale, mitigate investment risk, reduce the complexity of providing non-differentiating activities, and help set new market standards. All the banks interviewed believed that cooperation is extremely important and were willing to pursue collaborations in the future.

What's next for payments?

As technological advances, evolving customer behaviour, new market dynamics, and changing regulatory agendas converge with the after effects of the pandemic, the early 2020s may become an inflection point for payments. Despite the uncertainties of the current environment, this could be the moment for banks to secure the growth of value in their payments business over the next cycle—and to come together with other stakeholders to solve sector-wide challenges and capture opportunities.

Foreword

Payments have been at the forefront of innovation in European financial services over the past decade. New customer offerings such as digital wallets or payment gateways have established themselves alongside conventional payments services such as cash management, cards, and point-of-sale (POS) acquiring. Customers have switched an increasing share of their spending from cash to digital payments. Technological advances such as APIs and PaaS have enabled more connectivity across systems and organisations. A proliferation in payments solutions, supporting services, and standards has broadened customer choice and improved user experience and security, but it has also increased the complexity of providing payments services. The COVID-19 pandemic has intensified a number of trends already evident in the sector. It has accelerated the shift to digital, reshaped customer behaviour, and increased the pressures on banks' traditional position in the payments business. Banks have strived to respond to these trends, but it is difficult to predict how they will fare if pressures increase still further. The next few years could bring them opportunities to hold and even regain ground in their historical stronghold of payments—or the prospect of losing share to a growing field of competitors providing a wide range of payments products and services for consumers and businesses.

This paper is based on research jointly conducted by the Euro Banking Association (EBA) and McKinsey & Company. It draws on the collective experience of both organisations, along with interviews with industry leaders and representatives from banks and payments specialists. It focuses on three main topics: how banks' role in the European payments landscape is evolving, what strategic role banks aspire to play in the mid-term future of the industry, and how they could secure the market positioning they seek.

The paper aims to prompt a constructive debate on the future of banks in European payments, act as food for thought on the direction of the sector, and ultimately launch a call for action on industry change. We hope you find it thought-provoking and informative.

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Payments: A beacon for banks?

Historically, payment and account services for consumers and businesses have been at the core of banks' value proposition. Payments remain banks' most frequent source of customer interaction and the gateway to attractive value pools such as lending and savings. Banks have played a central role in transaction services as the providers of payments services and the holders of customer accounts. For the purposes of this paper, the term payments is used to refer not only to the transactions themselves, but also to the accounts required to execute them, the services needed to support them (such as remote authentication and liquidity provisioning), the data collected as part of payments processes, and the operation of the necessary in-house and external infrastructure.

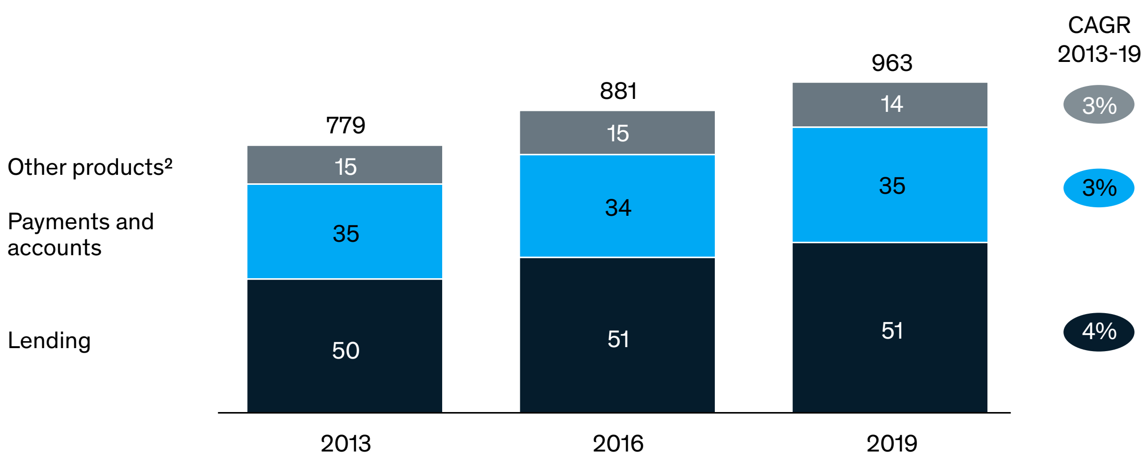
Payments and accounts services together contributed 35 percent of European banking revenues in 2019 (Exhibit 1). Despite regulatory changes, low interest rates, and intensifying competitive pressures, growth in the sector has remained steady at about 3 percent per year over the past six years. However, a number of large payments specialists—processors, acquirers, schemes, and others[1]—grew considerably faster than the sector as a whole, with some achieving double-digit growth rates (Exhibit 2).

[1] For the purposes of this paper, "payments specialists" refers to companies that provide payments services but do not undertake traditional banking balance-sheet activities, such as accepting customer deposits and lending money, as part of their core business. Most specialists are non-banks, although a few hold banking licenses in the countries where they operate.

Exhibit 1

Payments and account services represent more than a third of total European banking revenues.

European banking sector revenues[1]
Total value, € billion; relative shares, %

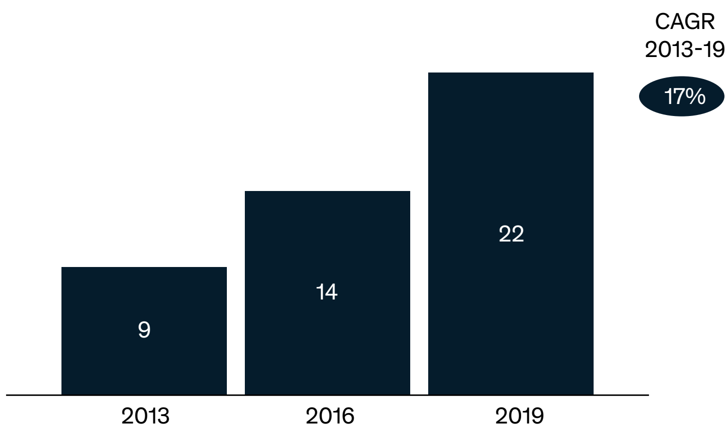


[1]Retail and wholesale revenues before cost of risk.
[2]Retail investments, insurance and pension distribution, investment banking, sales and trading, securities services.
Source: McKinsey Global Banking Pools; McKinsey Global Payments Map

Exhibit 2

European payments specialists grew at a double-digit pace between 2013 and 2019.

Revenues of European payments specialists[1]
Total value, € billion



[1]Revenues of 10 large payments specialists headquartered in Europe: Adyen, Bambora, Ingenico, Mastercard Europe, Nets (including 2019 revenues of Nets' account-to-account payments business in the process of being sold to Mastercard), Nexi, SIBS, Visa Europe, Worldline, Worldpay (including 2019 revenues after acquisition by FIS).
Source: S&P Capital IQ; company financial statements; McKinsey analysis

According to McKinsey's Global Payments Map, the COVID-19 pandemic is likely to cause a temporary fall of about 6 percent in European payments revenues in 2020, followed by a rebound. Given the acceleration in the shift from cash to electronic payments and from physical to digital commerce, the payments environment that emerges after the pandemic is likely to be more digital and dynamic. Fee-dependent revenues may rebound more rapidly than interest-dependent revenues, although the long-term compression of net interest margins in Europe had left less room for decline in this category. Further fuel for a rebound may come from an acceleration in electronic payments in southern and eastern Europe as these regions catch up with digital migration in the north and west.[2]

[2] See *The 2020 McKinsey Global Payments Report*, McKinsey & Company, October 2020, on McKinsey.com.

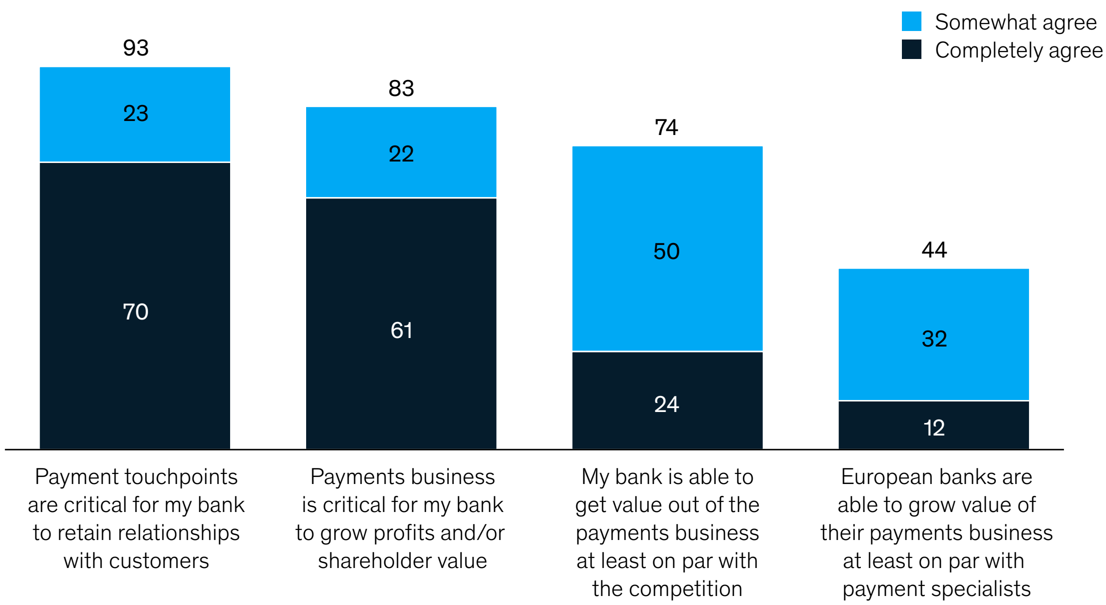
High strategic ambitions

Despite the difficulties and uncertainties of the current environment, banks continue to have far-reaching ambitions for their payments business. In a survey of EBA member banks and interviews with payments executives (see sidebar, "About the research"),[3] most respondents emphasised the continuing importance of payments to their strategies and customer relationships. Most banks were confident of generating value from their payments business, with 74 percent rating their ability to do so as equal to or higher than that of competitors. Yet they were more doubtful about the sector as a whole, with less than half of respondents agreeing that European banks in general could match payments specialists in growing the value of their payments business (Exhibit 3).

Exhibit 3

European banks continue to see payments as strategically important to their business.

To what extent do you agree with the following statements?
%



Source: Survey of 59 EBA members, February–March 2020

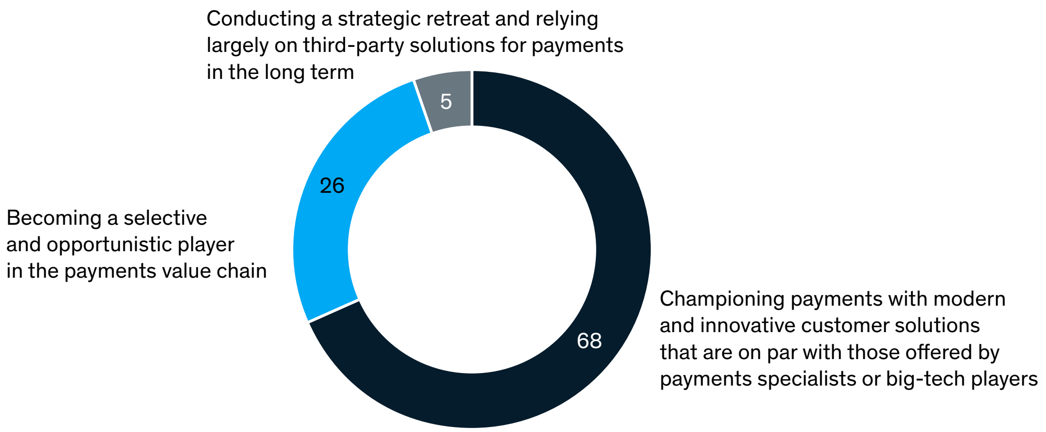
[3] The survey was completed before the outbreak of the pandemic in Europe, but its findings were confirmed in follow-up interviews in September and October 2020.

When the banks were asked to characterise their ambitions for payments, more than two-thirds agreed they wanted to champion innovative modern products and solutions that would be on a par with those offered by payments specialists and big tech companies (Exhibit 4).

Exhibit 4

European banks aspire to offer innovative payments solutions on a par with those of new competitors.

Which statement would best summarize your bank's strategic appetite for the payments business?
%



Source: Survey of 59 EBA members, February–March 2020

About the research

This paper is based on primary research and analysis undertaken jointly by McKinsey & Company and the EBA. Participants in the research included industry leaders and representatives from a wide range of stakeholders in the payments sector. To encourage a frank exchange of ideas, participants' anonymity was preserved and their perspectives were synthesized.

The first phase of the research was a scenario-based workshop with the EBA Board and McKinsey payments experts in November 2019. It was followed by an online survey of 59 EBA members in February and March 2020. Following the outbreak of COVID-19 in Europe in early 2020, McKinsey and the EBA conducted further research and held 12 structured interviews with EBA member banks from 11 different countries. Where indicated, the research was supplemented by proprietary McKinsey data and information from publications from McKinsey, EBA, and other institutions. This paper presents the insights and conclusions drawn by McKinsey and the EBA from the research findings.

The banks in the survey believed they have major assets that will help them continue to play a significant role in European payments, from their access to millions of customers to their status as trusted custodians of customers' accounts and data and their control over payments infrastructures (whether direct or via collaborations). Almost two-thirds of respondents believed that banks will continue to be the leading players in payments for European consumers and businesses in the next five years.

Even so, many of the executives and industry experts interviewed for this paper identified challenges for banks in growing the value of their payments businesses over the long term:

— *Competition* is increasing, including from tech companies that treat payments as a step in a larger ecosystem. These companies have shown a willingness to forgo conventional transaction fees and pursue long-term growth at the expense of short-term profitability, allowing them to access customer pools and attain scale at a pace banks would find challenging to match. The most contested areas are likely to be retail payments—where traditional banks face competition from neobanks (the new generation of digital-only cloud-based banks) and other fintechs—and acquiring. Conversely, infrastructure-heavy wholesale services where payments are often linked with liquidity provision are likely to be less contested in the view of some banks, though some profitable areas, such as financial supply-chain services for small and medium-size enterprises (SMEs), may see an increase in offerings from new entrants.

— With the rise of *technologies* such as PaaS and APIs, banks need to adapt to maintain their core strengths: a large and loyal customer base, control over current accounts, and infrastructure built over years. PaaS enables payments players to acquire technological capabilities from specialists quickly and without significant upfront investment, and allows them to maintain these capabilities at relatively low cost. With APIs, payments players and ecosystem partners can connect to a bank's infrastructure to streamline their internal operations and build a layer of new services on top. If non-bank payments providers are able to use these technologies to operate with a lower cost position and become the focus of the customer experience, banks may find it harder to maintain their customer interface, identify and satisfy new customer needs, and differentiate themselves in the market. Technology in general is seen as a major challenge for banks: two-thirds of the survey respondents cited legacy technology as an obstacle to growing the value of their payments business (Exhibit 5).

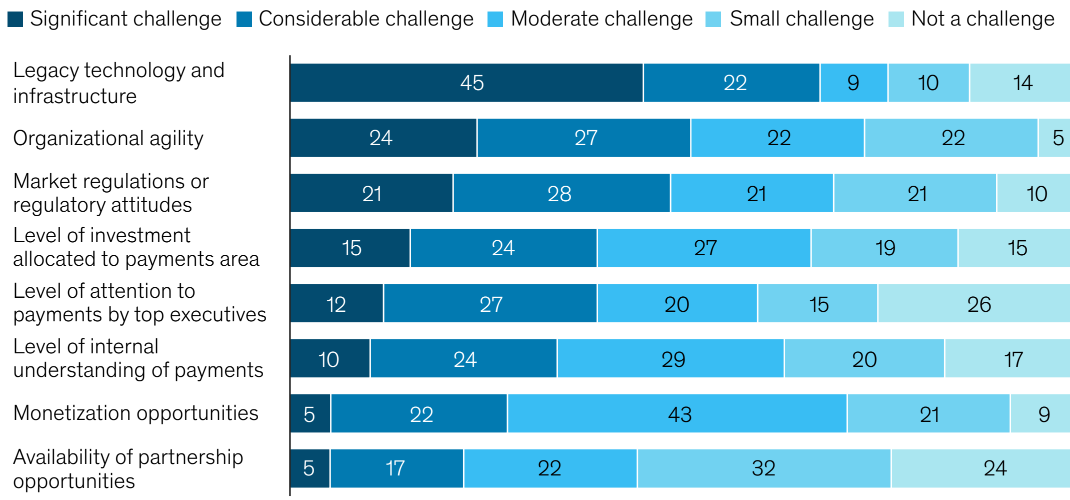
— Banks' *operating models*—the ways they set up their business and collaborate with partners to deliver value to customers—frequently lack the scale and agility required to keep pace with evolving market expectations. In acquiring and infrastructure, for instance, regional and pan-European leaders with consolidated IT platforms have been able to achieve advantages in cost efficiency and the scalability of new investments that few competitors could match. Similarly, banks' operating models are often too slow-moving and inflexible to meet the needs of rapidly changing segments such as e-commerce lending and international payments. Moreover, attracting and retaining top talent in areas such as software engineering, data science, and design is becoming more challenging for banks as more industries digitise and the demand for such expertise increases.

— The *revenue environment* is constrained. Account liquidity revenues have been squeezed by persistently low interest rates, while regulations concerning fee-based revenues have affected areas such as interchange, instant payments, and mandatory access to information. Monetisation models that rely on using payments to enable other business lines are also difficult to sustain in a

Exhibit 5

Banks identified technology, agility, and the regulatory environment as the biggest challenges in growing their payments businesses.

To what extent are the following factors challenges in growing the value of your payments business?



Source: Survey of 59 EBA members, February–March 2020

low-interest-rate environment that reduces income from deposits and lending. Finally, while payments specialists frequently pursue revenue growth through geographic expansion—which accounted for roughly 20 percent of their value creation between 2012 and 2017[4] —European banks seldom have the strategic, investment, and risk appetite to do so.

— *Customer expectations* are rising, and banks face a twofold challenge. On the one hand, they need to close the gap with competitors that have focused business models and offer distinctive customer experiences. On the other hand, to preserve their standing as stable institutions of social trust, banks are expected to meet the needs of multiple customer segments and uphold historical service standards (for instance, by maintaining a physical branch network and having adequate staffing to handle exceptions when customers raise problems).

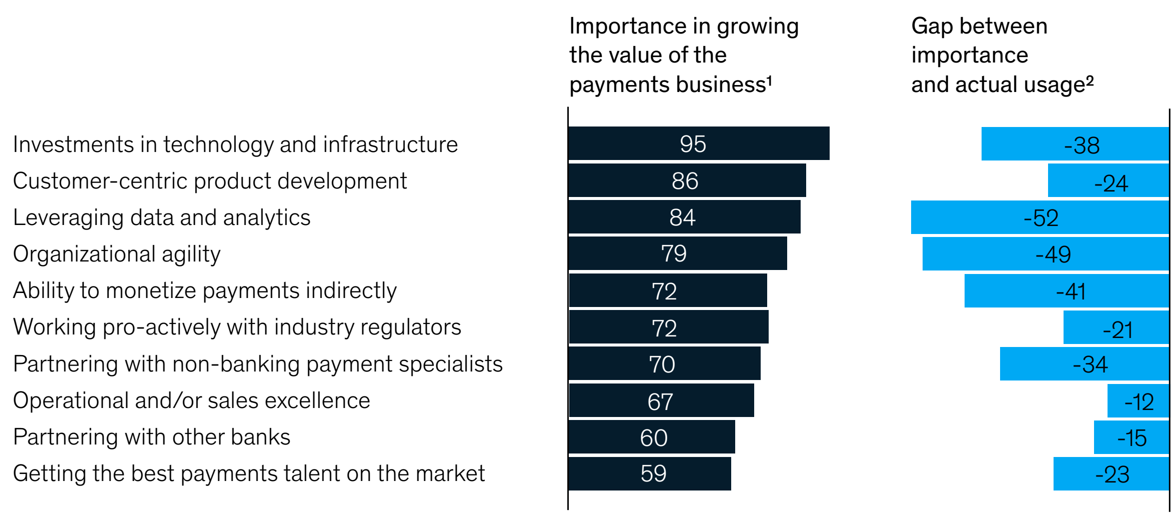
— The *regulatory outlook* remains complex, with a considerable number of newly proposed European regulations and a degree of fragmentation caused by differences in implementation from one country to another.

[4] Jeremy Borot, Reinhard Höll, and Tobias Lundberg, “As value creation reshapes payments, can banks catch up with specialists?,” McKinsey & Company, October 1, 2018, McKinsey.com

To add to these challenges, many banks feel they still need to develop some of the capabilities and practices required to grow the value of their payments businesses. The gaps they report most often relate to data and analytics, organisational agility, and monetisation models for payments services (Exhibit 6).

Exhibit 6

Banks identified significant gaps in the capabilities and practices needed to grow their payments business.



[1]As denoted by the percentage share of respondents who identified a value lever as “Extremely important” or “Very important”.
[2]“Actual usage” denotes the share of respondents who indicated “Usage at full potential” or “Extensive usage”; “gap” denotes the difference between stated importance and actual usage in percentage points.
Source: Survey of 59 EBA members, February–March 2020

In summary, the majority of respondents to the survey believe that banks will continue to play a leading role in European payments, that payments are strategically important to their institution, and that their institution will be able to create value from the payments business. At the same time, banks acknowledge that they face challenges and need to fill capability gaps to succeed in an increasingly competitive landscape. This apparent dichotomy between aspiration and ability raises questions about how banks can best position themselves to fulfil what they see as their destiny in payments.

The effects of the pandemic

In addition to its grave humanitarian and economic consequences, COVID-19 is reshaping the fabric of everyday life—a powerful reminder that all businesses operate in an inherently uncertain world. Physical distancing requirements are transforming consumer behaviour and business practices alike and fuelling the demand for remote and digital personal and commercial interactions. A McKinsey survey carried out in September 2020 indicates, for instance, that in most purchasing categories, 10 to 25 percent more consumers intend to shop online even after the pandemic subsides, compared with their pre-crisis habits.[5]

The economic downturn has undermined employment security and business confidence, depressing trade flows and overall economic output and reducing spending on travel, eating out, and other discretionary activities. In the same survey, only 14 percent of Europeans reported feeling optimistic about the prospect of rapid economic recovery, while 31 percent were pessimistic—a level of confidence much lower than that seen among consumers in the United States, India, or China.[6]

The impact of these changes on payments has been profound, but with considerable variation between sectors and categories. Payments revenues have declined in hospitality, airlines, travel and entertainment, high-street retail, and other sectors structurally affected by the pandemic. On the other hand, some digital commerce segments, such as groceries, have seen marked growth in transaction volumes. The same is true of certain POS categories, with mobile and contactless payments increasing as retailers discourage the use of cash for hygiene reasons. According to estimates from the McKinsey Global Payments Map, most European countries saw a 30 to 40 percent drop in cash usage during the spring lockdowns, a rate of reduction far higher than the single-digit trajectory of decline typically seen over the long term.

Across payments in general, an initial dip in overall volumes was followed by a partial rebound for many banks. Research indicates that banks are optimistic about the prospects of a recovery in payments volumes. A Finalta by McKinsey survey conducted among European corporate and small-business banking executives in September 2020 indicated that 48 percent of banks expect payments volumes to decline in 2020, as compared with 16 percent expecting growth. However, executives have a more positive outlook for 2021, with 60 percent expecting growth and only 5 percent expecting a decline in payments volumes.[7]

Interviews with European payments executives indicate that cross-border payments are an exception to this positive outlook. The curtailment of international travel and commercial activity caused cross-border transactions to fall sharply. Several of the banks interviewed commented on the decline in card transactions from business travel and the uncertainty over international trade flows. The World Trade Organization predicts an 11.7 percent decline in exports and a 10.3 percent decline in imports in Europe in 2020 that will be only partly offset by growth of 8 to 9 percent in European merchandise trade volume in 2021.[8] However, high-value treasury flows remained fairly resilient as large corporate treasurers sought to identify safe havens against currency volatility in Europe and deploy capital across borders to sustain operations.

[5] McKinsey COVID-19 Europe Consumer Pulse Survey, conducted 24–27 September 2020 among 5,338 adults in Italy, France, Germany, Spain, and the UK, sampled and weighted to match general European adult population.
[6] Data from McKinsey COVID-19 Consumer Pulse Surveys in Europe (as above), the US, India, and China, September 2020.
[7] Finalta by McKinsey Small Business and Corporate Banking COVID-19 Response and Strategy Survey, conducted 17 September–9 October 2020 among 35 corporate banking and 15 small business banking executives in Europe.
[8] Trade shows signs of rebound from COVID-19, recovery still uncertain, press release, World Trade Organization, 6 October 2020.

In some ways, the crisis has reinforced the importance of payments. Data from the payments business has contributed to live views of overall economic performance and enabled institutions to monitor changes in individual customers' creditworthiness as they occur. Digital identification and remote authentication have been essential in enabling banks to maintain customer touchpoints, sell financial services and products, and continue other operational activities. Moreover, payments have remained at the heart of the consumer experience in shopping, banking, and budget management, as well as a source of support for stressed companies large and small.

Are there brighter times ahead?

"Apart from providing liquidity, handling deposits, verifying digital identity, authorising and clearing transactions, protecting against fraud and money laundering, and maintaining security, what have banks ever done for us?"

—(with due acknowledgement to Monty Python's *Life of Brian* for "What have the Romans ever done for us?")

During the pandemic, banks responded swiftly to the support measures introduced by governments, such as loan repayment vacations and business interruption loans. More broadly, many banks stepped up their agility and speed of execution, rapidly adapting their operations to remote working, keeping customers informed about the evolving situation, and ensuring that customer service was not disrupted. Although it is too early to draw definitive conclusions, 2020 has highlighted some of banks' strengths and opportunities in payments. Among the positive signs noted by the banks and industry experts interviewed were:

— Banks' access to large customer pools helps provide stability for ongoing operations and opportunities to extend relationships across a wider range of financial services.

— Banks remain in control of current accounts, which represent a regulated and partly guaranteed way of storing money and funding transactions. In addition, they give banks access to important data that they can use to identify unmet needs and improve their customer offerings. In some countries, banks may have an opportunity to create more value from current accounts by providing customers with a digital ID that serves to authenticate their identity in non-banking contexts as well.

— Banks' balance sheets are a key source of liquidity for payments linked to consumer lending, the financing of working capital for business, and the management of high-value transactions on behalf of corporates.

— Banks see opportunities to improve their flexibility and reduce the cost of their operating models by using APIs, offering PaaS, and setting up industry utilities to build economies of scale.

— The development of real-time infrastructures for domestic and cross-border payments may enable banks to offer a fully digitised real-time customer experience and, if appropriately positioned, may open up opportunities to develop new sources of revenue.

— Banks are well positioned to accelerate the growth in digital payments by introducing new account-based payments methods for digital commerce and promoting the use of cards in online and offline payments.

— Banks have also benefited from other changes in customer behaviour; for instance, the decline in cash usage has reduced their expenditure on cash distribution and allowed them to optimise their cash-handling operations.

Many of the institutions interviewed for this paper said that the crisis has not changed the direction their payments business has been following for the past few years. Rather, it has reinforced their commitment to invest in areas such as digitising customer journeys, introducing machine learning, and improving technological and operational resilience. Some interviewees noted the postponement of industry-wide initiatives such as migration to ISO 20022 or spoke of deferring their own investments, including spending on initiatives designed to help differentiate them in the market. However, the majority of banks continued to invest strategically in payments during the crisis, often as part of a broader digitisation program.

Some interviewees observed a greater readiness among customers to adopt digital solutions that were already in place—and more cost-effective for banks—such as paper-free transaction banking for SMEs and corporates. More broadly, executives indicated that the pandemic had prompted them to review all the activities along their value chain, from core infrastructure to payment methods, ATMs, and even compliance-related flows such as KYC (know your customer) and transaction screening.

Or are there dark days still to come?

With the pandemic continuing to spread and its economic repercussions intensifying, it is too early to tell how European banks will fare in the next few months and years. Between January and November 2020, the stock market performance of the overall banking sector fell significantly below that of payments specialists, with a sharper decline and a smaller rebound (Exhibit 7).

These are times of deep uncertainty in which banks, other payments providers, and institutions in general are trying to prepare for any future. In the interviews conducted for this paper, executives and experts provided perspectives on the outlook for payments in the short to medium term:

— Many *banks* expect their performance to be affected by mounting credit losses, persistently low interest rates, and continuing efforts to digitise their operations and transform branch-based models. How much time, attention, and investment these efforts consume will depend on banks' exposure to particular industries, markets, and segments, their existing digital capabilities, and their capital strength or scale of operations.

— Many *payments* specialists stand to gain from the trends outlined above. How much they are able to do so will depend on their exposure to specific industries (such as travel or hospitality), merchant segments (large or small), channels (brick-and-mortar stores or e-commerce), countries, and payments networks and platforms (such as cards or account-to-account payments). Some specialists have been steadily building scale through organic growth, geographic expansion, and

Exhibit 7

Payments specialists recorded better market performance than banks in 2020.

Weighted average total shareholder returns,[1] January 1 to November 20, 2020, %

[1]Companies included are from the list of top 5,000 listed companies worldwide.
[2]Comprises 3 public companies listed in Europe and 8 global payments players with sizeable European operations.
[3]Comprises 91 public companies listed in Europe.
Source: S&P; McKinsey analysis

acquisitions. Indeed, over the past four years, their share of the M&A value transacted in Europe has grown to match that of banks (Exhibit 8).

— Many *fintechs* are in a position to target a broader pool of customers by building on their digital-first value proposition and capitalising on the structural cost advantages created by highly automated operations, scalable cloud-native tech architectures, and a lack of legacy physical channels. Although some European payments fintechs may face uncertainties over their capital position, the largest among them saw no significant decline in funding in the first three quarters of 2020. However, some fintech business models, like banks, may come under pressure from structural factors such as the reduction in cross-border payments volumes and the increase in credit losses during a downturn. Unlike traditional banks, though, they are often unable to benefit from the stabilising effect of customer relationships across multiple products, leaving them more exposed to these factors.

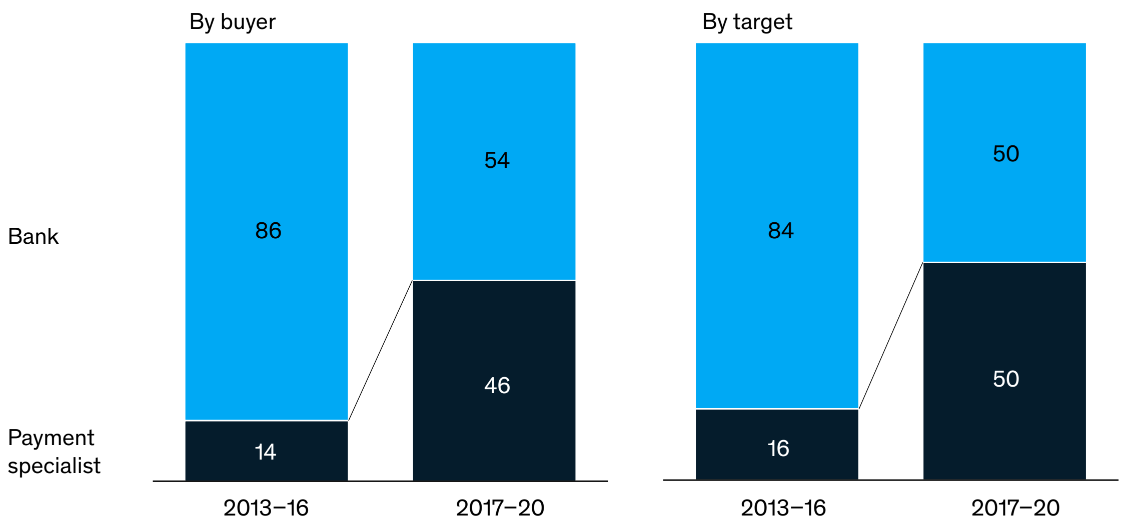
— *Big tech companies* could gain ground in payments given their capacity for investment and the accelerating shift of consumers and businesses to digital, online, and mobile domains. On the other hand, they may come under increased scrutiny from governments and regulators concerned about data protection, security, and control of monetary systems and infrastructure. They also face the challenge of making their ecosystems interoperable with others—a task in which banks may have a role to play.

— The role and credibility of some *governments* and *state institutions* have been enhanced by their response to the pandemic and their efforts to stabilise economies and banks. Banks believe they could affect the payments businesses in two important ways. As industry regulators, they could

Exhibit 8

Payments specialists are catching up with banks in European M&A transactions.

Value share of M&A transactions involving banks and payments specialists, %[1]



[1]Comprises transactions in excess of US$25 million with target company headquartered in Europe; data for January 2013 to September 2020; absolute M&A value is similar for the periods compared.
Source: Capital IQ; McKinsey analysis

support the growth of non-cash solutions and the operational continuity of payments providers to help the wider economy function during the pandemic and economic downturn. However, as providers of payments infrastructure, they could also extend their provision of services such as clearing and settlement as a public good, which would reduce the size of the opportunity for other participants in these markets.

— Across *Europe as a whole*, the convergence of multiple factors—among them geopolitical turbulence, the transformation of supply-chain economics through digitisation and automation, and the constraints on travel imposed by the pandemic—has prompted businesses to review their international sourcing networks to improve their transparency and resilience.[9] In turn, these developments may prompt a public debate on whether critical payments technologies should be sourced from within Europe, rather than beyond.

Yet despite all these uncertainties, interviewees perceive the outlook for payments as broadly positive. While acknowledging challenges in revenues and valuations, most executives felt that the ongoing crisis would not damage their strategic position in relation to other banks, fintechs, payments specialists, and big tech companies, and could even improve it.

In interviews, bank executives spoke at length about their efforts to upgrade customer value propositions and optimise operating models. Some interviewees also discussed the need to adapt business models to changing industry dynamics: for instance, by making better use of payments

[9] For more on this topic, see Susan Lund et al., *Risk, resilience, and rebalancing in global value chains*, McKinsey Global Institute, August 2020, on McKinsey.com.

data, expanding API-based offerings, combining payments with other services, and innovating with real-time payments and request-to-pay solutions. However, it would be reasonable to ask whether banks' current efforts are likely to go far enough to enable them to capture emerging market opportunities and grow the value of their payments businesses.

The strategic choices facing banks

In developing their payments strategy, banks will be guided by two main factors: their starting point, including how they emerge from the crisis, and their wider strategic aspirations, such as being a leader in serving a particular customer segment. Banks need to make deliberate choices that align their actions with their aspirations so as not to stretch their investments too thinly across too many initiatives.

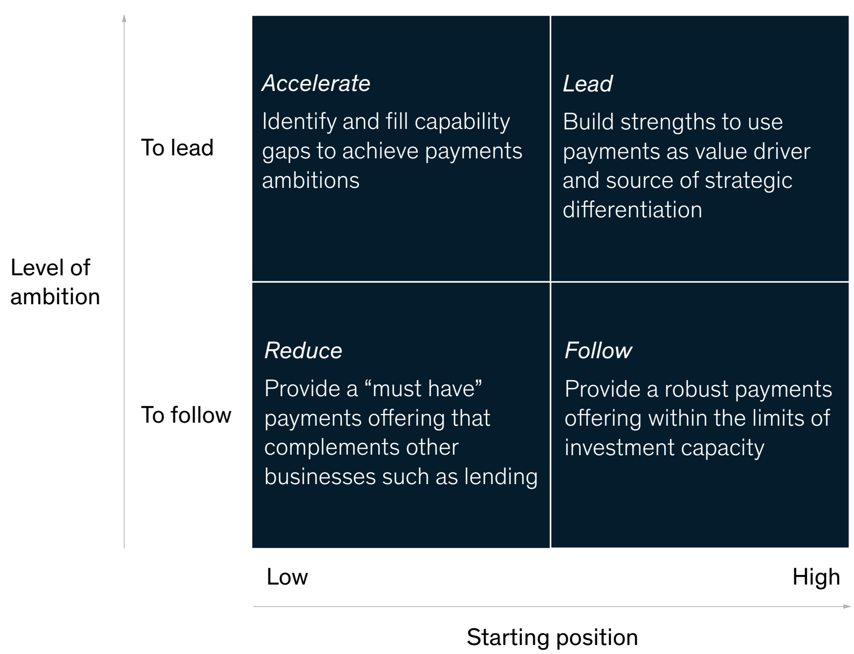
Banks face four broad strategic choices (Exhibit 9).

— *Lead* by setting ambitious goals, taking advantage of strong capabilities, and investing in payments as a means of differentiation in specific customer segments or steps in the value chain. All the banks interviewed as part of the research for this paper aspired to lead in at least one customer segment (consumer, business, or merchant) or area of the value chain (customer interface, infrastructure, or supporting services), though none expected to do so in all business areas.

Exhibit 9

Banks' strategic choices will be influenced by their level of ambition and starting point.

To be assessed for each target customer segment and step in the value chain



- *Accelerate* by making standalone investments; partnering with other institutions to gain scale, expand customer access, and reduce time to market; or forming industry coalitions to address customer pain points and build new propositions that no one bank would be able to deliver on its own. About half of the banks interviewed intended to accelerate in the consumer segment, where they had high strategic ambitions but a relatively low starting point in terms of their ability to differentiate themselves in the market.

- *Follow* if they are unwilling or unable to invest substantial resources but still intend to offer robust payments products and services. The interviews conducted for this paper indicate that some banks are already tacitly following this strategy, especially in areas of high scale such as wholesale and infrastructure and those, like retail, where they operate in a highly innovative environment alongside payments specialists and tech companies.

- *Reduce* their payments footprint by, for instance, keeping accounts in house but using partners to provide advanced cash-management, peer-to-peer, or merchant-acquiring applications. Few of the banks interviewed intended to pursue this strategy, with the notable exception of the merchant-acquiring segment. About half the banks admitted to a weak starting point in this segment and little ambition to improve it, perhaps because of the growing strength of merchant-acquiring specialists, to which many European banks are already delegating this part of their business.

In addition to these choices, banks face a range of opportunities to collaborate with other organisations to fill capability gaps, drive economies of scale, mitigate investment risk, reduce the complexity of providing non-differentiating activities, and help set new market standards. Interviewees saw considerable scope for cooperation and cited several areas as particularly suited to a collaborative approach:

- *Adopting PaaS*, where many parts of the underlying infrastructure, such as cloud banking, can be readily outsourced

- *Creating and operating national*, regional, or pan-European industry utilities in areas such as digital ID (for instance, .beID), processing (Finanz Informatik), acquiring (Nets), ATM networks and cash handling (Geldmaat), KYC (Nordic KYC), clearing and settlement (EBA Clearing). and back-office operations (SIBS)

- *Developing new payment schemes and infrastructure solutions*, whether national (such as MobilePay and Blik), regional (P27), or pan-European (EPI)

- *Ensuring interoperability* between payment methods to expand the reach of existing solutions, create a level playing field, and enable seamless digital customer journeys that integrate current accounts with other products. An example is the effort by EMPSA (European Mobile Payment Systems Association) to establish interoperability between mobile payments solutions

- *Enhancing customer value propositions* through partnerships with fintechs, corporates, or non-financial players.

Regulatory-driven initiatives are also fertile ground for industry collaboration, offering the potential to align all payments institutions on a single direction for the whole of Europe. In some cases, banks' investments to ensure regulatory compliance may also enable them to improve customer experience, develop new functionalities, or derive other competitive benefits. Regulatory requirements can also create momentum to accelerate implementation.

All the banks interviewed believed that cooperation is extremely important. Although some institutions expressed frustration over the lack of progress shown by some initiatives in the past, all were willing to pursue collaborations in the future. In interviews, banks identified a number of conditions that partners in an effective collaboration would need to meet:

— Alignment on a clear value proposition for each partner that takes into account differences between individual markets and players

— Flexibility and agility to align the collaboration model with market evolution

— A fair and transparent governance model

— An emphasis on entrepreneurship rather than technical acumen

— Bold leadership, whether from a facilitating organisation, the partners in a collaboration, or individual executives.

What next?

As banks continue to navigate the uncertainties created by the pandemic, their payments business is likely to need particular attention, given its high investment requirements and the constraints on their budgets. In developing a plan for its future in payments, each bank may want to consider:

— *Clearly defining its unique starting point and setting an aspirational but realistic statement of its ambition* by diagnosing where it stands in the post-crisis environment, assessing its market context, level of capabilities, and customer positioning, and determining its strategic positioning on a segment-by-segment basis (see sidebar, "Questions for banks to ask themselves," for questions that can help with this process).

— *Enhancing its customer value proposition* and ensuring it is international in scope but adapted to local contexts. One important consideration would be the cost of not winning in payments, in terms of reduced customer access and other disadvantages. The comparative benchmarks used in reaching these judgments may need to be adjusted to include more tech firms and fewer banks.

— *Adapting its business model* to reflect changes in its payments offerings and strategies. Examples might include:

  - Shifting the monetisation model from interest margins on deposits to fees for maintaining accounts and offering premium API services on top of those mandated under PSD2 regulation

  - Offering new liquidity services in consumer finance such as instant POS and e-commerce solutions as an alternative to traditional credit-card models

  - Expanding into other value-adding products, such as digital ID or analytics-driven anti-fraud and security services.

Questions for banks to ask themselves

As banks rethink their payments strategy, they may find it helpful to answer these questions to help them clarify their individual goals, advantages, and challenges:

What is the level of our ambition in payments?

— Do we aspire to be a leader in payments, creating innovative new products and services, differentiating ourselves in core customer segments, and competing with emerging specialists? Or do we see payments simply as a vital part of our broader service to customers, and need to follow fast rather than lead?

— Does our ambition for payments vary by segment? Should we aim to be a leader in corporate transactions, for instance, but a follower in consumer banking?

— Which elements of the value chain offer access to additional revenue streams or other potential benefits?

— Which internal activities contribute to cost but not value, and could be sourced externally or pooled with partners?

— What would it cost in investment, people, and management attention to achieve our ambition?

— How do competitors and other market participants behave, and does our ambition fit with the resulting market dynamics? Where do our competitive advantages lie?

What is our starting position?

— How relevant, lucrative, and loyal is our customer franchise? Are there some segments we need to serve for regulatory or public-service reasons? What is the underlying level of growth in our markets? Are we a natural beneficiary to capture it?

— What external factors—competition, customers, regulation, infrastructure—could prevent us from reaching our desired position in our target markets?

— What is our market position? Could we reinforce it by cooperating with other players?

— What revenue model, investment capacity, products, technologies, operating model, and ways of working do we need to achieve our strategic ambition?

— What organisational setup, talent, and skills do we need?

— Where are our capability gaps, and what would it take to fill them?

— *Developing a target operating model for payments* across the whole value chain. To reconcile its ambition and value proposition with continuing pressures on revenues and investments, a bank may want to review its entire operations, asking questions such as:

  - Are all customer journeys and internal processes entirely digitised? Can customers apply for and access all products and services remotely?
  - Is product development agile, customer-centric, and innovative?
  - Have operations reached scale in terms of cost, service quality, resilience, fraud resistance, and so on?
  - Are the right skills and talent in place?
  - Does the organisation hold frank debates on structural changes, partners, and outsourcing, including opportunities for PaaS, industry utilities, carve-outs, and scale-ups?

— *Defining a credible path to scale up payments* across multiple investment horizons—short-term incremental improvements, three- to five-year investment cycles, and long-term strategic and partnership decisions—and geographical scales (local or domestic and international or global). A bank may also find these considerations useful when considering its broader M&A strategy and involvement in any market consolidation.

In the years since the 2008 financial crisis, European payments have changed radically and grown dramatically. Yet even as banks' service models were digitised, they remained fairly fragmented. Despite a strong position in customer relationships, accounts, and infrastructure, banks have missed out on capturing a portion of the growth in e-commerce, acquiring, retail cross-border payments, processing, and new payments methods. It may be true, as some interviewees observed, that banks' role in the payments business is assured, but that does not mean they can succeed without rethinking their strategic posture and adapting to change.

As technological advances, evolving customer behaviour, new market dynamics, and changing regulatory agendas converge with the after-effects of the pandemic, the early 2020s may become an inflection point for payments. Banks could use the business to help drive their wider recovery by building directly on their payments revenues or indirectly on the role of payments in shaping customer touchpoints and enabling other banking products. Despite the uncertainties of the current environment, this could be the moment to secure the growth of value in the payments business over the next cycle. Banks' strategies will vary, but the elements of success are likely to include setting clear aspirations and deciding priorities, developing compelling new customer propositions, adapting business and operating models, and maximising economies of scale. In a business as highly interconnected as payments, this is also a time when every bank faces a call to come together with other stakeholders to solve difficult challenges and capture the opportunities ahead.

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The authors would like to acknowledge the contributions of Alessio Botta, Matt Cooke, Gottfried Leibbrandt, Ine Danckaert, Pavan Masanam, and Carlos Trascasa to this paper. We would also like to extend our thanks to the Board of the Euro Banking Association for their guidance, and to the executives and experts who agreed to be interviewed as part of the research.