Perspective on German payments

What is the long-term relevance for banks, cash, and cards?

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Germany has a reputation for being a high-tech country with a cash-dominated economy. Its cash usage is indeed high (67 percent of total number of consumer-to-business transactions in 2018), but the payment infrastructure is well-developed, with approximately 165 million cards, roughly 1.1 million terminals, and a well-established processing landscape (Exhibit 1).

For incumbents, payments are an important source of revenue and the most important customer touchpoint. The question now is whether developments such as Apple Pay or Alipay, ubiquitous card acceptance, and emerging specialists such as Adyen and Wirecard create a leapfrogging moment that relegates banks to the role of high-cost providers of cash, cards, and infrastructure, pushing them further away from the heart of the vibrant payments industry. Or more succinctly: will non-banks and fintechs be able to reap the benefits of the shift away from cash?

An overview of the German payments market.

**Payments in Germany**

<table>
<thead>
<tr>
<th>50 billion consumer-to-business transactions per year</th>
<th>Cash is still highly relevant Transactions by payments type, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>165 million cards</td>
<td>Cash: 12, Direct debit: 18, Cards: 5, Transfer: 5</td>
</tr>
</tbody>
</table>

But used mostly for small payment amounts

<table>
<thead>
<tr>
<th>Ø transactions volume in €</th>
<th>Cash</th>
<th>Debit card</th>
<th>Credit card</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>13</td>
<td>49</td>
<td>74</td>
</tr>
</tbody>
</table>

>15% of bank revenues are payments related

>90% of banks’ customer touch points are payments related

>70% of payments revenues in Germany are generated by banks

Source: McKinsey analysis
Non-cash payments are growing

Payments can be defined as covering issuing activities, i.e. transactions made through accounts, credit and debit cards, and (new) payment types such as PayPal, Apple Pay, and Amazon Pay. It also covers payment acquiring (terminals, merchant payment solutions), and ranges from the “traditional” point of sale (POS) to the growing e- and m-commerce channels, as well as the underlying processing and current account, cash supply, and logistics activities. More than 80 percent of payment revenues in Germany are fee-based (either directly or usage-based from merchants, current accounts, or instruments); the remaining 20 percent are generated from interest margins.

Importantly, most customer touchpoints with their bank are payment-related and linked to current accounts, generating approximately EUR 12 billion associated revenue in Germany. Leaving interest rate effects on the net interest income on current accounts aside, the revenue from payments has increased in recent years (Exhibit 2), driven by:

- A steady 1 to 2 percent annual decline in cash usage across all age groups leading to an increase in card and digital payments usage
- A steady 5 percent annual increase in card usage, albeit with moderate revenue growth (mostly due to regulations such as MIF regulation)
- An approximately 10 to 15 percent per-year increase in e- and m-commerce channel usage.

German domestic payments are dominated by current accounts, transactions, and debit cards.

Revenues in the German payments market, in € billion

<table>
<thead>
<tr>
<th>Year</th>
<th>Current accounts</th>
<th>Transactions</th>
<th>Credit cards</th>
<th>Debit cards</th>
<th>Alternative payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>13</td>
<td>1</td>
<td>5</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>2012</td>
<td>15</td>
<td>5</td>
<td>2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2017</td>
<td>22</td>
<td>6</td>
<td>6</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>2022E</td>
<td>25</td>
<td>13</td>
<td>6</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>

1: Excluding cross-border business.
2: €8 billion assuming constant interest rates, 2017-23; €7 billion assuming rising interest rates.
3: Includes cash, checks, transfers, direct debit’s documentary business, remittances.
5: Source: McKinsey Global Payments Map
In a European context, German payment revenues are lower than average; at about EUR 22 billion, they amount to 0.7 percent of German GDP (compared to the 1.0 percent European average and the 1.3 percent US average). German banks rely more on account-related liquidity than most other markets (Exhibit 3), making them more vulnerable to the current low-interest-rate environment.

**Germany falls into the current account-related-liquidity-driven country archetype.**

![Payments revenue drivers for different country archetypes in 2017, share in %, total in € billion](image)

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While German payment behavior is unlikely to suddenly rival China, where mobile payment methods such as Alipay are now used for 28 percent of consumer-to-consumer and consumer-to-business payments, some trends are evident:

1. The number of digital payment methods will continue to increase in the near term, enabled by increased adoption of mobile technology. However, other than in niche applications, this growth in payment methods will likely be temporary, with merchants and consumers pushing for convenience and less complexity.

2. Germany may follow the trend in other European markets and experience a continuing decline in cash usage to 30 to 50 percent in the next three to five years, as increasing numbers of people pay by smartphones or cards.

3. The customer interface remains the competitive focus of banks, card schemes, and payment specialists. Non-banks – that is, payment specialists...
and utilities – will continue to gain ground, particularly in non-customer-facing areas such as cash logistics and processing. Banks will continue to hold the balance sheet and big technology firms are likely to focus on the customer interface to support their core business.

We believe that customers, not technology, will be the key driver of change, as they increasingly expect seamless experiences across channels.

**A short-term proliferation in digital payments methods**

Online, Germans still mostly pay through traditional means – direct debit and bill pay account for 63 percent of all transactions, with PayPal and credit cards carving out most of the rest (20 percent and 11 percent). Meanwhile, mobile payments are still seen as distinct from online and brick-and-mortar payments; actual mobile payments are still very low (less than 1 percent of all transactions) compared to other countries such as Denmark, where mobile payments now make up 14 percent of total non-cash payments.

However, digitization, the advent of PSD2, and strong e-commerce growth have paved the way for the development of many new payment methods (Exhibit 4). The emergence of Apple Pay, Google Pay, and mobile payment solutions from banks, such as Kwitt, are likely to fuel mobile growth. It remains to be seen, however, how deeply digital payments will penetrate, given German consumers’ skepticism toward new providers. Experiences from other markets such as Switzerland, where the increased usage of TWINT has not led to a fall in card usage, imply that cards are here to stay (mostly at the expense of cash) and are likely to continue growth, either in physical, contactless, or digital form.

Overall, we expect both mobile and online payment volumes in Germany to continue to grow in the high single-digits. However, the number of payment methods may decline, given that merchants and customers prefer simplicity, and that payment solutions are highly scale sensitive. This may even lead to a leapfrogging moment when market volatility leads to more fluid customer preferences where alternative payment methods may gain a significant market share.

Moreover, in some very specific, niche use cases (e.g., e-gambling), distinct digital payment methods are likely to endure.

To succeed in this race, many payment providers have already started to enhance their offers with omnichannel service and more seamless shopping experiences; for example, allowing consumers to use the same PIN and password credentials online and on mobile. PayPal has significantly updated its mobile payments app; Visa and Mastercard are facilitating connectivity to multiple channels including third-party digital wallets; and Alipay is working with acquirers to offer an omnichannel experience (so far focused on Chinese tourists). While banks have not yet been able to translate their relevance in POS transactions (girocard as a national debit system has around 58 percent of non-cash transaction volumes) to the online and mobile
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arena, they have led several initiatives to upgrade girocard (e.g., allowing contactless payments) and their digital assets such as paydirekt.

The estimated number of payments methods in Germany has grown significantly, but in the mid-term future, we expect this number to decline.

![Graph showing the estimated number of payments methods in Germany from 1990 to 2025-30.]

**The future of cash in Germany**

Although the number of cards per capita in Germany is comparable with that of other European countries, domestic card usage is comparatively low, with 75 transactions per capita per year, compared to 84 in Spain, 173 in France, 279 in the UK, and 401 in Norway.

Cash usage in Germany today is like Sweden in 2003, Italy and Poland in 2015, and Europe overall in 2006 (Exhibit 5). Cash remains a major value proposition for most banks: ATMs are a key customer touchpoint and major reason for charging current account fees.

The trend in cash usage in these markets has been steady decline. In some countries (e.g., Poland, Netherlands, and Sweden) this decline accelerated in recent years. Germany will likely follow the same trend with an acceleration of non-cash usage within the next three to five years.
As cash becomes less relevant, so too do the existing cash/ATM value propositions, particularly at a time when supermarkets are offering free cash withdrawals. According to McKinsey analysis, banks in Germany currently spend about EUR 2 billion on cash – on a combination of setup and maintenance of ATM networks, cash logistics, and other related costs. It is likely, therefore, that banks will cut cash-related costs aggressively, while actively managing potential public reactions. While market forces may prefer 0 percent cash usage, this seems unlikely, as there are some groups (e.g., tourists or senior citizens) that may not have easy access to non-cash payment methods, and access to ATMs is often seen as a public good.

Germany’s banks will therefore need to address the costs of running the roughly 50,000 ATMs in the country. The number has been relatively stable as falling usage is counteracted by branch substitution (ATMs replacing bank branches). Banks could follow the example of payment markets in countries like Sweden and the Netherlands and pool their existing networks. This approach could likely start with banks’ non-customer-facing, back-office areas, and potentially result in a model like the Dutch Geldmaat, in which all banks pooled their cash/ATM activities in 2015 and rebranded all ATMs under a common brand in 2019.
A value chain of specialists: Are banks falling behind?

Germany has mirrored European trends towards a non-bank-driven consolidation in payments as banks’ value chain share has steadily decreased over the past decade (Exhibit 6), particularly in digital payments and non-customer-facing areas:

- **Issuing** revenue shares are dominated by bank-related entities and non-banks. In **debit cards**, girocard – the national debit card run by the banks – is the market leader (around 95 percent of the adult population have one). However, girocard has very limited online and mobile capabilities, which constrains the related bank-internal revenue growth. Germany has low **credit card** penetration (around 36 percent of the adult population). The position of international schemes (Mastercard, Visa) have focused on their debit solutions (e.g., Debit Mastercard) and started to add online/mobile capabilities that were originally developed for credit cards. **Digital and mobile payments** are growing rapidly from a low base, with only small market shares for bank-based solutions.

- **Acquiring** is mainly performed by non-banks (more than 80 percent of revenues). It has not been a focus for banks of late, both in Germany and across Europe. The bank-owned Concardis was divested in 2017, and...
currently only the Sparkassen continue to own a significant (albeit minority) share in Ingenico’s German operations after Ingenico’s acquisition of BS Payone.

- **Payment processing** in Germany is still relatively fragmented, mainly between bank-related entities and non-banks. While Commerzbank and the cooperative banks have partially outsourced processing to larger European non-bank players, the market-leading Sparkassen still run their own system (i.e., near-bank), as do some of the private banks, such as Deutsche Bank.

- **Current accounts, cash supply, and logistics** have remained firmly in the hands of banks, with the help of their contractors, i.e., related revenues are mainly earned by banks and bank-related entities. Unlike other European countries – such as the Netherlands, the UK, Sweden, and Finland – cash supply and logistics utilities across sectors have so far not emerged at scale.

Overall, the trend towards specialists and utilities in non-customer areas is set to continue; scale effects in processing and cash, as well as regulation (such as PSD2) and security remain important. In customer-facing areas (e.g., cards and digital payments) the picture is complex. Specialists such as PayPal are focusing heavily on digital payments but have not achieved broad market leadership. Banks clearly aim to strengthen and defend their customer touchpoints. They have an asset in girocard, a significant stake in credit cards, and at least a foothold in digital payments with paydirekt, giropay, and other methods. Customers seem to trust banks with sensitive payment data, but so far banks have not significantly benefited from this advantage. Card schemes are both their allies and competitors; their networks act in direct competition to girocard and may siphon significant value away from banks. They may, however, still be beneficial to banks, providing them with customer and data access.

**What should market participants do?**

As cash loses relevance, cards and digital payments expand, regulation fuels competition, and consolidation looms, firms need a clear strategy for strengthening their value proposition. While German banks are struggling to generate returns on equity (ROEs) of more than 5 to 10 percent and losing their share in the payments value chain, the valuation and total return to shareholders (TRS) of payment specialists has been high. As example, Wirecard’s P/E ratio is about 44, with a 21 percent ROE in 2018 and the overall payments TRS since 2010 is more than 20 percent per year. Given that payment-related activities are a primary customer touchpoint and a key to cross-selling, payments should be a central theme for almost everyone.

**Individually, banks** should decide on their payment strategy and whether it is a differentiator, i.e., play for a competitive advantage or just keep pace with market developments. Independent of the strategy, for most banks a significant share of their banking revenues will still be payment-related, banks should make sure to have clear management responsibility. Similarly, all banks should focus on gaining
operational excellence, particularly pricing power (e.g., considering fees for cash usage by businesses), the ability to accelerate sales, new product and service propositions, and further digitization are needed.

A more ambitious differentiation will require strengthening their current position through integrated offers, ecosystem plays, and partnerships with fintechs and – selectively – big technology firms. Regulation such as PSD2 and the proliferation of APIs may support such moves but will also put pressure on laggards as 3rd parties can easier gain access. As advances in technology and the accelerated growth of digital commerce rapidly reduce the viability of legacy systems, banks should consider divestment or outsourcing of assets where scale or differentiation cannot be achieved. An example is payment processing, where leading European players (such as Worldline) generated an estimated EUR 2.2 billion in revenue compared to EUR 5.7 billion in revenue in Germany for transactions overall. Nonetheless, selective insourcing of assets appears possible, when they may play into a differentiation strategy. Moreover, for certain players, such as small private banking players, a complete exit from offering payment services may be advantageous.

Banks as a group need to acknowledge the threats inherent in industry trends, but also grasp the opportunities, i.e., where they may want to cooperate to enable superior propositions vis-à-vis payment specialists and new market entrants?

They should give industry utilities serious consideration, given successful examples such as TWINT for digital payments in Switzerland aiming at the customer interface and Geldmaat for ATMs in the Netherlands aiming at cost efficiency.

Towards customers, banks need to accelerate the development of payment solutions and create highly convenient, omnichannel offers. With giropay, banks have an asset, but compared to their peers in other European countries, German banks’ response to non-cash-related payments has been fragmented. Offers focus on separate solutions, such as giropay, paydirekt and giropay (e-commerce), and Kwitt (P2P). Banks could also link their current accounts more directly with the digital world (e.g., by making online banking credentials/apps usable for e-commerce payments).

Banks may want to consider acting on statements by European politicians on the development of a European consumer-to-business/business-to-consumer scheme (potentially involving giropay, Europe’s largest domestic scheme) and even reaching into mobile-to-mobile-/internet-of-things-related payment issues in machinery, automotive, insurance, etc.

Towards cost, banks need to collectively improve their structure, i.e., by ensuring that cash stays affordable – through cross-industry consolidation and optimization of cash infrastructure, and by redistributing the true costs of cash between all users (banks, consumers, and merchants). This means banks will almost certainly need to develop new value propositions without cash. Indeed, withdrawals may even become free for customers of all banks, as they are in many other EU markets, to compete against payment specialists.
Specialists should be cognizant of what leads to success: mainly convenience and scale. Further consolidation might be a smart strategy. Acquisitions (often of payment assets divested by banks) can deliver cost synergies or extend a provider's services to less-penetrated markets. Specialists should continuously evaluate technology architecture and options for integrating systems as part of any deal. This consideration should also comprise the evaluation of the strategic focus, whether to partner up or compete with other specialists in the market. Specialists may also extend their payment offers to leverage into cash management, corporate accounts, and even into other areas such as leasing and factoring, for example, for large merchants. Some specialists (e.g., Adyen) have already obtained a banking license and are offering services such as cash management and FX. Similarly, credit card schemes may want to focus on enriching their omnichannel offers to solidify and expand their business in both the offline (particularly in debit) and digital channels.

So far, big technology firms have not treated German payment as core target and have generally been agnostic towards payment methods used on their platforms. Most digital wallets, for example, have been open to what payment methods they work with. Some big tech firms look at payment methods in terms of control of the customer interface; others see payments as a value driver from a sales funnel management perspective—that is, they favor the methods that will increase the number of consumers who click, buy, and pay while minimizing risk and complexity. Of course, they may still try to introduce their own payment methods, which could lead to a marginalization of banks. An example of this might be an overarching customer interface for payments where all scheme/interchange as well as transaction fees are captured. However, if truly distinctive, omnichannel offers emerge from banks or specialists, it is likely that tech players will integrate them into their platforms.

Merchants should take a more holistic view of the cashless trend and focus on the effects of payment complexity on buying behavior, data generation, and costs. The growth of digital payments opens possibilities for creating transparency on revenues and actively using payment data to manage sales funnels. These advantages are also more and more accessible for smaller retailers.

In conclusion, all players, and banks in particular, need to decide whether to be a differentiator—that is, play for a competitive advantage—or just keep pace with market developments. Playing for competitive advantage requires a flexible approach that can deliver superior customer value propositions that keep pace with changing customer needs, as well as a sharp focus on creating scale at selected points along the value chain. On the other hand, a fast-follower strategy will rely on third-party providers and may be more cost-efficient. In each case, customers can continue to expect more convenient payment offers and more tailored solutions.

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