FRANKLIN TEMPLETON INVESTMENTS

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How the Credit Card Networks Can Fend Off Fintech

PERSPECTIVE FROM FRANKLIN EQUITY GROUP

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The smartphone has hastened the digitisation of the global economy. Looking up information or buying nearly anything is now just a swipe or tap away. How consumers pay online, and offline, is changing as well. A wide array of financial technology, or fintech, companies have emerged to not only help consumers make online payments using mobile wallets, social payment systems and cryptocurrencies, but also transform the back-end payments system. While these technologies aim to change how payments are made and processed, we believe the incumbent card networks are likely to remain an integral part of the payments ecosystem.

The Payments Ecosystem Explained

When a consumer either hits the checkout button on an e-commerce site or makes a purchase at a point-of-sale terminal at the store they set off a fairly complicated behind-the-scenes process that can involve a number of different payment companies.

Merchant acquirers are the first step in the process, enabling a merchant, either online or offline, to accept electronic payments, credit cards or debit cards. The merchant processor, which can be the same company as the merchant acquirer or a different provider, provides processing and payment settlement services for the merchant before routing the transaction to the card network. Up next, the card network moves the transaction to the financial institution issuing the credit or debit card to the consumer. The card issuer then makes the payment to the merchant. These networks are the backbone of the payments system, connecting transactions between the merchant's bank and the consumer's bank issuing their credit or debit card.

Although a number of individual companies can handle each of these various steps, we are increasingly seeing consolidation and innovation across the payments system, as fintech companies looking to provide an end-to-end solution have proliferated in recent years. At the point-of-sale terminal, integrated software and hardware is both helping merchants run their businesses and is being joined with merchant acquirer payment services. We have seen investment opportunities in the space, including companies that have new and innovative approaches, but the majority of these are still linked to card-based transactions. Although we may see more payment functions come under a single roof, in our view, the card network itself is likely to remain unchallenged for now.

Card Networks Remain Well Entrenched

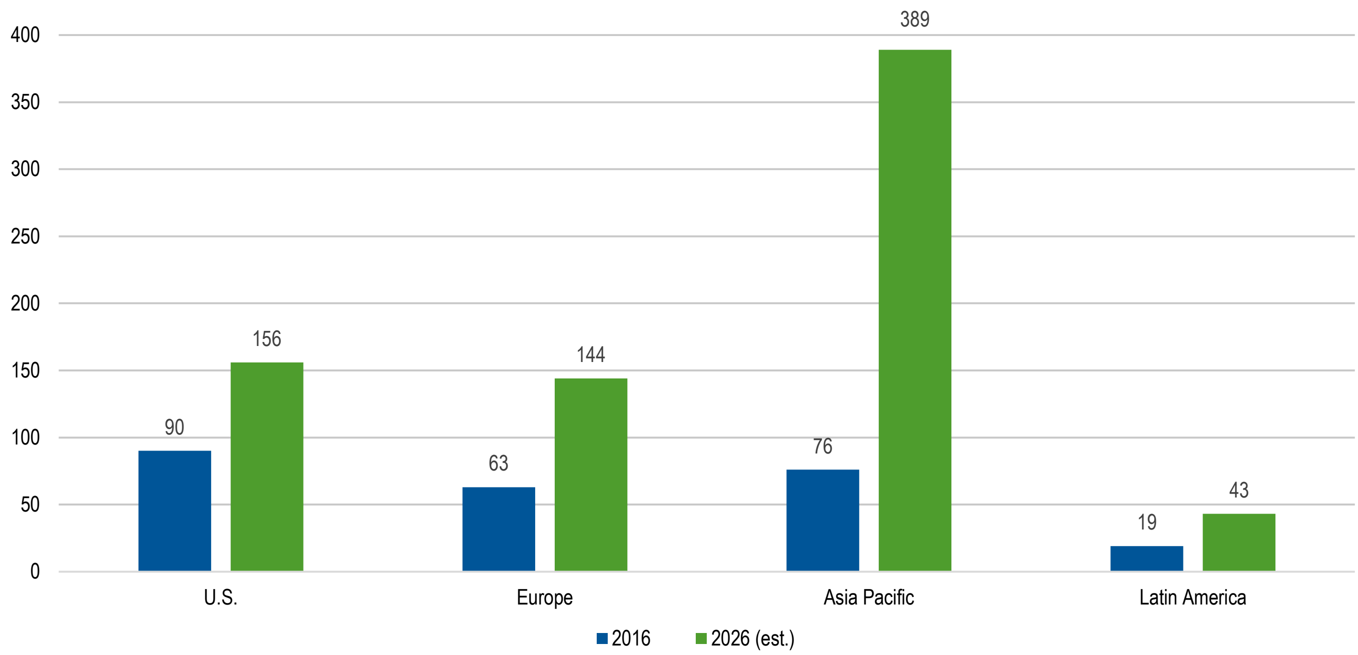
One reason we see card networks such as Visa and MasterCard in the United States and Europe remaining well positioned is that bank penetration is nearly universal in some of the largest developed economies. As a result, consumers have been long conditioned to pull out their credit or debit card when making a purchase either online or at the store. It's estimated that in 2026, global brand credit, debit, and prepaid cards are projected to reach US$767 billion in purchase transactions for goods and services worldwide (Exhibit 1).

To date, consumers have been slow to adopt mobile wallets since they do not offer any discernable advantage over using a physical card at checkout. Since credit and debit cards can be used in both online and offline transactions and a change in well-entrenched behavior could be required to get consumers to switch to a completely new technology, we believe it is currently difficult to bridge the card networks' competitive moat. The investment and scale needed to replicate the relationships the card networks have built up with financial institutions, consumers and merchants looks to us to be extremely high.

Long-term, however, the relationship card networks have with existing financial institutions could see the potential for greater threat, particularly if fintech companies are able to win bank licenses from regulators. A banking license could allow fintech firms to accept deposits and, as a result, they could begin to offer a greater number of payment services and potentially bypass the card networks. Linking mobile wallets directly to a checking account, for instance, could cut the card networks out of the process.

This type of alternative payment system, which provides an end-to-end service, is increasingly seen in emerging markets,

Exhibit 1: Card Purchase Transactions Worldwide (USD Billion)
2016 vs. 2026 (est.)



Source: 2018 The Nilson Report Global brand cards are Visa, Mastercard, UnionPay, American Express, Discover/Diners Club, and JCB.

where domestic financial institutions underserve consumers. As such, internet companies like Tencent or Alibaba offer a payment solution linked to a deposit account held at the internet company. We are seeing systems like this emerge in China, Africa and Latin America, where one of our internet holdings offers an online and offline payments system. While we recognise the disruptive potential in such an end-to-end payment system and the ongoing push from technology firms to develop one, the banks still have a significant advantage in Western markets where consumers have easy access to services, are comfortable using credit or debit cards and banks use loyalty reward programs to keep them happy.

A New Growth Opportunity

We have been invested in the US card network space for some time, not only because of its well-defended position in consumer payments, but also because of the potential growth opportunities in helping businesses facilitate payments to each other. On the consumer end of the business, card penetration has risen alongside both an increase in merchant acceptance of the underlying network and growth in e-commerce. We believe as more consumers make online purchases it will continue to have a positive impact on volumes at the card networks.

The bigger future opportunity may lie in business-to-business (B2B) transactions performed over the existing card networks. According to estimates from Goldman Sachs Investment Research, B2B payables are about a US$550 billion market. Currently, credit and debit card transactions represent a small portion of the B2B payments market, with most payments made through a traditional check. As instant payments between businesses become more prevalent, we believe that the card networks and software companies look likely to gain market share.

This growth, combined with the strong competitive advantage these companies have in operating their networks, suggests to us that as fintech changes and expands parts of the payment ecosystem, the networks that the current system operates over are unlikely to see much erosion.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size and lesser liquidity.

For all exhibits, there is no assurance that any estimate or projection will be realized.

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