Digital payments revolution threatens banks' comfort zone

Sam Theodore | September 2023

The digital revolution in payments suggests that banks, particularly slow technology adapters, will face growing challenges to their central role in this area. The surging presence of non-bank Payment Institutions (PIs), including players in alternative payment methods (APMs), represents a rising problem for ill-prepared incumbent banks.

Payments have always been a bread-and-butter business for banks, and that will not change. But it is also an area where new entrants and new business models are increasingly challenging incumbent banks. The dynamics of the payments landscape are evolving fast and not necessarily to the banks' advantage. The stability and sustainability of a bank's payments business, a source of stable and predictable fee revenues and of monetisable customer data, should command more attention from both investors and analysts. So far it does not.

I am not suggesting that the European banking sector will have its payments business severely disrupted any time soon, despite the growing inroads of APMs like mobile wallets (such as Apple Pay), payment enablers (such as PayPal), or payment providers like Adyen or Stripe. Banks still command nearly 90% of the payments fee pool in Europe; predictions suggest an 80% level by the end of the decade, which is still comfortable. While the payments business remains attractive for non-bank entrants, the risk of large-scale banking sector disruption is remote.

What is less remote is the negative impact of the fast-growing digital payments landscape, including the anticipated rapid growth of instant payments (IP), on banks that are behind in developing their payments-related tech infrastructure. Examples would be second-tier banks with stable local or regional franchises that are happy to remain in their legacy and digital comfort zones, hoping that "big boys" of the banking sector will take the first blows and do the fighting.

But larger banks also face challenges, especially those that are under-investing in technology. That may happen because they see other priorities as more important or perhaps because their own surveys indicate strong legacy-bank customer stability (a dubious assumption for the longer term).

The main factors driving the new payments landscape in Europe are technology advances, rebalancing customer preferences, and not least a regulatory push. Unlike emerging markets like China, Brazil, and India and to some extent the US too, end-to-end market coverage by banks in Europe leaves only limited space for new entrants. That is particularly true for digital-only banks in traditional banking products like deposits, loans, and mortgages. But the ground is shakier in the payments area, a highly commoditised and technology-driven business, requiring banks' full attention if they want to stay ahead of the game.

PSD3/PSR

When implemented in a few years, the recently proposed Third Payment Services Directive (PSD3) and Payment Services Regulation (PSR) will further challenge the status quo for EU banks. I covered this topic in more detail in a recent The Wide Angle report. As far as payment transactions are concerned, the proposed package will give direct access to the EU's payment systems – importantly, including those steered by central banks – to all payment institutions (PIs) and not just to banks as with PSD2. In time, this will reduce the dependence of non-bank PIs on banks. Banks will also be obliged to provide a payment account to PIs, something many are reluctant to do.

Furthermore, the proposed PSD3/PSR will require al PIs to become supervised separate legal entities if they are part of non-financial groups. This could provide an opening to big tech firms like Apple, Amazon, and Alphabet. Indeed, forthcoming tough anti-trust EU regulations may persuade them to diversify into new revenue streams for which they would not be considered gatekeepers. Offering financial products and services could be included.

Instant payments to the front row: are all banks ready?

A recent report from payments company ACI Worldwide compared countries in terms of IP transactions per head per month (year-end 2022 data). The top 10 are Thailand (23), Bahrain (19.1), South Korea (14.75), Brazil (14.2),

Sweden (9.5), Denmark (8.8), India (7.4), Netherlands (6.2), UK (5.9), and Malaysia (5.3). Major EU economies rank much lower: Germany and Spain with 1.3, Italy 0.6, and France 0.3. The US is not doing much better, with 0.9.

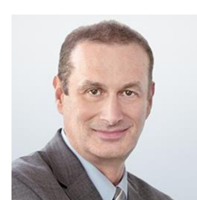
The high level of IP usage in the Netherlands and the Nordic region is explained by the fact that banks make IPs universally available and free to use. By contrast, other European countries charge high fees for IPs, sometimes as high as five times the amount for normal credit transfers. To address this problem, the European Commission proposed last October to make IPs commonplace across the EU by accelerating the mandatory adoption of the SEPA Instant Credit Transfer scheme.

This proposal, which is being discussed in the European Parliament, will likely kick in towards the end of 2024. It will prohibit banks and other IP providers from charging more than the very low cost of a normal payment transfer. This measure should considerably boost IP usage across Europe.

As for the US, this summer's introduction of the Fed's FedNow end-to-end IP system should in time lead to more significant growth of IPs initiated by households, businesses, and public authorities.

A legitimate concern is whether all banks, when faced with growing demand for IP transactions from customers, will have a robust enough payment infrastructure to meet this challenge. There is not much visibility around this aspect. Equally, being asked to satisfy fast-growing demand for IP transactions from customers without being able to charge for them will affect banks' future payment-related revenue streams, especially banks in countries where IP usage is low but likely to rise fast.

Analyst



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