When cash is no longer king: from mobile payments to central bank digital currencies

Scope Ratings

We expect a permanent shift in retail payments in Europe towards digital solutions. The European landscape today looks fragmented. Banks have yet to find a unified strategy or a way to position themselves in a market increasingly dominated by non-bank platforms. This is jeopardising a substantial part of their fee income. Central bank digital currencies will add more complexity and cost for banks and could lead to even more disintermediation.

The demise of physical cash and potentially cards in retail payments will be among the lasting developments of the Covid-19 crisis as consumers move towards the digital economy. Banks have long been benefiting from this trend by offering electronic settlement through current accounts with linked debit and credit cards. However, non-banks that offer more convenient payment solutions are competing with banks and card companies for market share.

This is above all the result of a favourable regulatory environment for payments innovation in Europe in recent years. Policy makers consider new technologies as a way of overcoming the fragmentation of European markets, particularly in the euro area.

Major initiatives such as TARGET 2 (the real-time gross settlement system owned and operated by the Eurosystem), SEPA (the Single Euro Payments Area that has established a set of tools and standards), PSD2 (the Payment Services Directive), and TIPS (the TARGET Instant Payment Settlement service) have all supported a move towards instant low-cost settlement across the euro area and with other currency areas.

Faced with a substantial opportunity, banks have had to carefully balance the cost and reward of their involvement in this high-volume but low-margin business. As a result, purely digital banks have acquired a share of the current account market and non-bank players have taken over merchant acquisition, card settlement and digital wallets.

With the move away from cash and commerce towards the internet, non-bank platforms have started to enjoy sizeable network effects that now risk undermining the competitive position of the incumbents.

Payments are an important source of fee income for banks

Payments constitute a significant share of bank revenues. McKinsey estimates that in 2019 39% of global revenues derived directly or indirectly from payments. In EMEA, payments revenue stood at USD 400bn in 2019.

According to a study by Accenture, interest revenues from credit cards are the most important source of income (44%) followed by transaction fees (35% incl. interchange) and maintenance fees (21%). These are important incremental revenues for a sector already squeezed on lending margins and seeking to offset negative deposit margins with rising fee income.

The largest banks in each European market generate between 20% and 40% of their fee income from payments services, which can add up to annual revenues of EUR 3bn-EUR 4bn in the case of Santander and BNP Paribas. The proportion can be even higher at smaller retail banks that do not have diversified sources of fee income.

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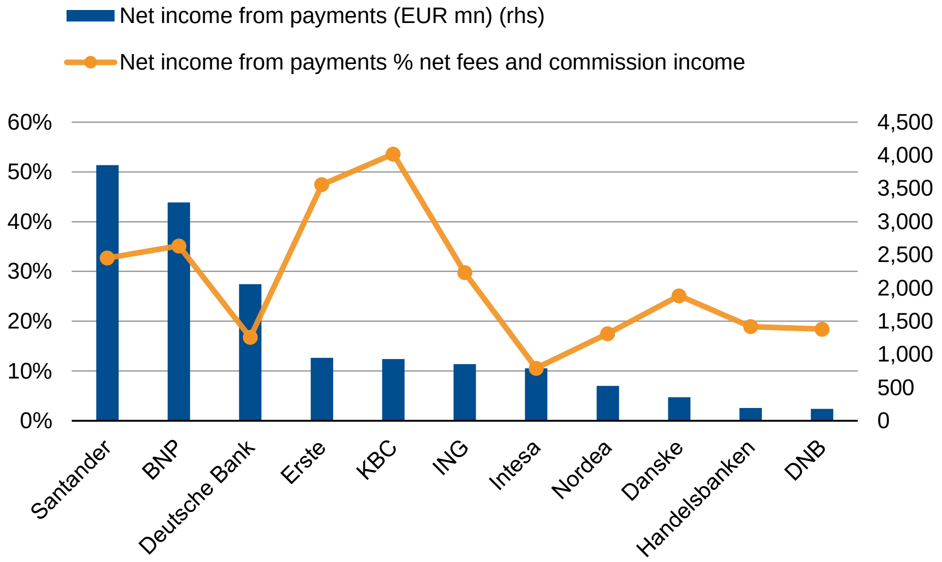
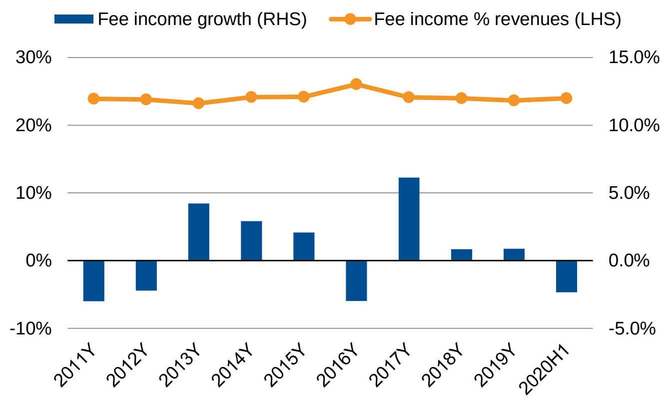
Figure 1: Payments income and as % of banks' revenues, 2019



Source: Company data Note: for DB figures are gross, KBC includes securities services

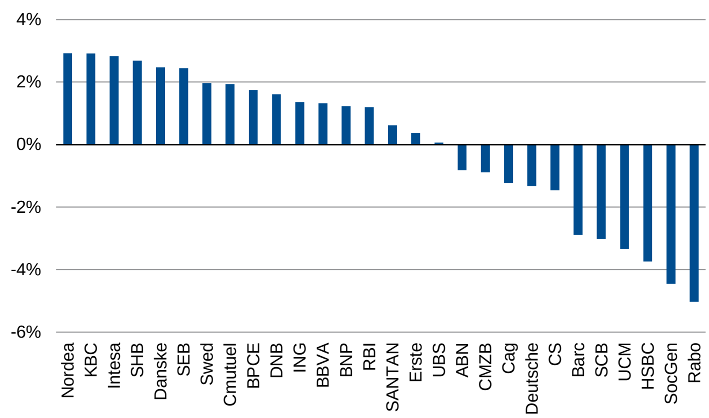
Despite the significant efforts to grow total fee income, the share of commission income in total revenues has been steady at around 25% over the past 10 years and the net rate of growth has been close to zero across the industry. A few large banks, notably in Scandinavia, Southern Europe and France have been able to generate modest fee growth since 2010; others have experienced falling fee income. This has been due to a variety of factors related to volatile capital markets and has not just affected payments, yet payments are one of the stable revenue sources that banks will seek to defend.

Figure 2: Net fee and commission income of major banks



Source: SNL, Scope calculations

Figure 3: 10y average annual fee income growth

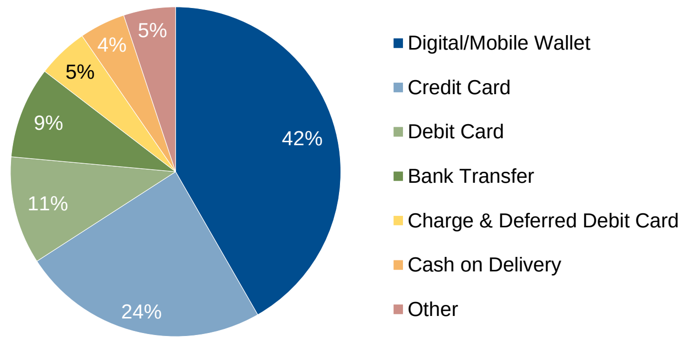


Source: SNL, Scope calculations

The sharp decline in spending this year, combined with falling consumer leverage and reduced volumes in travel, has clouded the near-term outlook for the consumer payment and card sector. Long-term, however, Covid-19 has accelerated a secular trend in the industry towards digital money for in-person and online transactions.

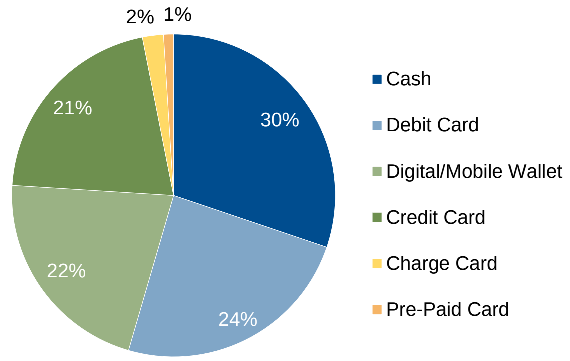
In China, for example, many consumers have already leapfrogged bank cards in recent years and moved to mobile wallets. In 2010, 61% of retail transactions were paid in cash and 35% via card. Last year, mobile payments (via QR codes) accounted for half of POS transactions. The combined market share of non-bank platforms AliPay and Tenpay (WeChat) in mobile payments was 94%.

Figure 4: Global eCom payment methods



Source: Worldpay Global Payments Report 2020

Figure 5: Global POS payment methods

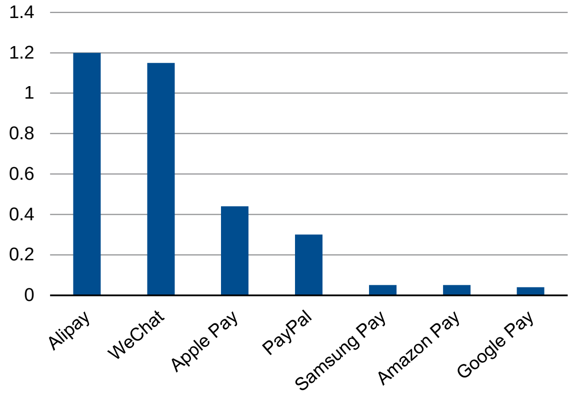


Source: Worldpay Global Payments Report 2020

The most recent ECB triannual survey of payment attitudes of consumers in the euro area (SPACE) and published in December 2020 shows that cash was the preferred method in POS and P2P transactions in 2019. Cards came second and contactless technology (including wallets) was used in 38% of transactions. However, a further ECB survey in July 2020 found that 40% of respondents were using less cash and 90% expected to continue to do so after the Covid crisis, citing the increased convenience of paying electronically. More than half of respondents said they had access to e-payment solutions and almost a third had installed mobile payment apps (e.g. Apple Pay) on their phones.

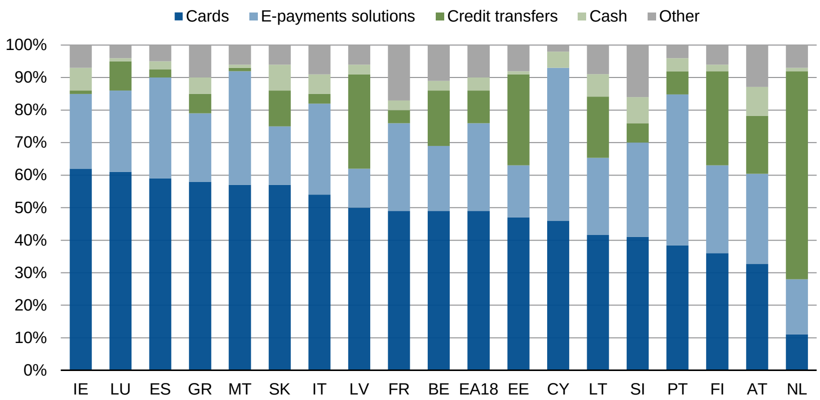
The ECB survey found that non-bank electronic payments platforms such as PayPal accounted for 27% of on-line transactions, second only to cards. Use of e-payment solutions is lower in countries that offer well established national solutions for credit transfers by the banking system, for example in Estonia, Lithuania, Finland, and the Netherlands.

Figure 6: Active users of most popular wallets/PSPs



Source: Company information from 2018/2019

Figure 7: Online purchases per payment instrument per country (number of transactions)



Source: Study on the payment attitudes of consumers in the euro area (SPACE), ECB, 2020

PSD2 a game changer that has yet to play out in Europe

The introduction of PSD2 in the EU was a significant milestone in the transformation of the European payments landscape. The legislation lowered entry barriers for non-banks but also for banks seeking to expand their footprints beyond their current client base.

Apart from addressing transparency and security, the Directive permits third-party access to bank accounts, including the ability to initiate payments. By entering the “API economy” large banks with strong digital platforms are seeking to expand their market share by integrating third parties, squeezing smaller competitors without a strong digital presence (which risk being consumed by larger platforms over time).

Interestingly, and notwithstanding the investment made in this area, there have not yet been any substantive shifts in market shares on the back of this developments. There has also been no radical transformation of the industry yet compared, for example, to the disruption of the travel industry caused by booking platforms. However, the option to expand digitally without a physical presence is one of the reasons banks might be reluctant to buy out smaller competitors in domestic or cross-border acquisitions.

Meanwhile, banks and non-banks could in theory remove cards and current accounts from the payments market entirely by offering stored-value solutions, and real-time peer-to-peer payments, potentially supported by their own digital currencies. In principle, these are attractive solutions for consumers and merchants if they lower the cost and increase the safety and convenience of payment services. New forms of credit, notably instalment loans at the POS, could also emerge as popular alternatives to credit cards because pricing is more transparent.

As so often in Europe, a complex web of national markets and payments systems puts banks at a disadvantage to established global players such as Visa, Mastercard, PayPal and Apple Pay, to name but a few. While these operators still need to link back to banks for crucial functions such as settlement and customer identification, the declining role of traditional forms of payments risks undermining the role of banks and central banks in payments unless they adapt.

Banks seek to co-operate to fend off competition

So far, European banks have been investing at the national level, providing solutions for online and, in some instances, POS mobile payments that leverage their existing infrastructure. Examples include iDEAL in the Netherlands, Payconiq in Benelux, Giropay in Germany, Blik in Poland, MobilePay in Denmark, and Swish in Sweden. As the ECB SPACE survey has shown, these systems allow banks to retain market share at the national level.

To overcome fragmentation within the euro area and to compete with providers such as Visa and Mastercard, 20 large European banks launched the European Payment Initiative in July 2020. This expensive project is based on the banks' existing SEPA system and it plans to offer a European branded debit card and digital wallet by 2022.

There is a risk that possible EU subsidies for an exclusive consortium raises concerns about unfair competition. Given the low margins in debit cards and wallets, the platform will also need to grow very quickly to justify the investment. The plan to capture 65% of a market with 500 million consumers by 2025 looks ambitious, but correctly reflects the pressure to break even on a project of this scale. Thus, for banks this is a risky strategy and only very large players may be able to justify the investment, while others will prefer to co-operate with existing offers.

Towards a digital central bank currency?

Central banks in Europe have long acknowledged the need for innovation in retail payments, not only through PSD2 but also through the introduction of a real time settlement system for small-value payments (TIPS) and, most recently, a digital version of the euro. The latter will enter the project phase next year, alongside digital currency projects in Sweden and the UK.

The exact purpose of this product will need to be clarified because households already have access to a diverse range of electronic payments products for large and small purchases. However, policy makers have voiced concerns about the future availability of riskless and universally available legal tender in a world where cash is no longer king because transactions have moved online.

Less subtly, they have also warned of the risks to central bank autonomy from relying on non-European payment ecosystems and from a potential invasion by foreign digital currencies. Consumers may be less concerned about the latter because convenience and safety appear to be the overriding motive for using digital payments.

Central bankers are concerned that oligopolistic pricing behaviour by privately-owned payment platforms may increase the cost for merchants and consumers if there is no alternative means of exchange in the form of digital central bank cash.

In its report on a digital euro, the ECB favours a model where intermediation between users of a digital euro and the ECB is provided by supervised private sector intermediaries. Similarly, the e-Krona project of Sweden's Riksbank relies on intermediaries for the settlement of payments and KYC due diligence. Creating a digital currency will give central banks influence over the payments industry not only by providing a means of exchange but also by the defining the rules for a level playing field between the various intermediaries, including non-bank platforms.

Even when ignoring the extra cost and complexity of a digital currency, it is hard to see how banks can benefit from a digital central bank currency. Large amounts of risk-free digital currency units that can be easily exchanged between households and merchants will reduce the need for electronic money created through banks' current accounts. If, in addition, non-banks are given direct access to central banks' much enlarged payment platforms, a digital currency would reduce the role of banks in the payments system altogether.

Banks will also have financial stability concerns related to digital bank runs and the need to raise more wholesale funding to refinance deposit outflows into risk-free digital currencies that are stored outside the banking system. In the current environment, negative rates will accelerate such a shift unless the ECB either limits the use of its digital currency and/or pays negative interest on it. Such bells and whistles hardly make the digital euro attractive to consumers, who already have other means to settle their transactions digitally.

Given these considerations as well as the significant investment that would be required to create the infrastructure, we remain sceptical about how fast a central bank digital currency (CBDC) can be established, especially if central banks are at the same time seeking to promote and limit its use. Such ambiguous messaging undermines private-sector investment in the required infrastructure and may limit acceptance by households and enterprises. It is far from clear what benefits a digital euro from the ECB will deliver to the industry, in addition to the critical infrastructure the Bank already provides for real time processing of large (TARGET, SEPA) and small (TIPS) payments.

The coming year will see further movement in this direction by the People's Bank of China, which could well define the way forward for CBDCs. The Chinese project relies on a hybrid architecture, in which the central bank provides the digital currency and infrastructure while commercial banks and other payment services serve as interfaces with the public. Aside from complementing online transactions, the introduction of a CBDC in China is directly aimed at weakening the market position of Alipay and WeChat Pay in the mobile payments market.

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