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FUTURE DIRECTIONS IN PAYMENTS: ISSUER CHALLENGES AND OPPORTUNITIES

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EXECUTIVE SUMMARY

The ongoing and rapid transformation of payments raises tough challenges for Retail Banks. Ten years ago the U.S. payments ecosystem was mature, with participants, consumer expectations, and rules well-established and understood. Today, every component of the payments world is undergoing dramatic transformation, with bank and non-bank card issuers facing new competitive threats. Tech-savvy consumers are setting new expectations for ease, convenience and value. At the same time, a diverse set of innovative competitors that extends beyond the borders of the financial services industry are rewriting standards and inventing new business models which will challenge banks' traditional debit and credit card economics.

Payments and related account fees provide ~50% of Retail Banking (pre-tax) profits[1], yet most financial institutions do not have a clear picture of what the potential future threats to transaction counts and economics are, and as a result, are also lacking robust plans to fend off these threats. What must banks now do to win in the digital payments space while adoption rates are still low?

In this paper, we present a view of the most tangible potential future threats to issuer economics and/or transaction counts, with suggestions for how to respond to this environment. The good news is that banks today retain important advantages that should allow them to prosper, despite potential challenges from new technologies and nimble non-bank competitors.

To be a winner, we believe banks must:

- Continually work to secure and retain top-of-wallet status
- Aggressively protect customer relationships and experience
- Implement robust information strategies, recognizing data is the strategic lifeblood of customer and merchant relationships

THREATS WITHIN AND WITHOUT

The payments businesses of U.S. banks are entering a period of unprecedented transformation, especially driven by new technologies, partnerships, and substitute forms of payment. Potential future challenges are:

1. Wallet position competition
2. Alternative rails
3. Financing substitution

1. Source: Oliver Wyman analysis

1. WALLET POSITION COMPETITION

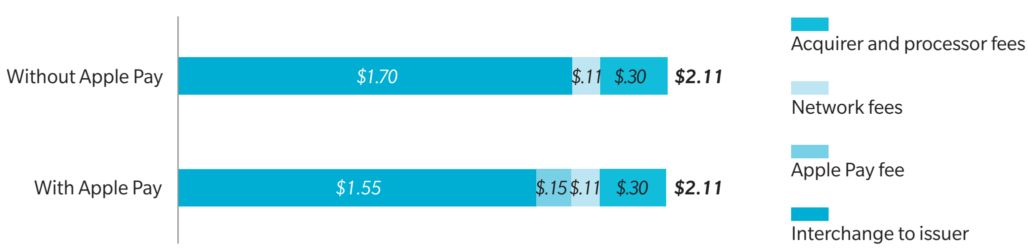
Competition for position in the customer's physical wallet dates back decades. Issuers and networks use marketing, loyalty programs and partnerships to influence consumer payment decisions, with the goal to be the first choice at the checkout. With the rise of digital payments, aggressive positioning for the #1 spot with consumers is being fueled by mobile wallets, social networks and internet giants, and increasingly hidden payments. The digitization of this battle has added new players, often building their brand and their business at the expense of issuers. New participants extract rents and impose their rules for access to consumers. The threat to issuers is reduced brand awareness and consumer influence, leading to increased expenses to counter waning influence, including "buying" wallet position.

MOBILE WALLETS

One example of this phenomenon is Apple Pay, where Apple reportedly takes 15bps of each credit card transaction and half a cent for each debit card transaction in the U.S. (see Exhibit 1). The business case has been positioned as one of greater security (reduced fraud) and new transaction volumes through converting cash transactions to card (more interchange and fees), with issuers ceding transaction economics to gain volumes and retain customer relationships. Competing wallets from Samsung and Google do not currently charge issuers a fee, though the more successful they are the more capable they will be to go the Apple route, if they choose.

Exhibit 1: Merchant Discount and Apple Pay economics

EXAMPLE: MERCHANT DISCOUNT ON A STANDARD $100 CREDIT CARD TRANSACTION[1]



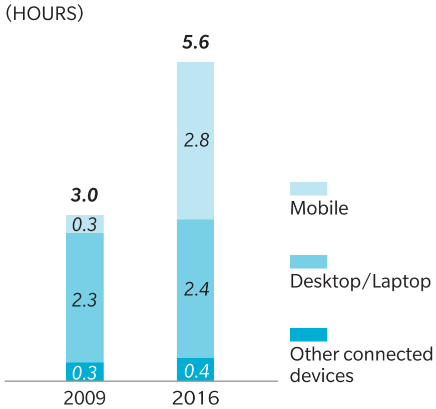
Source: Federal Reserve, Credit Suisse
1 Merchant Discount figures refer to cost-plus pricing model

SOCIAL NETWORKS AND INTERNET GIANTS

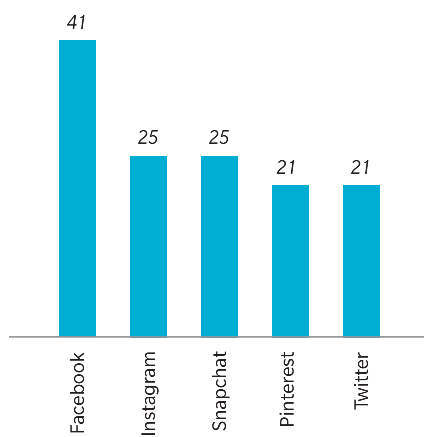
Google, Snapchat, Twitter, Facebook (and the list goes on), have entered the payments arena with services that are attractive to consumers because of their convenience. Snapchat and Facebook introduced P2P with Snapcash and Facebook Messenger payments. Twitter, Facebook and Pinterest have explored "buy" buttons that enable consumers to make purchases from their social feeds. These companies all have something that banks typically do not – daily, prolonged engagement with nearly every consumer segment (see Exhibit 2). This consumer attention, particularly with younger consumers, allows social networks to have significant influence over buying and paying decisions, which is a risk to both merchants and banks. With control of the buying experience, social networks especially have the optionality to choose their path in payments: the traditional method-agnostic merchant route, a route such as Apple Pay where issuers pay for access, or the DIY route, where they become a competitor to banks in the same vein as PayPal. Starting with a traditional suite of payments and associated economic flows for issuers certainly does not preclude a shift to other options as control and influence is established.

Exhibit 2: Importance of digital media and social media

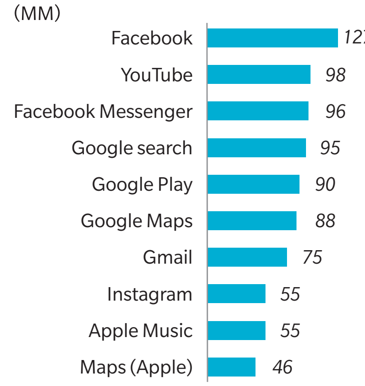
AVERAGE TIME SPENT PER ADULT USER PER DAY ON DIGITAL MEDIA[1]
(HOURS)



AVERAGE DAILY TIME SPENT PER U.S. CONSUMER ON SOCIAL MEDIA[2]
(MINUTES)



TOP MOBILE APPS BY NUMBER OF ACTIVE MONTHLY U.S. USERS[3]
(MM)



1 Source: MIT Technology Review, Siemens, eMarketer
2 Source: KPCB Internet Trends 2016
3 Source: Nielsen, comScore

HIDDEN PAYMENTS

As consumers increasingly vote with their thumbs for seamless digital experiences, payments are increasingly invisible in shopping and checkout. The consumer is making an overt *buying* decision during the shopping journey, but often is not making an explicit *payment* decision at “checkout”; the transaction is charged to a default card that may have been set up years ago. Traditionally, the online payment process contains many points of friction including registrations, confirmations, and numerous clicks. Consumers create an account with the merchant, select a payment method, enter payment information, provide authentication data, enter billing and shipping addresses and in some cases confirm the transaction with additional security measures such as multifactor authentication. This transaction friction leads to lower conversion rates at checkout as customers become frustrated and abandon their shopping cart. Many businesses- Uber and Amazon among them – are providing streamlined checkout, relying on default payment accounts and eliminating much of the payment friction (see Exhibit 3). The Internet of Things will serve as an accelerant to hidden payments, as consumer purchasing and digital payment points that use default payment accounts experience significant growth.

Exhibit 3: Examples of payments hidden in the buying decision

For each merchant utilizing hidden payments, one issuer with top-of-wallet card status is the “winner” of a consumer’s transactions. But if an issuer’s card or account is not selected as the default payment choice for a merchant, the issuer will miss the opportunity to be part of every transaction for that consumer at that merchant. Furthermore, to regain a lost customer will be difficult and expensive. Issuers will likely be pushed to pay rents, explicitly through fees or implicitly through promotions with strategic merchants, further reducing per transaction economics.

2. ALTERNATIVE RAILS

Today, ~70%[2] of non-cash payments are processed through established card network infrastructures, resulting in ~$140 BN in yearly revenues to issuers in the U.S.[3] Alternative forms of payment such as ACH-based payments, and cryptocurrencies, along with continued pressure on U.S. interchange fees pose potential threats to banks' revenues in the medium to long-term, where we estimate as much as 10-15% of issuers' revenues from card transactions could be eliminated.

ACH PAYMENTS

ACH rails to route payments directly between bank accounts is a form of payment that is widely used by consumers to pay recurring expenses such as a monthly utility bills, phone bills or mortgages. With the help of retailers and billers that are eager to reduce processing costs and increase negotiation leverage, ACH has expanded beyond traditional bill payment use cases into physical and online merchants. Though in its infancy in the U.S., other markets show the speed and scale with which ACH and direct bank payments may proliferate (see Exhibit 4). Transactions which are routed over ACH instead of a card network represent a reduction in issuer revenue.

Exhibit 4: Examples of Pay-by-bank solutions in other markets

MARKET	EXAMPLES	DETAILS
China	ALIPAY™	Uses bank credentials to route transactions and now has ~57% of the ecommerce market in China
Sweden	swish®	P2P app used by half of the Swedes and is now accepted at many small businesses. Participation from the leading banks in the country
	Klarna	Payment option that requires minimal details to authorize a transaction, such as name and zip code. Over 40% of all online transactions in Sweden and 10% of all online transactions in Europe go through Klarna, and pay-by-bank is one of the ways consumers can settle up with Klarna within the mandated 14 days
UK	Zapp™	Pay-by-bank option with a number of large retailers supporting the rollout, including Sainsbury's and Thomas Cook. Participation from the leading banks in the country

Source: Company website, Reuters, Jefferies, Wired

2. Percentage of spend; the remaining 30% includes electronic payments (e.g., ACH/direct debit) and paper instruments (e.g., checks).
3. Revenues from interchange and interest (i.e. credit card revolving balances).

CRYPTOCURRENCY

Cryptocurrencies are an emerging form of payment which leverage a shared ledger blockchain technology rather than the card networks' processing infrastructures and frameworks. Alternative currencies are being piloted by many banks, regulatory agencies, technology companies, and fintechs around the globe.Retailers such as DISH Network, Dell and Overstock.com accept bitcoin as a method of payment. Emerging fintechs such as Circle and Coinbase helped bitcoin gain adoption, partially by emphasizing the wallet functionality over the bitcoin association. Though largely stalled at the moment, additional iterations of cryptocurrencies are likely to emerge. It remains to be seen what traction they will gain in payments, but if and where successful, issuers would be cut out of the traditional card-based payment economics for those transactions.

3. FINANCING SUBSTITUTION

The explosion of credit outside the traditional banking system has given rise to purchase finance, a non-card credit alternative. Purchase finance is a potential substitute for some credit card use cases, and aims to attract new customers by focusing on card-substitution at time of checkout.

PURCHASE FINANCE

Point-of-sale financing has long been offered at checkout for large consumer purchases such as autos, home improvements, and major appliances. New entrants are now pushing point-of-sale financing into new venues and lower transaction amounts. Merchants offer instant credit to customers who may not otherwise have means to pay, and merchants also see opportunities to increase order size and conversion rates online as well. Some consumers may be attracted by lower rates or flexible terms, while others may not qualify for other sources of credit such as a credit card. Affirm is a company that has partnered with online retailers to offer rapid approval for purchase loans online, and is partnering with merchant acquirers to offer the option at point-of-sale terminals in-store.

For transactions that utilize alternative purchase finance means, card issuers lose the transaction interchange versus paying with a credit card, and they also forgo financing revenues on the purchase.

WINNING HEARTS AND MINDS – AND WALLETS

In order to proactively respond to these potential future threats to both issuer economics as well as consumer relationships, we see three main areas for banks to take action: top of wallet status, ownership of customer relationships and experience, and data ownership.

1. CONTINUALLY WORK TO ACHIEVE AND RETAIN TOP-OF-WALLET STATUS

With the payment decision increasingly decoupled from the buying decision, it is all the more important for card issuers to achieve top-of-wallet status with key customer segments. Tactics banks can use to win and retain top-of-wallet status include:

Employ segmentation-led service strategies informed by rich data analytics.
Example: tailor mass affluent services according to deep understanding of those consumers' financial lives.

Differentiate rewards value propositions across merchants.
Example: Amex cardholders earn double points on Uber rides.

Evolve individual service features for relevance in a digital payments world.
Example: Discover Freeze lets users disable their credit card from their smartphone app.

Enable self-service leveraging digital capabilities.
Examples: geo-location based fraud management on mobile permits consumers more control and provides greater security.

Form partnerships with merchants or other key players in the ecosystem to promote brand and usage.
Example: Citi Private Pass provides members access to live music and sports events; Amex cardholders can pay with points on Amazon.

2. PROGRESSIVELY PROTECT CUSTOMER RELATIONSHIPS AND THE CUSTOMER EXPERIENCE

Protecting relationships with customers and owning the customer experience is critical for strengthening a bank's brand and maintaining strong margins, particularly as newer players in the payment ecosystem gain power. Several factors are important in owning and protecting relationships:

Drive the bank's brand attributes through every aspect of the customer's experience, for every activity with the bank, throughout every channel.

Form partnerships with relevant merchants, social media players, device manufacturers, value-added service providers and other key stakeholders in the commerce and payments ecosystems to promote the bank's brand.

Create hybrid or innovative forms of payment that proactively demonstrate the desire to meet the needs of particular consumer or merchant segments, and reinforces the bank's brand.

Upgrade customer service channels (self-service and assisted) for a seamless experience that integrates physical with digital channels for customer service, fraud control and stronger relationships.

3. GATHER, PROTECT AND USE INFORMATION WISELY

Data is a bank's lifeblood derived from the unique tri-party relationship established between the consumer, the merchant, and the bank. No one has the view that banks do into data about their customers, data that reveals information on many aspects of a customer's life, from their financial health, to spending patterns, to major life events, to share of wallet. Banks have significant opportunities to take greater advantage of these critical information assets.

New business models with non-traditional organizations in the payments and commerce value chain may require new approaches to information access and usage. However, banks have greater opportunities to capture, store and analyze more and better data than ever before particularly about a customer's digital financial footprint. Using this data could offer unique possibilities to expand consumer relationships, and where information is not directly available, banks can partner with other firms to gather "social" or "lifestyle" data. The opportunities for banks from a more digitally connected payments and commerce ecosystem are numerous:

- **Streamline new account acquisition,** whether with consumer, small business, or commercial businesses, for a faster, more efficient application process.
- **Enhance underwriting intelligence,** using alternative and additional data sources, to enable new payments products to be profitably offered to each customer segment, with higher approval rates.
- **Create personalized services and experiences** to enhance convenience of, and value from, interactions between consumers and the bank.
- **Publish relevant offers, coupons, and messaging** to the consumer in conjunction with their shopping.
- **Provide service linkages that are relevant for the customer's life** such as linking home improvement offers to a new mortgage application.

THE FUTURE IS NOW: ARE YOU READY?

Over the past 20 years, digitization has fully disrupted and reimagined entire industries: iTunes disrupted the record industry, Uber the taxi industry, and Netflix the DVD industry. The payments ecosystem is not immune from similar, major disruption. As consumers shift to more digital interactions, the payment ecosystem is expanding to include more components of the shopping journey than ever before.

Despite the fintech hype, banks are not to be dismissed in this evolution. Banks possess significant assets such as broad customer bases, brand awareness, trust, data, risk management processes and robust security standards. Banks have a right to win in the digital commerce space, but doing so will require creative innovation, a new approach to customer interactions, and, likely, evolved business models. The key for banks is to leverage these significant and unique strengths in building digital payment solutions that will drive growth, market share, and profitability. To be a winner, we believe banks must address key questions:

1. What steps are we taking to secure and retain top-of-wallet status with consumers?
2. What have we done to maximize brand strength and own the customer relationship?
3. Do we have a robust data strategy that utilizes information for the good of our customers?
4. How can we leverage our unique assets to create differentiated payments solutions for our customers?

Banks and payment providers must think differently about digital payments and the evolving commerce ecosystem, or risk contraction of economics brought about by the the emergence of new threats in payments.

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