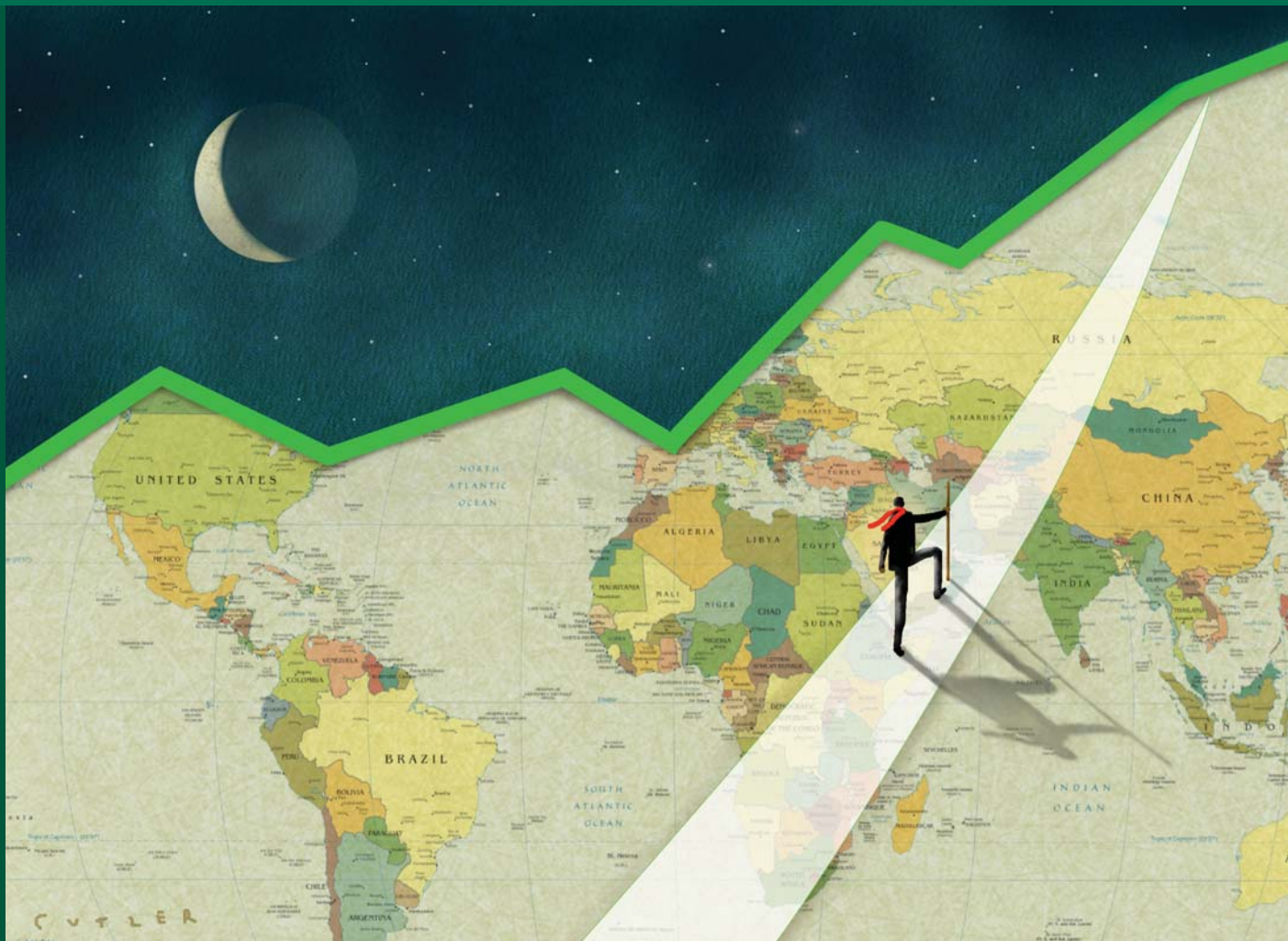


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October 2012



The Transaction Banking Advantage

The Path to Profitable Growth

- ◇ *Building Future-Proof Business and Operating Models in Wholesale Transaction Banking*
- ◇ *Profiting from Asia's Rise and from New Global Trade Flows*
- ◇ *How Banks Can Take the Lead in Mobile Payments*
- ◇ *Capturing Payments Opportunities in Rapidly Developing Economies: Lessons from Brazil and India*

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Preface

Transaction banking businesses are facing unprecedented change. To drive the thinking at Sibos 2012 on the challenges and opportunities that financial institutions are facing in the new competitive landscape, SWIFT has partnered with The Boston Consulting Group. The articles in this collection, authored by BCG, concern topics addressed in four sessions at Sibos 2012. All of these subjects are critical to the future of transaction banking.

- *Building Future-Proof Business and Operating Models in Wholesale Transaction Banking* looks at how numerous banks are struggling to achieve an optimal balance between “design to flexibility” and “design to cost,” finding themselves stuck in between. The steps to shaping better business and operating models are: excel at standard solutions while innovating prudently; enhance frontline expertise; organize around multilocal setups; manage complexity before seeking scale; and build a stronger bridge between the business and IT/operations.
- *Profiting from Asia’s Rise and from New Global Trade Flows* investigates the expansion of global trade, particularly Asia’s ascendance. With companies experiencing increased supply-chain fragmentation, and small and midsize companies becoming more active in cross-border trade, key success factors include creating optimal geo-footprints and delivery platforms.
- *How Banks Can Take the Lead in Mobile Payments* deals with the fact that hype, consumer and merchant ambivalence, and the constantly shifting competitive climate have made it extremely challenging to develop a mobile payments strategy. There are, however, steps that banks can take to position themselves: establish security protocols; preserve the attractiveness of card products; and form a “house view” on m-wallets.
- *Capturing Payments Opportunities in Rapidly Developing Economies: Lessons from Brazil and India* explores the rich potential of payments businesses in RDEs—possibilities driven by the migration from cash to electronic payments, by strong growth in mobile phone penetration, and by relatively young populations that are quickly mobilizing. To succeed in RDEs, banks must innovate in mobile banking and mobile payments, determine how best to leverage domestic networks, and collaborate effectively with telcos and service providers.

We hope that you find these articles insightful and thought provoking.

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BUILDING FUTURE-PROOF BUSINESS AND OPERATING MODELS IN WHOLESALE TRANSACTION BANKING

by Niclas Storz, Gero Freudenstein, and Stefan Dab

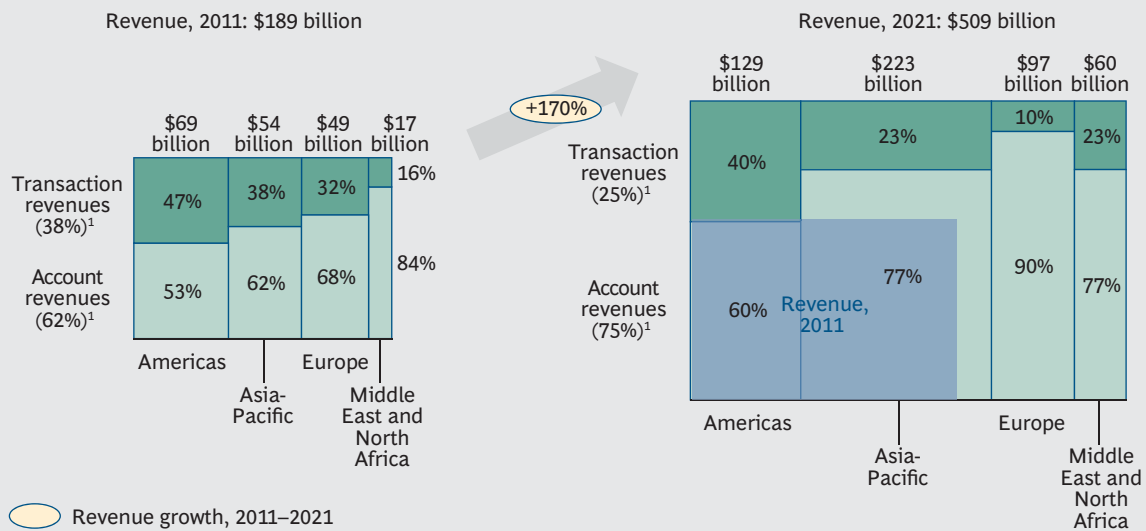
THE QUESTION OF THE moment is, “How can financial institutions gain a competitive advantage in transaction banking in a hypercompetitive climate?”

We believe the answer lies in sharpening both business and operating models, making them strong enough to withstand the volatility that is sure to continue or potentially worsen—in essence, making them “future proof.”

Of course, despite intensified competition and a generally troubled global-banking en-

vironment, wholesale transaction banking continues to be a highly attractive business. Despite shrinking margins, significant revenue growth of approximately 170 percent—or a compound annual growth rate of roughly 11 percent—is anticipated between 2011 and 2021. (See Exhibit 1.) Rapidly developing economies are expected to drive the bulk of this expansion, outperforming developed markets. This is especially the case in the Asia-Pacific region and in Latin America, where there is significant room for growth in terms of key indicators such as the value of

EXHIBIT 1 | Significant Revenue Growth Is Anticipated in Wholesale Transaction Banking



Sources: BCG global payments model; BCG analysis.
¹Weighted average; the rest of the world is not included.

wholesale payment transactions per GDP and the number of wholesale payment transactions per capita.

Why does the outlook for wholesale transaction banking seem relatively rosy when other segments of the banking industry seem so uncertain? There are several reasons. First, transaction banking activities are historically stable, with fairly predictable business-development and upward-revenue trends across all client segments. The business still offers attractive profit and contribution margins as well as low capital absorption compared with other banking activities—leading to superior returns on economic capital. Moreover, wholesale transaction banking represents an inexpensive source of funding and liquidity for banks, particularly in the current market environment.

But the market landscape has grown more competitive as many corporate banks across the globe pay more attention to transaction banking. For example, highly evolved players—many of which have combined their transaction-banking businesses into a distinct, organizational entity—are moving this segment to the forefront of their offerings, up to the same level as private banking, corporate banking, and other core market segments. Such a shift gives more weight to the segment both externally and internally (where it also raises performance expectations). In addition, many emerging transaction-banking players—whose transaction banking activities are typically still fragmented throughout the organization—are now beginning to follow suit. The landscape has been further altered by mergers and acquisitions. Although the M&A activity has not necessarily been triggered by transaction banking concerns, multiple players have enhanced their transaction-banking presence in this fashion.

Globally, it is clear that the wholesale transaction banking segment is gaining in strategic importance relative to other banking segments, especially in a time of tight credit markets. In several credit-crunch scenarios that we examined, banks that derived a large share of their revenues (50 percent or more) from sources related to transaction banking—institutions that

we refer to as “transaction champions”—were far less damaged in terms of economic profit than players whose revenues were derived largely from credit products.¹

Yet what exactly is the right way to “do” transaction banking? Many banks still struggle with this core question. In our view, the key lies in revisiting business and operating models at the same time.

Taking a Fresh Look at Business and Operating Models in Transaction Banking

To get back on the right track, banks need to take a fresh perspective on the business model (what to do) and the operating model (how to do it). But succeeding is not just a matter of defining and optimizing each layer of these models separately. In fact, it is much more about developing a holistic business and operating model that works from an end-to-end perspective.

There are two fundamental design paradigms in play today: “design to flexibility” and “design to cost.” Although first-rate service levels and excellence in overall execution are obviously important to both, each paradigm has distinct characteristics that need to be examined from both the business- and operating-model viewpoint.

- *Design to Flexibility.* This model enables the highly customized solutions required in wholesale transaction banking by many companies—particularly leading multinationals and large caps, as well as those in certain industries such as manufacturing and global trading. The model places a premium on product innovation. The emphasis is on meeting demands that are specific to highly sophisticated companies that are clear about the degree of customization they need—in essence, tailoring solutions down to a segment of one. Banks that do this successfully can achieve true differentiation in the marketplace.

Such a business model has significant implications for the underlying operating model. Processes, IT, and governance must be designed in a way that allows for close

alignment between the front and back offices, for seamless transfer of client requirements, and for joint and realistic assessments of the bank's ability to meet extremely specific client demands, often under considerable time pressure. Overall flexibility, rapid time to market, and effective bundling of solutions are key success factors. These elements all require cutting-edge skills in IT and operations.

- *Design to Cost.* This model focuses on serving clients whose needs can be met sufficiently with standardized products. What matters most to these companies is cost efficiency, fast and flawless processing, and immediate rectification of errors. Highly engineered, complex products—which typically demand elevated levels of customer maintenance and onboarding time—are perceived as undesirable from a cost perspective. Moreover, not all functionality that might be technically feasible—such as cash management solutions that enable pooling across different countries, banks, and currencies—is seen as required. An analogy can be found in the automotive industry: a car that is fast and extremely fuel efficient, and that never breaks down, but that has few, if any, sophisticated extras built in.

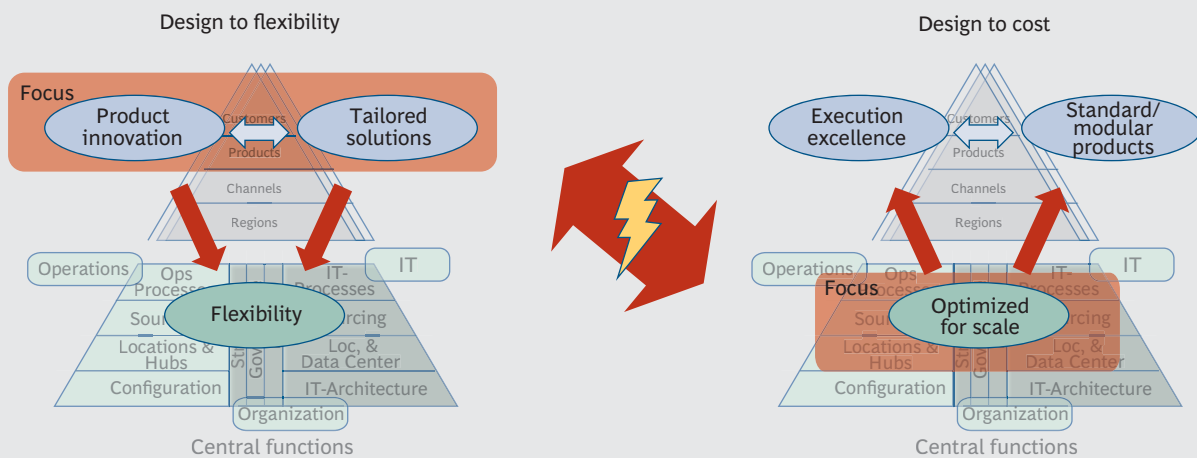
Of course, for a business model designed to achieve cost optimization, the stan-

dardization of products, services, and processes is mandatory. Ideally, all processing products should be standardized, while still allowing for some variation in sales products. Leveraging standardization in order to achieve scale in the operating model is of course critical. Process consolidation can help attain scale on platforms, and governance must push a disciplined cost agenda. Typical client segments for this paradigm include small and medium-size enterprises, mid caps, and low-end large caps, as well as certain industries such as telcos, utilities, and retailers.

Clearly, the most suitable design paradigm greatly depends on the individual bank's targeted clients, its own resources and capabilities, and the products that are most relevant from a revenue perspective. We have observed, however, that relatively few banks today are firmly committed to one model or the other in their transaction-banking businesses, instead remaining stuck in the middle, trying (and often failing) to maintain a primary focus on product innovation while also achieving significant scale effects. (See Exhibit 2).

The problem with straddling both models is that true excellence is typically achieved in neither. For example, a bank focused mainly on the design-to-cost paradigm that also tries to customize products runs significant risks. Its

EXHIBIT 2 | Many Players Are Stuck in the Middle Between the Two Paradigms of Transaction Banking



Source: BCG analysis.

investments in a highly efficient platform can be compromised both by a need for specialized IT (required to handle client-specific demands) and by insufficient volume in standardized products. Overall, optimal performance requires that business and operating models act in concert.

Three Common Pitfalls

Within this context, there are three common traps that many banks fall into when trying to improve their transaction-banking businesses:

- *Undifferentiated Coverage.* Many financial institutions active in transaction banking approach all clients as if they were complex multinationals, even though most of their revenues come from domestic products and from mid- to large-cap companies—which have their own distinct needs. Even among multinationals, the transaction banking needs of telcos and utilities, for example, differ significantly from those of manufacturing and trading companies. Indeed, customer requirements in wholesale transaction banking are driven not only by company size but also by industry background. Banks should objectively consider who their target customers really are—and define their coverage models accordingly.
- *Falling Short on Customer Needs.* Interviews with transaction banking customers show that many value accurate execution of transactions and high service levels more than customized products. Indeed, many companies feel that standardized product portfolios meet their needs perfectly, but that basic service standards, such as “somebody picking up the phone,” are often not fulfilled to a satisfactory level. According to one interviewee, “All banks are frustrating for corporations from the standpoint of overselling and underdelivering.” Such comments are consistent with our observation that many transaction banks focus on adding new products to their portfolios, with improvements in customer service being a low priority. There appears to be a fairly frequent mismatch between customer requirements and banks’ strategic priorities.

- *Failing to Achieve Scale Advantages.* In examining cost and volume trends among the top transaction banks globally over the past five years, we have observed that these banks have not systematically managed to realize scale effects. For example, volume (indexed for payments, trade finance, and securities) has grown by roughly 24 percent over this period, yet operational cost (noninterest expenses) has grown at nearly the same rate, clearly indicating that scale effects have been negligible. Moreover, expectations on cost savings should have been higher, as many players have carried out restructuring programs that should have started to pay off.

Five Steps to Action

In our view, financial institutions wishing to shape future-proof business and operating models in their transaction-banking activities should take action in five specific areas. Improvement in these domains can go a long way toward building competitive advantage in an increasingly challenging marketplace.

1. *Products: excel at standard solutions and be prudent about innovations.* Realistically define target customer segments, as not every transaction bank can be a global player; understand true customer requirements instead of following common doctrine; ensure execution excellence in core products; if you innovate, make sure it pays off.
2. *Coverage: enhance expertise at the frontline.* Tailor your coverage model to the type of company you are serving; increase (industry) expertise at the frontline and weave product experts into the coverage model; make sales success in transaction banking relevant by developing incentives that have a clear impact on remuneration; be responsive to your customers in a way that drives loyalty. The broader goal is to generate holistic client coverage across transaction-banking, lending, and capital-markets offerings—in a way that enables transaction banking products to serve as cross-selling tools that facilitate deeper client relationships.

3. *Footprint: organize around multilocal rather than global setups.* Keep country-specific functions and infrastructure local, since globalization is not a silver bullet; clearly distinguish among local, regional, and global functions and infrastructure, and eliminate overlaps and disconnects; ensure sufficient resources and talent at every layer of the organization.

4. *Platform: manage complexity before seeking scale.* Strive for end-to-end process excellence; release frontline capacity for customer focus; (re)align the platform, providing a limited number of products but a large number of variations; distinguish between client-aligned and shareable activities, considering only the latter for outsourcing and offshoring.

5. *Governance: bring business and operations/IT closer together.* Fix the governance model to stimulate cooperation between transaction banking businesses and operations/IT across countries; insist on a solid business case for all investments; increase financial transparency and performance management; do not allow regulatory compliance to determine your business or operating model.

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NOTE

1. See *Global Payments 2011: Winning After the Storm*, BCG report, February 2011, https://www.bcgperspectives.com/content/articles/financial_institutions_globalization_global_payments_2011/.

ULTIMATELY, IN THE current hypercompetitive environment, only those banks that take bold steps and make tough tradeoff choices on how to run their transaction-banking activities will be in a position to profit from the growth that is expected to come. Those that stick to the status quo may find themselves lingering behind more nimble rivals.

PROFITING FROM ASIA'S RISE AND FROM NEW GLOBAL TRADE FLOWS

by Michael Guo and Oliver Dany

UNTIL ABOUT 1800, ASIA contributed approximately 50 percent of the world's economic output. Then, with the advent of the Industrial Revolution, Europe and North America ramped up their share of production, catapulting the West into a commanding position in global trade as well. Asia's share of global output shrank to a meager 10 percent, despite the remarkable postwar success of Japan.

Now the balance of global production and trade has swung back in Asia's favor, traversing another historic tipping point. By 2010, Asia accounted for more than 30 percent of world trade, rising from 22 percent in 2001. By 2020, it is expected to account for 35 percent. That is not a short-term trend. Asia will continue to be the driver of growth in global trade for the foreseeable future.

Asia's economic ascension is already reordering the ranks of the world's top-ten trading centers. In 2001, Japan and China were the only Asian nations in that group. By 2020, six Asian trading centers will dominate the top-ten list. China will jump to the number-one position among Asian nations, bumping Japan into

second place. The four others, in order, will be India, South Korea, Singapore, and Hong Kong.

There is a second, equally important trend. As Asia's trade accounts rise, the volume of global trade itself is soaring at nearly twice the growth rate of global GDP. World trade is forecast to reach \$86 trillion in 2020—more than double the 2010 total of \$38 trillion and five times the 2001 total of \$16 trillion. (See Exhibit 1.)

These two coinciding trends have enormous implications for transaction banking. From 2011 to 2020, the industry's revenue pools will leap 80 percent, from \$39 billion to \$70 billion, driven by open-account financing and processing, with documentary collections nearly stable.

Six Key Trends in the Evolution of Global Trade

But there are many devils in the details. To determine an optimal strategy, banks need to look beyond the headlines and understand six key trends in the evolution of global trade:

- *The Rise of SMEs.* Trade growth in Asia has spawned the rise of

export-oriented small and medium-size enterprises. Emerging-market SMEs' share of global trade is expected to grow to 20 percent in 2020 from 13 percent in 2010—driven mostly by Asia—as their share of GDP rises. In China, SMEs already account for 78 percent of exports. In India, their share of exports will rise to 44 percent by 2013—a 6 percentage point gain in two years. Across Asia, trading partners are becoming smaller and more local. In developed countries, by contrast, SMEs' share of global trade is shrinking.

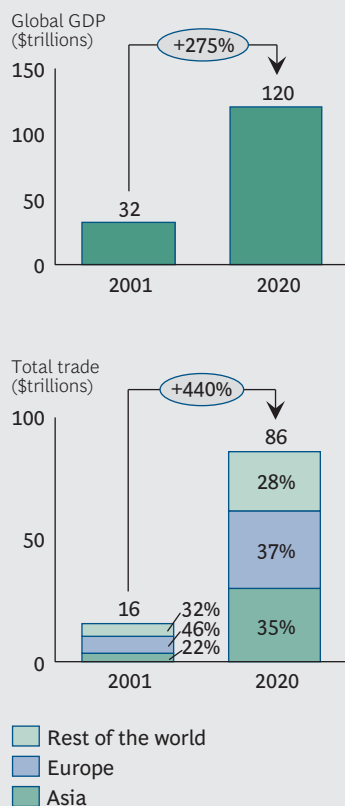
- *The Growing Importance of Commodities.* Rising demand and attendant price increases will expand commodities' share of all traded goods from 24 percent in 2001 to 35 percent in 2020. Oil and other petroleum-related commodities will account for 80 percent of this increase and for 50 percent of overall commodities trading.
- *New Trade Corridors.* China and other emerging economies in Asia are driving trade growth. China will become Asia's major trade center by 2020, replacing Japan.

Singapore will retain its number-two ranking, Hong Kong will strengthen its position as a regional hub, and India will appear on the map of major trade centers for the first time. (See Exhibit 2.)

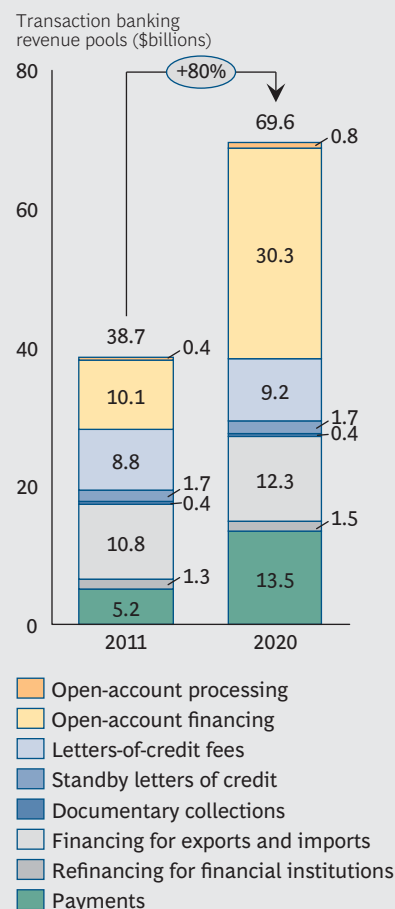
- **The Rise of Open Accounts.** Growth in open-account trade continues unabated. Related finance and servicing revenues are expected to almost triple through 2020 to \$30 billion. Straight payments, too, are growing but will remain smaller at \$13 billion. The picture for letters of credit is less bright, but they are still a crucial factor in trade with and within Asia and also serve as collateral.
- **A Robust Growth Scenario.** Several megatrends are driving growth: a liberalized world-trade regime, labor cost arbitrage in global supply chains, low freight rates, and rising demand from Asia fueled by the increasing wealth of its middle class. Meanwhile, potential threats to trade growth, such as the risk of spreading protectionism, have not materialized despite the lingering effects of the 2008 financial crisis. Thus, even in the negative scenarios we have modeled, revenue pools are expected to grow 80 percent between 2011 and 2020.
- **Increasing Complexity for Nonbank Companies.** Just as banks are challenged to keep up with these broad changes, so must other companies adapt to shifts in supply and demand as well as rising complexity. Supply chains are becoming ever more complex, often involving dozens if not hundreds of suppliers spread around the globe. Many of these are among the rising class of Asian SMEs. This kind of fragmentation results in greater risk and often leads to ruptures in the financial supply chain.

EXHIBIT 1 | Global Trade Growth Outpaces GDP, Expanding Transaction Banks' Revenue Pools

Trade is soaring at nearly double the growth rate of global GDP...



...boosting banks' revenue pools



Sources: Economist Intelligence Unit; U.S. International Trade Commission; BCG analysis.
Note: Actual ITC import-export statistics were used for trade data through 2010; forecasts for 2011 through 2020 were extrapolated from EIU assumptions about the growth of goods and services. Worldwide GDP forecasts were based on EIU data through 2016; forecasts through 2020 were extrapolated from selected EIU country-growth data. All growth is nominal.

Treasurers List Their Banking Priorities

Not surprisingly, the executives most exposed to these challenges—company treasurers—are thinking hard about how to meet them. In interviews conducted by The Boston Consulting Group with dozens of treasurers regarding their banking needs, the following priorities emerged:

- **Back to Basics.** Treasurers place a heavy premium on complete and near-real-time transparency across accounts, transactions, and

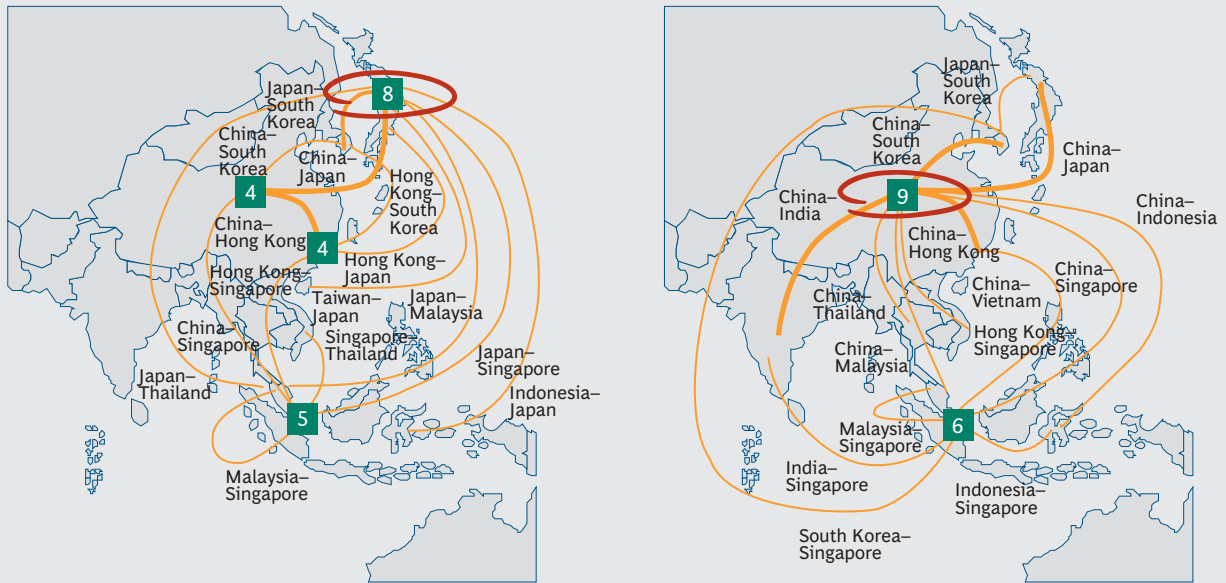
markets. There is increasing demand for transaction banks to improve data integrity and offer consolidated reporting at the account level with analytical tools to enable better risk and liquidity management.

- **A Flight to Trust with Rewards.** Treasurers are restructuring the portfolio of banking relationships, establishing closer relationships with trusted banks and rewarding them with a larger share of wallet on transaction business. BCG's

EXHIBIT 2 | New Trade Corridors Are Emerging as Asia's Center Shifts From Japan to China

2001: Japan is a major trade center; Singapore and China are regional hubs

2020: China is more dominant than Japan ever was; Singapore retains its number-two ranking



■ Number of large trade corridors terminating at a given trade center

Sources: U.S. International Trade Commission; Economist Intelligence Unit; BCG analysis.
Note: The thickness of the trade route lines indicates relative trade volume.

client experience suggests that the share of wallet of core banks can be two times more than that of noncore banks.

- *Management of Diversity in Asia.* Both Asian champions and multinational corporations are accelerating the regionalization process in Asia in an effort to capitalize on economic growth. However, Asia is not a homogeneous market but rather has varying regulatory requirements, capital control policies, and levels of sophistication and maturity. As a result, there is strong demand for harmonized regional services and technology solutions with the flexibility to manage the diverse and complex needs of different countries.

The Growing Power of Collaboration

For banks, winning strategies will often center on collaboration. That will

require establishing partnerships across the value chain and learning to leverage open infrastructures. (See the sidebar, “*Coopetition: Benefit by Embracing Your Nonbank Rival.*”)

Early movers are taking action. Some regional banks, for example, are establishing partnerships with local banks to extend their market coverage and capture the business of local clients. Forward-thinking global banks are broadening their capabilities through acquisitions or partnerships with niche financial-service companies. A number of emerging champions are forming joint ventures with large companies to create mutually advantageous ecosystems.

In the process of formulating a strategy, banks need to address several key questions. Among the initial ones: What are the bank’s target segments? Which industries does it need to support? Given the rising importance of commodities, should the bank develop specific capabilities?

Other questions involve the growing wave of SMEs involved in trading: How can the bank best serve them? Conversely, how can it help domestic corporations manage their SME trading partners?

Banks also need to address questions of infrastructure and capabilities. Given its targets, what footprint does the bank need, especially in the new Asian trade hubs? How well are the bank’s product suite and technical capabilities tuned to meet the demands of its target segments?

Finally, based on the answers to these questions, banks must determine their optimal platform. Should they build or buy, and where should they partner or offer white-label services?

The answers to these questions will vary, depending on whether the bank is a global organization, a regional bank from a developed market, a local Asian bank, or an emerging Asian global challenger.

COOPETITION

Benefit by Embracing Your Nonbank Rival

In the traditional trade ecosystem, three players shared in the financial supply chain: buyers, suppliers, and banks. As the trade services and finance needs of companies grow and become more sophisticated, nonbank providers have emerged. There are generally four types of these new competitors:

- *Financial-supply-chain providers* offer a full range of automated solutions, from purchase orders via document handling and invoicing to payments.
- *Supply chain financiers* focus on financing based on the trade goods in transit.
- *Business-to-business payment and invoicing providers* specialize in outsourcing solutions for SME treasuries. Several of these

players are reaching high adoption rates among multinational corporations.

- *Credit insurers* build on their local knowledge of the market and clients, often in more remote regions and among smaller clients. They thereby exploit the increasing importance of SMEs in global trade.

These new providers can be seen as competitors, but they also offer banks the opportunity for *coopetition*—cooperation and collaboration with a competitor when that is advantageous. Coopetition can be especially advantageous to regional champions and domestic banks. Nonbank credit insurers, in particular, can provide these banks with access to new sets of customers that would otherwise be out of reach.

Second, they must integrate cash-management and trade-finance offerings through enhanced data-mining capabilities in order to assess buyer-supplier relationships. And they must price credit dynamically and rate the pairs based on experience, connecting seamlessly with third-party platforms to extract supply-chain-status information and update financial risk and payment status.

Finally, they must leverage open platforms, such as SWIFT, to enable the strategy outlined above and to establish a level playing field on which to compete against the proprietary platforms of global banks.

Local Asian Banks. These banks are well positioned to capture both the SME opportunity and local niches in commodities or other industries. To succeed, they must establish partnerships with global and/or regional banks in order to gain international access as well as sophisticated products and platforms with which to meet the international needs of local companies. In addition, they must access regional services and product offerings by either joining a proprietary platform or participating in a multibank open platform.

Emerging Asian Global Challengers. In theory, these banks are in the best position to benefit from the rise of Asia. Yet few of them have either strong expertise in international trade and its products or their own platforms. To succeed, emerging Asian challengers will likely have to expand their geographic footprint and client coverage through organic growth and partnerships with other regional and local banks. They may also use partnerships to strengthen their international-trade and cash-management capabilities and platforms. And they will have explore potential M&A opportunities to accelerate growth. Success with M&A will require the internal

Global Banks. These banks are investing heavily in expanding either organically or through partnerships or acquisitions. They have some inherent strengths but also face challenges.

For example, their global footprint and local presence—either direct or through partnerships—coupled with typically strong capabilities in their capital-markets divisions enable them to excel in serving multinational corporations and building commodity-specific services. Yet their very reach is a potential Achilles' heel. Corporate business is often very local, in terms of both presence and product requirements. Managing the tradeoff between a global footprint and regional and local peculiarities will be a constant challenge. But therein lies the mutual advantage of partnerships between

global and local or regional banks. The infrastructure of global banks makes them attractive to local banks, while local banks can provide global banks with transaction flow and access to local SMEs.

Regional Banks from Developed Markets. The growth opportunities for these banks, which face sluggish growth at home, lie in meeting the demands of their export-oriented domestic client base. This entails a few strategic imperatives.

First, regional banks from developed markets will have to partner with local banks as a defensive play in order to provide access to local payment systems and local client knowledge for better compliance. Partnering with credit insurers could mitigate the risks associated with local SMEs.

capability to manage large investments, particularly the ability to integrate acquisitions and extract the relevant know-how.

WHATEVER the type of bank, the fundamental revenue levers will remain the same: follow your clients overseas, understand the increasing needs of trade-oriented SMEs, innovate or partner with inno-

vators, and—if you have not done so already—integrate trade finance into your cash-management strategy.

No bank's path is simple in today's environment. One thing, however, remains certain. Whether the bank is global or regional and whether it is based in Asia, Europe, or the Americas, it must not ignore the opportunities offered by Asia's economic rise and the expansion of global trade.

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HOW BANKS CAN TAKE THE LEAD IN MOBILE PAYMENTS

by Mohammed Badi, Laurent Desmangles, Alenka Grealish, Sushil Malhotra, and Carl Rutstein

MOBILE PAYMENTS AND MOBILE wallets—when they come into full force—will affect a wide variety of stakeholders: mobile network operators, handset makers, operating-system providers, retailers, consumers, and of course financial institutions. (For definitions of terms, see the sidebar “Mobile Payments and Mobile Wallets Defined.”) Yet many banks are in a quandary about how to position themselves to participate fully in this opportunity.

Despite heightened excitement in the payments industry and media about m-payments, strong growth is not yet around the corner. M-payments are not likely to become mainstream for more than a decade,

and even then, credit and debit cards will still be widely used. Moreover, the growth in discount deals and offers sent out to consumers via their smartphones is likely to far outpace the adoption of m-payments, generating significant value over the next five years and potentially representing the largest revenue pool in the payments arena. (See Exhibit 1.)

Banks need to start developing their mobile strategies today, well in advance of the time when it becomes as common for someone to make a purchase at the point of sale with a smartphone as it is with a credit or debit card today. Indeed, banks need to play a leading role in addressing issues such as security and

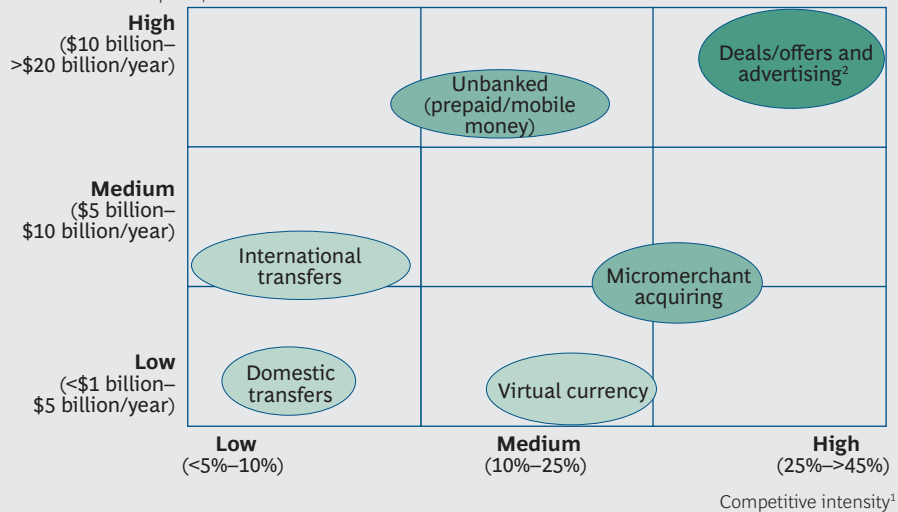
MOBILE PAYMENTS AND MOBILE WALLETS DEFINED

Many definitions of m-payment have been bandied about. For our purposes, an m-payment is a payment made with a smartphone (or another mobile device) at the point of sale. We therefore exclude e-commerce and m-commerce transactions made remotely with a mobile phone, as well as purchases billed to a phone statement. An m-wallet enables a consumer to use credit cards, debit cards, and account balances to make a payment through a single access point. While most m-wallets

rely on a smartphone to initiate a payment, a few require only an ID (such as an e-mail address or a mobile-phone number) and a password or PIN. Most observers expect m-wallets to include coupons, deals and offers, and loyalty cards. Eventually, they could also include a dynamic optimization feature, which would select the best payment choice depending on whether the consumer’s goal is to optimize air miles, cash back, low APR, or some other special offer.

EXHIBIT 1 | Deals and Offers Will Constitute a Significant Revenue Pool

Potential revenue pools, 2015



Sources: *Financial Times*; Inside Network; BCG interviews and analysis.

¹Percentage of companies pursuing the business opportunity (based on 100 companies observed).

²Most revenues derived from deals/offers and advertising, followed by merchant acquiring. Less than 5 percent is likely to accrue to issuers.

the development of standards that can accelerate adoption of m-payments. Otherwise, nonbank players will forge ahead with deals and offers, pushing their m-wallets at the point of sale and eroding banks' interchange revenues and the integrity of the payment system.

But before banks can take meaningful steps, they must be able to separate the hype surrounding m-payments from the realities.

A Few Realities Amid the Hype

Both our client work and our research have revealed some clear truths about m-payments that banks and other payments players should consider.

The value will be in deals and offers, not in payments. The main reason for the slow progress of m-payments and m-wallets has been the absence of a compelling value proposition for the consumer, bank, or merchant. Indeed, m-wallets are challenged by the classic chicken-and-egg relationship between merchant acceptance and customer usage. That is, as a pure payment vehicle (or "form factor"), the mobile handset does not yet offer sufficient benefits to drive mass consumer adoption. M-wallets need to be both clearly beneficial and trustworthy

before consumers will change their behavior. Merchants, in turn, are naturally reluctant to invest in new equipment at the point of sale until there are clear benefits to doing so, such as increased customer satisfaction, higher incremental sales, less fraud, or lower payment costs.

But both merchants and consumers have shown that they value deals and offers. These can be a better value proposition for consumers when they are funded by merchants and other advertisers rather than by credit cards, whose rewards and rebates are constrained by interchange levels. Indeed, given the experience of one large U.S. retailer, consumers are not likely to change their payment behavior for deals and offers involving discounts of less than 5 percent, especially when some deal companies can offer discounts of ten times that much.

Given the likely slow rate of m-payment adoption, players should separate deals and offers from their payments strategy. To be sure, there is more traction to be gained by targeting the 60 percent of consumers who own a smartphone rather than the (at most) 1 percent of consumers who regularly use their phone to make payments (never mind the fraction of consumers who have phones equipped with near-field communication, or NFC, capability).

We expect offers to be separated from payments for at least the next five years.

Cards will not disappear anytime soon.

According to even the most aggressive estimates, only 24 percent of payments will be mobile within ten years (with 80 percent of merchants using NFC and 60 percent of consumers owning a smartphone and using it to pay for half their purchases). And just as ATMs and the Internet did not eliminate bank branches, merchants will have to keep accepting plastic cards for the remaining 76 percent of transactions. Cards will remain in use until m-payments account for more than 95 percent of transactions, which will not happen for a very long time. Experience shows that until a card network reaches 95 percent merchant acceptance, its cardholders still feel the need to also carry a competing network's card.

M-payments are not yet superior to traditional payment methods. M-payments are still in an immature state. They are vulnerable to security breaches and theft. Stakeholders have yet to come together to establish standards, security protocols, and liability responsibilities (these are particularly important for issuers). Meanwhile, headlines warn consumers about the perils of mobile financial transactions and phone theft. And mobile stakeholders have yet to explain how they are protecting consumers.

Banks are the masters of their own destiny.

It is commonly believed that banks are at a disadvantage in m-payments compared with other stakeholders and early movers, such as network providers and deal companies, but the truth is that banks (along with financial networks and clearing and settlement systems) are at the center of the payments universe. Banks bring a range of know-how and experience to the table. (See the sidebar "Banks' Assets.") Banks also have vast experience detecting fraud, leveraging customer insight, mitigating risk, and navigating the regulatory environment. It is banks that hold federally insured deposits, extend credit, provide statements, send and collect bills, and provide zero liability for fraud. They influence consumers' payment habits through product innovation, marketing, and incentives. They have tens of millions of consumer relationships—and, as a result, rich repositories of data—as well as strong relationships with retailers. Finally, banks have the ability to create new and compelling offerings, integrating payments into a host of mobile banking features. For these reasons, banks should play a vital role in any shift in the payment behavior of consumers.

How Banks Can Seize the Moment

The preceding points notwithstanding, m-wallets will likely pose a considerable strategic

BANKS' ASSETS

Banks bring the following attributes to the table that are set to make them a pivotal part of the m-payments world:

- Extensive experience in risk management, security, fraud mitigation, and payments processing
- Possession of the only true gateway to the payments infrastructure (card issuing, Automated Clearing House, and wire)
- Effective card reward programs (approximately 40 percent of credit card holders are convenience users)
- Data from card and check usage that can be used to identify broad buying behaviors and individual customers who generate a large number of transactions
- Relationships with merchants—both on the credit/cash management side and on the acquiring side; these ties can be leveraged to build mutually beneficial deals
- Branch networks that can serve as linchpins for local deals with neighboring merchants
- Established large customer bases

challenge to banks over the next decade. The biggest risk is the erosion of the secure payments infrastructure currently in place, which could happen if new players piggyback on the existing framework without taking responsibility for safety and soundness—leaving banks to pay the price.

Banks can and should begin to play a leading role in the m-wallet game.

In addition, some interchange revenues will be at risk if retailers or other nonbanks come up with compelling m-wallet deals that encourage direct transfers from bank accounts in lieu of credit card funding. Banks can and should charge customers for such transactions—just as they do for foreign ATM transactions—but it would be better if they proactively developed their own value propositions. What is more, if m-wallet providers start to control the customer interface, banks risk losing direct links to their customer base from a relationship and individual transaction standpoint.

In our view, banks can and should begin to play a leading role in the m-wallet game, as opposed to the supporting role they have played up to now. The m-payments business is banks' to lose. There are four immediate “no regrets” steps that banks must take to get on track.

Establish security protocols. Both consumers and regulators expect banks and networks to maintain the integrity of the payments system and mitigate losses in case of a breach. As stewards of the safety and soundness of the payments industry, banks—along with financial networks and clearing and settlement systems—must play a leading role in establishing security protocols, clarifying liability responsibilities, and ensuring reliable, seamless transactions. As a result, banks must make sure that they have visibility into all m-payment transaction details (for example, at the merchant level) in order to monitor fraud.

Preserve the attractiveness of cards. Banks need to ensure that their card products remain sufficiently attractive as the m-wallet gains in popularity. Since the jury is still out on whether traditional rewards on cards (such as cash back) will be able to compete with merchant- and manufacturer-funded deals available through m-wallets, banks need to closely monitor how customers respond to their reward programs and continue to innovate in order to improve uptake. Traditional rewards and rates will likely continue to drive consumers' payment preferences in the medium term, but there is no guarantee that they will hold sufficient sway in the long term. One reason is that m-wallets, not being limited by interchange fees, can give merchants more margin to work with than banks can. Another is that dynamic optimization features in m-wallets will challenge what it means to hold the “top of wallet” position with consumers. Therefore, expect more banks to develop or participate in their own deals and offer schemes to stay competitive.

Form a “house view” on the m-wallet. Banks need to develop an enterprisewide m-wallet strategy that leverages overall bank resources—particularly in light of lower payment-related revenues resulting from new regulations. Developing this view will require creating an executive role to properly assess the bank's resources and capabilities, articulating an action plan, and determining realistic ambitions. The executive will need to interact with all stakeholders within the bank—including operations, risk, credit cards, retail banking, IT, finance, and marketing, as well as Internet and mobile banking. Among the questions that banks should ask themselves is whether they should do the following:

- Invest in card innovation to bring a strong product to m-wallets
- Build a bank-owned wallet (open or closed) in addition to or instead of joining existing platforms (such as Google or Isis)
- Develop deals and offers independently or with a partner—such as a merchant or deal company—inside or outside of an m-wallet

- Proactively manage m-wallet access to customers' checking accounts via direct transfers (for example, by charging customers if they use m-wallets in ways that jeopardize or piggyback on the existing payment system)

Invest to gain experience. Once a house view is established and banks have gained a clear idea of what resources and capabilities they can bring to the table and are sure that their many silos are not working at cross purposes, they should engage in partnership discussions and select at least two concrete initiatives. Many banks are well equipped to be at the forefront of the payment market's evolution. A few could even become market disrupters.

Banks willing to be proactive can generate win-win deals for both merchants and consumers. Such initiatives must be carefully executed, however, and most banks will pursue the lower-cost and lower-risk route of partnering with experienced providers of deals and offers. Others will leverage their consumer-transaction data and formulate deals on their own, going head-to-head with deal companies—some of which have recently been charging higher fees, causing merchants to lose their enthusiasm for working with them. Overall, banks can leverage existing merchant

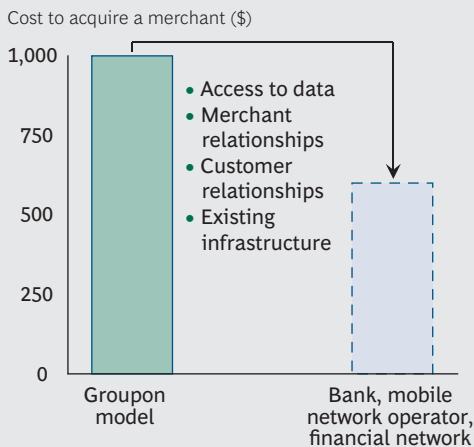
and consumer relationships to win in this arena. (See Exhibit 2.)

THE NEXT FIVE years will be murky ones for m-payments. Consumers will face an onslaught of choices, and valuable new customer interactions will be up for grabs. There will be both opportunities and risks for banks. Although some may choose to stay on the sidelines, no bank should face the next five years without understanding what is at stake in the new payments world. To avoid falling behind competitors, banks must make sure that they have full visibility into the transaction flow and are able to monitor fraud and uphold regulatory requirements (such as “know your customer”). In order to win, they must decide on a strategy now and lay the groundwork for efficient execution of that strategy going forward.

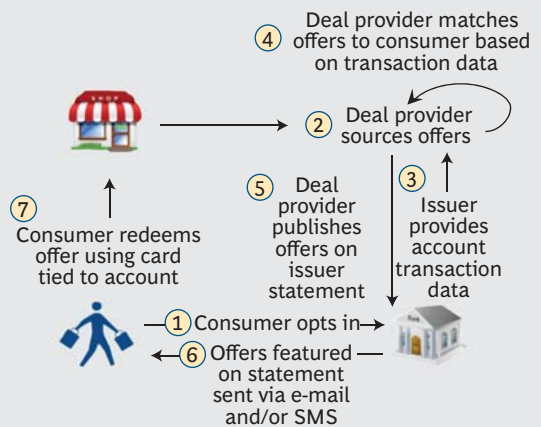
Ultimately, it will become more and more evident that proactive institutions stand the best chance of benefiting from the rise of m-payments, which are still in a nascent state. Banks currently have a great opportunity to develop unique customer value propositions, including deals and offers, and to ensure a strong positive customer experience across the payments spectrum, from tight security to

EXHIBIT 2 | Banks Can Leverage Existing Relationships to Succeed with Deals and Offers

Players with established relationships can reduce deal acquisition costs



Banks can leverage their transaction data to integrate deals and offers



Revenue sharing

- Merchant pays deal provider a commission on offers redeemed
- Deal provider and issuer share the commission (75%/25% split to 50%/50% split)

Source: BCG interviews and analysis.

24-7 convenience. Joining the game late and missing the window of opportunity may leave many banks unable to control their own mobile destinies.

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CAPTURING PAYMENTS OPPORTUNITIES IN RAPIDLY DEVELOPING ECONOMIES

LESSONS FROM BRAZIL AND INDIA

by Neeraj Aggarwal, Tijsbert Creemers-Chaturvedi, André Xavier, Achim Seyr, and Jorge Becerra

OVER THE COMING DECADE, the dynamics of payments markets in rapidly developing economies (RDEs) will shift dramatically toward the financial inclusion of the unbanked, the replacement of cash and checks, and the reduction of cash-based, underground economic activity. At the same time, innovation in mobile payments, prepaid cards, and new payments technologies will provide great opportunities for the most nimble players, as well as pave the way for new market entrants.

But the landscape is a highly variegated one. There are substantial differences not only between developed and developing payments markets but among RDE payments markets themselves. Brazil and India, two of the largest RDE payments markets, provide a useful lens for examining these differences, although other large markets, such as China and Russia, have their own distinct characteristics and evolutionary trends as well.

For example, card penetration per capita in Brazil has reached 3.5 cards, compared with 0.25 cards in India (and 1.0 to 1.5 cards in China). Moreover, an overwhelming 94 percent of cards in India are used solely to with-

draw money at ATMs. Many cardholders in India either do not know that they can use the card to make purchases at the point of sale (POS), or they perceive such transactions as risky. Also, Internet penetration is still relatively low in India (about 10 percent, compared with 40 percent in Brazil). Internet penetration differs widely among RDEs in general, and the use of electronic payments varies accordingly.

The differences among RDE payments markets can be largely explained in terms of three factors:

- Access to banking services—that is, financial inclusion—is highly variable among RDEs. Currently, it is at about 65 percent in Brazil and 50 percent in India. Although banks have grown rapidly and profitably serving the mass-affluent and “aspirer” consumer segments, the cost structure of their branch-based distribution models is not suited to serving those with lower incomes.¹
- There are sizable differences in the number of merchants that accept cards—roughly 170 credit-card POS terminals for

every 10,000 inhabitants in Brazil compared with just 5 in India. These variations are driven by such factors as merchants’ perceptions of the cost of electronic transactions, taxation issues, and the organization of retail businesses.

- Banking clients have very different outlooks on the value that payment systems bring to their business models. In Brazil, for example, there is a comprehensive, sophisticated electronic-payment network that the country developed in response to the high inflation it experienced in the 1980s and 1990s. This network has facilitated banking clients’ appreciation of the value of electronic and card payments, which in turn has helped banks maintain healthy margins. By contrast, this infrastructure does not exist in India, prompting banks to lower margins for payments products in an attempt to attract new customers and bring them into the banking system.

Ultimately, banks and other participants in the payments value chain in RDEs need to reinvent their pay-

ments models for four market segments: retail (private-individual) banked and unbanked customers, and commercial (business) banked and unbanked customers. (See Exhibit 1.) Below, we focus primarily on payments models for unbanked customers in Brazil and India.

Competitive Dynamics for Serving the Unbanked Are Evolving Rapidly

In general, banks in RDEs are showing renewed interest in payments models for the unbanked for several reasons. First, the pace of change in these markets—with respect to new technology, innovative payment schemes, the regulation of payments value chains, and financial inclusion—is highly accelerated compared with developed markets. Obviously, the impact of change will vary for different types of RDE markets, such as large versus small and retail versus commercial.

Second, through technological innovation, large swaths of currently unbanked customers can be served profitably and with strategic value. Examples include remittances processed through mobile phones; “rural POS,” in which a mobile phone functions as the acquiring terminal and is equipped with either card-swipe hardware or the capacity to acquire a transaction via a real-time mobile interface; direct subsidies from governments to unbanked households using prepaid cards or mobile wallets; and mobile payments that are integrated with supply chain processes, helping businesses optimize their working-capital efficiency and cash-pooling needs.

Third, several competing low-cost models are emerging. These include business correspondents (individuals or merchants who facilitate banking transactions in areas where such services are not readily available);

EXHIBIT 1 | Banks Need to Reinvent Their Payments Models for Four Market Segments

	Retail (private customers)	Commercial (business customers)
Unbanked customers (financial inclusion)	Develop low-cost payments models <ul style="list-style-type: none"> Onboard customers in banking system 	Cashless up-country payments and collections <ul style="list-style-type: none"> Microacquiring Mobile or card-based collection/payment Integrated finance
Banked customers	Develop easy-to-use mobile and Internet solutions <ul style="list-style-type: none"> Mobile banking apps Aggregator wallets 	More integrated and low-cost working-capital solutions <ul style="list-style-type: none"> Ubiquitous Reduction of cash and checks Seamless

Source: BCG case experience and analysis.

branchless banking, such as the viral mobile distribution of First National Bank in South Africa; prepaid-card models like that used by the Brazilian government to disburse *Bolsa Familia* funds; and mobile wallets with low-cost distribution networks such as M-Pesa in Kenya, MTN in Uganda, and, more recently, Easy Pay in Pakistan and Airtel Money in India. Overall, it is possible that emerging payments models in RDEs may eventually break the traditional quality-cost tradeoff—meaning that low-cost solutions will deliver high-quality services. (See Exhibit 2.)

Our interviews with unbanked consumers confirm that they have a broad set of financial-services needs—including remittances, secured and unsecured credit, insurance products, and bill payment for medical and utility expenses—that are not being met because the cost to serve these consumers is too high for financial institutions or because they simply cannot be reached efficiently or effectively. But banks that can create targeted value propositions capable of bringing unbanked consumers into the fold will be in a position to profit handsomely.

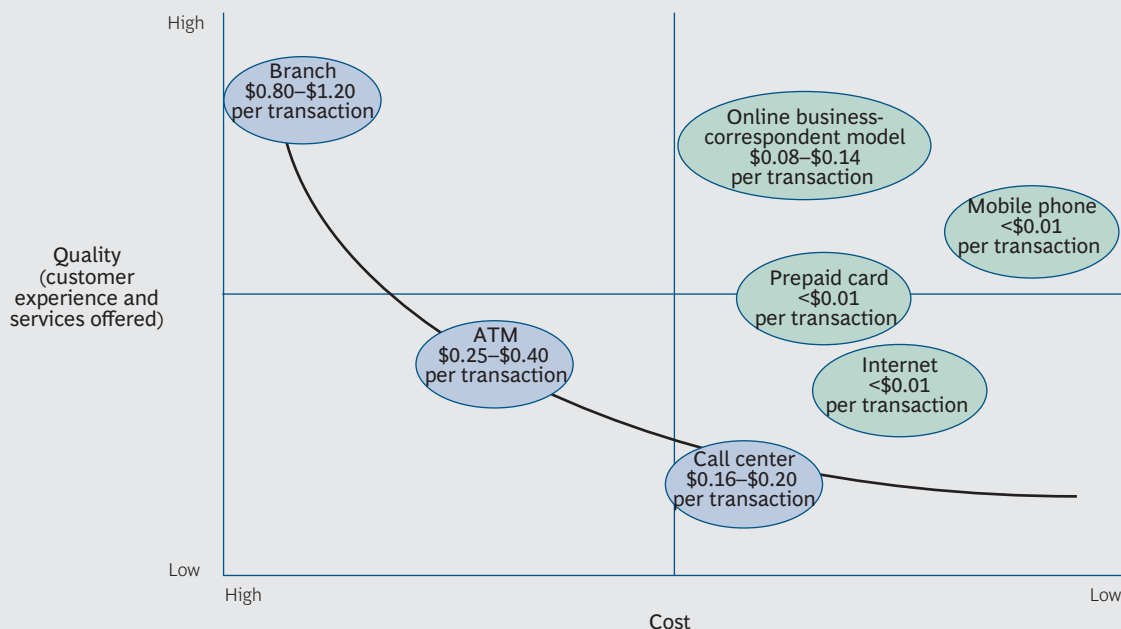
Of course, substantial growth will not happen overnight. Serving unbanked customers in RDEs is likely to be only moderately profitable over the next three to five years—a revenue pool on the order of tens of millions of dollars—as different value propositions compete for scale and market share of at least 10 percent. Within this time frame, the use of low-cost payment solutions will depend on operational solutions from both issuers and acquirers. But once critical scale on both the issuing and acquiring sides is reached, revenue pools may grow exponentially.

Clearly, there is real strategic value in serving unbanked RDE customers, not just in terms of short-term numbers—in India, for example, mobile phone penetration is between 70 and 80 percent, while banking penetration (financial inclusion) is only about 50 percent—but in terms of building long-term relationships and cross-selling platforms.

Five Key Elements of the RDE Payments Opportunity

Although the payments landscape in RDEs is clearly still evolving, we have

EXHIBIT 2 | Emerging Payments Models May Break the Quality-Cost Tradeoff
Example: India



Source: BCG case experience and analysis.

observed five factors that market participants should keep in mind as they target this opportunity.

The best solution for each RDE will be unique. Winning value propositions do not come easily. For example, while around 120 mobile wallets have been launched worldwide, only a handful have succeeded. Moreover, we have not observed any truly successful imports of payments models from one country to another. For instance, while M-Pesa in Kenya is mobile money's biggest success story, with 14 million subscribers, its rollout in Tanzania and South Africa has been, at best, a partial success.

The key lesson is that given the high level of diversity among RDEs—including their overall economic evolution, the influence of regulation, the sophistication of the payments market, as well as demographic and cultural factors—there is no silver-bullet payments strategy that will be optimal for all RDEs. The best solution for each will be unique. Brazil and India are good illustrations.

In Brazil, multiple solutions will coexist, including traditional cards, prepaid cards, and mobile-based offers. In recent years, banks have tapped the opportunity to develop prepaid-card propositions to attract unbanked customers. They have then leveraged the existing cards infrastructure and the status that consumers associate with more-sophisticated products to steer qualified new customers toward standard cards and savings accounts.

In India, there is great opportunity in mobile wallets for both individuals and businesses. For example, recent regulatory momentum is allowing telcos to operate semiclosed wallets (which enable payments, but not cash withdrawals, using mobile phones). In addition, since card penetration is so low, mobile payments are not perceived as necessarily less convenient or more risky than the use of cards. One example of a new mobile scheme is Airtel Money, which has already reached 1 million users with a targeted value proposition aimed at helping urban unbanked consumers carry out bill payments

and person-to-person transactions. In addition, the growth of mobile payments in India may enable banks to forgo further heavy investment in card infrastructure.

Going forward, retail acceptance of mobile wallets in RDEs will be driven by both unbanked and underbanked consumers—which is likely to have a ripple effect, prompting more banked clients to experiment with mobile solutions. Commercial acceptance will depend on mobile value propositions that enable businesses to improve the efficiency of their collection and payment interactions with unbanked small and medium-size enterprises—thereby optimizing their supply chain.

The key message is that the endgame in payments in RDEs will likely differ by market, depending on the starting position and aspirations of each one.

New collaboration models must be created. Reaching profitable scale quickly will require strong distribution, processing, and risk-manage-

ment capabilities. Yet many banks and telcos, wary of sharing too much proprietary knowledge, still try to develop new models in-house. In our view, there is an opportunity to create competitive advantage by collaborating more closely to leverage the specific capabilities of different institutions. Banks, for example, cannot create the distribution reach required for rural households. Therefore, they will have to think boldly in order to forge meaningful links with other players, such as telcos and business correspondents (which bring extensive consumer reach and experience), and with payments processors (which bring operational excellence).

Leverage opportunities in domestic schemes. Emerging domestic payments schemes, such as ELO and Hipercard in Brazil, RuPay in India, and China UnionPay, are examples of domestic schemes that can have a major impact in their home countries and help drive the development of RDE payments markets. Banks can leverage such networks by using domestic brands as potentially lower-cost alternatives to cross-border

products, customer relationships, and regulatory savvy—domestic banks may well enjoy an advantage in tapping the growing payments market in RDEs. This does not mean that multinational banks and other global payments players cannot be successful, but these institutions will need to leverage all their capacities and depth of experience to the fullest in order to compete. They may need to focus on niches where they can create local scale or collaborate with local banks or telcos.

Choices by governments and regulators are likely to heavily influence the success of payments models. The volume and value of social-benefit payments and subsidies to unbanked consumers can create the necessary scale for some payment instruments. In Brazil, for example, there are roughly 12 million *Bolsa Familia* prepaid cards that carry social benefits. Worldwide, government-to-person payments in the form of subsidies to financially excluded people are estimated to reach \$1 trillion by 2015. If even a fraction of such a substantive sum were to go through the domestic payments

cally, many of these subsidies have been plagued by leakages and inefficiencies. The new developments offer a potential win-win solution for all concerned.

Clearly, regulators have to perform a balancing act between sticking to tried and tested methods and embracing innovation. But they often have more confidence in familiar mechanisms that can be held up to tighter scrutiny. At the same time, they are innovating in tranches, observing the results, and then going further—always taking care not to create high systemic risk. Regulators will continue to face dilemmas about how much payments activity to shift to new ways of working, and how quickly. The decisions they make will strongly influence the domestic-payments endgame.

Looking Ahead

Ultimately, the direction that payments markets take in each RDE will depend on multiple factors. Among them are the ability of banks and others to develop low-cost payments models and to forge practical value propositions for both unbanked and banked consumers, the ability of banks and telcos to work together to create innovative mobile solutions, and the willingness of governments to create a favorable regulatory climate for growth.

Clearly, different markets will evolve in different ways and at varying speeds, depending on their starting position. In the near term, different payment propositions are expected to coexist as each builds scale in niche markets such as university campuses, rural areas, and low-income metropolitan areas. In the longer term, convergence is inevitable because consumers and merchants require network solutions—of sufficient scale and interoperability—in order to interact with each other.

The volume and value of social-benefit payments to unbanked consumers can create the necessary scale for some payment instruments.

der schemes for low-value customers such as the previously unbanked and the urban lower middle class. For instance, in India, RuPay promises a 40 percent lower operational cost per transaction for banks, making it a viable solution for servicing new tiers of (first time) customers.

Banks with large local franchises will have an advantage. With many success factors being country specific—involving local knowledge,

infrastructure, the economics of the network would measurably improve.

In India, the government is aiming to shift the payout of about \$60 billion in subsidies for employment guarantees and other types of support to electronic benefit-transfer mechanisms. In addition, subsidies for fuel, fertilizer, and other commodities (amounting to another \$40 billion) are being examined for payout through electronic methods. Histori-

But one thing is certain: the growth opportunities are significant. Only those banks and other payments players that are willing to take action, to make tough decisions on tradeoffs, and to think innovatively will capture a sizable share of this growth.

NOTE

1. Aspirers are those in the rising middle class, with incomes of more than roughly \$1,500 per year; we expect this segment to reach mass-affluent status within the next ten years.

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NOTE TO THE READER

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