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Global Payments 2017: Amid Rapid Change, An Upward Trajectory

Global Banking Practice

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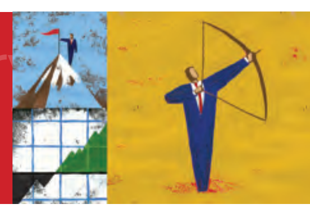
Introduction

An Upward Trajectory Global Payments



Six Key Insights

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Introduction

In 2016, the global payments industry accounted for 34 percent of overall banking revenues—up from 27 percent just five years earlier. For the next five years, annual growth will average 7 percent, making payments a $2 trillion dollar industry by 2020, according to McKinsey's latest Global Payments Map data. As is always the case, the dynamics underpinning performance in various countries vary; revenue drivers in China are starkly different than those in the United States, for instance. The overall data, however, reinforce our previously stated view that the industry has reached a turning point, with strong fundamentals providing a buffer against macroeconomic uncertainties.

As always, a meaningful portion of performance in payments is related to macroeconomic factors—increasing global GDP growth expectations, an improved interest rate environment—largely beyond payments executives' control. But the fundamental aspects of the business are on a clear positive trajectory as well—particularly electronic transaction volumes and account balance growth.

The payments industry outperformed most financial services sectors in 2016—indeed, payments was a stand-out among all industries. These solid results come at a time of increased change. Non-banks have stepped up the pace of innovation, and the advent of open banking and development of e-commerce ecosystems stand to fuel significant disruption in the coming years. Financial institutions must rise to the occasion and play a formative rather than reactive role in this transformation.

Beyond the top-line revenue numbers, the results of this year's Global Payments Map led to six key insights—some counterintuitive, others offering data-driven validation and subtle twists on conventional wisdom—that can inform an effective payments strategy:

- Fee-based payments revenue now nearly equals liquidity-driven income.
- Consumer revenues have overtaken business revenues.
- The war on cash continues to have meaningful impact in several countries.
- Cross-border transactions still generate substantially higher margins than domestic, even as volume increases.
- Payments between consumers and businesses represent the largest opportunity, despite heightened competition and a frequent focus on B2B and C2C.
- Although trends indicate that consumers are less likely to carry balances, credit cards remain the primary revenue driver in the Americas, and are projected to extend their lead.

The insights in this paper are based on the 2016 version of McKinsey's Global Payments Map, which has been the industry's premier source of information on worldwide payments transactions and revenues for two decades. The map gathers and analyzes data from more than 40 countries.

An Upward Trajectory for Global Payments

Despite unexpected interest rate declines in many regions as well as ongoing digitization across the globe, payments remain a large and growing industry. Comprising 34 percent of overall banking revenues—up from 27 percent just five years earlier—payments will represent a $2 trillion dollar business by 2020. While Asia-Pacific[1] will contribute the majority of net new revenue, every region offers meaningful growth opportunities over the next five years.

At a macro level, global payments revenue grew by 5 percent to $1.6 trillion in 2016, continuing a recent trend of solid gains.[2] Performance, as always, varied by region. Latin America's[3] 19 percent growth in revenues from 2015 to 2016 marked the region's second consecutive double-digit performance. The second-fastest growing region was North America (Canada, US), which maintained

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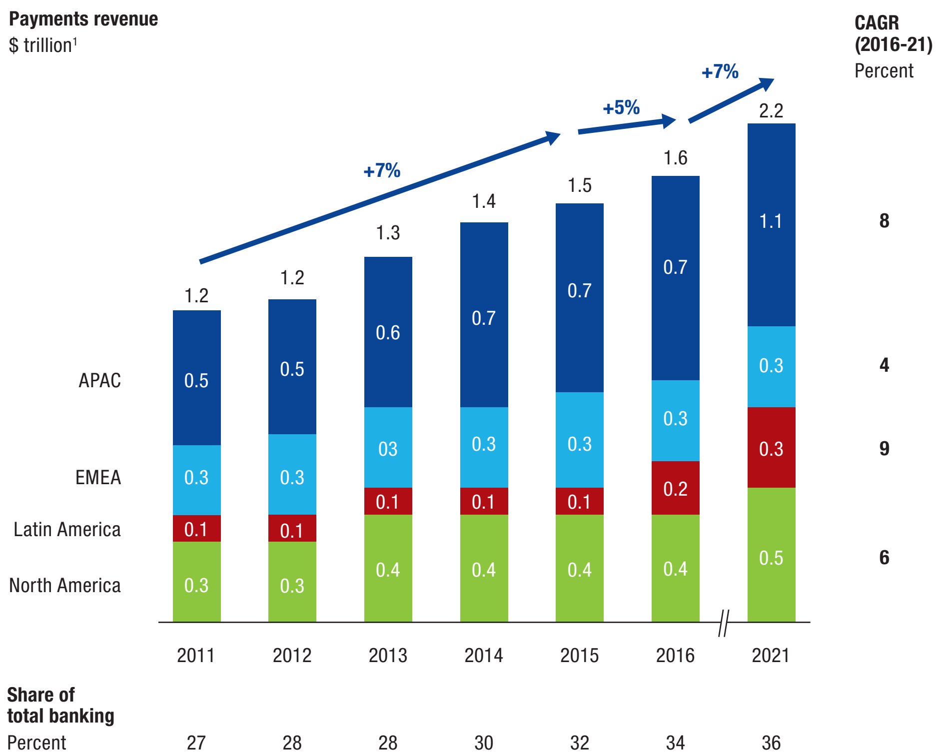
[1] Australia, China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Singapore, Taiwan, Thailand

[2] US dollar-denominated revenue figures have been restated from our 2016 report ("*Global Payments 2016: Strong Fundamentals Despite Uncertain Times*," September 2016) based on two factors: (a) revenues in US dollar appear lower because of the appreciation of the US dollar against other currencies in 2016, and (b) we have revised downward our estimates of cross-border revenues based on new insights.

[3] Argentina, Brazil, Chile, Colombia, Mexico, Peru

Exhibit 1

Global payments revenues will average 7% annual growth through 2021



[1] At fixed 2016 $ exchange rates, for the entire time series.
Source: McKinsey Global Payments Map

its 2015 year-on-year growth rate of 6 percent in 2016 (Exhibit 1).

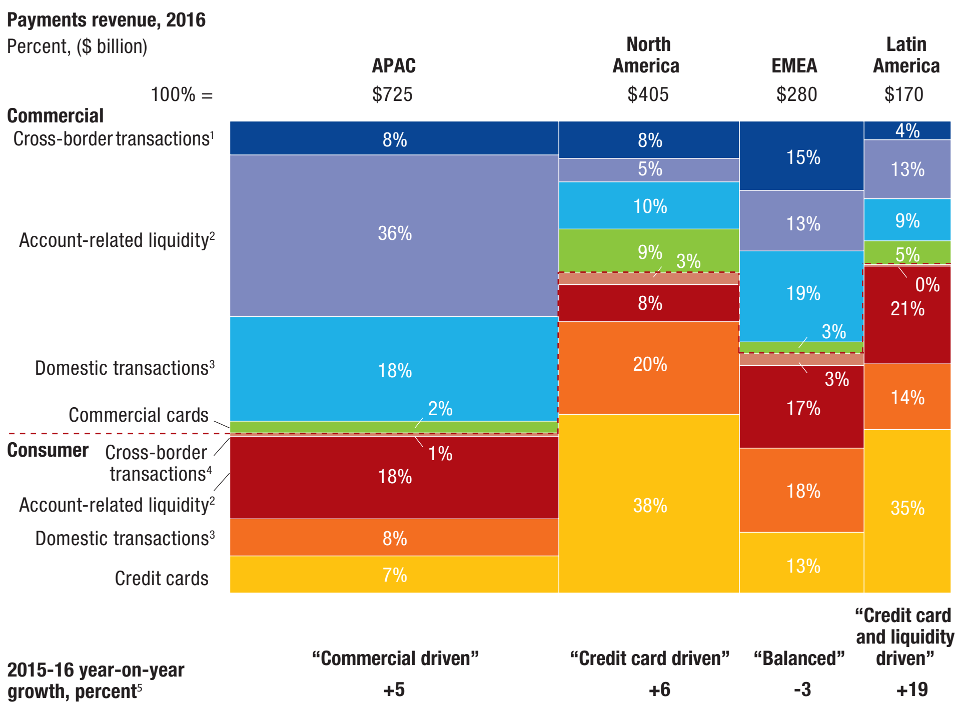
While total payments revenue is growing well ahead of GDP, growth in fee-based revenues (as opposed to revenues driven by interest margins) is even more robust, with card volumes maintaining a solid upward trajectory in all regions. Margins, already healthy, are poised to improve as growth in volume and interest margins, efficiency gains, consolidations, and value-chain expansions outweigh competitive pressures, particularly on the consumer side. A widely anticipated but by no means certain rebound in global interest rates would only brighten this outlook.

Asia-Pacific continues to comprise the largest share (45 percent, or $725 billion) of the global revenue pool, and its 5 percent growth led to 2016's largest dollar increase in revenues. Meanwhile, EMEA[4] revenues slipped by 3 percent—after two years of relative stability—erasing all of the region's revenue gains since 2013 (Exhibit 2). Transaction

[4] Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Morocco, Netherlands, Nigeria, Norway, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, Spain, South Africa, Sweden, Switzerland, UK

Exhibit 2

Revenue sources differ across regions



[1] Trade finance and cross-border payments services.
[2] Net interest income on current accounts and overdrafts.
[3] Fee revenue on domestic payments transactions and account maintenance (excluding credit cards).
[4] Remittance services.
[5] At fixed 2016 $ exchange rates, for the entire time series.

Source: McKinsey Global Payments Map

volumes, account and credit card balances, as well as transactional revenues, all continue to grow in EMEA. These gains, however, were offset by falling interest margins.

Six Key Insights

Several unexpected and perhaps counterintuitive trends emerge when we look past the top-line numbers. A closer look can inform a more effective payments strategy.

1. **Fee-based payments revenue now nearly equals liquidity-driven income.** Revenue generated from fees now constitutes almost 50 percent of global payments revenue. Fee-based revenue growth of 7 percent annually from 2006-16 significantly outpaced fee compression. This pace of growth has accelerated recently, with a CAGR of 9 percent since 2013. Liquidity revenue is less stable, a natural by-product of the cyclical interest rate environment. Net interest income (NII) grew at a 6 percent CAGR from 2006-16, falling dramatically in 2009 and charting a slow recovery path since 2011. The regional picture is more nuanced—while interest income dropped substantially in EMEA, it increased from 58 percent to 62 percent of overall revenue in Latin America. While it is possible that a rate recovery—particularly in Europe—could tilt the balance once again towards liquidity-based revenues, recent history reinforces the need for payments operators to seek robust new revenue foundations, be it from steady

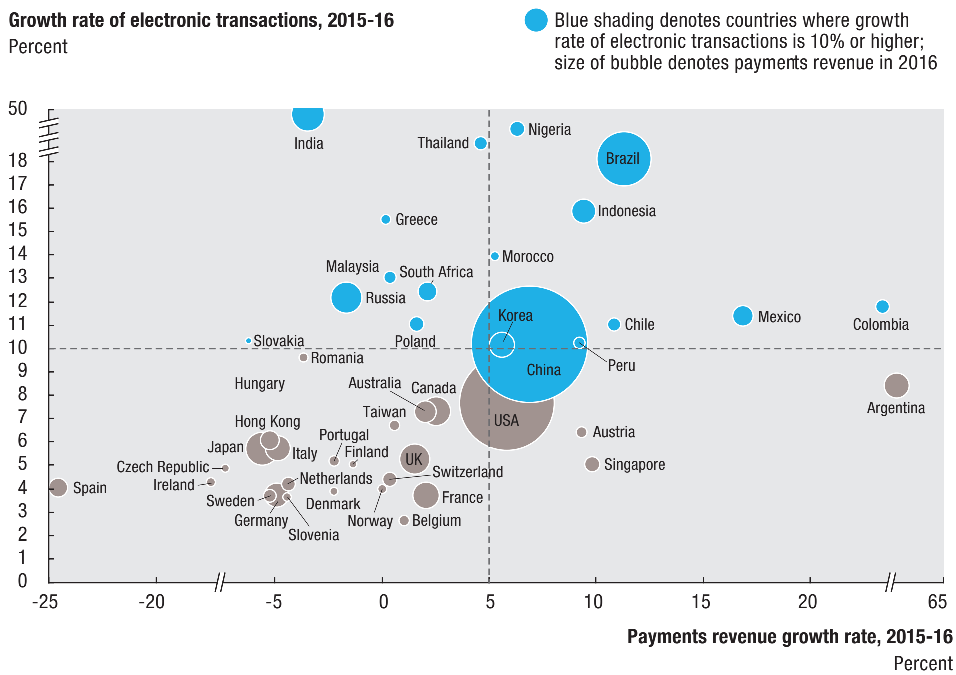
growth in transaction volumes and fee-based events, alternative sources of revenue in high-growth areas such as cross-border commerce, or additional services such as commerce enablement, loyalty, risk and fraud management.

2. **Consumer revenues have overtaken business revenues.** The consumer segment is demonstrating greater overall strength, although the pattern is not uniform across regions. In Asia–Pacific business revenues continue to dominate, and actually increased their share in 2016 to 64 percent. In the other three regions, consumer payments are driving the majority of growth; in both North America and Latin America consumers account for nearly 70 percent of total revenue. The balance is quite even in EMEA, with the consumer sector having edged ahead in 2016 largely as a result of the depressed interest rate environment. Growth in consumer payments has been driven by credit cards across all regions. In absolute terms, credit cards provided the greatest lift to consumer payments across nearly all regions (with the exception of Latin America, where account balances contributed somewhat more). At the same time, commercial payments growth slowed down—particularly in EMEA, due to the decline in interbank interest rates. The well-documented momentum toward open banking protocols (including regulations such as PSD2 in the EU) will drive many such growth opportunities, with the potential to alter the competitive balance between banks and nonbanks. As with many of these high-growth avenues, the challenge—and opportunity—for payments providers is to wrap seamless value-added services around the core payments transaction.

3. **The war on cash continues to have meaningful impact in several countries.** India's demonetization, which involved reissuing 86 percent of its currency, was primarily intended to force "grey money" out of the shadows and into taxable status. Notwithstanding a painful transition caused by the delayed availability of new currency, other collateral effects were welcomed by many in the industry—a sharp increase in the use of mobile wallets, debit and credit cards, and other means of electronic payments. These levels receded somewhat once the supply of paper money stabilized, but a new, higher baseline has clearly been set. Meanwhile, the British Retail Consortium reports that in the UK debit card use has overtaken cash as a payments vehicle at the point of sale, with cash having fallen from 52 percent to 42 percent of retail purchases in the past three years alone. In the Netherlands and Sweden, cash usage has dipped below 35 percent and 20 percent of all payments transactions, respectively, and South Korea is in the process of abolishing coins altogether by 2020. Cash remains a meaningful part of the payments

Exhibit 3

Countries with high revenue growth are also characterized by high growth in electronic transactions



Source: McKinsey Global Payments Map

equation, and the residual volume will be the toughest to displace. Initiatives in low-cash usage countries are demonstrating new opportunities to reduce the cost of remaining cash payments, for instance, by optimizing nationwide deployment and management of ATM networks across all banks. Experiences like India's recent currency overhaul provide other hints of potential pathways to fostering mobile wallets and other solutions. Despite fears in some circles that electronic transactions generate lower unit revenues, there is a notable correlation between countries with high electronic transaction growth and high revenue growth. Countries where electronic transaction growth rates increased by 10 percent or more also enjoyed the highest revenue growth, with a few exceptions (e.g., Russia, Malaysia, and India) (Exhibit 3).

4. **Cross-border transactions still generate substantially higher margins than domestic ones, even as the volume of cross-border commerce and small and medium-size business trade increases.** Cross-border transactions, both remittances and ecosystem-based payments, deliver lucrative margins of up to 100 times their domestic counterparts for retail

remittances. The average margin on a cross-border consumer-to-consumer transaction is 635 basis points, compared to 6 domestically, due to the greater complexity, the additional foreign exchange revenues, and the premium positioning of the service. Examples of these transactions include e-commerce payments, cross-border tuition, real estate payments, royalty payments to developers, and payments involving SMEs. The difference is not nearly as stark in the business-to-business (B2B) space, but cross-border margins of 12 basis points remain about four times that of domestic counterparts. Digital challengers are exploiting these opportunities to build strong and growing portfolios with lucrative valuations. Meanwhile, banks have an opportunity to reassert their role in this space by leveraging their positioning as global partners for the rising global affluent population. However, as the world is still globalizing, especially in the area of cross-border e-commerce and peer-to-peer trade platforms, this business will become more competitive with margin erosion likely. Already today, remittance attackers such as Transferwise are expanding rapidly into the SME space. Despite this margin pressure, McKinsey expects that volume growth, driven by international marketplaces such as Alibaba and Amazon, will create new revenue opportunities for focused players, both banks and specialists.

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5. **Payments between consumers and businesses represent the largest opportunity, despite heightened competition and a frequent focus on B2B and C2C.** Among revenues attributable to specific counterparty transactions, 35 percent stem from B2B transactions. However, 60 percent relate to customer-to-business (C2B) transactions—nearly three-quarters of that amount accruing to the originating—that is, the consumer's—institution. Transactions for which a consumer is the recipient generate relatively small revenue pools, with the much-discussed consumer-to-consumer (C2C) category currently only 2 percent of the total. These percentages may not be reflective of future opportunity or other strategic considerations; the more complex the transaction, the greater the opportunity to provide added value and to price accordingly. For instance, a B2B solution that improves funds transparency and streamlines payables processes could create new revenue streams. And, banks' desire to maintain C2C volume has as much to do with client engagement as with direct revenues.

The rollout of real-time and instant payments is now generating new payments revenue opportunities in certain countries. Real-time is a bit of a misnomer, as most of the value creation comes from other advantages brought by these new systems, including irrevocability, immediate access to funds, transaction transparency and standardized information content, rather than from speed itself. The UK and Singapore are two relevant examples. Real-time payments were introduced in UK (branded as Faster Payments) in 2008 and have grown by an average annual rate of 43 percent since then. This growth has primarily come from the cannibalization of cash and check payments, as ACH transactions have continued on a steady growth curve. Faster Payments enabled the introduction of new UK solutions like Pingit, Paym, and Zapp. In Singapore, real-time payments grew by 42 percent in 2016—a rate remarkably similar to the UK's. For government, real-time payments provide a more secure and cheaper means to disburse social welfare benefits—transferring funds directly into bank accounts. It is also a highly efficient means of distributing emergency aid relief. For businesses, real-time payments are a superior means of making urgent supplier payments, emergency payroll corrections, or customer refunds. For SMEs, the ability to receive immediate credit for incoming payments is an enormous benefit for managing cash flow. For example, SMEs and individuals managing "hawker" stalls in Singapore require quick turnaround of funds to allow for daily purchases of perishable raw food items. While using cash as a means of payment provides them liquidity, security concerns lead them to deposit and withdraw cash from ATMs on a regular basis. Although card payments similarly allay these security concerns, funds are not available until a few days later, creating short-term cash flow issues. In such a scenario, real-time payments provide both security as well as immediate access to funds.

6. **Although consumers show a greater propensity to pay their monthly spend in full rather than carry balances, credit cards remain the primary revenue driver in the Americas and are projected to extend their lead.** In North and Latin America, credit cards alone comprise 47 percent and 40 percent, respectively, of payments revenue. This includes both network fees and net interest on carried balances for both consumer and business card activity, with the solid majority contributed by consumer, and with business card revenues driven more by fees than balances. Over the next five years, cards will contribute more than half of each region's growth as well; in the case of North America, business cards will play as meaningful a role as consumer cards.

High-Growth Opportunities

To achieve the growth mandates built into their business plans, most banks and fintechs will need to pursue high-growth opportunities to counterbalance the moderate growth in large, mature areas. Such opportunities exist in every region, whether at a country or product level.

In both Brazil and the United States, credit cards account for a significant share of payments revenue (in 2016: 47 percent in Brazil; 48 percent in the US). Brazil relies more on interest income (credit card NII alone accounts for 36 percent of total payments revenue) compared to the US's more balanced profile (credit card NII accounts for 28 percent of total payments revenue). Also, the US's $183 annual revenue per card is nearly double that of Brazil ($98), implying further growth opportunities for the latter.

The story in Indonesia, another high-growth economy, is very different from Brazil's. Credit cards account for a mere 6 percent of total payments revenue. Current accounts provide the largest share of revenue at 64 percent; this composition is expected to be stable through 2021. Current account NII alone accounts for nearly 40 percent of total payments revenue, or close to two-thirds of total current account revenue. In India too, current accounts provide the largest share of revenue at 53 percent. However, unlike Indonesia, nearly all of the current account revenue comes from NII, making it more vulnerable to interest rate changes. In 2016, for example, payments revenues in India experienced a dip because of the fall in interbank rates.

The five-year horizon

In 2016, McKinsey forecasted 5 percent growth over the 5-year horizon.[5] While 2016 revenue did indeed grow at 5 percent, we have upgraded our outlook to 7 percent growth, with most of the increase attributable to improved interest rate expectations, particularly in China (Exhibit 4). The outlook for transaction levels and fees remains largely unchanged. After establishing an all-time high in 2015, account balances continued their expected double-digit growth in 2016, with balances increasing by 11 percent to $30 trillion. While our forecast for B2B payments revenue headwinds was borne out in EMEA, they did not materialize as expected in China, which comprises nearly 50 percent of Asia–Pacific revenues, and where business payments strength shows no sign of abating.

Steep drops in commodity prices and slowdowns in Chinese imports led to a pause in the growth of cross-border revenues in 2016, the potential for strong growth remains in place. Because macroeconomic factors will take some time to rebound fully, our five year-growth outlook for cross-border revenues has been reduced to 3 percent. Nonetheless, given the increase in use cases, disproportionate share of revenue and high margins, cross-border payments should remain an area of focus.

Looking ahead, McKinsey expects payments revenue growth averaging 7 percent over the next five years, through 2021, a rate consistent with the trend established from 2011-16, despite some bumps in the road. All told, payments will be a $2 trillion business by 2020, reaching $2.2 trillion globally by 2021.

All regions will grow at solid overall rates over this period, with Latin America continuing to lead the pack at 9 percent, riding on continued strong Brazilian performance, particularly in credit cards (Exhibit 5, page 16). Roughly 38 percent of the region's absolute revenue growth will stem from credit cards in Brazil alone. These card revenues will be volume driven, as net interest margins are expected to decline in Brazil. Mexico's 11 percent growth is also expected to lead the region, with account balances and interest margins contributing 66 percent of its growth.

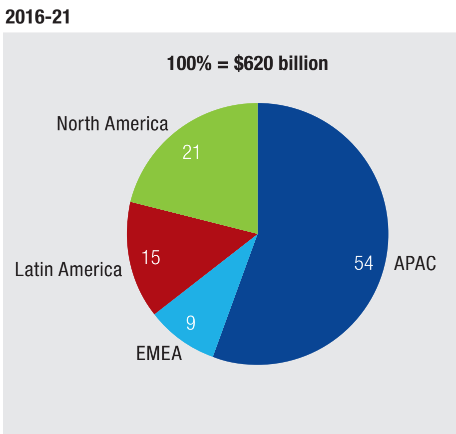
Asia–Pacific's 8 percent growth, combined with its large base, means it will comprise $340 billion of new payments revenue by 2021, more than half of the global increment. This growth will be driven by large transaction and balances growth, combined with solid transaction fees. China alone will deliver $250 billion of net new payments revenue by 2021, over 40 percent of the global total of

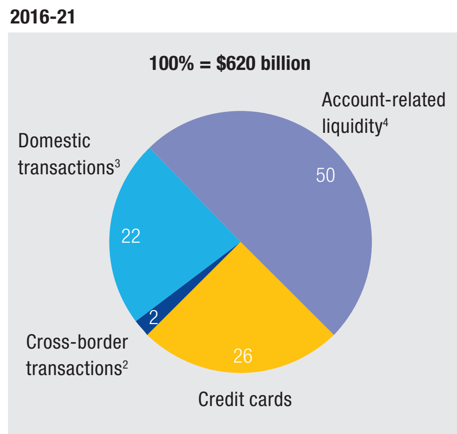
[5] "*Global Payments 2016: Strong Fundamentals Despite Uncertain Times*," McKinsey & Company, September 2016.

Exhibit 4

APAC and account-related liquidity revenues will drive revenue growth over the next five years

Composition of net new payments revenues through 2021[1]
Percent, $ billion





[1] At fixed 2016 $ exchange rates, for the entire time series.
[2] Trade finance and cross-border payments services, including remittance services.
[3] Fee revenue on domestic payments transactions and account maintenance (excluding credit cards).
[4] Net interest income on current accounts and overdrafts.
Source: McKinsey Global Payments Map

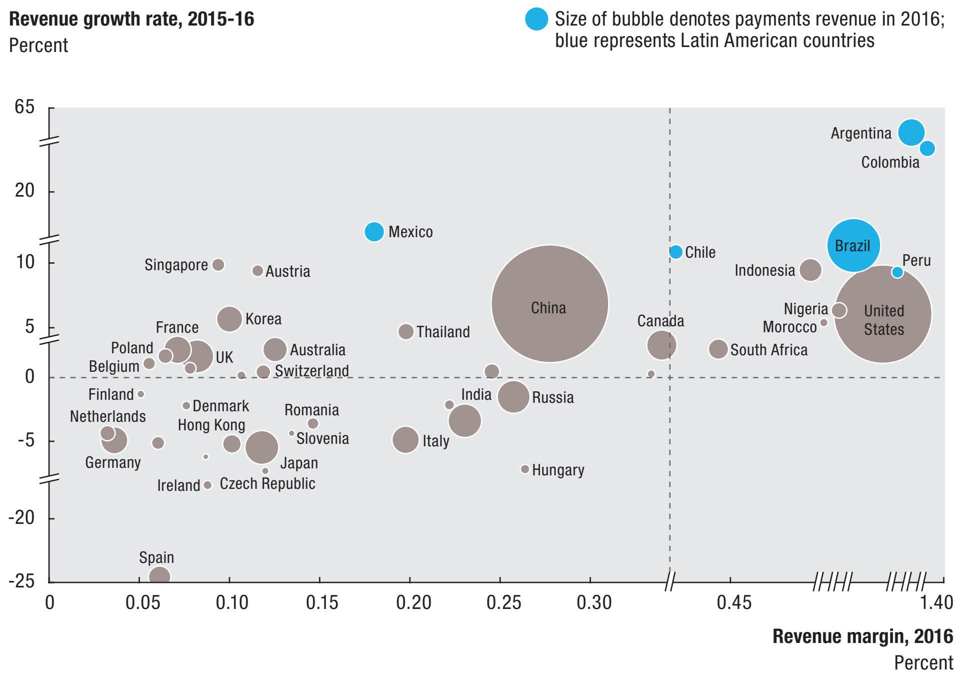
$620 billion. However, in percentage terms, the fastest-growing countries in Asia–Pacific will be India and Indonesia, at 13 percent and 11 percent, respectively.

Revenue growth should continue to be modest in EMEA, at 4 percent, a consequence of regulatory developments and competitive fee pressures. Eastern and Western European revenues will grow at similar rates (with the former nominally higher), albeit with a different composition. Credit cards and a continued move from cash to electronic transactions are the key Eastern European growth drivers, while a rate-driven recovery in current accounts will generate a greater lift in Western Europe. Despite this nominal growth outlook, we still expect $55 billion of new revenue opportunity to emerge in EMEA. Finland, Germany, and South Africa are expected to grow more robustly than the region overall. Besides the recovery in interest rates, revenue from domestic transactions will be an important growth driver in Finland and Germany. In South Africa, we expect card payments—specifically debit cards—to drive growth. At the same time, operating margins may deliver more positive results as EMEA realizes significant increases in payments efficiency, through continuing electronification, digital and agile transformations, and further consolidation of infrastructure providers.

From a product perspective, global card revenues are expected to grow at more than 7 percent annually over the next

Exhibit 5

Latin America leads in terms of revenue margin and revenue growth rate



Source: McKinsey Global Payments Map

five years, and will account for more than half of North America's top-line growth. Overall, however, interest revenue from account balances will lead to the majority—$315 billion, or 50 percent—of revenue growth.

Consumer payments revenue growth will exceed corporate across all regions, although an important country-level exception is China, where the liquidity component of corporate payments will remain the predominant driver. The relative strength of consumer payments revenues speaks to the later stages of global economic recovery, with stronger GDP growth intertwined with greater access to consumer credit.

However, a congestion of competition on the consumer side will create margin pressures. Consequently, higher-margin opportunities in business payments remain quite attractive despite nominally slower growth.

Not surprisingly, payments revenue forecasts are sensitive to interest rate assumptions. Perhaps less expected, different regions and specific countries are far more impacted by these swings. In countries like Argentina, Brazil, India, Malaysia, and Nigeria, more than 60 percent of total payments revenues are currently derived from NII. More than 70 percent of revenue growth over the next five years in Brazil and India will be driven by NII. In Argentina, however, where interbank rates are expected to fall from current levels, this contribution will be less than 15 percent. At the other extreme, countries like Germany, Korea, Slovakia, and Slovenia derive less than 30 percent of payments revenue from NII. More than 70 percent of Germany's revenue growth through 2021 is expected to derive from NII as an outcome of the expected rebound in interbank rates in the eurozone. This would merely return the interest composition of Germany's payments revenue to near 2008 levels, an indication of the importance of rates to the payments equation.

Consistent with past forecasts, global transaction growth continues its strong, steady upward trajectory. Overall electronic transaction growth will average 7 percent over the next five years. Isolating the more lucrative card-based payments, three geographies will post double-digit growth: Latin America, Eastern Europe, and Africa (the latter off a small base). Although the mature Western European card market will post the slowest growth (4 percent), combined with its high-growth sub-sectors, EMEA card transaction growth remains at a quite healthy 7 percent. Globally, the value conveyed by these payments will rise slightly more rapidly than the transaction counts themselves, further enhancing revenue opportunities.

As transaction-driven revenues comprise an increasing share of the overall payments equation, they provide a welcome buffer to the more volatile rate-related income streams. The UK's Open Banking initiative—and similar efforts under consideration in other countries—promises to create dynamics conducive to transaction-oriented revenue streams as well. While the composition of payments revenue continues to evolve, it establishes a firmer foundation while opening new opportunities for players across the value chain.

* * *

The global payments industry continues to be locus of innovation and a center of opportunity in the larger financial services arena. The industry is also fast-moving, and buffeted by a number of external forces—new regulation, the incursion of fintechs, macro-economic shifts. These characteristics make the current moment an exciting one for both incumbents and new players. For both the former and the latter, success in this soon-to-be $2 trillion industry will require a deep perspective on exactly where the currents of growth and opportunity flow, and a clear strategy for tapping into them.

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McKinsey's Global Payments Practice

McKinsey's Global Payments Practice is a network of more than 100 partners worldwide serving a broad range of institutions (banks, credit card companies, transaction processors, payments cooperatives, technology firms and nonbanking firms) on strategic, organizational and operational issues in retail and wholesale payments. The practice is recognized as a leader on topics such as digital payments, payments industry profitability, credit card strategy for issuers and merchants, loyalty and marketing, payments processing and transaction banking.

McKinsey Global Payments Map

The McKinsey Global Payments Map has been the industry's premier source of information on worldwide payments transactions and revenues for two decades. The map gathers and analyzes data from more than 40 countries. For information on the McKinsey Global Payments Map, or to contact the McKinsey Global Payments Practice, e-mail paymentspractice@McKinsey.com.

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