A burning platform: Revamping bank operating models for payments

The payments segment is performing well for banking—but not for banks. Under pressure from multiple forces, successful banks will develop a new operating model better suited to changing times.

Olivier Denecker

Yaniv Lushinsky

Albion Murati

Jonathan Zell

Payments remains among the best-performing financial-services product segments around the globe. Despite the direct impact of COVID-19-related lockdowns, leading payments players have rebounded surprisingly quickly, and many aspects of commerce resumed relatively uninterrupted in most regions almost as soon as lockdowns were lifted. Payments providers' central role in the economy—and their business potential—is illustrated by their healthy total shareholder returns (TRS) even amid the economic downturn (Exhibit 1).

Although some segments of the payments industry—including travel-related services, international remittances, and specialty integrated point-of-sale solutions—face deeper and longer-term impact, digital payments volumes have soared overall, partially driven by accelerated consumer migration to digital channels and payments forms. This momentum is expected to persist as a next normal develops.

Unfortunately for banks, historically the main providers of payments services, this momentum does not extend to most of them. Traditional revenue sources, such as interest margins on current accounts, revolving credit lines, interchange revenues, and cross-border fees, are under pressure in the current environment. Interest rates are at historically low levels globally and are not expected to rebound soon. Credit-card losses are exacerbated by the economic downturn. And interchange and cross-border payments fees are pressured by regulation and competition. As a consequence, the bank side of the payments revenue model has substantially declined over the past year, especially because of compressed net interest margins and attrition of bank-specific fees such as interchange. Recovery is not imminent.

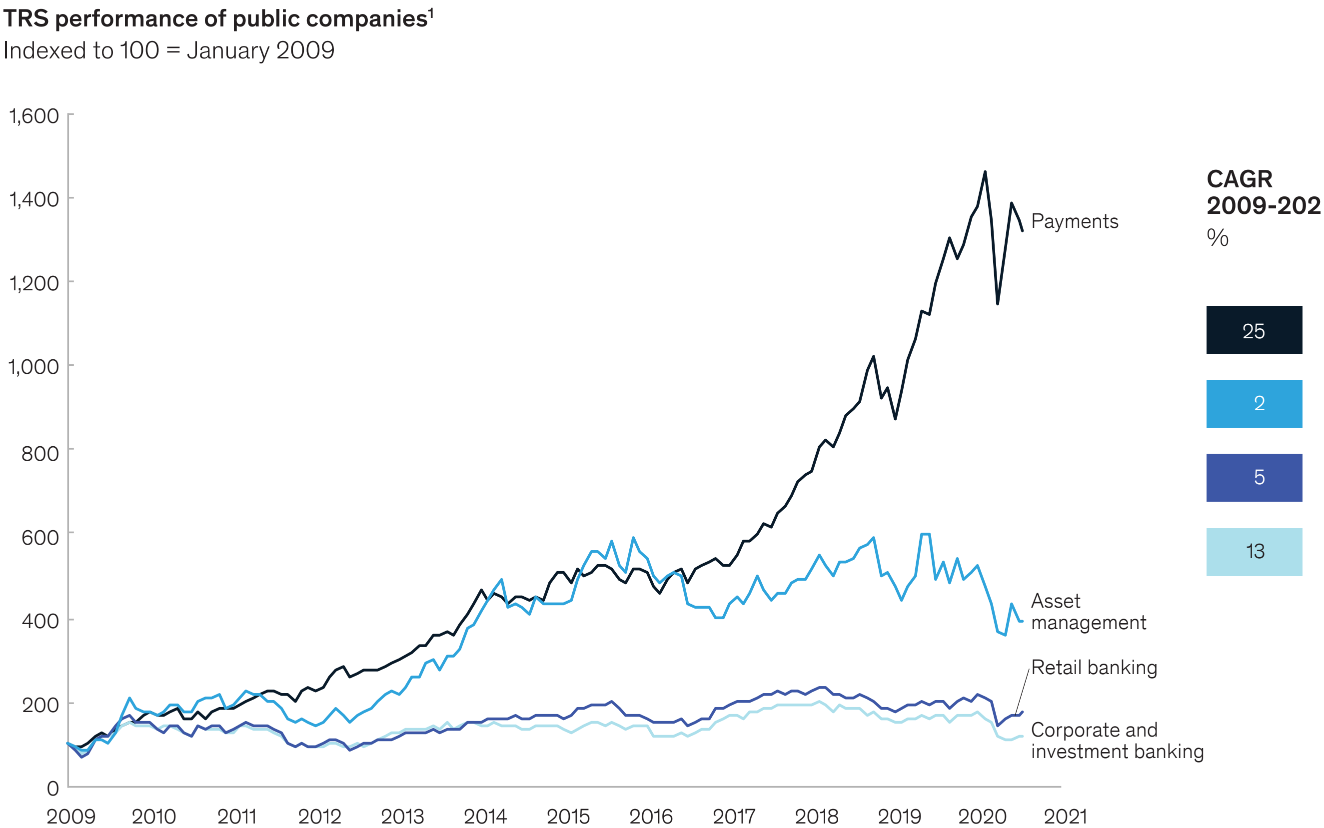
In a highly competitive market where it remains difficult to charge substantial transaction fees, the payments P&L outlook for many banks is challenged in the near to midterm, absent significant cost rationalization. Success for banks will depend on thoughtfully assessing capabilities, determining the role of payments in market strategies, and appropriately aligning payments operations to achieve the required performance improvements. More than traditional cost optimization, this may involve unit carve-outs, payments as a service, outsourcing, and/or partnerships to ensure appropriate performance.

Investment needs challenge banks' ambitions

Payments remain a substantial factor in banks' operating cost base, sometimes representing as much as 30 to 40 percent, partly because of the high technology spend associated with providing payments services. A disproportionate share of effort and resources is required to maintain and improve infrastructure, manage upgrades, implement rule changes, and rationalize legacy technology. This often leaves insufficient resources for sorely needed digitization efforts and investment

Exhibit 1

Payments companies continue to outperform other banking sectors in value creation.



[1] Based on an analysis of public companies; custom indices (market-cap weighted) based on identified public European peers: payments N=27, retail banking N=20, asset management N=17, corporate banking N=5; 2019 data as of October.

[2] TRS CAGR for Jan 2009-July 2020.

Source: S&P Capital IQ; McKinsey analysis

in new customer services and applications. The complex nature of integrations between payments and many other bank systems add to the cost of change.

All signs point to the expectation that for banks, the cost of ownership of payments services will remain high, given the ongoing number of regulatory, IT, and market-driven sector changes (e.g., instant payments, open-banking adoption, PSD2—and perhaps 3—proliferation of alternative payments methods). The majority of these investments focus on staffing supporting projects, ensuring compliance with external requirements, and shielding the customer experience from disruption, rather than freeing up capacity to allow banks to develop new products and enable new customer experiences.

However, given that payments represent the most frequent touchpoints between a bank and its customers, the need for digital investment to remain competitive also is growing. In the context of lower bank payments revenues, concern is increasing over the ability of leading banks to continually harness the capital resources required to pursue market leadership, particularly given the demonstrated investment capabilities of the leading nonbank payments specialists.

COVID-19's impact on the top and bottom lines of bank P&Ls (including payments) and the need to continue investing in technology to offer a compelling value proposition require banks to determine the strategic role and their level of ambition in payments. While some banks view payments as a differentiating factor, others do not see their payments value proposition as a core component of their unique product offering.

Given the industry's rapid evolution, payments leadership requires the willingness to commit significant investment. As a point of comparison, leading payments specialists each committed between 3 and 13 percent of their revenues to capital expenditures in fiscal year 2019, representing annual budgets ranging from $250 million to nearly $1 billion. While a "fast follower" strategy to capture real growth—for instance, by casting one's organization as a disruptor or service champion at a lower price tag—certainly has appeal, it too places added requirements on the operational capabilities and systems of banks and still triggers the need for investment.

In this context, the one truly negative option is to do nothing in the face of market upheaval. Whatever role payments play in a bank's overall strategy, the industry's rapid changes coupled with the increasing investments required to play in this space require banks to rethink their payments operating models.

Changing the operating model: Four options

Today, for banks to retain their central position in customer journeys and the payments business, they will need to reflect on the fundamentals of their operating model. Incremental efficiency gains will no longer be enough to maintain banks' structural advantages in the space. We believe cost improvements of 30 percent or more will be needed for banks to create the necessary headroom for investment and acceptable profitability. And although that target might seem daunting, we believe it is within reach.

The urgency to fundamentally rethink the payments operating model is heightened by the confluence of several market factors. These are increasing pressure on margins; growing international standardization, enabling potential scale gains and the emergence of technologies supporting change; and growing regulatory pressure to revamp operations to enable services like instant banking and open banking.

But change to what? Four potential operational models, each with appeal to banks facing particular strategic circumstances, offer potential. These are a carve-out and scaling of payments, a partnership to share payments utilities, offers of payments as a service, and outsourcing of selected payments services.

Carve-out and scale-up

In certain cases, a payments business operating within a bank organizational structure may suffer from underinvestment and lack of scale. This condition may result partly from serving a small set of internal customers and partly from the absence of an outward payments market focus. In such cases, banks should consider whether a carve-out and scale-up of the payments business, operated as a separate P&L, may create more value for customers and other stakeholders.

As payments services commoditize and margins contract, payments businesses need to drive scale quickly to reduce per-transaction cost and improve profitability profiles. That can be difficult to accomplish within a bank structure, as payments services are mostly limited to bank customers. Treating payments as a stand-alone entity allows for the expansion of services to other banks and direct offers of services to a broader array of customers, thereby driving scale and improving profitability. A successful carve-out will also empower entrepreneurial leadership within the new entity, which can prompt development of new skills and create an appetite for growth.

Eventually, this approach typically enables greater investment in the business and introduction of more innovative and value-added services to customers than a purely in-house operation would likely have achieved. It's an appealing strategy for banks that view payments as an operational strength and a competitive differentiator; it can further bolster these advantages by driving additional investment. Carving out the payments business enables a more flexible approach to growth while also establishing a currency that makes subsequent consolidation possible, as carve-outs can tap into the higher valuation afforded payments companies. Historically, the carve-out of Worldpay from RBS in the United Kingdom and the carve-out of Vantiv from Fifth Third Bank in the United States are key examples of how value in payments can be generated through carve-out and scaling of the payments asset.

Shared payments utilities

Banks can consider partnering with one or more peers to establish shared payments utilities that improve and expand upon services provided to their joint customer base while reducing the investment that would have been required if each bank had developed the solution on its own. Such pooling of resources and coordination between consortium members leads to the development of superior payments products with a higher probability of wide-scale adoption, enabling banks to win customer relationships and protect them from nonbank payments specialists.

By nature, sharing payments utilities limits banks' opportunity to differentiate based on product features. Therefore, the strategy is best suited for products benefiting from a common core feature set and/or institutions looking to compete based on service, rather than banks with the objective of being a "payments leader." In addition, banks can still differentiate from other banking players by leveraging the shared utility to introduce innovative solutions or address specific use cases not offered by other banks. For instance, a real-time-payments (RTP) scheme can be developed as a shared utility but allows each bank to develop unique RTP use cases for different customer segments.

Examples include the establishment of electronic alternative payments methods that have helped reduce merchants' payment costs. A consortium of banks established P27, a pan-Nordic real-time payments scheme, while six large Swedish banks, in cooperation with the Central Bank of Sweden, launched the mobile payments platform Swish. Neither of these undertakings would have been likely to gain sufficient scale if it had been approached independently by a single bank. Similar shared-utility opportunities exist in national debit schemes and in joint know-your-customer (KYC) and fraud-prevention initiatives.

Payments as a service

While outsourcing of the full payments stack is a possibility, a new generation of technology providers has emerged allowing banks to expand quickly and modernize their payments product portfolio without incurring high upfront investment. Payments-as-a-service (PaaS) players operate cutting-edge cloud-based platforms to provide specialized services, such as card issuing, payments clearing, cross-border payments, disbursements, and e-commerce gateways.

Banks wishing to offer these services can integrate these platforms via application programming interfaces (APIs), which allow the institutions to link these products into their core banking platforms, in effect building a cloud-based payments services stack of their own. Banks can then offer these services to end customers and can update and swap out services more readily. The ability to rapidly add or replace specific solution providers is key to this model, as it allows the bank to realize the "fast follower" vision of capitalizing on best-of-breed solutions. Therefore, it essential to confirm that such plug-and-play interchangeability is truly attainable.

This allows banks to enjoy several advantages. First, they can expedite time to market for new payments products—say, launching a new credit-card program in two or three months rather than two years. They also can reduce capital investment; instead of building a credit-card stack in-house, they pursue a much simpler integration with the cloud platform. In addition, they can ensure that products are continuously updated and upgraded without disproportionate maintenance investment, since the PaaS partner handles platform maintenance and upgrades, ideally in collaboration with bank product leaders. Finally, they can forger a stronger link between cost and revenue, since the majority of PaaS fees are transaction based and/or based on API usage.

Prominent institutions have adopted this approach. JP Morgan recently partnered with Marqeta, a PaaS card issuer, for virtual commercial credit cards. Oxbury Bank has chosen to work with ClearBank, a PaaS payments clearing and agency-banking provider, to clear its UK wholesale payments.

Outsourcing

Banks that do not wish to—or cannot afford to—invest in building or upgrading a full payments technology stack can still offer best-of-breed payments products to end customers by outsourcing select services. This approach is applicable to a variety of services, including merchant acquiring and processing (especially for small and medium-size enterprises [SMEs]), cross-border payments, B2B payments, and card issuing.

Outsourcing enables the rapid expansion of service breadth, even for banks unable to justify the cost of developing the service in-house. Banks can mix and match to create a broad suite of payments services suited for their customers. While outsourcing leads to some loss of control over product and service quality and can inhibit the marketing of a holistic, integrated product portfolio, banks do retain control over critical customer touchpoints and, in many cases, valuable transaction data.

Although large banks like Chase in the United States and Lloyds in the United Kingdom offer their own merchant acquiring and processing solutions, many other large brands rely on external providers to support their SME merchants payments needs. Transferwise now offers remittance services to banks, a solution that reduces the cost of operations for cross-border payments and often expands payment corridors offered to customers for banks lacking global reach.

Banks also have the option of a full outsourcing of their payments stack. Many smaller US institutions have done this with players like Fiserv. In Europe, Commerzbank and UCI have done this recently with Worldline.

Moving to a decision

Changing the operating model of a business that typically represents one-quarter to one-third of the bank's business is difficult (see sidebar, "Lessons from experience"). Nevertheless, for most banks, it is a necessary step to ensure long-term success in a critical and rapidly evolving market.

Deciding on a bank's future payments operating model first requires determining the bank's level of ambition in payments. Bank leaders should ask themselves what is critical to their bank in the payments arena. Is it strategically important to retain control of customer touchpoints and data, or is it enough simply to ensure provision of a full suite of essential payments products? Which payments products and services are critical to differentiation? Is the bank meeting this desired standard today?

Given the high investment required to lead in payments in the future, banks should also take a brutally honest look at their current level of payments capabilities and consider these questions: What is our stand-alone potential for improvement? What are the bank's realistic prospects for in-house development and innovation, including its ability to earmark sufficient investment funds?

For banks that are ambitious in payments and at a solid starting point in terms of in-house payments capabilities, we consider carve-outs of the payments business as a potential development for the mid- to long term. Carving out the payments business could create long-term value by attracting top-notch talent free of the constraints of banking labor agreements, creating a clearer path to scale by attracting other banks' volumes, and building out stand-alone operations in an environment that generates high-multiple valuations.

Lessons from experience

We reviewed our experience with outsourcing, utility, PaaS, and carve-out operations to uncover a few lessons that banks should consider applying when choosing a new operating model:

- Convincing the bank to outsource operations can be difficult and requires a strategic discussion at the executive level from day one. Continued executive involvement will be necessary to keep the process from stalling in operational layers of the organization.
- Understanding the bank's interest and pain is the key. Services that do not address a specific pain point are mostly irrelevant.
- Decisions about which services to provide must weigh provider capabilities and identify where the providers can outperform the market.
- Options can—and in many cases, should—include legacy and low-margin services. Creating a value proposition in these spaces is often more beneficial than pursuing innovations.
- Assuming the bank intends to scale the service beyond an initial set of clients, it should pursue easy integration and management of a variety of interfaces.
- Decision makers might need to consider different types of providers to obtain the required value proposition. Multiple types of partnerships may be necessary for acquiring the needed scale.
- Building commercial capabilities in payments may involve either building an in-house sales force or partnering with outside providers.

If the bank lacks the investment capabilities required to keep pace with the competition or hasn't committed to being unique in its payments offerings, an attractive alternative is to investigate the wide array of available outsourcing plays. A full complement remains incomplete in many markets outside the United States, however, although some players are developing in this space. Before choosing which route to take, banks should ask themselves several questions: What scope of partnering and outsourcing is my bank willing to consider, and in which areas? How much cost savings could be gained from each outsourcing option? Is there a reliable payments supplier in the market to outsource to, or is there a need to build a common utility? What will be the impact of the transaction on my HR and social situation? How would the bank mitigate associated risks, ensure sufficient input in future product decisions, and retain flexibility for potential future changes?

Whatever level of ambition and starting point in payments a bank may have, now is the time for its leaders to take a close look at its payments operating model. With several options available, strong players are already creating the new generation of payments. Those that cling to old ways will be left behind.

Olivier Denecker *is a partner in McKinsey's Brussels office,* **Yaniv Lushinsky** *is a consultant in the Tel Aviv office,* **Albion Murati** *is a partner in the Stockholm office, and* **Jonathan Zell** *is an associate partner in the New York office.*