Payments Disruptors: Are You Prepared for the Next Wave?

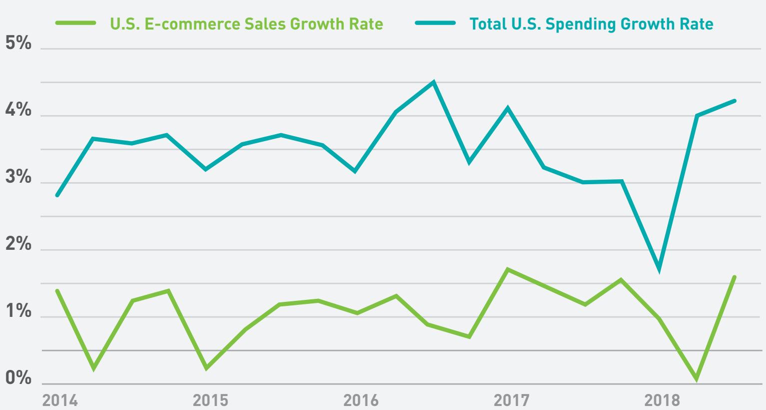
Professionals have been debating for some time whether Amazon will open a bank, and what impact it will have on the financial services industry if the e-commerce giant does so. It's a fascinating question – it also largely misses the point.

Amazon – which often stands in as convenient shorthand for e-commerce or fintech in general – is capable of altering the payments landscape without opening a bank. Indeed, it has already spearheaded a variety of shifts in the way consumers shop. Though we typically think about its impact on brick and mortar retail, the e-tail giant's influence on the payment process itself is game-changing.

There's a good chance your financial institution's payments business has already been impacted by shifts in consumer behavior that you might attribute to Amazon. However, just as often these changes are byproducts of shoppers' increasingly digital mindset. The pace of change in this regard is clearly on the increase and the financial services industry is scrambling to respond. For evidence, look no further than the recent acquisitions by Fiserv, FIS, and Global Payments as they scramble to position themselves in the new payments landscape. Banks and credit unions must do the same, or face progressive deterioration in revenue streams and their relevance to consumers. At the same time, the situation is not hopeless nor does it require actions as draconian as doomsayers have declared.

In this report, we will look at the e-commerce payments model and how it affects customer expectations. We'll then explore how mobile is changing our financial lives; consider the implications of P2P services; and finally, peer through the looking glass at a potential 2025 payments landscape and how financial institutions should prepare for this not-too-distant future.

E-commerce Growth Continues to Outpace Overall Spending Growth



Source: Federal Reserve Bank of St. Louis

THE VIRTUAL GENERAL STORE

Amazon has clearly excelled in the art of commerce, becoming for many consumers the modern day one-stop-shop equivalent of Sears or JC Penney, a "virtual general store." Much like a brick-and-mortar retailer, it's in Amazon's interest to offer every payment option its customers may want to use, so long as it does not complicate the checkout experience. In that regard, they have delivered a state-of-the-art payment interface, with an intuitive workflow including stored credentials, Amazon-branded payment options, and even the ability to redeem reward points from issuers like Chase and Discover at checkout. As if that is not enough, the phenomenon of expedited free shipping for Amazon Prime members has itself moved the meter on consumer behavior.

Amazon has certainly fueled the rapid adoption of e-commerce by consumers. Federal Reserve data shows that the average number of payments made per household is growing at an even faster rate than spending. This implies that consumers are disaggregating their spending into a greater number of discrete events. Given the convenience and immediate gratification of online shopping, this is perhaps not surprising. Rather than physically shopping multiple stores only to find that one or more of these retailers do not have one of the items on their list, consumers can now click and buy on a whim, regardless of the buyer's – or seller's – location.

One might assume that this increase in transactions would have been equally divided across industry players. However, this is not the case due to the other innovations in online shopping introduced by Amazon and mentioned earlier in this report. The phenomenon of free two-day shipping for Amazon Prime members shifted more market share for Amazon. The impact of these innovations by Amazon were so pronounced that many other e-commerce players had to adopt similar offerings. For most consumers, there is no incentive to wait and bundle orders; it's easier to order items when the need or desire arises; as is evidenced by the abundance of curbside boxes on recycling day.

Another area in which Amazon excels – and it must be said most financial institutions do not – is in owning the customer even though other organizations are making the transaction possible. For example, many of the purchases the average consumer thinks come to them from Amazon are actually fulfilled by smaller merchants via Amazon's marketplace.

Through it all, Amazon serves as the face to the consumer of these transactions, and then settles payments behind the scenes with the third-party merchants. The fact that no bank name is present in this process flow is a topic of concern to many financial institutions, driving them to seek ways to "brand" those transactions with their own logos.

Amazon still relies on card rails and credentials, and so does display network logos – and in some cases the issuer logo as well – on their website. This may not continue to be the case for much longer – a scenario we will address later in this paper.

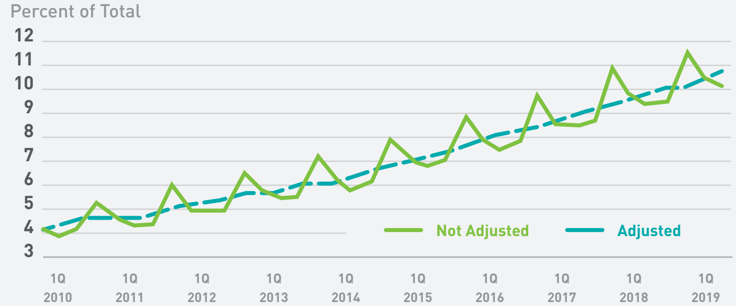
Two final points that are important in framing this discussion of Amazon's impact.

- Despite a steady stream of reports declaring the "death of brick-and-mortar retail," the fact remains that it still accounts for nearly 90 percent of US consumer sales. This stat is not intended to offer comfort; it also means far more leeway exists for online commerce to continue to upend payments economics.
- Facebook's recent announcement of the Libra digital currency – in partnership with key players such as MasterCard, Visa, Spotify, Uber, and Lyft – hints at another potential dynamic that could impact the industry. Amazon's name was notably absent from Libra's initial partner list, but the cost of payments acceptance remains a hot button topic for merchants of all stripes. Setting aside the potential settlement role for a new type of digital currency such as Libra, such an instrument could put substantial pressure on interchange fees.

It's hard to overstate the impact of smartphones in resetting consumers' expectations of financial service providers. Thanks to the "anytime, anywhere" expectation established in large part by mobile devices, remote interactions are increasingly replacing face-to-face conversations.

On any given day, a typical consumer can pay for parking, order the latest title for book club, pay her daycare provider, open and fund a bank account for one of her children, and pre-order a latte–all completed on her phone in the time it takes to walk from her car into a nearby Starbucks.

Estimated Quarterly U.S. Retail E-commerce Sales as a Percent of Total Quarterly Retail Sales:
1st Quarter 2010 – 2nd Quarter 2019



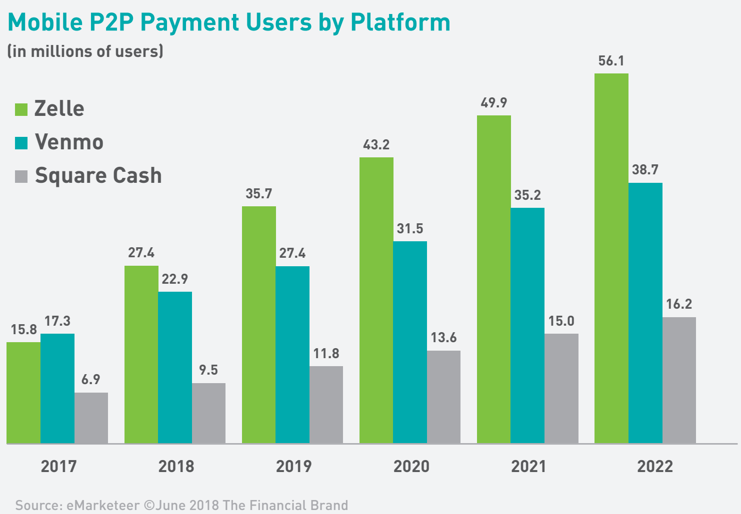
Source: U.S. Census Bureau

These conveniences create expectations that will continue to extend to a wider array of activities. Financial institutions who wish to remain relevant, and therefore competitive, must continually remake themselves to deliver increasing levels of convenience. One key for these institutions will be to differentiate high-value from low-value client interactions to get the revenue growth and loyalty for which they strive.

WHAT IS P2P ANYWAY?

Another area of payments ripe for disruption is P2P (person-to-person or peer-to-peer) payments. P2P is among the last of payment categories still dominated by paper (cash or check), drawing the attention of innovators.

Until recently, a key challenge for individuals and small businesses has been the inability to easily accept electronic and card payments. This has begun to change, again thanks in part to the trusty smartphone, which Square has leveraged to make it far easier (and cheaper) for small businesses and sole proprietors to accept cards. While Square began as a solution for artisans to



make sales at pop-up markets, from that foundation it has made a fairly simple jump to serving as a means to pay the babysitter, gardener, or a friend for half of the dinner tab.

On the consumer front, the brand name drawing the most attention in this space is Venmo, the unit of PayPal that has built a loyal base among younger demographics through its simple interface and savvy integration of social media features. A newer entrant, Zelle, offers a bank-friendly spin on a similar model. Zelle is owned by Early Warning Services, a company which is itself owned by seven of the country's largest banks.

Thanks to its big bank affiliations, Zelle has built significant early traction, particularly in certain use cases. It's often used as an easy approach to account-to-account transfers, including between parents and college-aged children or for paying one's portion of the rent. As a result, Zelle's average ticket sizes are significantly higher than Venmo's.

The oddity with P2P is that, unlike with other payments instruments, there is no clear way to monetize the offering directly. Aside from the nominal fee Venmo charges for quicker access to incoming funds, the current P2P models lack a clear revenue stream. For the most part, consumers are not conditioned to pay to make payments and there is usually no merchant on the other side of the transaction to foot the bill. Ironically, Venmo potentially delivers more direct revenue to banks and credit unions than Zelle, since a portion of its transactions generate debit or credit interchange.

For some this may beg the question, "In that case why should banks and credit unions focus on defending these volumes?" Here, financial institutions must think like retailers, considering P2P as a loss leader. Failing to offer or choosing to discontinue P2P services could introduce a risk of becoming disintermediated from the payments process in the consumer's perception. In addition, a competitor (e.g., a digital bank) could use P2P to expand into adjacent revenue-generating products. Zelle is already exploring this angle in two ways: by testing bill pay functionality for which billers would pay a fee, and by enabling acceptance at points of sale.

There has been a fair bit of debate over whether Zelle or Venmo will prevail in this battle. This is unlikely to be a winner-take-all proposition; however, it could play out like MasterCard and Visa in the card space, with a small group of options coexisting with various use cases and/or affiliations.

Unlike retail payments, in which the payer tends to dictate the means of remittance, in P2P the payee typically determines the payment method. It's entirely possible that consumers will maintain multiple apps on their phones – or have them integrated into digital wallets – to have available for use as needed, much as they carry multiple credit cards in their physical wallets today.

AN EMBARRASSMENT OF RICHES

The US market has proven itself to be quite good at launching new payment methods, but quite incapable of retiring old ones. As a result, Americans have an embarrassment of riches when it comes to payment options. As recently as the 1970s, buyers were basically limited to cash or check. Depending on how one counts, the list of payment options now numbers a dozen or more. Even travelers' checks remain a payment alternative.

In concept, this abundance of choice should be a positive. In a practical sense, however, it leaves merchants with the expense and administrative burden of multiple channels to manage, while creating confusion and complications for consumers juggling numerous accounts.

At the end of the day, consumers aren't concerned with distinctions like bill pay and P2P or with the merchant's challenge of maintaining multiple options for completing transactions. Consumers simply want to make a purchase to complete a transaction with the payment option of their choice. In addition, this complexity offers additional opportunities for fintech innovators, whether to help merchants and/or consumers navigate the existing landscape (such as Control Tower, Wells Fargo's tool to help consumers manage recurring payments), or to create a new, simpler one.

THROUGH THE LOOKING GLASS–THE 2025 LANDSCAPE

There is an alarming number of financial institutions that do not have an enterprise payments strategy. The number one goal for banks and credit unions should be to ensure their strategy reaches at least five years so that by 2025 they remain relevant to consumers. For institutions willing to evolve with marketplace needs, this should be a very achievable goal. The definition of relevance will evolve; however, it will no longer equate to "keep all activities within my own four walls," if indeed it ever did. Financial institutions must learn to meet customers where they are, which increasingly is anywhere and everywhere.

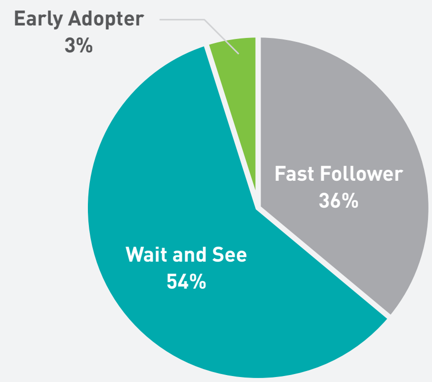
The key to relevance is to remain the transaction account – the base of operations from which clients coordinate their financial lives. As a greater share of commerce continues to migrate online, a key tactic toward this end is ensuring your debit/credit card is registered, ideally as the default, in as many digital wallets as possible. "Top of wallet" has been a primary objective of card marketers for years. It still is, only the form of that wallet has changed and the number of ways to pay that are housed in that wallet continues to grow.

Marketers may also need to reconsider long-held notions around branding. The 3-5 largest US banks possess the advertising budgets and ubiquitous branch footprint to maintain top-of-mind awareness with consumers. For the remaining 10,000 or so institutions, customers may not be as brand conscious as many bankers would like to think.

Given this potential shift in mindset, picture how important it is for a bank's brand to be seen while executing a transaction. With a few exceptions (such as Chase and Capital One who enjoy the benefits of huge media budgets), most consumers notice the network logo on their card rather than the issuer's brand, a problem in an environment in which issuers invest vast sums in ad spending. Issuer branding recedes even further in a digital environment, but if interchange revenue continues to flow is that such a big deal? Bear in mind that in the days of check writing, the payer bank's brand was not particularly visible either.

That's not to say smaller banks and credit unions should simply concede brand visibility. They can and should establish themselves as the trusted partner for payments convenience. For instance, financial institutions could explore providing available balance data within Amazon's checkout page as a means of informing the payment decisions–creating the side benefit of encouraging balance retention within the consumer's core account. Consumers commonly cite cash back at the point of sale among their most desired features; bank should work to incorporate the ability to redeem accumulated reward points at checkout, in both the physical and virtual worlds.

Most Institutions Adopt a Holding Pattern for Payments Technology



8 out of 10 Institutions are Slow to Implement Payments Strategy

Source: American Banker Payment Strategy Survey 2017

The storyline of an insurgent entering the banking world and reinventing the space is nothing new. Walmart, Apple and PayPal have all taken their turns in headlines with rumors of pending bank charters and market disruption schemes. Interestingly, to date all have elected to partner with banks and other fintechs, continuing to leverage existing payments rails. The most recent round of press reports claim that both Google and PayPal seriously considered applying for the OCC's new special purpose fintech charter, but ultimately opted to walk away.

The underlying question remains: why would a company founded on commerce expertise choose to set up a new business line to operate a bank, when they can access the necessary services and data through other, less onerous means? The financial services infrastructure is so complex and tightly regulated that no one wants to tackle the endeavor of rebuilding it from the ground up. Instead, the main opportunity lies in putting a new, simpler face on the existing one. Arguably, this can be accomplished without a banking charter.

This leaves banks and credit unions with a valuable area of demonstrated expertise – serving as a regulatory and compliance platform for an array of financial services, some offered directly, others through partners. The bigger challenge may be retaining profit margins at levels expected by investors. The highest margin activities tend to be the ones directly interfacing with the parties to the transaction (payer/payee). Players such as Amazon are already well-positioned at the center of e-commerce. This does not imply the battle has been lost – it has merely gotten more complex.

Examples like Tencent and Alipay in China are frequently offered as a nightmare scenario representing imminent disruption. These can serve as valuable case studies, though not for the reasons often cited. These fintech solutions demonstrate the potential growth curve for a streamlined solution addressing key market pain points. They also show the value of embedding technology solutions to leverage existing behavior. On the other hand, China's existing infrastructure, consumer market, and regulatory environment are all so fundamentally different that the same Tencent/Alipay approach would be unlikely to gain traction in the US. Tencent, Alipay and China Union Pay may yet become formidable competitors in the US market. For now, however, they remain focused on supporting foreign nationals traveling abroad.

CONCLUSION

Predictions of the imminent demise of banks and credit unions are quite premature. Financial institutions, at least the larger ones, will be here for many years to come and likely for as long as there is commerce. The consolidation of smaller institutions will continue, just as it has done for the past 30 years. This factor has been fueled more by regulatory change than by nonbank competition, and has resulted in greater concentration among existing players rather than share loss to nonbanks.

No industry should expect to thrive with a static business model. It's only natural that banks and credit unions need to evolve to remain relevant in a changing marketplace. The financial services landscape is far more complex now than it was 20 years ago. Banks and credit unions remain in the best position on many levels – expertise, longstanding relationships, trust–to play a lead role in demystifying the payments process for their customers. Doing so will require revisiting some long-held assumptions.

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