Global Payments 2022

The New Growth Game

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Overview

Unlike some other facets of the financial services universe, the area of payments affects just about everyone every day. Payment transactions are also at the center of a dramatic cultural shift that has evolved with modern technology.

Arguably, daily human behavior has changed more in the past 20 years than in the previous 20 centuries, because most of us now have what amounts to a fifth appendage: the smart phone, a tool that people increasingly use to make payments of all kinds. The notion of paying for goods or services with cash or a physical check is becoming nearly as quaint as CD players or large desktop computers.

This report is BCG's 20th annual examination of the global payments industry. We begin by offering a comprehensive market outlook from both a global and a regional viewpoint, and then continue with deep dives into the challenges facing acquirers, issuers, networks, wholesale transaction banks, and fintechs. Taken as a whole, these factions form the core of the ever-evolving payments ecosystem.

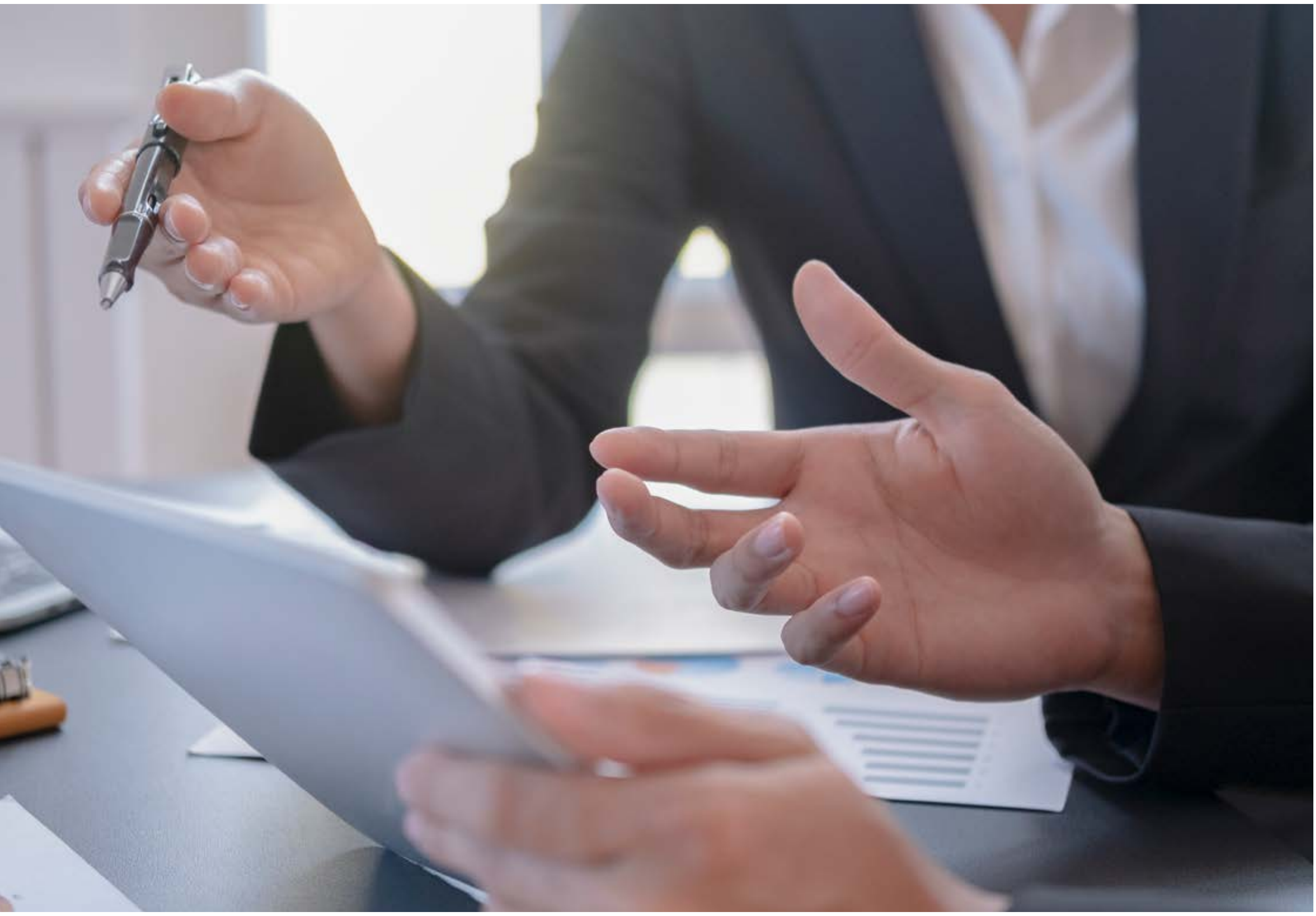
If pressed to describe the payments industry in a single word, we might choose *resilient*, especially considering today's uncertain economic and geopolitical climate. Indeed, despite headwinds originating from multiple sources, revenues are on track for solid growth over both a five-year and a ten-year horizon. That said, the era of soaring market performance may now be in the rear-view mirror. Other overarching trends include increasing demand for electronic payments, the rise of central-bank digital currencies, and heightened financial and nonfinancial risk that is drawing commensurate regulatory scrutiny.

In the merchant services space, which the COVID-19 pandemic significantly altered, the competitive landscape is shifting. Integrated software vendors (ISVs) are gaining more power, and large merchants are treating payments as an increasingly critical element of the overall customer experience. Embedded finance has the potential to generate huge value. On the issuing side, evolving payment methods such as "buy now, pay later" (BNPL) have paved the way for players to move beyond a transactional role. Consumers are demanding heftier rewards and a more customized loyalty experience.

For networks, a key hurdle is that numerous countries are working to exercise more oversight on their domestic payments infrastructure, potentially limiting the roles that international card networks can play. In addition, inflation, market volatility, and tougher competition will put networks to the test in coming years. Wholesale transaction banks, for their part, will have to cope with the necessity of making massive investments in the payments infrastructure, while simultaneously redefining their role in a more diverse competitive environment.

In the fintech space, investors, customers, and other stakeholders in the payments industry are pursuing a flight to quality. Fintechs must therefore focus more squarely on profitability, rather than on pure revenue and customer growth, over the next several years. Many fintechs may be experiencing the first economic slump since their inception, and they must prove to investors and company boards that they have built a strong, reliable business model.

Finally, as in each of our previous Global Payments studies, this report offers steps for the various types of players in the payments ecosystem to take. These initiatives will help companies identify and execute cutting-edge strategies that put them on the road to achieving and maintaining competitive advantage. Ultimately, payments industry participants will be playing a whole new growth game. We hope that readers will find our analysis and our suggestions engaging and useful.



Market Outlook

Global payments revenues have hit a new stride and are expected to rise year-on-year by nearly 9.5% in 2022, compared with our estimate of 6.9% in last year's report—a remarkable acceleration given the market tumult of the past year.

Indeed, the payments industry remains resilient—despite the combined effects of expansionary monetary policy, geopolitical instability, pandemic-driven supply chain shocks (which reduce transaction volumes), and a macro-economic environment characterized by high inflation and rising energy costs (both of which hit consumer and business spending). Our forecasts suggest that global payments revenues will rise by a compound annual growth rate (CAGR) of 8.3% through 2026. Moreover, through 2031, driven by solid fundamentals and ongoing cash-to-noncash conversion, payments revenues are on track to rise by a CAGR of 7.6%. Key drivers will include both transaction-related (primary) revenues from payments made with cards and noncard instruments, and non-transaction-related (secondary) revenues from sources such as deposit interest, account-maintenance fees, foreign exchange, value-added services (including cash pooling and reconciliation), and overdrafts.

Double-digit expansion in noncash instruments has been a major driver of primary revenue growth in recent years, with a CAGR of about 8.7% from 2016 to 2021, compared to a CAGR of about 4.6% for secondary revenues. An extreme low-interest-rate climate for banks, particularly in Europe, was largely responsible for the relatively subdued secondary revenue growth over the past five years.

In 2022, we are seeing an inversion in the growth trajectories of primary and secondary revenues. Growth rates for the former are being eroded by margin pressure on cross-border transactions, acquiring fees on card transactions, and a merchant discount rate/interchange cap in various markets. Meanwhile, for the latter, interest-rate hikes by central banks around the world in response to high inflation have raised margins for banks.

For these reasons, we expect transaction-related and non-transaction-related revenues to grow at estimated CAGRs of 8.0% and 8.5%, respectively, from 2021 to 2026. Revenues from revolving credit-card balances, deposit interest, and account fees will be particularly strong areas of growth. By 2031, global industry revenues should reach $3.3 trillion. (See Exhibit 1.)

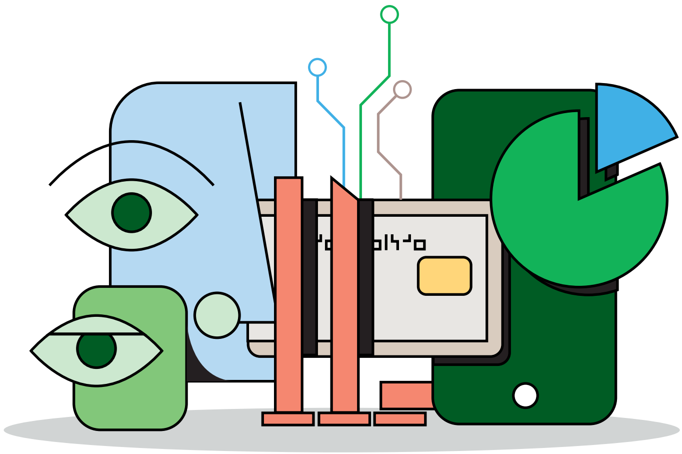
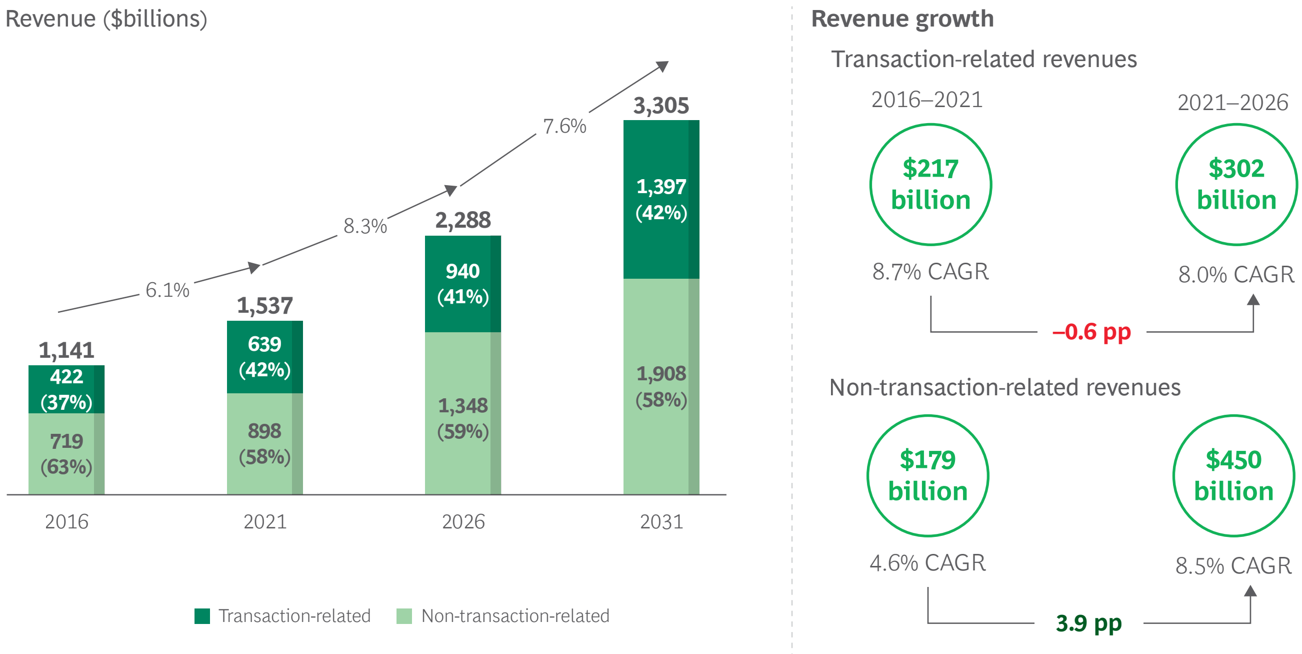


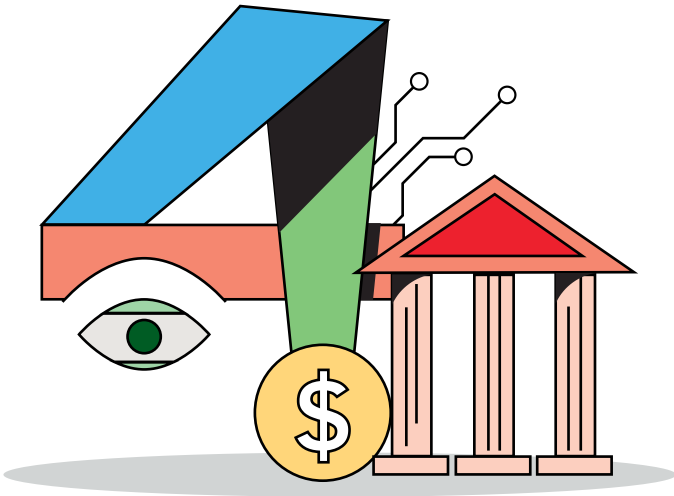
Exhibit 1 - In 2021, Global Payments Revenues Reached $1.5 Trillion



Source: BCG Global Payments Model 2022.

Note: Transaction-related (primary) revenues from transactions made with cards and noncard instruments. Non-transaction-related (secondary) revenues include revenues from deposit interest, card maintenance, account maintenance, revolving revenues from credit cards, foreign exchange, value-added services, and overdrafts. CAGR = compound annual growth rate; pp = percentage points.

Four Global Payments Trends



Based on BCG's analysis, we believe that the following dynamics related to market performance, electronic payments, digital currencies, and risk will shape the outlook for the payments industry over the next five years.

The era of outsize market outperformance has ended. The combined effects of high inflation and interest rate hikes have induced a global flight to quality in capital markets, with the capitalizations of many high-growth tech players plunging to half their mid-2021 peaks. In addition, the payments industry is suffering from an insecure market environment and a post-COVID-19 normalization in some markets, reflected by flattening e-commerce growth.

Across the board, acquirers, networks, and other industry participants have seen their total shareholder return contract. (See Exhibit 2.) The drop has been most pronounced for younger businesses that have not yet achieved profitability and are exposed to balance-sheet and/or regulatory risk. Stripe, for example, cut its internal valuation by 28% from an implied $95 billion valuation at the end of 2021 to $74 billion in July 2022. Similarly, Klarna's valuation plummeted from $46 billion in June 2021 to $6.7 billion in July 2022, according to Klarna, a slide of 85%. But even more mature, well-capitalized players have been affected. Declining market performance will compel payments players to substantiate their value propositions and demonstrate clear paths to profitability in order to attract and maintain customers and investors.

Yet with markets and valuations flirting with bear territory, attractive opportunities can emerge on two fronts. First, merger and acquisition (M&A) candidates that were too expensive to pursue a year ago may now be in play. According to BCG's Fintech Control Tower, venture capital funding for payments-related fintechs declined by 20% year-on-year during the first half of 2022. Consolidation, which started to heat up in 2021 in some payments sectors, is likely to grow more fevered in the short term. Engagement could come from private-equity players seeking to break into high-growth arenas; from payments players and banks wishing to add new products, regions, and customer segments to their portfolios; or from ever-hungry digital giants.

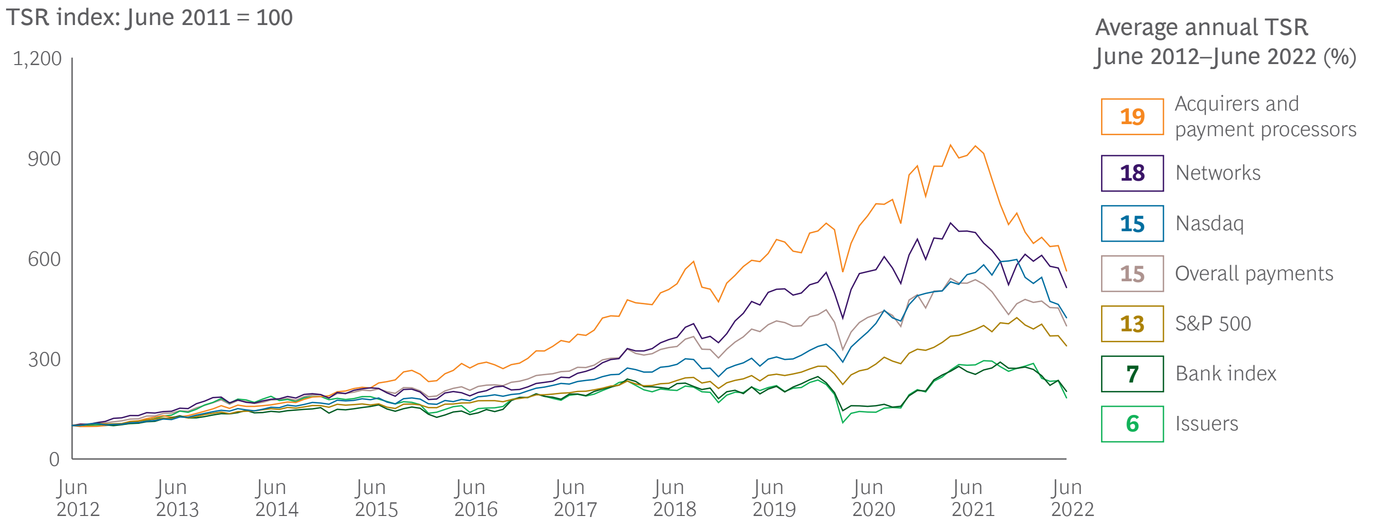
Both the integrated software vendor (ISV) and the buy-now-pay-later (BNPL) spaces could emerge as major M&A hotspots, owing to their nascent and fragmented status vis-à-vis mature segments such as issuing. We see a strong M&A pipeline in ISVs, where established players are making tuck-in acquisitions to complement their products. For example, in 2021, the ISV player Lightspeed acquired capabilities in e-commerce (Ecwid), retail software (Vend), and B2B supply-chain management (NuOrder). Meanwhile, in the BNPL space, players that fall prey to pressure from lower capitalizations, higher funding costs, and a potential surge in delinquencies could become prime acquisition targets for fintechs and established payments companies seeking to strengthen their BNPL remits—as Block (formerly Square) did with its acquisition of Afterpay in November 2021.

A second avenue for growth involves expansion toward a payments-plus model. As payments processes have become more integrated with retail and corporate customer journeys, a gateway has opened to an ever-widening array of banking and value-added services. These include integrating payments into software platforms—an attractive opportunity for tech giants such as Apple or Meta to complement their customer touch points and revenue streams—and coupling payments with lending products. Overall, we expect more banks, payments players, and fintechs to develop payments-plus propositions.

Moreover, non-payments businesses (such as merchants and digital marketplaces) are starting to adopt payments as a way to strengthen their core customer journeys or to move to adjacent revenue pools. Payments enablement also generates valuable streams of customer transaction data that providers can monetize, setting up whole new business models across all sides of payments ecosystems. Such models include consumer data plays or open-banking access, merchant value-added services (such as merchant lending), and payments-as-a-service (PaaS) offerings.

Demand for electronic payments is getting stronger. The sustained cash-to-noncash conversion, the ongoing growth of e-commerce, and the increasing integration of payments into retail and corporate customer journeys will drive payments revenues globally. In addition, in the area of card payments, card-not-present spending online is

Exhibit 2 - Payments Players Are Seeing Their Total Shareholder Return (TSR) Contract



Sources: S&P Capital IQ; BCG ValueScience® Center; BCG analysis.

Note: Total shareholder return (TSR) as of June 2022.

poised to climb by a CAGR of 11.0% from 2021 to 2026, with Latin America and Eastern Europe (excluding Russia and Ukraine) likely to see the highest CAGRs, estimated at 23.4% and 19.6%, respectively. Over the same period, North America should see omnichannel spending grow by a CAGR of 11.0%, and Western Europe by a CAGR of 8.5%.

Meanwhile, real-time account-to-account (A2A) payments are expanding rapidly—especially in key emerging markets, where in some cases they pose a challenge to cards. PIX, launched by the Brazilian Central Bank in November 2020, reached 122 million registered accounts in July 2022, representing over half the country's population. In 2021, PIX payments were equivalent to twice the total value of card payments in the country—approximately R$5 trillion for PIX versus about R$2.5 trillion for cards ($926 billion and $463 billion, respectively, in US dollars), and are on track to surpass card transaction volumes as well. In 2016, India launched the Unified Payments Interface (UPI), which enables A2A real-time payments (RTP) on a mobile platform. By 2021, UPI was handling transaction volumes that were roughly 11 times those of credit and debit cards combined. UPI also saw a ninefold increase in its transaction volumes over the past three years, growing from 5 billion transactions in fiscal year 2019 to about 46 billion transactions in fiscal year 2022 (April 2021 through March 2022), and accounting for more than 60% of noncash transaction volumes in the country.

Other nations, including the US, are also seeing explosive A2A payments growth. Same-day National Automated Clearing House Association (NACHA) transaction value grew at a CAGR of 124% from 2016 to 2021. The modern automated clearing house (ACH) network experienced significant growth in 2021, with 29.1 billion payments valued at $72.6 trillion, while same-day ACH payments volume grew by nearly 74%.

The rapid growth of A2A RTPs is poised to accelerate, thanks to continued investments in infrastructure modernization. The US Federal Reserve expects to launch its RTP system in 2023, while across the Atlantic, Nordic countries are readying their panregional payments system, known as P27, with more than a dozen banks set to test the platform by the end of 2022. In the Middle East, the Gulf Payments Company launched the first phase of the AFAQ payments system, handling the first financial transactions between the Central Bank of Bahrain and the Saudi Central Bank, at the end of 2021.

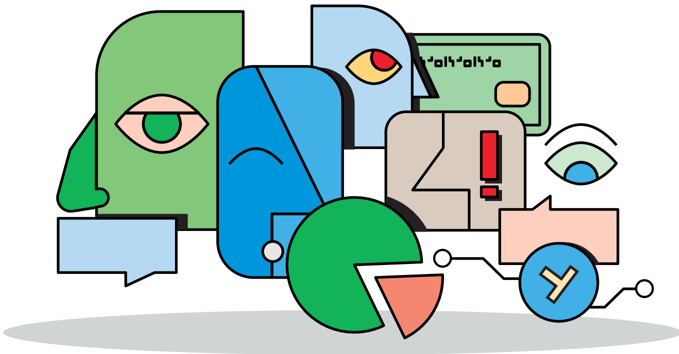
Central bank digital currencies will gain momentum. Cryptocurrencies and digital assets have been in the headlines for much of 2022—frequently for the wrong reasons. The spectacular collapse of the algorithmic stablecoin Terra USD in May 2022 triggered a widespread crypto selloff, eroding asset values and market confidence across the ecosystem, and heightening regulatory scrutiny. Although much of the activity and media interest remains focused on speculative crypto assets, which regulators increasingly regard as securities, the payments industry has accepted that the future landscape will primarily involve central-bank digital currencies (CBDCs).

The emergence of unregulated, often-volatile, privately issued cryptocurrencies and stablecoins has accelerated central banks' efforts to develop viable CBDCs.[1] According to a BIS survey conducted in May 2022, 90% of central banks are actively exploring CBDCs. Ten countries have already launched such initiatives, including Nigeria, the Bahamas, and Jamaica, while 15 other markets are running pilots at varying levels of maturity. Consensus points to the emergence of CBDCs in key markets as a question of when rather than if. Indeed, central banks are warming up to CBDCs as a tool to implement monetary policy more quickly and more granularly by modulating monetary supply in near real time. Financial institutions need to prepare for the potential fragmentation and complexity that these new instruments and rails will introduce.

Payments businesses face significant risk and increasing scrutiny from authorities. Payments players today face a strong case for strengthening their risk and compliance activities in order to continue on their growth paths and install required safeguards for their businesses. Market participants must address four key risk dimensions in the coming years:

- **Financial Risk.** Managing financial risks (for example, in merchant acquiring or card issuing) requires keen vigilance in a turbulent macroeconomic climate. A holistic financial-risk operating model not only provides downside protection from heavy losses, but also serves as a steppingstone to conducting business in attractive high-risk segments.

- **Compliance Risk.** Owing to rising regulatory scrutiny, reputational risk, and the prospect of a macroeconomic contraction, compliance risk in payments demands urgent attention. Payments providers should ensure that they have a robust compliance operating model in place to strengthen know-your-customer and transaction monitoring. Areas of attention include compliance strategy, governance and people strategy, compliance risk management, and top-down compliance culture. A well-built model can increase SME (small to midsize enterprise) and merchant onboarding speed fourfold through a fully digitized fraud, risk, and anti-money-laundering onboarding process, thereby professionalizing risk management and supporting business growth.



- **Cyber Risk.** Online payments are a prime target for fraudsters, and fraud shows no signs of abating. Indeed, card and electronic payments represented 84% of the £730.4 million ($832.7 million) lost to fraud in the UK in 2021, and Europe's revised Payment Services Directive (PSD2) places liability for monetary losses stemming from online merchant fraud directly on the shoulders of payment service providers. We have observed a convergence of threats related to fraud and cybersecurity, with diverse actors such as nation states, cyber criminals, and corporate employees using similar methods (such as phishing attacks) to pursue nefarious goals.

- **Crypto Risk.** As the cryptocurrency and decentralized finance industry has matured, and as various speculative bets have expanded, demand for regional and global crypto regulations and internal crypto-risk management has increased sharply. Some countries are banning private cryptocurrencies in order to push their own CBDCs; others are promoting countrywide and government-supported stablecoins as payment alternatives, while awaiting the development of CBDCs.

1. See a detailed discussion in our green paper, A New Era for Money, published in partnership with The Payments Association, paywith.glass, and other industry stakeholders.

A Regional Perspective

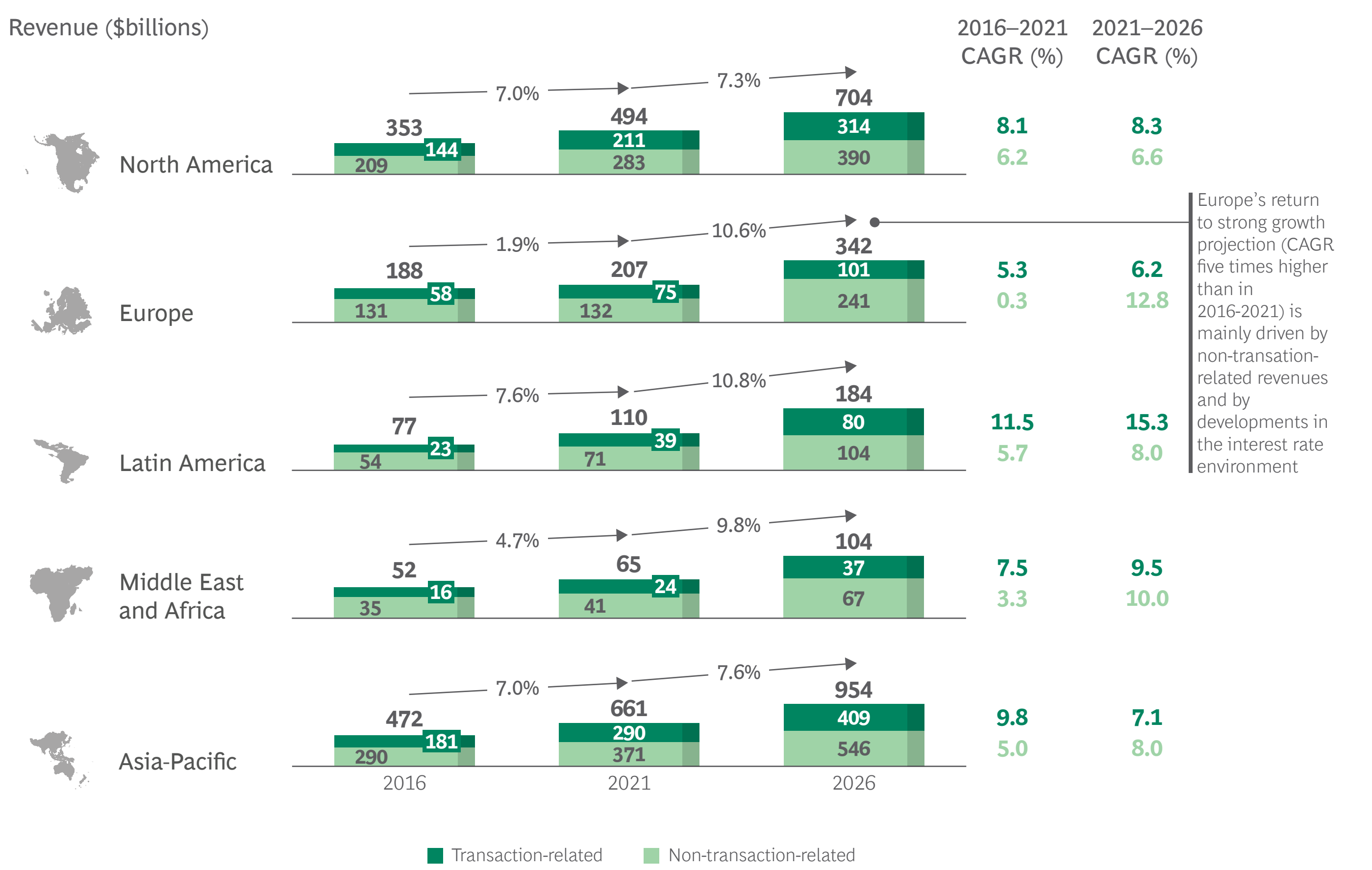
All regions are showing steady growth in payments revenues after a strong post-pandemic rebound in 2021 and 2022, and that growth is likely to continue over the next five years. (See Exhibit 3.)

North America

North America has continued to experience significant activity in payments, driven by strong consumer demand (returning to pre-pandemic growth trends in primary and secondary revenues), funding support from investors, and innovation in the industry. We expect payments revenues to grow at a CAGR of 7.3% through 2026 after a strong 10% year-on-year rebound in 2021–2022. Credit card spending, in particular, recovered significantly in the second quarter of 2022, up 19.8% year-on-year with absolute values well above pre-pandemic levels. Overall, the payments industry experienced a strong windfall, with acquirers seeing significant gains in revenue growth owing to several trends: a shift to debit and card-not-present transactions; issuers reporting strong net income; and networks experiencing sizable gains in card volume during the first half of 2022, benefiting from the shift to noncash transactions and the resumption of international travel. At the same time, fintechs reported increases in customer bases and purchase volumes.

North America is also experiencing a push to develop new payments infrastructure. FedNow, the US Federal Reserve's highly anticipated RTP network, is slated to launch in 2023 and will add another option to the RTP system operated by The Clearing House. Canada aims to upgrade from legacy payment and settlement systems with the introduction of three new systems: Lynx, a high-value payment system that leverages the ISO 20022 messaging standard, launched in September 2021; Real-Time Rail, which is expected to launch in 2023; and improvements to key parts of Automated Clearing Settlement System for retail, its batch system.

Exhibit 3 - Latin America, the Middle East and Africa, and Europe Will See the Highest Revenue Growth Rates



Source: BCG Global Payments Model 2022.

Note: Transaction-related (primary) revenues from transactions made with cards and noncard instruments. Non-transaction-related (secondary) revenues include revenues from deposit interest, card maintenance, account maintenance, revolving revenues from credit cards, foreign exchange, value-added services, and overdrafts.

Europe

The impact of macroeconomic and geopolitical shocks is still playing out in Europe. The combined effects of runaway inflation in the European Union (9.8% annually as of July 2022, compared with a historical average of 2.0% per year from 2000 to 2022), along with the effects of pandemic-induced supply-chain shocks and labor tightening, may weaken consumer spending.

Still, the pandemic clearly jolted the region back into growth. Payments revenues are likely to rise by a CAGR of 10.6% from 2021 to 2026, driven mostly by a boost to secondary revenues from lending and account fees associated with anticipated rising interest rates in the region. This would be a remarkable recovery in light of the 1.9% CAGR seen during the period from 2016 to 2021, when low or even negative interest rates dominated the Eurozone. The higher growth rate will intensify competition in the European payments market. Three key dynamics are in play.

First, competition will heat up as digital payments leaders continue to expand across Europe while alternative payment methods mature. For example, Block ventured into the Spanish market in September 2021, aiming to serve the SMEs that make up 99% of the country's companies. This move followed the service's launch in the UK in 2017 and its expansion to Ireland and France in early 2021. Stripe launched Stripe Terminal, its programmable point-of-sale product, in Ireland, France, Germany, the UK, and the Netherlands in November 2021. Stripe also partnered with the neo-bank Revolut in July 2022 to accelerate the latter's international expansion. We also see alternative payment methods, such as Bizum in Spain, gaining momentum and banks investing into partnerships with payments providers, such as Deutsche Bank with Fiserv.

Second, the European Central Bank (ECB) continues to build momentum toward developing the Digital Euro. Following the bank's public consultation on the matter—conducted from October 2020 to January 2021—all Euro area countries engaged with focus groups from October to December 2021. The investigation phase is expected to continue until October 2023. Meanwhile, Europe's ambition to develop regional payments infrastructure continues, with the European Payments Initiative (EPI) focusing on a pan-European digital wallet and the European Mobile Payment Systems Association (EMPSA) aiming to improve interconnectivity among more localized European mobile/digital wallets.

Third, open banking continues to evolve. In May 2022, the European Commission began to review PSD2, the regulatory framework for open banking in the European Union. The consultation will gather views from industry organizations and the public to assess whether existing legislation addresses the needs of users and the rapid evolution of the payments market.

Latin America

Despite the many challenges that it brought to Latin America, the COVID-19 pandemic catalyzed payments growth in the region from a historical CAGR of 7.6% from 2016 to 2021 to a spectacular jolt of 15.6% likely from 2021 to 2022. We expect Latin America to grow at an accelerated pace (with a CAGR of 10.8%) through 2026. Infrastructure innovation, an explosion in fintech activity, and a fast-developing regulatory environment will drive much of this robust expansion, with an estimated CAGR of 15.3% in primary revenues through 2026.

The growth in Latin American payments is fueled by the battle against cash and by rapid innovation in the sector. Key trends observed in the region include the surge and consolidation of payments fintechs, the rise of ecosystem plays in payments, the increasing uptake of BNPL, the acceleration of RTP initiatives, and the introduction of open-banking regulation.

For example, in Brazil, the government-led RTP initiative PIX has seen vigorous success. Since its launch in November 2020, PIX's payments values have increased by nearly 30 times, although its main use is still as a substitute for cash rather than for cards. Nevertheless, the platform has faced recent setbacks owing to a wave in crime conducted through PIX—for example, stolen mobile phones being forcibly unlocked to drain victims' PIX accounts, or kidnappings in which the perpetrators force users to transfer funds to them. The speed and irreversibility of transactions, long lauded as major advantages over other payment methods, are now central to a debate over how to improve security.

On the open-banking front, Brazil's central bank continues to push toward open finance, moving into phase three of its roadmap, albeit at a slower speed and with a less-punitive attitude toward noncompliance, as banks continue to grapple with the costs and complexity associated with regulatory compliance and security.

Our current forecasts suggest that global payments revenues will rise by a compound annual growth rate (CAGR) of 8.3% through 2026 and reach $2.3 trillion.

Middle East and Africa

The Middle East and Africa is another region where post-pandemic growth has spurred payments revenues. Having shown resilience both to COVID-19 and to some major macroeconomic shocks affecting other regions, in the Middle East and Africa is likely to see payments revenues jump by 15.3% year-on-year in 2022. We estimate a CAGR of 9.8% for the region through 2026, in stark contrast to the 4.7% CAGR observed in the period from 2016 to 2021.

Multiple factors will underpin this step change. At a regional level, there is a substantial push toward A2A payment methods that aim to replace cash and checks for bill and government payments. The six countries of the Gulf Co-operation Council are exploring the prospect of developing further domestic payments infrastructure, along with cross-border links to enable faster payments between consumers and businesses across the region.

Saudi Arabia's RTP system Sarie, launched in April 2021, has set the stage for future growth in A2A payments, as a complement to a market dominated by cards. The mandatory nature of the scheme for banks and other market participants should lead to steady volume growth.

The UAE is experiencing a boost in payments and fintech activity, too. Digital bank offshoots from incumbents such as Emirates NBD's Liv and Mashreq's Neo have entered the market, emphasizing payments as a key customer touch point. A combination of drivers—such as the country's young, tech-savvy, and fast-growing population; Dubai's bid to become a crypto and fintech hub; and the future launch of a domestic scheme to introduce greater competition into the card payments market—are paving the way for future growth.

Africa, long the world's mobile payments powerhouse, accounted for more than 70% of mobile-money transaction value globally as of 2021, according to the Global System for Mobile Communications. Africa continues to accelerate its pace of payments digitization—powered by new infrastructure developments, interoperability initiatives, new mobile payment solutions, and wallets driven by banks, fintechs, telcos, and other players—to address the needs of underbanked and unbanked populations.

Asia-Pacific

The Asia-Pacific region continues to be an engine of growth for payments, despite a post-COVID-19 recovery muted by the effects of strict lockdowns in the region. Payments revenues are likely to grow by 6.2% from 2021 to 2022, and we expect a reacceleration in the coming years, with revenues expanding at a CAGR of 7.6% from 2021 to 2026.

China continues to push CBDC usage. In April 2022, the People's Bank of China (PBOC) expanded e-Yuan, its CBDC pilot, to 23 cities, covering roughly one-fifth of China's population. From the start of the trial in 2019 to the end of 2021, the pilot processed a total of RMB 87.6 billion (approximately $13 billion), an estimated RMB 53.1 billion ($8.3 billion) of which was transacted in the second half of 2021. According to the PBOC, the number of individual digital yuan users reached 261 million by the end of 2021, up from only 20.8 million the previous June. The PBOC also announced integration with the digital wallet WeChat, adding the CBDC as a payment option when paying via the super-app.

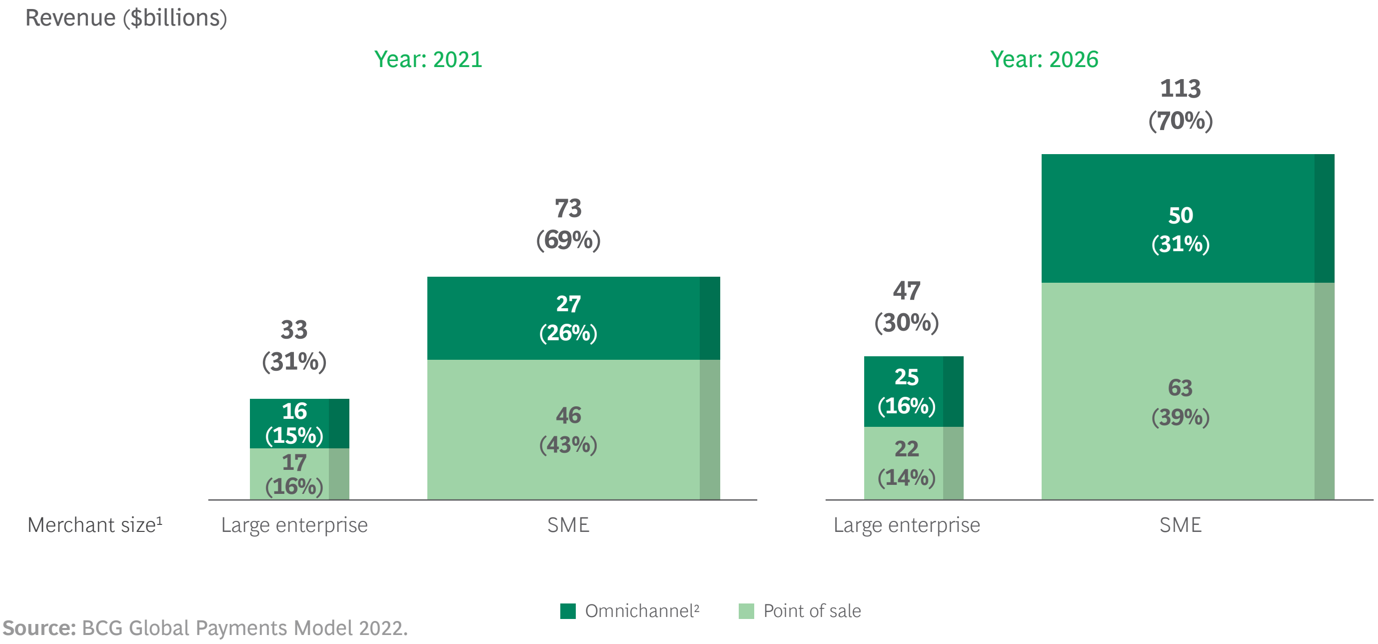
The Australian payments market has experienced key changes as well, albeit ones fraught with controversy. Debit card least-cost routing—a Reserve Bank of Australia initiative designed to lower acceptance costs by enabling merchants and consumers to choose a payment scheme to process dual-network debit-card transactions—has prompted debate over the system's potential impact on issuers and networks' revenues. Moreover, in October 2021, the government regulator approved the proposed merger of the country's three major payment service providers—BPAY (a major bill-payments rail), Eftpos (a domestic debit card network), and NPPA (which looks after Australia's recently updated RTP rails, the New Payment Platform). The new entity, Australian Payments Plus (AP+), is expected to accelerate innovation in the payments market as it promotes focused and coordinated efforts in this area.

Merchant Acquirers Need a Multifaceted Strategy

The merchant acquiring industry is maturing rapidly, as the COVID-19 pandemic may have created permanent shifts in the market from offline to online. Many competitive challengers are now at scale and expanding into new regions, segments, and products. Merchants' business models have evolved significantly, too, with many pursuing omnichannel capabilities. Such changes are altering the center of gravity for key participants in the payments industry.

From 2021 to 2026, our analysis suggests, revenues for the acquiring industry will expand at a CAGR of 8.7%, raising its total revenue pool to $160 billion. Revenue pools from SME merchant acquiring will grow at a faster rate than those from larger merchants, contributing roughly 75% of incremental revenue expansion. Growth will increasingly come from omnichannel merchants, although the expansion will need to be disaggregated according to merchant size, regional market characteristics, and online versus offline commerce. (See Exhibit 4.)

Exhibit 4 - SMEs and Omnichannel Merchants Will Drive Revenue Growth in Merchant Acquiring



Source: BCG Global Payments Model 2022.

Note: After each revenue figure identified in the chart, the relative percentage is reported in parentheses. SME = small to midsize enterprise.

[1] Merchant size definitions are based on OECD definitions (SMB = 0–249 employees; large = 250+ employees).

[2] Omnichannel values of payments comprise all payments that are not done physically in a store.

Moreover, ISVs and specialists—such as payment orchestration layer providers and BNPL providers—are getting closer to merchants with solutions that support either an array of commercial activities or specific merchant needs with an easy-to-use interface. Large banks with acquiring activities and large independent acquirers are facing greater margin compression and competitive threats from these nonbanks, as well as coping with slower rates of revenue growth.

Yet traditional acquirers can alter this trajectory. If they take a holistic approach to serving merchants and define a blueprint for growth, incumbents can open new adjacent revenue pools from embedded finance—such as with merchant accounts to support instant settlement or with merchant financing options.

The Pandemic Has Altered the Acquiring Environment

Within the first few months of the pandemic, businesses that previously had no e-commerce capabilities were up and running with full-blown web shops. Marketplaces emerged to serve this on-demand economy and to support new consumer-spending categories. Many incumbents and challengers adapted their payments offerings accordingly. New features such as curbside pickup and tap-and-go became increasingly standard. Overall, we see several trends evolving.

The competitive landscape is shifting. Challengers that entered the market over the past decade, such as Stripe and Block, have gained significant scale, especially in the past 24 months. Most challengers evolved from serving a niche segment of merchants to offering a wide array of payments, banking, and value-added services to a broader range of companies. In some of the larger established markets, challengers now control as much as 10% to 15% of the market. We are seeing multiple playbooks, one of which is to leverage a two-sided network and offer compelling value to both merchants and consumers. Another is to expand into the banking-as-a-service (BaaS) space in digitally native merchant segments and platforms. In the meantime, incumbents have not stayed still, executing such megadeals as Worldline with Ingenico and Nexi with Nets and Sia (to become Nexigroup), and the planned acquisition of EVO by Global Payments. The principal aim of such mergers is to gain scale, geographic reach, or new capabilities.

ISVs are gaining more power and influence with SMEs. In key acquiring markets such as the US and Europe, more than half of all small to midsize merchants now use ISVs. In these markets, ISVs now command almost 30% of merchant-acquiring revenue pools, a share that is likely to grow rapidly over the next five years. The platforms that these software companies provide—many tailored to specific industry verticals such as Toast for restaurants, Mindbody for Fitness, and Jobber for field services—have made it easier and faster for entrepreneurs to open an online business while bypassing traditional banks and payments intermediaries. Pre-pandemic, the typical e-commerce startup journey for an SME involved multiple interactions with different parties over the course of several weeks or months. Now, digital platforms such as Shopify permit entrepreneurs to go from initial concept to fully realized online business in just a few hours. As a result, ISVs have become the primary point of contact for many merchants and can influence an SME's choice of payments and banking providers—an influence that's likely to become stronger in the future.

Large merchants see payments as a critical element of the customer experience. Large merchants have heightened expectations regarding their acquiring partners, driven by changes in the competitive environment. As the availability and reach of e-commerce grow, customers find that they have more purchasing options at their disposal and fewer barriers to switching. With buyer loyalty less assured and margins tighter, merchants globally are optimizing for three objectives: creating a seamless, frictionless payments experience; driving incremental revenues through their existing payments offerings (such as through co-branded relationships); and achieving greater cost efficiencies.

Merchants are also looking for expertise in areas such as new payments journeys (for example, click-and-collect), and new payment methods (for example, BNPL). Traditional acquirers have an opportunity to help merchants meet all of these needs and, more broadly, to become a one-stop shop solution for payments, banking, and e-commerce services.

Embedded finance could generate massive value for players. Our research indicates that a significant number of SMEs are eager to obtain everything from working capital finance to business credit cards through their ISVs. To capture this demand, banks that once exited merchant acquiring are trying to get back in, often by partnering with ISVs to bring their banking solutions to market. For example, Synovus, a regional bank in the US, launched a white-label platform, Maast, that ISVs can use to embed payments and banking services in their workflows.

Although strategies vary, banks will need to make clear choices about where to play and how to win. So far, the scale of merchant acquiring businesses has been a challenge for most banks. Consequently, banks need to assess the strategic value of the payments opportunity more holistically in order to decide which role to play. For example, they may need to decide between owning the full value chain and focusing on leading in one or two areas of embedded finance.

A Blueprint for Growth

Incumbents have a chance to alter their growth trajectory and win significant share in the burgeoning acquiring market. But in order to do so, they'll need a multifaceted strategy that encompasses the following initiatives.

Define winning plays. Traditional acquirers must identify which opportunities are most feasible, given their current resources and positioning, and which can deliver the greatest potential returns. The choices they make will have significant implications for their business model. For example, when it comes to segments, SMEs bring the prospect of higher take rates (often ten times greater than those for large merchants) and lucrative embedded-finance revenues. But the cost of acquiring such accounts is relatively high and requires seamless onboarding. Conversely, large merchants have much lower take rates but offer significantly higher volumes and the opportunity to cross-sell into adjacent revenue pools such as authorization solutions and return-and-dispute management. Having aligned on a set of strategic priorities, acquirers should assess the capabilities they need to achieve a dominant leadership position.

Inorganic plays have the potential to accelerate the strategic plan, and as valuations decline, acquirers can be opportunistic. Large incumbents can aim to acquire capabilities to help them win in high-growth areas, while players with a more limited presence can look to gain volume scale in order to strengthen their price competitiveness.

Develop a focused strategy for SMEs. SMEs account for a significant share of merchant acquiring revenues globally. For example, nearly 75% of such revenues in the US stem from SMEs. Accordingly, it's quite difficult to be an at-scale, profitable merchant acquirer without serving this segment. However, given the growing influence of ISVs, traditional acquirers and banks will need to go granular and define tailored solutions that address specific verticals. Rather than spreading themselves too thin, acquirers should study the composition of their existing customer base and prioritize industries in which they can differentiate and win. They can then partner with ISVs to develop appropriate solutions.

Many software vendors may be eager to collaborate, as they lack banks' infrastructure, regulatory competence, and embedded-finance expertise. With a modular payments stack, an innovative and flexible pricing model, and the right analytics, incumbent players can create a holistic view of an SME's financial needs. They can use that information to design loans and other value-added services, which they can then offer through the ISV platform.

Become a trusted advisor to large merchants. Acquirers have an opportunity to become a partner of choice for large merchants. Indeed, many such merchants need help assessing and enabling the BNPL opportunity, managing their commercial journeys, and determining which payment methods are most suitable in different markets from both a customer perspective and a cost perspective. Incumbents can leverage their vertical-market data to develop solutions that are tailored to a merchant's priorities, offering a level of custom integration that most generic payment-orchestration businesses cannot provide.

For merchants interested in setting up or expanding a digital marketplace, acquirers can provide key services such as pay-in and pay-out, submerchant management, and accounts payable/accounts receivable automation. Acquirers can also establish internal environments to support innovation in payments—for example, by allowing large merchants to test new commercial journeys and by optimizing tradeoffs through analytics and artificial intelligence. Such efforts can lead to a more trusted relationship between the acquirer and the merchant.

Improve revenue management. Acquirers proactively adapt their merchant offerings to the macroeconomic environment, enabling new solutions such as faster settlements and easier access to working capital, which in turn can help merchants mitigate cash-flow issues. Such actions can yield new revenue streams and closer merchant relationships. Acquirers will also need to adopt a more active revenue-management posture to improve back-book and front-book pricing. Starting with price setting, acquirers should optimize for higher-margin structures where possible and consider steps such as tiered pricing. In some markets, they should revisit how they categorize transactions (for example, qualified, midqualified, and nonqualified). To improve price realization, acquirers should give their sales teams clear discounting guidelines, reduce the frequency of waivers, and perform retrospective reviews on refunds and revenue slippages.

Take proactive risk and compliance management actions to create resilience. With the possibility of a recession looming and with increasing regulatory scrutiny in the payments space, incumbent acquirers must prepare for greater volatility and shore up their risk-and-compliance management practices. As a first step, they should define their appetite for risk, which entails conducting a review at the overall portfolio level and per industry. Next, they should develop a toolkit to reduce exposure to potential loss, part of which will involve defining requirements for merchants. Further, acquirers can harmonize onboarding guidelines and processes both to ensure efficiency and to mitigate compliance risks stemming from shifting regulation. They must consider credit-risk factors for merchants, along with all related scoring, while establishing contract terms for new merchants. Creating an integrated 360-degree view of each merchant will ensure transparency regarding exposure to risks—in particular, those related to financial crimes.

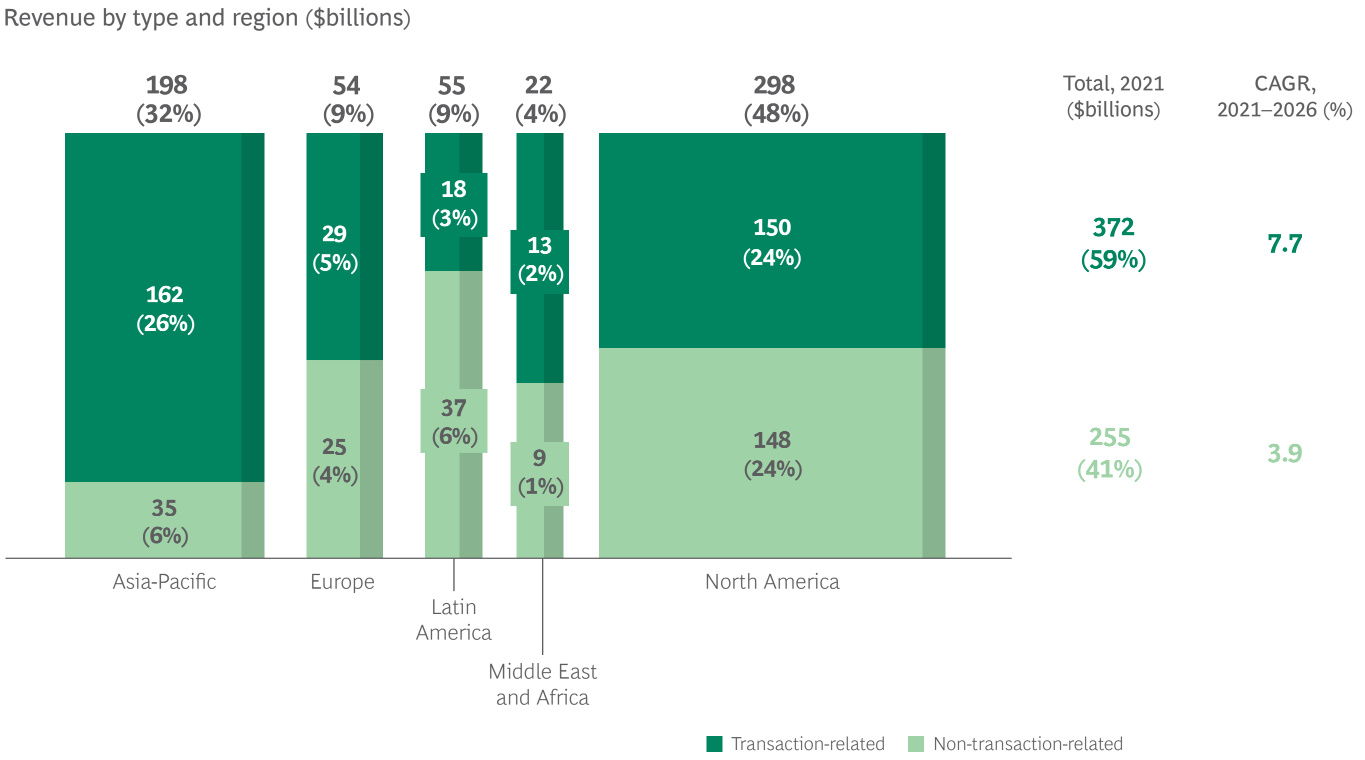
In parallel, incumbent acquirers should establish a risk-governance structure that ensures the involvement of all relevant decision makers. As the macroeconomic situation evolves, they should consider setting up a central team charged with reporting ongoing risks, monitoring early-warning indicators, and tracking interactions with merchants.

How Issuers Can Build Advantage

The issuing industry has maintained steady growth in recent years. Looking ahead, we expect issuer revenues, which amounted to $627 billion in 2021, to keep rising at a healthy 6.2% rate annually over the next five years. Primary (transaction-related) revenues, mainly from interchange fees, will drive much of this growth (CAGR of 8.4%), followed by secondary (non-transaction-related) revenues that include foreign-exchange and annual card fees (CAGR of 3.9%). (See Exhibit 5.) We further expect issuer revenues to reach a value of over $1 trillion globally by 2031.

Digitization, the expansion of e-commerce, and the increasing importance of consumer data have the potential to vault issuers to the front of the payments value chain, allowing them to play a more central role in servicing the needs of both merchants and their customers. As a result, issuers must rethink merchant engagement models and reimagine customer journeys and loyalty programs—all against the backdrop of a more challenging global economic environment. With inflation rising and consumer confidence on edge, leading issuers must take proactive measures to shore up their core risk management, collections, fraud, and underwriting businesses.

Exhibit 5 - North America and Asia-Pacific Account for About 80% of Global Issuer Revenues



Source: BCG Global Payments Model 2022.

Note: After each revenue figure identified in the exhibit, the relative percentage is reported in parentheses. Transaction-related (primary) revenues include interchange, penalty and variable foreign exchange revenues. Non-transaction-related (secondary) revenues include annual card fee and credit card net interest income revenues. CAGR = compound annual growth rate.

In particular, two major shifts are reshaping the issuing space.

New payment methods such as BNPL have opened the door for payments players to move beyond a transactional role. Traditionally, card issuers have enabled merchant-customer transactions at the point of sale by offering a convenient payment method. Today, payments businesses, such as BNPL players, that sit at the center of two-sided networks between merchants and customers can go beyond this role and support multiple stages of the purchasing journey. BNPL currently represents 3% of global e-commerce payments volumes, a share that is likely to rise.[2] We expect more companies to launch BNPL-related portals and merchant-funded marketplaces in pursuit of that opportunity.

Tech heavyweights are entering the arena, too. For example, Apple plans to launch Apple Pay Later—a BNPL initiative backed by a new, wholly owned subsidiary called Apple Finance—before the end of 2022. (See the sidebar “What’s Next for BNPL?”)

Consumers expect richer rewards and a more personalized loyalty experience. For years, issuers have operated according to the same basic construct: offering consumers a convenient way to pay, combined with a strong rewards proposition primarily focused on travel, entertainment, and daily spending categories. This pattern has been especially persistent in the US market.

2. BNPL adoption rates vary significantly with some markets well above 3% global adoption rates e.g., Australia, Nordic countries, Germany and Netherlands.

What's Next for BNPL?

Buy now, pay later (BNPL) enables consumers to receive tailored offers with the flexibility to pay later or by installments, at no fee. This payment option has evolved into a simple, frictionless, and convenient online payment method that continues to build momentum. Merchants gain repeated purchases, larger shopping baskets, and a new affiliate marketing channel. The BNPL or marketplace orchestrator receives a steady flow of associated fee revenue. Everyone wins. As a result, BNPL has achieved significant traction over the past two years, and players that have harnessed the key drivers of success have seen soaring growth. In recent years, BNPL purchase volumes have grown by more than 50% year-on-year.[1]

However, several speed bumps are emerging that could slow down this trend:

- **Limited Funding.** Fintechs as a whole, and BNPL players in particular, are seeing a decline in their valuations and muted investor enthusiasm. As a result, BNPL providers must evaluate their current operations and ensure that they have sufficient equity funding to ride out a potential recession. With less cash in hand, companies may also need to slow the pace of innovation and product development.

- **Challenging Economics.** Faced with rising interest rates and a challenging macroeconomic environment, BNPL players may need to shift their focus to raising debt under higher interest-rate conditions, which could end up crimping margins. Likewise, the merchants that BNPL providers support may find themselves stretched and unable to fund rewards or experiment with new payment methods at the same rates as before, impacting growth prospects.

- **Intensifying Competition.** The combination of a crowded BNPL space and a challenging market outlook will invite leading players to consider consolidation plays. We will probably see regional or global champions emerge.

- **Increased Regulatory Scrutiny.** We have noticed increasing demand for higher visibility of BNPL debt on credit scores, along with rising regulatory concern over consumer data being sold to merchants.

Ultimately, the BNPL market is likely to undergo a more moderate growth phase, as it navigates the external challenges associated with macroeconomic uncertainty.

1. See our white paper "BNPL: Too Good to Miss?"

But the pandemic has spurred a revolution in the traditional value and perception of rewards, while the growth of digital wallets has made cards less visible in daily purchases. With travel curtailed, traditional mileage, restaurant, and entertainment rewards have had less allure for consumers, forcing issuers to experiment with new offers such as expanding cash-back or statement credits to new spending categories (such as food delivery and streaming services) or extending “pay with points” to all types of spending. Such changes have added spark to rewards portfolios, but at a price: issuers in the US, for example, are seeing the costs of their loyalty programs rise by an average of 5 percentage points higher than the corresponding growth in customer card spending.

Moves That Issuers Should Make Now

We believe that the issuing space is at an inflection point, as the trends cited above point to fundamental shifts in value flows. Even so, issuers have a chance to capitalize on these shifts and play a more vital role in the purchasing ecosystem, while also protecting themselves from the current economic volatility. To achieve these goals, they need to take three key steps.

Diversify revenue streams by turning data into a superpower. First-party data is becoming increasingly valuable, and issuers sit on troves of it. As third-party cookies are phased out, marketers are finding it harder to obtain high-quality consumer data efficiently. By leaning on their rich data assets and sharing them in an anonymized, regulation-compliant manner, issuers can enhance the value of the data that they provide to merchants and can open significant new revenue streams for their own businesses. Harnessing this data, however, may be challenging for traditional players that operate on a legacy tech stack, necessitating a transformation.

Here are a few examples of how issuers might monetize data:

- **Provide curated offers to increase spending and lending.** Issuers have the chance to expand their addressable market significantly by using their data to create hyper-personalized customer spending journeys, eventually backed by relevant merchant-funded offers. Doing so can trigger a virtuous cycle that benefits all participants. Instead of generic marketing, customers gain curated offers that align with their tastes, needs, and life stage. And rather than diffusing their spending on outbound marketing, merchants gain a steady stream of qualified leads that issuers pull in for them.

- **Become a two-sided retail-consumer network.** Issuers can turn their connection with consumers into a two-sided ecosystem that also integrates merchants. Such ecosystems could serve as a curation ground for digital platforms and merchants, enabling issuers to increase customer engagement and loyalty.

- **Become a trusted third-party data source.** Issuers that also have a merchant acquiring arm could create an entirely new business model by providing merchants and other partners with high-quality anonymized consumer data to support their own personalization initiatives. In addition to providing sanitized raw data, issuers should invest in strong analytics capabilities that merchants can leverage to better understand customer behaviors and unlock cross-selling opportunities.

Buy now, while valuations are attractive, to modernize the approach to data. Issuers will need to significantly alter their approach to monetizing data. In addition to revisiting their data architecture, governance, tech setup, existing partnerships, and go-to-market methods, issuers could leap ahead on this journey through inorganic moves.

With market volatility limiting digital players’ valuations and access to funding, now may be a smart time for issuers to acquire distinctive technology. Fintechs—especially in the BNPL, data aggregation, and loyalty spaces—could bring critical data-management and technological expertise to help issuers create the data-driven ecosystems they will need to support merchant-funded offers. Issuers could also leverage best-in-class go-to-market capabilities to optimize affiliate marketing budgets and investment returns for merchants.

Protect the core business from a potential downturn. Issuers should ensure that they are prepared to weather a possible economic downturn and to shore up their underwriting, collections, and recoveries capabilities. Priorities should include the following actions:

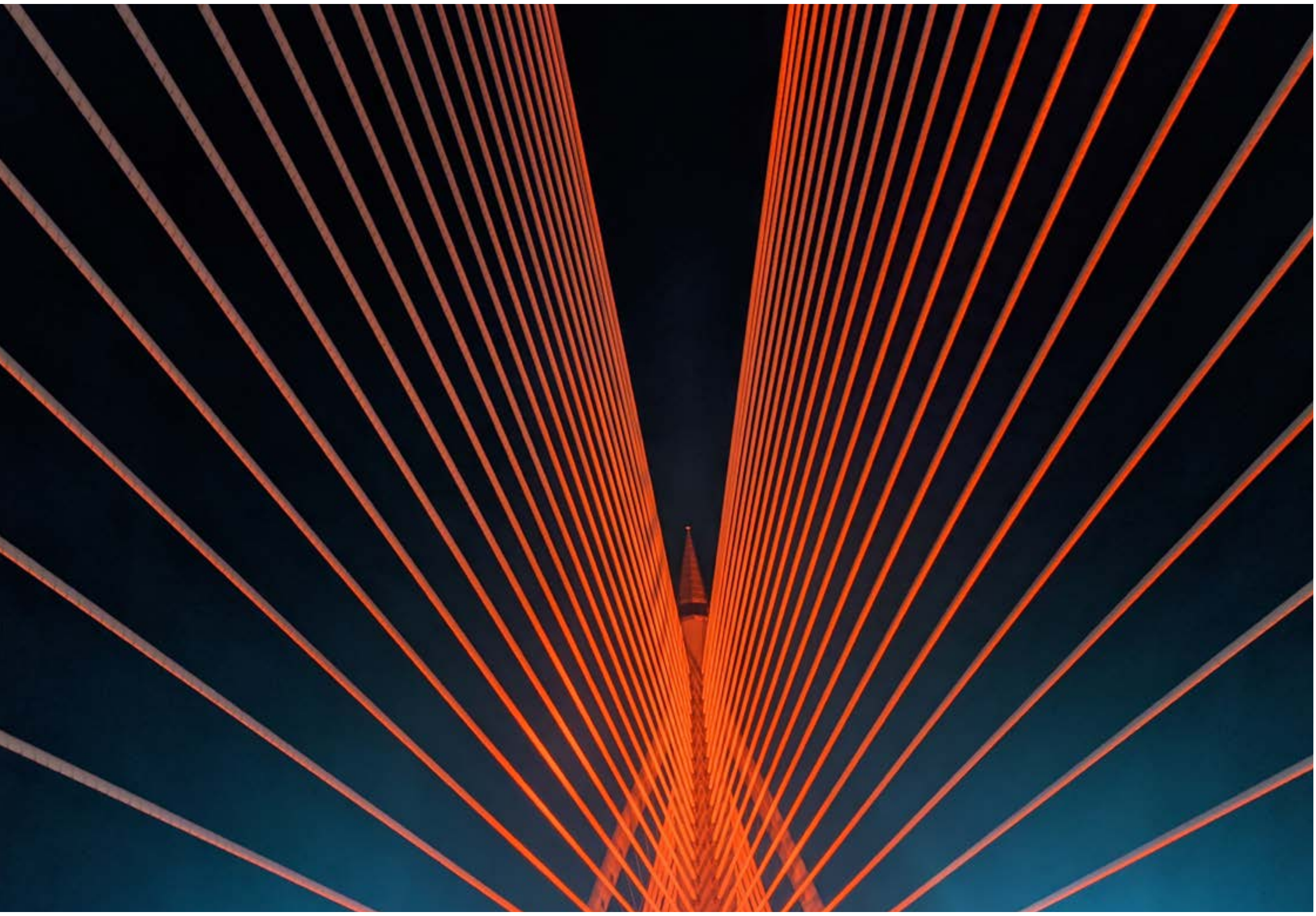
- **Adopt an integrated multichannel strategy.** Deliver unified campaigns to manage collections across several platforms while prioritizing SMS, email, and push notifications over the phone—all while complying with regional outbound call regulations. Recovery rates will likely increase, and reputational risk will diminish.

- **Empower customers.** Develop an autonomous digital-first collections model to provide customers with self-servicing options. This initiative will aid, in particular, customers that are prone to missing monthly payments.

- **Strengthen the organization.** Empower risk and collections teams with higher self-governance levels, rapid testing capabilities, and advanced analytic techniques. Adopt flexible policies that permit employee transfer between departments (including cross-training), and position external agents for deployment during periods of peak volume.

Lenders should increasingly view collections as an opportunity to forge and retain valuable, long-term customer relationships, not simply to mitigate losses. Such initiatives could also lead to a 5% to 10% reduction in charge-offs and be self-funded by the revenue generated from data, loyalty, and offering strategies.

Despite headwinds originating from multiple sources, payments industry revenues are on track for solid growth over both a five-year and a ten-year horizon.



Global Networks Must Diversify to Sustain Growth

Networks have proved their resilience and adaptability throughout the pandemic, and these attributes will stand them in good stead in the years ahead. Our analysis suggests that networks' revenues—from both international and domestic schemes combined—will rise at a CAGR of 8.9% from 2021 ($63.8 billion) to 2026 ($97.9 billion). That's a healthy growth rate, but it's lower than CAGR of 10.2% for the prior five-year period from 2016 to 2021.

A major challenge is that more countries are seeking to exert greater control over their domestic payments infrastructures and limit the role of international card networks in them. In addition, inflation, market volatility, and an intensifying competitive environment will test networks' mettle in the coming years.

A2A and other alternative payment methods are becoming credible alternatives to the payment card ecosystems, especially in fast-growing emerging markets such as India and Brazil, while regulators and governments explore how domestic card networks might counterbalance the perceived dominance of international schemes. However, global networks that diversify their revenue streams and offset concentrations in challenged sectors and regions can open new sources of customer value and place themselves on a significantly higher growth curve. Several key dynamics are in play.

Momentum Remains Strong but New Risks Are Emerging

Positive pandemic-related developments and ongoing investments to improve core businesses are likely to help networks sustain sizable growth in the years ahead. Two key trends are active:

- **Core products are still in demand.** In the second quarter of 2022, cross-border, travel-related volumes surpassed their pre-pandemic levels for the major card networks. Further, the use of cards and other electronic instruments continues to grow, boosted by behavioral changes cemented during the pandemic and by the global shift away from cash. Although some networks were concerned that BNPL adoption might cannibalize credit-card volumes, this has not materialized outside a handful of markets such as Australia. In fact, for many networks, BNPL has been a revenue multiplier because installment payments generate more traffic over card rails than a single credit or debit transaction. Looking ahead, we expect demand for traditional networks' products to remain healthy.

- **Networks are shoring up key capabilities.** Investment in new products and adjacent capabilities remains robust. Large networks are trying to preserve their positioning in payments volumes, particularly on the credit side, through product innovation and partnerships. Networks are also actively pursuing attractive M&A opportunities in cross-border payments, open-banking connectivity, personalization and loyalty, bill payments, and crypto analytics/compliance.

Networks in today's payments universe must navigate a complex regulatory, geopolitical, and competitive landscape. Indeed, international networks' perceived dominance in some markets has led to renewed scrutiny from regulators, prompted by sovereignty concerns. For example, banks in Europe, under the auspices of the ECB, have tried to launch a regional network, but the project—part of EPI—has faced setbacks. Meanwhile, in June 2021, the Reserve Bank of India (RBI) banned Mastercard, American Express, and Diners Club from issuing new cards in that country due to noncompliance with local data-storage rules. Although the RBI lifted the ban on Mastercard in July 2022, the episode reflects a growing interest on the part of governments and regulators in strengthening their control over international networks' activities.

Moreover, rising interchange fees—which the networks set and card issuers accrue—are prompting pushback from retailers. In November 2021, Amazon threatened to stop accepting UK-issued Visa credit cards after the network raised its retail interchange fees for card transactions from 0.30% to 1.5%. The two companies later resolved the dispute, but the incident highlights the increasingly complex relationship between card networks and other parties in the payments ecosystem.

Networks Can Achieve Faster Growth and Greater Resilience

To go beyond inertial growth and protect against downside risks, networks must diversify and take a number of actions.

Go vertical. Developing vertical-specific product propositions in industries such as gaming, construction, health care, and transportation can help networks acquire a foothold in high-growth sectors. Prior investments in areas such as push-payment solutions (in which payments are credited to a user's account), A2A payments, and payments acceptance technologies such as SoftPOS for small businesses have given many networks a running start. But to address the complex requirements of end users in key opportunity segments, networks must go further.

Gaming businesses need cost-effective micropayments and push-to-card solutions. The construction sector needs integrated processes that support seamless payments to contractors and suppliers through deep integration with payables and receivables systems, virtual card issuance, and detailed spending analytics. And health care businesses need payments offerings that comply with the industry's strict security and confidentiality requirements. Networks should set up their sales forces and partner with acquirers and fintechs to create market-tailored solution bundles for software-as-a-service (SaaS) companies in fast-growing industry verticals. To issue virtual cards, these companies will need propositions related to banking identification number sponsorship, SaaS deployment models, and vertical-specific value-added services (VAS).

Accelerate the adoption of open banking and A2A payment flows. Some networks, through their acquisition of open-banking connectivity players (such as Visa's purchase of Tink and Mastercard's purchase of Finicity), are preparing to play a larger role in establishing a new network pertaining to data flows. The short-term opportunity for networks lies in cross-selling open-banking solutions to their issuer customers or selling card solutions to open-banking connectivity users. Networks can also help open-banking participants manage their payments compliance activities, taking a costly requirement off their shoulders, especially in the case of cross-border A2A payments.

Networks are increasingly well positioned to develop differentiated application programming interface (API) pricing solutions to support open-banking data use cases in areas such as lending decisions, loyalty, personal finance, wealth management, accounting, fraud detection, personal real estate, and personal insurance. Networks can build VAS to remove frictions for open-banking ecosystem participants in such spaces as consent management, dispute management, and risk management.

Gain first-mover advantage in new growth frontiers. Although card payments remain poised for growth, the rise of alternative payments instruments and rails could fragment the landscape, posing a risk to the networks as payments volumes spread across fiat and digital currencies. In response, networks are expanding to capture new forms of monetary exchange such as cryptocurrencies, stablecoins and—potentially— CBDCs. For example, in partnership with Circle in late 2020, Visa became the first major network to enable settlement in USD Coin, a US stablecoin. Visa is also incubating a multicurrency interoperability hub called the Universal Payment Channel that will permit seamless payment settlement in central bank and private digital currencies.

B2B payment flows represent the next growth frontier for networks. Along with person-to-person, business-to-consumer, and government-to-consumer payments via emerging channels such as push-to-card, B2B represents a potential $185 trillion opportunity per year globally, as estimated by Visa. Some large networks are investing in B2B solutions and platforms, but they have not had much success in penetrating that new payment flow opportunity. Moreover, they have yet to develop the use cases, technology, and process integrations they will need to fulfill the often-complex requirements of those flows across multiple stakeholders, instruments, currencies, and geographies.

Lead the sustainability agenda in payments. Given the growing urgency of the need to reduce carbon emissions, networks have an opportunity to help issuers, merchants, and consumers advance sustainability. Major networks are developing solutions that enable issuers to add sustainability features to their card offerings, such as carbon footprint calculators, carbon offsets, and cardholder benefits that reward sustainable behaviors. Networks should continue to develop new sustainability solutions that enable issuers to differentiate their card product propositions. For example, tracking corporate ESG performance could enable networks to create tools that help consumers make better-informed purchasing decisions and help manufacturers advance supply-chain sustainability, corporate governance, and fair-trade practices. The sustainability agenda also gives international networks an opportunity to establish a collaborative dialogue with merchants beyond the traditionally adversarial discussion centered on interchange fees.

Hedge against a broader set of risks. Although pursuing expansion opportunities is crucial to growth, so is risk management. For example, a prolonged period of inflation coupled with stagnant economic growth could lead to some demand destruction and a subsequent hit to payments volumes as consumers and businesses adapt to an environment of reduced purchasing power.

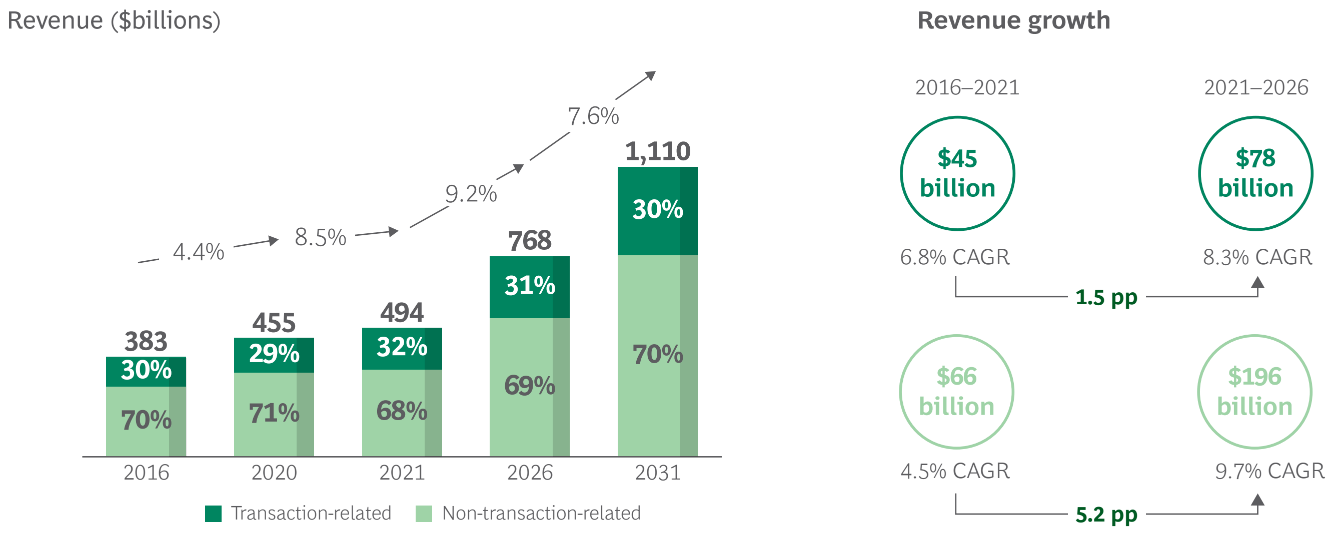
To manage potential exposures, networks need to track a broader set of risk categories and hedge their flow mix. For instance, some networks may wish to focus more heavily on B2B trade, since that area tends to be more resilient to inflationary pressures and can help offset networks' historical reliance on travel-related revenue streams. But networks must survey the market carefully in doing so, since B2Bs in certain sectors and geographies may face greater inflationary pressure and more contraction in demand.

How Transaction Banks Can Claim Their Share of a $500 Billion Pie

Periods of economic instability leave little room for error, and no one knows this better than chief financial officers and corporate treasurers. In addition to helping their organizations manage cash flow, liquidity, and payments operations, these senior executives must look downstream for risks that could destabilize their business or prevent it from achieving its strategic goals.

Banks that meet the evolving needs of CFOs and treasurers could tap into a global revenue pool worth up to $494 billion in 2021, a sum that our forecasts suggest could grow by a CAGR of about 9.2% through 2026 to $768 billion. (See Exhibit 6.) In addition, services that fall under the wholesale transaction banking umbrella—including domestic and cross-border payments, cash management, and supply chain and trade finance—deliver stable, fee-based income with low capital consumption.

Exhibit 6 - Traditional Transaction Banks, Despite a Positive Revenue Outlook, Will Face Intensifying Competition



Source: BCG Global Payments Model 2022.

Note: Transaction-related (primary) revenues relate to transaction-based revenues. Non-transaction-related (secondary) revenues relate to fee and interest revenues associated with checking accounts and credit cards. A2A = account to account; CAGR = compound annual growth rate; ERP = enterprise resource planning; FX = foreign exchange; pp = percentage points; SME = small to midsize enterprise.

Customer lifetime value (CLV) is another potentially significant metric. Payment services lead to deep customer relationships, laying the groundwork for mutually beneficial, long-term interactions.

But capitalizing on the wholesale transaction banking opportunity is not a simple endeavor. Competition is intensifying, digitization is more urgent, and scale is essential. Banks must think two steps ahead, review their traditional business models and go-to-market approaches, and partner more strategically with nonbank players to capture and defend growth.

The Road to Success Is Getting Bumpier

The wholesale transaction banking opportunity is worth winning. But four key challenges complicate the path to success.

Corporate customers have heightened expectations. With liquidity concerns paramount, CFOs and treasurers need full transparency with regard to their companies' incoming and outgoing cash flows. They also need predictive intelligence to manage and schedule their domestic and cross-border payments, and they need it delivered over a convenient and secure corporate-to-bank interface. Also, CFOs and treasurers need help with back-office digitization and data reconciliation. Many would like to integrate transaction data across their myriad banking relationships, legal entities, and operating jurisdictions and then transfer this information into their corporate systems—such as procurement, accounting, and enterprise resource planning (ERP)—on an automated, near-real-time basis. Of course, the importance of these features to multinationals, large corporates, and SMEs may vary and may depend in part on the current level of expertise within their treasury organization. But creating a relevant portfolio of APIs to enable this integration or establishing a PaaS experience could help corporate customers optimize cash flow and protect their companies' financial stability.

Nonbanks are posing a greater competitive challenge. Banks used to be the primary provider of transaction banking services, but not anymore. Both the number and the variety of entities competing in corporate payments, cash-flow optimization, and financing have grown massively in recent years. Today, banks face challengers in each segment of the wholesale transaction banking landscape, forcing them to defend share across the value chain. Some of these competing entities are large players, and many have large ambitions to match. Together, they are changing the rules of the game. We see several trends:

- **Connectivity is the new norm.** Big tech players such as Alipay and Amazon are hosting digital marketplaces, folding a variety of financial services and payments functionalities—such as Amazon Business, Amazon Lending, and Amazon Pay—into their offerings, and making integrated journeys a standard experience for their business customers and merchants.

- **Procurement platforms are a predominant delivery method.** Besides enabling the electronic exchange of purchase orders and invoices, procurement platforms such as Coupa, Tradeshift, and SAP Ariba embed financial services into their procure-to-pay services. Corporate customers can avail themselves of everything from credit transfers and card payments to international supply-chain and trade finance. Many of these platforms create ecosystems that bring buyers, suppliers and (regulated) financial services players together—adding value for all participants.

- **Rapid innovation leaves no room for mediocrity.** Domain specialists, often fintechs and boutiques, are redefining excellence in each area of transaction banking. Examples include players offering solutions in treasury management, cross-border payments, or supply chain finance. Their ability to concentrate on specific links of the value chain and churn out next-generation features raises expectations for all participants.

The need for digital investments keeps growing. In addition to dealing with mounting competitive pressures, banks must evolve their processes to address a number of sweeping mandatory market standards and regulatory changes. For example, by the end of 2022, banks must comply with ISO 20022 to implement MX formats (XML message definition) for cross-border payments, with an interim period until 2025 during which use of the old SWIFT MT formats will still be permitted. And by 2023, European banks need to implement updates mandated by the Single European Payments Area (SEPA) rule book, including upgraded MX formats for SEPA payments. In parallel, many banks are working on additional payment use-cases—such as request-to-pay solutions, a messaging functionality that initiates an instant credit transfer. Similarly, to comply with open-banking rules, institutions must find ways to transform legacy IT for payments into modular, cloud-based architectures that can support creating and sharing APIs. Transaction banks will also need to prepare their systems to handle digital currencies, especially as more central banks around the world launch pilots for CBDCs.

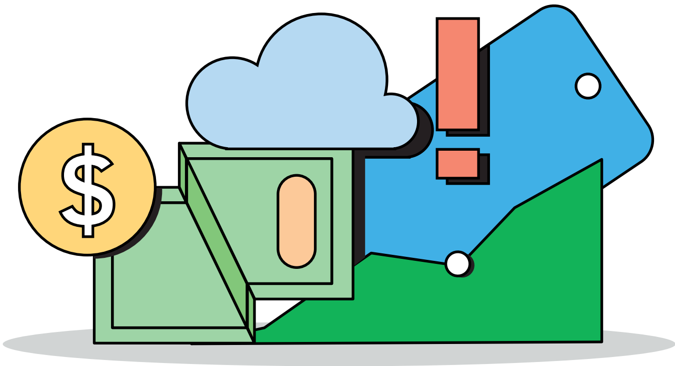
Subscale players are losing ground. Many banks do not operate at the scale needed to fund innovation and modernization. Although some larger banks and specialized payment service providers (PSPs) execute more than 5 billion to 10 billion transactions each year, small and midsize banks handle only a fraction of that volume. As a result, top-tier banks and digital PSPs can cover their costs and fund differentiating solutions more easily than their smaller competitors can. Small and midsize banks in Europe are especially challenged, owing to the region's fragmented banking landscape and the limited size of individual domestic markets.

Winning Moves That Wholesale Transaction Banks Should Make Now

To capture the growth projected in the transactions arena, banks must be willing to reconfigure traditional approaches and consider markedly different ways of operating. The following actions are necessary for success.

Think like a platform player. Value is flowing toward integrated journeys and ecosystems. Banks need to embrace this shift and scan the market for opportunities to create smart platform plays. Goldman Sachs, for instance, created a BaaS platform that allows corporations, fintechs, and e-commerce marketplaces to access a full suite of treasury services. Other leaders are integrating their offerings into platforms and ecosystems managed by different entities.

With the same focus on integration, banks should examine their own processes and make it as simple as possible for customers to embed transaction data into the corporation's ERP, accounting, procurement, and treasury systems. To accomplish this, banks will need to redesign core customer journeys and streamline and automate key steps to improve treasurers' front-to-back customer experience.



Leverage transaction banking data to open new revenue streams. Transaction banking activities generate a large data trail. Managed appropriately (and with customer data privacy a priority), these data assets enable banks to provide customers with tailored working-capital analytics, real-time liquidity modeling tools, balance-sheet insights, and industry benchmarks. In addition, banks can use transaction and third-party data together with artificial intelligence to improve their own business performance. We have seen cases where combining payments data and advanced analytics has helped to lower customer churn by 10% to 15%, improve anti-money-laundering screening, and automate credit decisions.

Build a modern, modular payments architecture. Given the trend toward integrated, platform-based services, wholesale transaction banks must modernize their IT architectures. They will need to enable development of APIs and other extensions that allow them to embed solutions into various platforms and corporate systems. Orchestration is crucial, too. Banks must invest in capabilities that let them connect and automate corporate finance journeys—such as payment validation and scheduling—end-to-end. In addition, at the outset, cybersecurity and data privacy protections will need to be designed into the IT architecture in order to mitigate risks and enable the bank to respond efficiently to evolving compliance rules. The right strategy will vary for different types of players, with many larger banks opting for an in-house approach and many smaller banks seeking cost-efficient solutions such as setting up payment utilities or outsourcing payment IT and operations to specialized payment service providers.

Make service the differentiator when scale is compromised. Small and midsize banks won't be able to match the business volumes of large institutions. But instead of competing on scale, they can compete on service, becoming an indispensable partner to SMEs in their core geographic areas. Smaller companies often feel overlooked by large banks, and they often end up paying relatively high fees because their transaction banking volumes are lower than those of larger companies. Subscale banks that tailor distinctive services to SME needs, with value-based pricing to match, can emerge as winners. Important prerequisites for success include customer centricity, the ability to leverage client transaction data, and the know-how to digitize the core offering. (See the sidebar "Capturing the SME Opportunity for Wholesale Payments.")

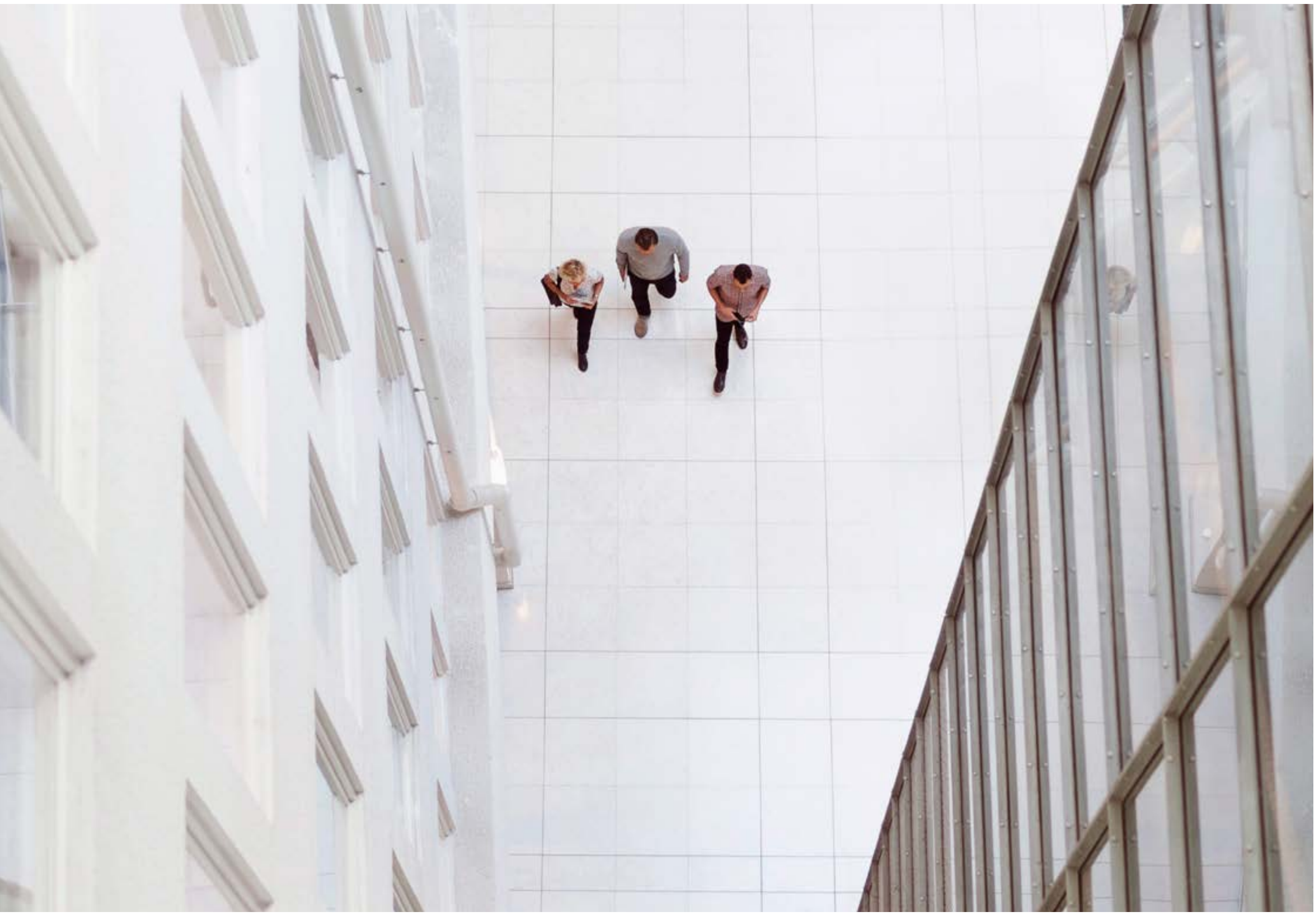
Partner to grow. Most banks will benefit from assembling a close group of trusted partners to assist with various aspects of their transformation agendas. And partnering outside the banking ecosystem can spur growth in several ways. Banks can use fintech partnerships to complement their product and service offerings in areas such as cross-border payments, trade finance, and supply-chain finance. For example, Wells Fargo partners with TransferMate to complement its cross-border payments offering and with Bill.com to improve accounts payable and accounts receivable processes for SMEs. Whichever strategy banks pursue, it's best to approach partnership arrangements in a measured way rather than attempting to complete multiple negotiations in parallel. Developing the cooperation agreement, establishing a revenue-sharing model, and integrating technology can take many months.

Capturing the SME Opportunity for Wholesale Payments

Small to midsize enterprises (SMEs) are a pivotal customer group for corporate banks and payments players alike. Digitization has made it more cost-effective to serve this segment, but it has also given fintechs and payment service providers an edge. Many have created digital and platform-based solutions tailored to smaller businesses. Examples include digital SME-banking (such as Penta), digital lending and data-driven invoice factoring (such as MarketFinance and Billie), SME-focused corporate cards and/or business-spending management (such as Pleo, Spendesk, and Moss), and cross-border payments (such as Wise and Ebury).

Nevertheless, banks can challenge fintechs in many of these areas. The SME market is poised to see significant growth over the next several years, and wholesale transaction banks that single out this segment with a customized portfolio of services could tap into the same growth trajectory. To do so, they need to expand their SME product line beyond basic offerings such as using the current account to enable domestic and cross-border payments.

Among the many areas that banks can explore are tools to support SMEs in spending, expense, and invoice management; customizable mini-ERP offerings; and software-enabled dashboards that make it easy for business owners to view their incoming and outgoing payments. Additional opportunities include providing tailored solutions for SMEs to project liquidity and optimize working capital—such as virtual credit cards, data-driven invoice factoring (without complex onboarding, contract terms, and minimum quotas)—and developing BNPL offerings for B2B e-marketplaces and procurement platforms. Once banks establish their core product range, they can expand into adjacent areas.



Fintechs Must Balance Growth, Quality of Service, and Profitability

From 2016 through 2021, close to one-fifth of all new fintechs globally were dedicated to the payments space. Together, these businesses accounted for roughly 20% of cumulative fintech equity funding raised during this period. (See Exhibit 7.) Ready access to funding has allowed fintechs to outstrip banks on tech, product, and marketing spending by a factor of three to four, helping them achieve significant product-innovation and customer-acquisition advantages. In addition, an expanding economic cycle, a manageable regulatory environment, and an increase in digital payments by consumers, merchants, and businesses have created fertile ground for fintechs to thrive.

But the high-flying sector has returned to earth. Over the past six to nine months, a number of fintechs have seen their valuations deteriorate significantly. Many have been forced to accept “down rounds” at lower valuation levels. At the same time, investors have become warier, some going so far as to pull out of deals after signing. Given such trends, what do the next five years look like for payments-focused fintechs? We expect to see three dynamics play out over that period.

Exhibit 7 - Globally, Payments-Focused Businesses Account for About 20% of Fintech Launches and Funding

Payments fintechs are multiplying and attracting investors...

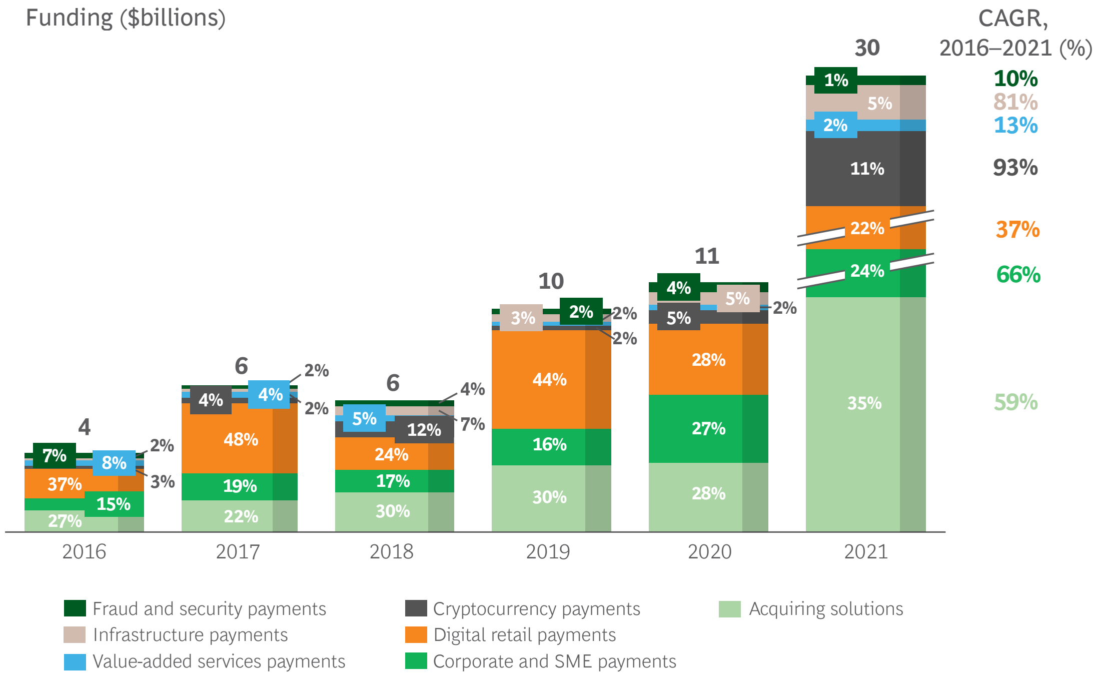
19%

Share of total fintechs launched

20%

Share of total fintech funding

...and they posted significant growth in funding over the past five years



Source: BCG FinTech Control Tower.

Note: CAGR = compound annual growth rate; SME = small to midsize enterprise.

Funding will become more prudent. The first half of 2022 saw investors funnel $11 billion into payments-related fintechs—lower than 2021 funding levels, but still well above the amounts generated in 2019 and 2020. Looking ahead, we expect overall funding levels to fall below or equal pre-pandemic levels. Investors will continue to fund a diverse set of fintechs, but acquiring, merchant payments, and e-commerce fintechs will continue to account for the bulk of the funding pool. There will probably be other challenges as well. For example, established fintechs may have to rely on more expensive funding sources or accept funding rounds (as well as IPOs) at depressed valuations. For their part, smaller fintechs will face more scrutiny from prospective investors regarding the soundness of their business models.

Anchor plays will evolve into full-service plays. Payments-related fintechs have grown by facilitating digital commerce and integrating solutions into both consumer and corporate customer journeys. A typical approach for such players has been to offer payment solutions as an anchor product to embed themselves into a variety of journeys.

Over time, however, the most successful players have adopted a payments-plus approach, with payments opening a gateway to a wider array of value-added services and products. For example, Wise launched a stock-trading platform and a set of business-accounting tools, while Stripe branched out into business loans and card issuance. PayPal added a pay-monthly product to bolster its BNPL offering, and Afterpay announced that it would be extending its BNPL functionality in-store in the US and Australia through Block’s point-of-sale solutions. We expect plays similar to payments-plus to become the dominant model for successful fintechs in the future.

The margin for error will erode. A more cautious investment climate is prompting many fintechs to hoard cash, trim headcounts, and freeze hiring. As a result, as interest rates rise, some fintech business models will likely be exposed to additional challenges such as having to depend on securitization of loan and credit-card portfolios or on wholesale funding from banks in order to fuel their credit operations. They will also be more vulnerable to rising interest rates as the cost of funding goes up. Further, declining household income and lower consumer spending could trigger an increase in delinquencies, placing additional pressure on margins. Such a shift could push fintechs with a payments-plus model to invest more heavily in credit-risk management at the cost of growth—a shift that they must prepare for as the macroeconomic cycle turns.

How Can Fintechs Demonstrate Quality and Secure Profitable Growth?

Investors, customers, and other key stakeholders in the payments industry are embracing a flight to quality. As a result, over the next several years, fintechs must focus on profitability rather than on pure growth. Many will be experiencing the first downturn since their inception and will need to prove to investors and company boards that they are resilient businesses. To deliver the quality that their stakeholders expect, fintechs must address several imperatives.

Revisit paths to profitable growth. Now is the time for fintechs to review their business models and chart a road map for more profitable growth over the next few years. First, they need to focus on optimizing customer acquisition costs (CAC) against CLV, and they must design value propositions for key customer segments instead of being overly product centric. New partnerships, especially with banks, might facilitate the journey. Although fintechs have often competed with banks, some also play an enabler role, providing payments and other supporting services to traditional financial institutions. For example, a fintech with a single product offering can use partnerships to reduce its CAC by leveraging banks as an acquisition channel. A deeper partnership with banks can enable fintechs to gain access to critical know-how on risk management and collections capabilities, a skill set that many are likely to need.

Another frontier is pricing. Fintechs should revisit their overall pricing models and consider moving to a value-based pricing structure where possible. Fintech leaders should scan their product lines, assess which offerings are most likely to suffer negative impacts from rising interest rates, and reprice to gain advantage.

Professionalize risk and compliance management. It can be difficult to maintain consistent risk oversight in an environment with a high level of business and market volatility. Creating scalable processes can help fintechs remain alert to potential exposures during periods of growth, and it can create a foundation for strong risk governance. To create such processes, players need to review their risk and compliance management function holistically. They must make risk management a C-suite priority, reviewing strategy, organizational structure, and workforce structure, and putting the right risk-management tools and methodology in place, in order to achieve positive culture change.

As a first step, fintech management and board members should reach a common understanding of the organization's overall risk appetite. Achieving consensus on this point at the outset can establish guardrails to keep downside risk within defined tolerances. Next, leaders need to forge a policy framework that provides guidance on basic risk elements such as compliance and anti-money-laundering provisions, along with establishing appropriate risk policy standards and tracking exceptions. They should devise product approval processes similarly. Some fintechs should consider granting their risk officers veto power over new products, a move that can elevate the stature of risk management in fast-moving organizations.

Review cost structure and spending. In anticipation of a potential macroeconomic downturn, fintechs should place renewed emphasis on liquidity. First, they should carefully look at burn rates and forecast cash-in-hand based on macro scenarios. Next, management teams should define objectives and key results (OKRs) with the aim of bringing discipline and governance to decision making related to capital allocations. To gain organizational buy-in, fintechs must ensure clarity and action on three levels: setting and tracking OKRs, driving OKRs at the business unit level, and incentivizing behaviors needed to drive OKR adoption. As OKR rollouts scale to all functions and business units, organizations can leverage them to go beyond capital allocation and inform changes in annual planning, budgeting, and decision making.

C-suite leaders also need to revisit marketing costs. BCG research has found that the average fintech spends considerably more on marketing than banks and other payments businesses do. In 2020, for example, the top ten public fintechs spent $8 billion on marketing, compared with $6 billion by the top four US banks. In light of the tightening macro environment, fintechs should revise their customer acquisition cost and marketing strategy. One option is to explore affiliate partnerships that go beyond lead generation and handover. Fintechs should also become more aggressive in optimizing display and search spending, directing digital allocation toward higher ROI, and implementing high ROI tactics such as margin-based marketing. [3]

3. For more on margin-based marketing and tactical tips for deploying this methodology in the context of digital marketing auctions, see BCG Digital Ventures' article The Rise and Fall of "Growth At All Costs" for Digital Startups and DTC Firms.

Conclusion

Payments are part of virtually everyone's daily life. This dynamic will only strengthen as the ranks of the unbanked shrink and overall financial inclusion expands. Technology will continue to discover innovative ways to execute payments more conveniently, more rapidly, and more securely. Each type of entity in the ecosystem—retail banks, merchants, acquirers, issuers, networks, wholesale transaction banks, fintechs, and others—will play a key role. Success for all, in addition to besting the competition, will call for collaboration. Different elements of the industry can work together for the greater good.

Above all, the payments industry has shown itself to be remarkably sturdy, despite headwinds from such sources as the uncertain macroeconomic environment and deteriorating company valuations. Players' ability to adapt to the new normal, diversify, create new business models around data, establish partnerships, strengthen risk management and compliance, and ultimately unlock new sources of revenue will be decisive in determining winners and losers. Yet if the past is truly prologue, the industry will remain strong—and resilient.

For Further Reading

Boston Consulting Group has published other reports and articles that may be of interest to senior financial executives. Recent examples include those listed here.

Global Retail Banking 2022: Sense and Sustainability
A report by Boston Consulting Group, September 2022

Taking Digital Banking Beyond Customer Journeys
An article by Boston Consulting Group, July 2022

Global Wealth 2022: Standing Still Is Not an Option
A report by Boston Consulting Group, June 2022

Global Asset Management 2022: From Tailwinds to Turbulence
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Global Payments 2021: All in for Growth
A report by Boston Consulting Group, October 2021

Unlocking the Potential of Carbon Markets to Achieve Global Net Zero
A report by The Global Financial Markets Association and Boston Consulting Group, October 2021

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Global Asset Management 2021: The $100 Trillion Machine
A report by Boston Consulting Group, July 2021

Global Wealth 2021: When Clients Take the Lead
A report by Boston Consulting Group, June 2021

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