Building a commercially viable European payments model

A transformation agenda for generating revenues and reducing complexity
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Payments globally are moving toward a cashless future. There is immense potential for scalable, pan-European innovation in digital payments, helping improve the lives of the region’s citizens on many levels.

Yet although Europe is a leader in payment standards and customer privacy, its ability to grasp this future is being held back by a fragmented payments landscape, structural impediments that limit revenue-generation potential for banks, a focus on data privacy, and insufficient industry innovation.

The opportunities for financial-services firms have been clear since at least 2018, but European banks and payment providers have not yet taken advantage of them. We have three key recommendations:

1. **Innovate on a European scale.** Make customers, not infrastructure, the focus: Invest more in convenience and user experience, as compared with the historical emphasis on costs, standards, and security.

2. **Empower users.** Give users more control over payment methods, while educating and enabling them to reap the benefits of sharing their own data.

3. **Rationalize Europe’s payment infrastructure.** Simplify and upgrade Europe’s payments backbone for instant payments.

In following these recommendations, European financial-services firms must act now, in a collaborative, cross-border way. It is risky to postpone taking action; it could make individual banks fall further behind, making them more vulnerable to upstart competitors. But if they can rapidly develop and execute a strategy for noncash payments, the European FS sector can capture the potential benefits of innovation and generate enough revenue to thrive.
The challenges for payments

Building a commercially viable European payments model will require banks and payment providers to increase their revenues from payments. That is increasingly urgent because the world’s biggest technology companies, including Google, hold payments licenses in Europe, posing a threat. Indeed, although Facebook’s recently announced plans for a digital currency called Libra have been questioned by regulators in Europe and the U.S., the cryptocurrency concept represents another potential example of tech players capturing the benefits of innovation in payments.

One problem facing payment providers is the persistence of the use of cash. Although this varies by country, overall it is limiting the revenue generated in payments. This issue was found, for example, in a 2018 survey conducted by Strategy&, PwC’s strategy consulting business, of 2,500 individuals in 10 European countries. When asked which payment instruments they used, more people answered “cash” than any other form of payment. To be sure, there were exceptions: In the U.K., Sweden, and the Netherlands, people were more likely to reference debit cards, and in France, credit cards were the most frequent answer (see Exhibit 1).

Note: Consumer average calculated as weighted average based on population numbers.
Source: Strategy& survey of 2,500 consumers across 10 European countries, 2018

EXHIBIT 1
Percentage of European consumers preferring cash, by country
A second problem is that the noncash payments landscape across the E.U. and European Free Trade Association (EFTA) is fragmented, with multiple payment methods, overlapping infrastructure, and varying patterns of consumer behavior. Encouragingly, there is regulatory support from the E.U. and banking authorities for innovations, including Europe-wide instant payments and open banking, mandated by the E.U.’s revised Payment Services Directive (PSD2). However, payments are less convenient and profitable for European banks and payment companies than for their counterparts in the U.S. and China, restricting the funds these companies have available to invest in revenue-generating opportunities in payments (see Exhibit 2). That is because card fees are capped in Europe at levels significantly lower than in the U.S. — meaning that there is limited scope for payments to be a profitable activity in Europe.

There is an important data angle, too. China is rapidly developing a payments model in which alternative payment methods — such as that used by Alipay — are making inroads into the payments system by deploying data in a bid to get close to the end customer. In Europe, by contrast, use of customer data is tightly governed by the General Data Protection Regulation (GDPR), which came into force in 2018.

**EXHIBIT 2**

The payments landscape in the U.S. and China

*These two payments models, very different from each other, are more profitable for banks and convenient for customers than the current system in the European Union.*

<table>
<thead>
<tr>
<th>The U.S. model</th>
<th>The China model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments are profitable by themselves (e.g., card income is 2–3 percent of payment value)</td>
<td>Credit transfer and direct debit account for less than 10 percent of noncash payments</td>
</tr>
<tr>
<td>Data is a new source of revenue with relevance for loyalty or loans</td>
<td>There is a large amount of data capture and heavy usage</td>
</tr>
<tr>
<td>Banks face increasing competition from nonbank players</td>
<td>Payment is embedded in large systems such as chat services</td>
</tr>
<tr>
<td>Three out of four noncash payments are on cards</td>
<td>Half of noncash payments occur via alternative payment methods</td>
</tr>
<tr>
<td>The U.S. came late to infrastructure innovation because its margin-driven focus is on consumer improvements</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bank for International Settlements, Nilson Report, Strategy& analysis
A survey by Strategy& of financial-services professionals conducted in 2018 — involving 58 professionals from banking and payments organizations mostly based in Germany, Italy, and France — sheds light on how far apart consumers and the industry are in how they perceive the future of payments. There was a considerable gap between professionals’ assumptions about consumer behavior and attitudes and the reality from the users’ perspective, as well as attitudes toward data and trust.

Specifically, there were two findings of which banks should take note:

• When asked who was likely to profit most from growth in payments revenues, 83 percent of respondents cited alternative payment methods such as PayPal or Klarna, the Swedish-German account-based payment method. Only 7 percent thought that banks and card issuers would profit most.

• As many as 93 percent of respondents said they believed consumers would be willing to share payment data in exchange for rewards, but only 20 percent of consumers agreed when asked the same question.
Europe: One region, multiple payment systems

The E.U. and EFTA payments landscape has three main features:

• Europe is a bank account–based payment territory; 43 percent of noncash transactions in 2017 were executed via credit transfer or direct debit, and another 43 percent via debit cards. Other means of payment, mainly credit cards, accounted for the remaining 14 percent.

• Cash continues to be popular in many countries, particularly Germany, Italy, Spain, Switzerland, and Austria. Cash was used for almost four out of every five point-of-sale payments in the euro area, for example, according to a 2017 report by the European Central Bank (ECB).

• The E.U. has developed its own set of e-privacy and data protection rules under GDPR. Europe’s payments model focuses on protecting the individual’s right to privacy, rather than on the benefits of data sharing and monetization. In the Netherlands, for instance, as described in a July 2019 Finextra newswire report, the data protection authority stopped banks from using customers’ transaction data to send them personalized offers.

A new European payments model must reflect this context rather than rely on hopes for any radical change in consumer behavior, such as the rapid shift to online and mobile-based payments in the Chinese market. A viable Europe-wide model also requires coordinated cross-border action to address the following issues.

A plethora of country-specific payment methods. Europe has 15 domestic card payment systems, as well as an even greater number of (mainly country-specific) online and mobile payment programs and identity systems. Some are operated by banks for their customers, and others connect different banks across a national market. However, there is so far no pan-European mobile payments service. To help facilitate this, the European Payments Council is establishing a secure Europe-wide registry of mobile phone numbers and the bank accounts (identified by International Bank Account Number, or IBAN) linked to those phone numbers. Banks and other payment providers will then be able to access the registry and exchange the data necessary to initiate and send a payment.

Low card fees for banks. In Europe, card commissions for issuing banks are a fraction of U.S. and international commissions. Since 2015, consumer debit cards have incurred a maximum commission of 0.2 percent (compared with 1.3 percent in the U.S.), and credit card fees are capped at 0.3 percent (compared with 1.6 percent in the U.S.). Low fees and transaction volumes limit the resources available for innovation and hamper the previous “easy” commission-based model. E.U. regulatory reforms affecting foreign exchange fees threaten to reduce payment revenues further.

Inertia among banks. The E.U.’s PSD2 regulation has opened up the market for payment services to nonbanks, and all the biggest technology companies, with the exception of Apple, have applied for licenses. We expect retailers to follow suit. From September 2019, nonbanks with the new payment licenses will be allowed to access customer accounts with their consent and originate payments. This will allow outside companies to supply services to consumers, such as viewing all their accounts, credit cards, and savings details across various banks on one app, with the ability to set up payments from any of them via that app.
So far, banks have been preoccupied with meeting minimum PSD2 requirements for providing access to customer data. The European Banking Authority and some national supervisors have provided a grace period beyond the original September 14, 2019, deadline. This will give banks more time to take advantage of PSD2 by offering their own digital services based on access to user data. It is not yet clear how many banks are taking advantage of this opportunity. In 2018, Strategy&’s survey of professionals in the payments industry showed that 21 percent of banks had no plans for data sharing or open banking, and an additional 19 percent had not yet launched their planned services. If this lack of action continues, it will leave the field open to alternative providers.

Outdated services. Credit and debit cards account for almost half of Europe’s online payments market. However, several of the domestic debit card plans still do not allow for online payments. And, just as it is in other regions of the world, the online user experience for cards is outdated, with customers having to enter their 16-digit card number, plus a three-digit security code, and sometimes another code, in order to complete a transaction. More convenient international solutions such as Alipay and PayPal come at a higher price to merchants, and Europe still abounds in legacy transaction options such as invoice payments or cash-on-delivery.

No single European identity standard. Banks, insurers, and certain other companies must verify their customers’ identities before any transaction, to comply with anti-money laundering and anti-terrorism laws. Europe is awash with different forms of national identity checks: For example, the U.K. accepts photo ID for customers, unlike Germany, which allows video ID. In the payments sector, these inconsistencies obstruct pan-European on-boarding of users, e.g., in new credit card applications. Greater harmonization of identity check processes carried out by public entities such as cities and governments has already been enabled by the E.U.’s September 2018 electronic identification, authentication, and trust services (eIDAS) regulation, which requires member states to recognize one another’s online ID criteria. But the private sector has yet to be harmonized.

Inflexible bill payments. Direct debits are more common in Europe than in the U.S. and China, representing 24 percent of noncash transactions in the region, according to the ECB, compared with 10 percent and 2 percent in the other two regions, respectively, according to the Bank for International Settlements. And in more cases than one might think, direct debits try to debit from accounts that have insufficient funds in them — and the customer is charged for missed payments. In the U.K., for example, more than a quarter of people have missed a regular payment, in more than half of those cases due to a lack of money in their account, according to a VocaLink survey.

Europe is a bank account–based payment territory; 43 percent of noncash transactions in 2017 were executed via credit transfer or direct debit, and another 43 percent via debit cards.”
Unfinished business: The persistence of cash

Most payments from consumers to businesses in Europe are still in cash, which is costly to distribute and process. Yet there are wide variations among consumers in different countries regarding preference for cash transactions. Only 20 percent preferred cash in Sweden in the 2018 survey, versus 61 percent in Germany. On average for all European countries, 47 percent of consumers surveyed preferred to pay with cash today, and 35 percent would prefer to pay with cash in the future. If this result continues, it will just be in line with the expectations of professionals — 52 percent of whom said that they anticipate that cash displacement will accelerate between 2018 and 2025.

The following reforms are needed:

• **Reduce the need to carry cash by having low — or no — ATM fees.** This is already widely the case in the U.K., Sweden, and Finland. The more cash that customers feel they need to carry (to avoid multiple trips to an ATM and multiple withdrawal fees), the less inclined they will be to use their cards. In the U.K., for example, Strategy& calculations based on ECB figures suggest that the average number of withdrawals per capita is higher than in Germany: 40 per year compared with 26. However, the total amount withdrawn over the year is lower in the U.K.: €3,372 (US$3,732) per capita compared with €4,675 (US$5174) per capita in Germany. One way to reduce ATM costs could be for banks to form shared utilities, or networks, to manage the routine functioning of ATMs, thereby reducing their costs and helping to release funds elsewhere.

• **Make digital payments more convenient for both merchants and customers** by leveraging technological innovations as described in this report. The use of digital tools for payment analysis and visualization also increases customers’ oversight of their spending.

• **Create “digital” euros and other currencies with the same status as cash.** These would be certified by central banks, and could be used to pay for the majority of daily purchases in which ID is not required. Currently, in noncash payments, merchants know the name of the person making the payment; by contrast, digital wallets containing digital currency would be anonymous. Sweden’s Riksbank is already considering whether the kronor might need to be made available in electronic form.

• **Create a level playing field by making noncash payments legal tender across Europe in addition to cash.** This would allow service providers and merchants to offer the most appropriate choice for their situation. For example, cash can be very efficient in large supermarkets, though costly to handle at an unattended parking meter or in a snack kiosk.
How to build a European payments model

Building a commercially viable European payments model will require banks and payment providers to tap into additional sources of revenue. We have three recommendations for how this can be achieved.

1. Innovate on a European scale

**Improved user experience.** Chinese payment providers create integrated, customer-friendly journeys based on everyday life. European players lag far behind and must shift their focus from costs and security to innovation that improves the user experience. Some banks and issuers in Europe are finally seizing this opportunity. In the U.K., for example, customers can manage their finances via their bank’s app on their smartphone. However, with the new E.U.-wide requirement for banks to provide transaction data if their customers allow it, banks and payment services face growing competition from fintech companies focused on providing the best user experience.

**Enhanced payment functionality.** For services such as insurance and telecommunications, which require customers to prove their identity before any transaction can take place, Europe’s merchants could increase their online sales conversion rates by combining identity checks with payment functionality to create a one-stop user experience. One step in this direction was taken last year when Norway’s regulator approved a merger of Vipps, a mobile payments solution; BankAxept, a national card payment system; and BankID, the electronic identification system, to create an integrated electronic payment and identification verification operator in the country. Other opportunities include “smart” contracts, under which payments are automatically triggered if certain conditions are met.

**Request-to-pay services.** Although many European companies have request-to-pay e-invoicing services for their supply chains, consumers still need a convenient payment service that allows them to check an invoice and authorize the timing of the transaction. This could be done via a single message to their smartphone, for instance, and such services have been available in the U.S. for a decade. The U.K.’s retail payments authority has taken a lead in Europe with the launch of a request-to-pay functionality in 2018; however, other countries must follow suit. It would be particularly beneficial in southern Europe, where direct debits have never been widely adopted.

**Embedded payments.** The Internet of Things (IoT) is creating opportunities to integrate payments into manufacturers’ ecosystems. Strategy’s surveys of consumers and financial-services professionals suggest that mobility and smart homes are the two most promising sectors for IoT payments, due to Europe’s strength in automotive equipment and household devices. We expect that over the next decade, average annual mobility-related payments in Europe could increase in number from around 30 per person to more than 200. In tomorrow’s “mobility-as-a-service” world, bus rides, electric car recharging, and more will be payable via a single digital platform (see Exhibit 3, next page).

Meanwhile, digitally integrated smart homes will enable consumers to take advantage of numerous payment options, such as replacing multiple online supermarket purchases with automatic “fill-my-fridge” transactions. Embedded payments like these are the clearest demonstration of the shift away from payments as a separate financial-services function toward payments as a core element of a platform or a service such as car sharing. In China, Alipay and WeChat Pay derive their strength from being deeply embedded in a variety of proprietary and third-party services.
Building a commercially viable European payments model will require banks and payment providers to tap into additional sources of revenue.”
2. Empower users

**Allow consumers to reap the benefits of sharing their own data.** The 2018 Strategy& survey of consumers found that only around 20 percent of respondents would share their data in return for benefits, and a further 23 percent were undecided. By contrast, 93 percent of respondents in the Strategy& survey of professionals thought consumers would share their data for rewards. Europe’s banks and payments providers need to realize they have an uphill task in convincing customers that data sharing is desirable and potentially beneficial. Businesses should develop attractive data-sharing opportunities with obvious customer benefits and strict privacy protection. Finally, banks should make greater use of data to sell financial products on a personalized, targeted basis to customers. Banks do have at least two advantages: They have large customer bases and, according to the Strategy& consumer survey, they are more trusted in data sharing than other payment service providers. Around 21 percent of customers would share data, including transactions, with a traditional bank or credit card issuer, compared with just 7 percent who would share it with tech companies such as Apple or Google.

**Increase consumers’ ability to meet their financial liabilities while improving payment security.** A new payments model should offer users real-time transparency about their financial situation across all platforms and payment methods. There should be greater ability for users to categorize and allocate separate items of expenditure, such as groceries and insurance; to anticipate upcoming expenditures; and to enjoy increased flexibility regarding settlement dates — services offered by many so-called challenger banks, especially in the United Kingdom. Payment security should be reinforced by advanced biometric technology and control tools that allow users to set card spending limits for particular categories of purchases or locations they visit.

3. Rationalize Europe’s payment infrastructure

Europe suffers from multiple, overlapping combined technical and service layers for account-based payments, namely credit transfers, direct debits, debit cards, and bill payments. Recent technological advances in mobile payments, distributed ledgers, open banking, and instant payments are increasing the complexity of Europe’s payment infrastructure. Compounding the problem, European countries tend to retain legacy infrastructure for years after new technologies are introduced.

Europe’s payment infrastructure should be radically simplified in order to reduce costs. Currently, card-based and bank account-based transactions are handled on three different technical platforms that have been built up since 2002: SEPA (Single Euro Payments Area) Credit Transfer, SEPA Direct Debit, and SEPA Card Clearing. A fourth platform, SEPA Instant Credit Transfer (SCT Inst), was introduced for instant payments under a voluntary industry initiative in 2017. We recommend that SCT Inst be used to replace the other three platforms, after additional features — such as deferred settlement and bulk payments — have been added (see Exhibit 4, next page).
### Potential impact of the SEPA Instant Credit Transfer platform

#### Status quo:
- **A fragmented landscape**

#### Future outlook:
- **A rationalized infrastructure**

##### Multiple service and technical layers

<table>
<thead>
<tr>
<th>Service</th>
<th>Description</th>
<th>Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEPA Credit Transfer</td>
<td>Standardized across Europe, low cost, bank account–based.</td>
<td>mobile, peer-to-peer (P2P), other payments.</td>
</tr>
<tr>
<td>SEPA Direct Debit</td>
<td>Standardized across Europe, but not used in all countries, bank account–based.</td>
<td>mobile, P2P, online, and other payments.</td>
</tr>
<tr>
<td>SEPA Card Clearing</td>
<td>European framework, but country-specific implementation.</td>
<td>card-based payments.</td>
</tr>
<tr>
<td>SEPA Instant Credit Transfer (SCT Inst)</td>
<td>European framework, voluntary adoption, restricted functionality.</td>
<td>P2P and settlement (instant).</td>
</tr>
</tbody>
</table>

##### Optional service layers

- **Mobile payments**
- **Card-based payments**
- **P2P**
- **Settlement (instant, D+1, deferred)**
- **Request to pay** (at an early stage of development in 2019)

**Technical layer**

- **SEPA Instant Credit Transfer (SCT Inst)**

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*Source: PwC’s Strategy&*
Conclusion

Our proposals for an innovative European payments model would benefit consumers, banks and payment companies, and merchants in the following ways:

- **Consumers** would enjoy more convenient noncash payment methods with enhanced functionality. New technologies would give them greater control over their personal finances. Users would have greater power to decide whether to share their data in return for rewards and benefits.

- **Banks and payment companies** would increase their volume of revenue-bearing transactions through accelerated displacement of cash, enhanced functionality, and, critically, the rationalization of Europe’s payments infrastructure. Increased profits would enable further innovations.

- **Merchants** would benefit from improved payment offerings, better risk management, and greater opportunities to personalize products and services based on data. A cross-border payments model would reduce complexity for larger merchants operating in more than one European country. Merchants would also have greater flexibility if noncash payments were recognized as legal tender throughout Europe.

However, following the curbs on interchange and cross-border transaction fees, plus limits on using customer data, it is all the more important for the payments industry — including banks — to be able to foster services that leverage open banking and GDPR, Europe having taken a lead in both dimensions.

It is already clear that Europe’s fragmented payments and settlement model is not fit for purpose. Europe-wide action is urgently required before the currently disjointed payments model becomes too unprofitable or intractable to reform.
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