Banks' Retail Payment Operations at a Tipping Point

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Banks cannot ignore the challenge from merchants on card interchange – nor can they underestimate nonbank payment providers. The response requires an end to the product development mentality and a stronger alignment between issuing and acquiring operations.

Key Findings

- Cardholders are increasingly using comparative Web sites to choose payment instruments, and they are looking to consolidate their purchases on one card.
- Relationship rewards make those comparative engines less meaningful – and are a step in the right direction – but will not be sufficient to differentiate among banking peers.
- Merchants are challenging the interchange pricing model, but they are essential partners for banks that want to succeed with payment initiatives and differentiate and offer more-meaningful rewards to cardholders.
- This calls for a new generation of merchant services, based primarily on added value – not price.

Recommendations

Bank payment strategists, product managers and line-of-business (LOB) heads:

- Reward your customers in financial terms for their use of your payment services and the extent of their banking relationships.
- Introduce payment information value-added services (PIVASs) to reduce pricing pressure from merchants and initiate a virtuous circle for retail payment operations.
- Transform your acquiring services into payment advisory services for merchants.

Bank payment "technologists":

- Actively push payment services innovations.
- Promote and use business intelligence (BI) and analytical and dynamic pricing tools to ensure cost transfer and revenue recognition across LOBs.

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Third-party card processors:

- Offer banks solutions that support relationship rewards.

- Offer PIVASs.

ANALYSIS

1.0 Overview

Retail payments are entering a new phase. Merchants are challenging the card interchange model, while regulators are putting pressure on the card industry to provide more transparency with its pricing model.

Consumers are not easily convinced to adopt different payment instruments, and the card will remain the main payment instrument for years. However, new consumption patterns are increasingly captured by instruments supplied by nonbank payment providers. The issue for banks is not just about losing some processing revenue. More importantly, it is about a loss of connection with potential and established customers.

As a result, banks and the card industry are looking into technology-centric growth drivers, such as contactless or mobile phone-based payment systems, to replace cash and deal with emerging consumption patterns.

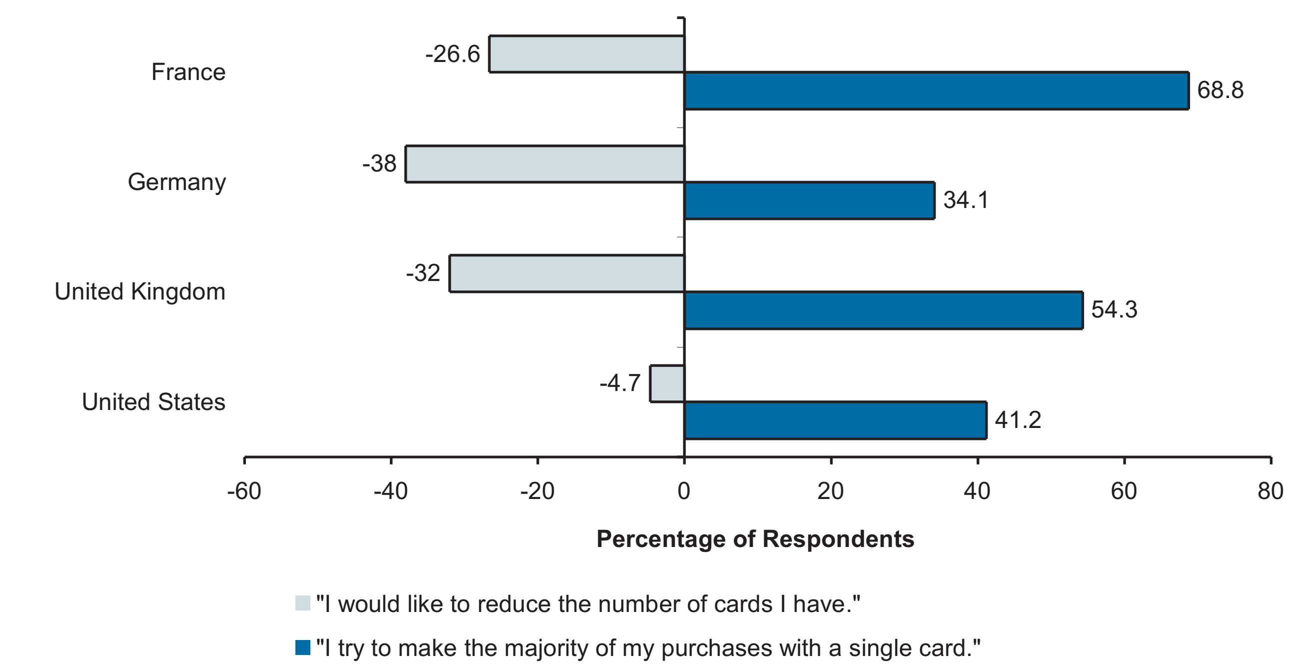
But banks and the card industry are not alone. Competitors are entering bank comfort zones with aggressive pricing models and value-added services to lure merchants from bank payments.

To deal with those competitive threats while responding to their customers' requirements, merchants and account holders alike, banks and the card industry must develop better payment services to:

- Demonstrate the value in existing card networks to merchants to dilute the interchange debate and protect their retail payment margins

- Enlist merchants' participation and support to provide momentum to banks' card programs and card industry-led initiatives, such as contactless cards

Figure 1. Consolidation of Transactions – Not Cards



Note: The net is calculated by subtracting those who agree with the statements vs. those who disagree. Neutral responses are not taken into account
Source: Gartner (December 2005)

- Demonstrate value to consumers and support their growth objectives

However, banks face two conflicting objectives. The card industry must protect its revenue, and therefore a common solution delivered by bank-owned networks and processors is called for. But card issuers must differentiate their own services. As a result, banks will have to improve the integration between their issuing and acquiring operations to strengthen their merchant relationships and achieve a competitive advantage.

2.0 Focus of Document

In this document, we will look at how banks' issuing and acquiring services must evolve to account for shifts in client demand, consumers and merchants alike.

3.0 Analysis

3.1 Confusing Consumers to Avoid Commoditization

3.1.1 The Race to Become the Primary Payment Provider Is On

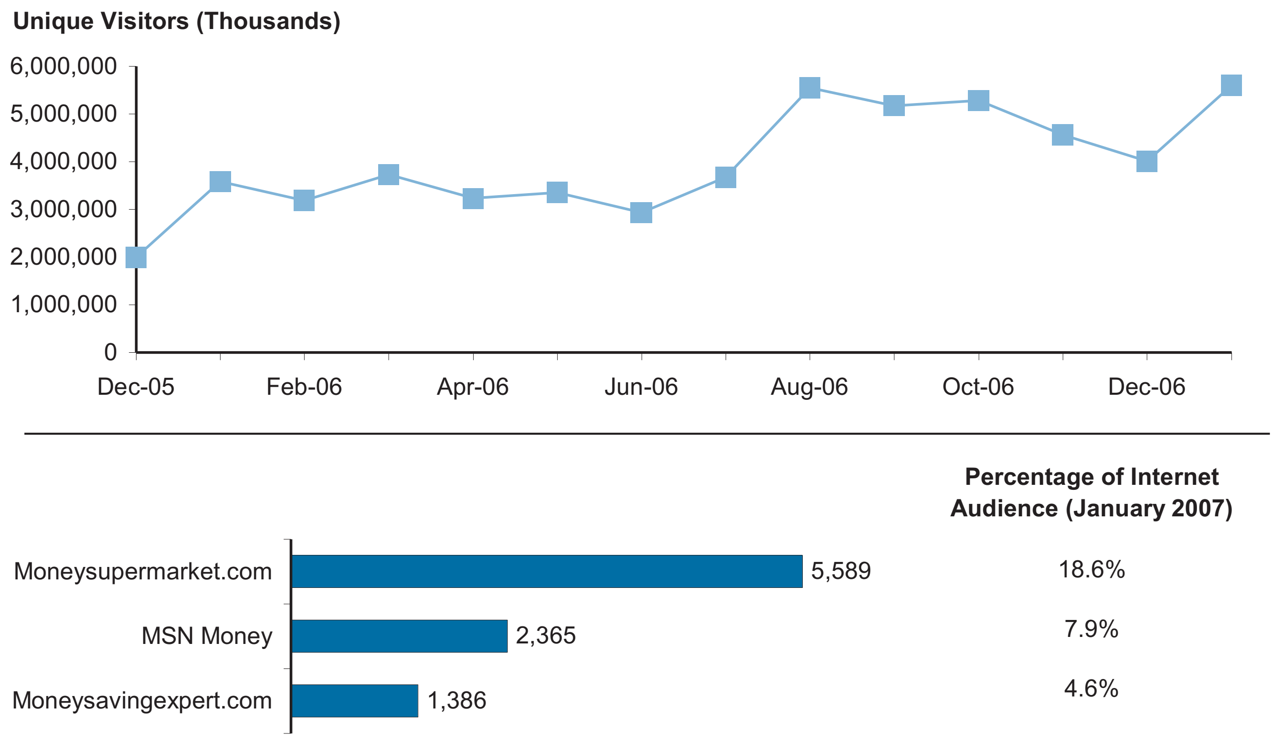
Figure 1 shows the balance of cardholders that agree with two key statements versus those that don't – "I try to make the majority of my purchases with a single card" and "I would like to reduce the number of cards I have."

Cardholders across the United States, the United Kingdom, Germany and France are looking to consolidate their purchases on a single card. However, this does not imply that they will reduce the number of cards that they have. In other words, they are becoming accustomed to managing a portfolio of cards for different purposes. As a result, some cards in consumers' wallets are inactive. Consequently, the battle to become the primary card issuer is intensifying.

In the United States and United Kingdom, competition among card issuers, notably credit card issuers, has always been strong. In Europe, the creation of the Single Euro Payment Area (SEPA) will lead international banks to use payment services as entry points to customers' retail banking relationships as part of their banking expansion plans in Europe. Even if this will not be felt immediately, competition in card markets in Europe is poised to intensify.

Cardholders have access to more information via comparative engines. The United Kingdom is an interesting market to follow, in which consumers tend to manage multiple banking relationships and are therefore more prone to shop around. Using data compiled by comScore, Figure 2 shows the reliance of consumers in the United Kingdom on comparative and financial information sites: It shows the most-visited comparative personal finance sites and personal finance information sites in the United Kingdom and how the leading comparative site's audience had evolved during the past year.

Figure 2. United Kingdom: Consumers Increasingly Relying on Comparative Sites for Personal Finance, 2005-2007



Note: The net is calculated by subtracting those who agree with the statements vs. those who disagree. Neutral responses are not taken into account

Source: comScore

Not every market features such a high degree of personal finance awareness. But whatever the region a bank operates in, it's time to prepare for cardholders moving to a more self-reliant mode. It's time for banks to make it more difficult for consumers to achieve product comparisons.

3.1.2 How to Make Product Comparisons Less Meaningful
How should banks avoid the commoditization of their card offerings, driven by competitive pressure and consumer access to product information? Some of the cardholders' key attitudes toward financial products are shown in Figure 3.

Cardholders are price-sensitive, and charging them more for extra services or rewards will meet strong resistance. Product-specific reward programs and strong and consistent customer service are part of the service equation but not sufficient.

In most markets, cardholders are not rejecting product consolidation with a given financial services provider (FSP), but they want to be rewarded accordingly. They want to be rewarded for their banking relationships in terms of better terms for holding multiple accounts. This could contribute to changing cardholder attitudes toward product consolidation, even in a market such as the United Kingdom's.

As a result, it becomes more urgent to reward customers who use card products as their main payment instrument. Banks will increasingly have to adopt that approach with consumer payment services and integrate customer payment instruments' use with the pricing of other banks' products and services. Examples of such programs include:

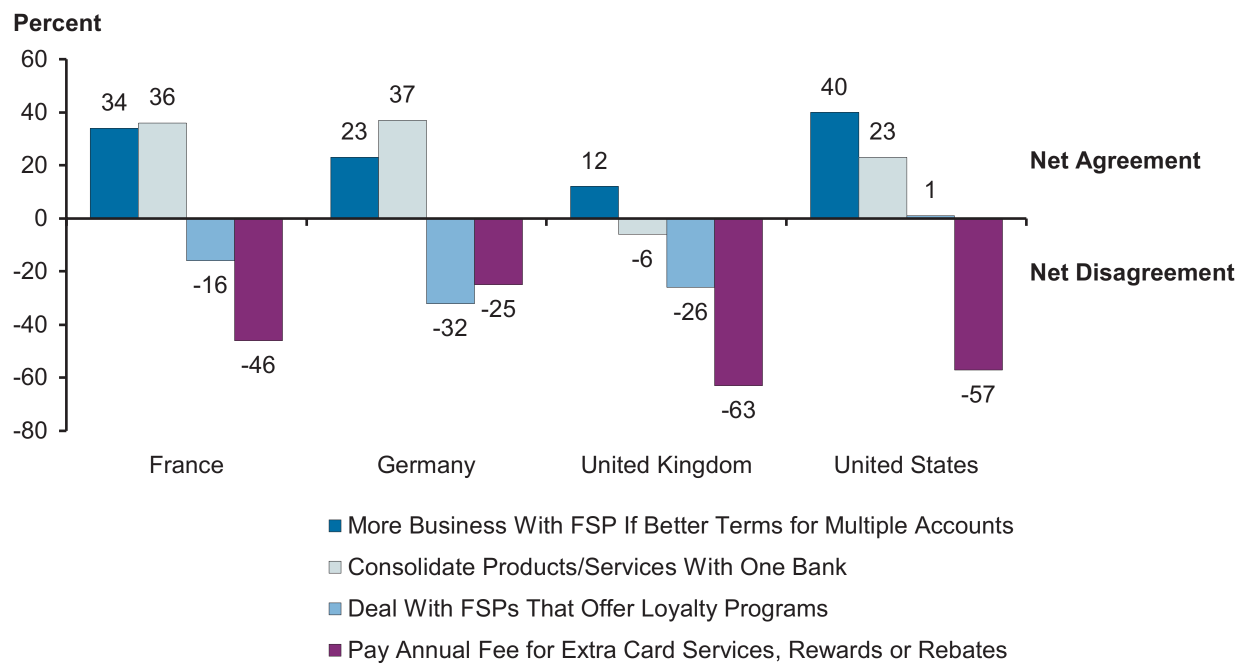
- Citibank ThankYou Network rewards customers on a monthly basis according to the number of products that they have with the bank, card transactions that they make during the month and their shopping activity at selected retailers.

- Bank of America's Keep the Change has been one of the drivers of card business growth, with an estimated 3 million users. On debit card purchases, the bank rounds up the value of the transaction to the nearest dollar and puts the difference in the user's savings account. Bank of America matches 100% of the deposits for three months and 5% thereafter, with an annual cap of $250. This increased deposits by $200 million and increased the sales of checking accounts, a key relationship product for banks, notably with the increasing use of debit cards.

- In the United Kingdom, Lloyds TSB has implemented a similar program to Keep the Change – Save the Change. As with Keep the Change, Save the Change rounds up debit card purchases to the next pound and transfers the difference to a savings account, which can be owned by another family member.

Some banks use these programs to better control how consumers use their cards to make a purchase. For instance, via its ThankYou

Figure 3. Cardholders Want Rewards for the Extent of Their Banking Relationships



Note: The net is calculated by subtracting those who agree with the statements vs. those who disagree. Neutral responses are not taken into account
Source: Gartner

program, a Citibank cardholder gets 1 point for every $2 spent on purchases when signing the receipt and 1 point for every $3 spent when a personal identification number (PIN) is used. This drives interchange revenue, which is higher for signature-based debit card payments than PIN-based debit card payments.

These programs create a strong defense against competitors using card products to enter the marketplace because relationship rewards are much more complex to duplicate. To be more defensive, the programs must encompass more than savings accounts and take into account lending, insurance and even investment products. Comparative tools will adapt to the first generation of relationship rewards, but as those become more advanced, it will become increasingly difficult for consumers to rely on those tools. A cross-business-unit response is therefore essential to the long-term success of these programs.

Furthermore, relationship rewards should not restrain themselves to card payments. Consumption patterns are emerging, and banks must respond to new retail payment requirements.

3.1.3 Time to Plan for Other Instruments

Increasingly, banks must consider consumption patterns, such as micropayments and mobile commerce. If they don't, they risk losing business and future customers to nonbank payment providers such as PayPal and Google Checkout.

The worrisome aspect of this competition for banks goes beyond lost transaction revenue: A nonbank's ability to meet these customers' payment requirements threatens to reduce a bank's ability to build and sustain customer relationships. This reduces banks' abilities to market banking products and services to customers that frequently interact with them via payment services. This is especially valid for younger customers, who are more apt to rely on the Internet or wireless networks for their entertainment and shopping needs. This could displace banks as the primary source for financial services, especially at a time in which some consumers are relying on so-called social lending services, such as Zopa, the United Kingdom-based online person-to-person lending and borrowing exchange.

As a result, banks have to be prepared to introduce new payment instruments. For instance, integrated contactless mobile payment systems are complementary to existing card offers.

Banks won't have complete control over success but should ensure that they consider the ability of those instruments to reach the next generation of credit customers and collect more information on their consumption and lifestyle habits.

3.1.4 Differentiation Requires Merchant Involvement

Banks must deal with the threat from nonbank payment providers and introduce payment programs that demonstrate the value to customers of bank payment instruments and services. Working with card networks is often the best way to achieve this because it supports interoperability. However, banks must differentiate from their peers, on top of introducing industry-based solutions.

Banks' retail payment operations must better reward their customers, according to the extent of the retail banking relationship. The differentiation can be achieved by working closely across business units and introducing adequate BI, analytical and dynamic pricing engines.

This will support defensive strategies against nonbank payment providers and banks with a limited product set, but it will not be sufficient to deal with other banks that can easily copy those programs. Strong merchant involvement is called for:

- Nonbank payment providers are growing in acceptance among merchants via aggressive pricing models at a time in which merchants are challenging the card interchange pricing model. As a result, new card industry or bank-based payment instruments will have to demonstrate value to merchants and dilute the interchange pricing debate.

- The card industry is pushing for the adoption of cards equipped with radio frequency ID chips to let consumers wave their cards in front of the point-of-sale (POS) to conduct a payment. The objective of contactless payments is to accelerate cash replacement. Merchants are critical to achieve this objective.

- Selected merchants are critical to support card issuers' forays into affluent markets. For card programs dedicated to those customers, the interchange is higher, but merchants must offer the right blend of rewards to those cardholders who are looking for better access to specific entertainment venues.

- In selected regions, such as in Europe, with the creation of SEPA, Europay MasterCard and Visa (EMV) migration is mandatory. Some merchants are not keen on supporting the EMV migration because of the related costs of the upgrade to their POS hardware and software. And participation is essential to ensure a smooth transition, especially in countries without PIN use at the POS and where cardholders' shopping experiences will be the most disrupted.

And this will only be feasible if another kind of acquiring service emerges.

3.2 Building the Next Generation of Acquiring Services

3.2.1 What Banks Don't Want to Happen

Some payment reforms had a profound effect on payment margins. The reforms instituted by the Payments System Board of the Reserve Bank of Australia in November 2003:

- Defined interchange benchmarks, which set ceilings for programs' credit card interchange fees

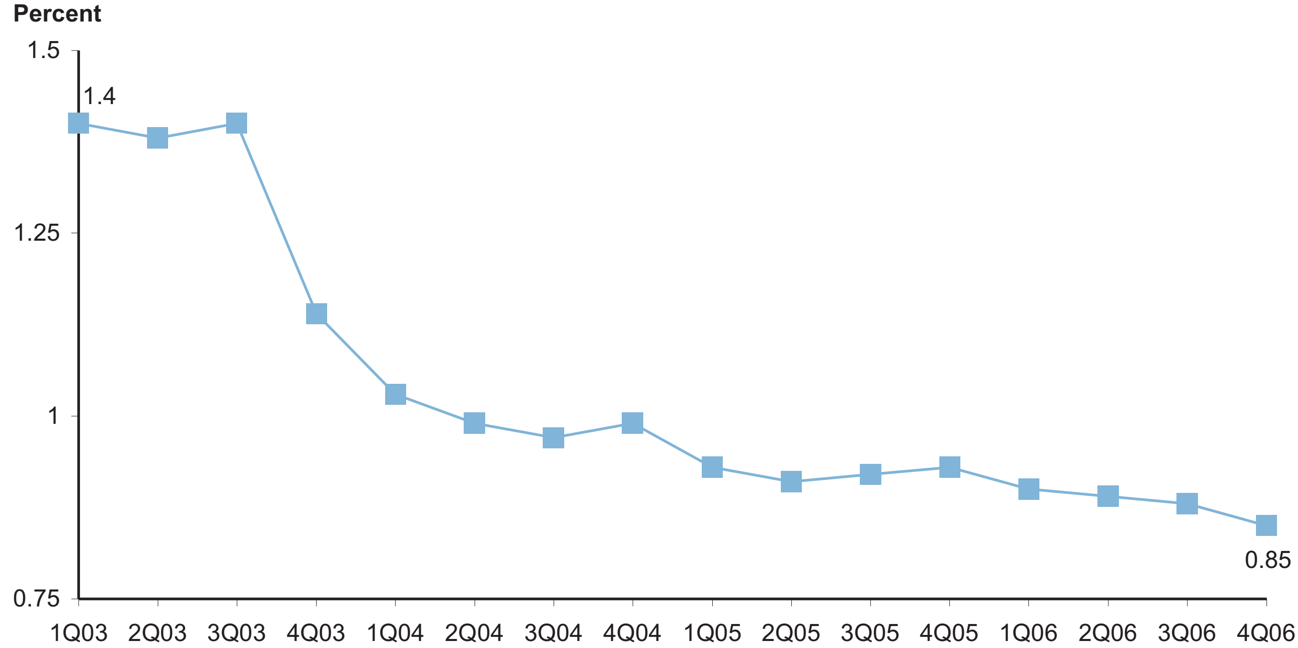
- Led to the abolition of the no-surcharge rule, which used to prevent merchants from introducing a charge to cardholders using cards bearing a higher interchange rate

- Improved access to existing payment networks with the creation of the Specialist Credit Card Institution license

- Increased the transparency of merchant services pricing by publishing related indexes and market share

- Resulted in a decline in the merchant services charge (paid to the acquiring bank), as shown in Figure 4

Figure 4. Australia: Acquiring Services Under Pressure



Source: Reserve Bank of Australia

According to the Payments System Board's annual report of the Reserve Bank of Australia for 2006, the average interchange fees for the Bankcard, MasterCard and Visa credit card programs declined from 0.95% to 0.55% of the transaction value from November 2003 to June 2006. During the same period, the decline in the merchant service fees was higher (51 basis points).

As a result, the impact of interchange pressure on acquiring services has been compounded by increasing competition generated by more pricing transparency and lower barriers to entry. We are not suggesting that the same payment reforms will be applied to other regions. But in Europe, with the creation of a SEPA and the resulting push for more transparency in the pricing models of card programs, acquiring operations are in for a rough ride, according to the experience in Australia.

3.2.2 "A" for "Advisory" – Not Just "Acquiring"

Banks must demonstrate the value of bank-sponsored payment networks to entice merchant participation in their consumer payment programs and deliver services to de-commoditize merchant services. It's time for merchant services to evolve toward an advisory services platform to support these objectives.

3.2.2.1 Payment Information Value-Added Services

In "Findings: Banks Can Tap New Revenue Stream via Aggregated Customer Data," we introduced three types of PIVASs:

- Individual – Payment data is captured at an individual level, at the POS terminal or check-out screen for Web purchases. The data can be collected over a period of time (for example, to consider the number of purchases made by the customer in a given shop during the past month):
    - Immediate individual – The data is used to tailor individual retailer incentives or customer offers that are provided at the time of the trigger purchase, the purchase that defines that the consumer is qualifying for a rebate or promotion.
    - Retrospective individual – This tends to involve a retrospective analysis of payments. The data is used to offer customers a range of products and services at a later date – not at the time and place of the trigger payment.
- Aggregated – Data from individual payment transactions is combined with data from every other transaction from other consumers to ensure anonymity. Combined data is reused to create a wider view of certain customer segments.
- Hybrid – Aggregated data is used to provide insight to the catchments of the retailer or its target customer base and support the delivery of offers/promotions that account for individual payment data.

The benefits can be strong. The customer payment data that is buried in payment products offers banks a way to increase revenue by taking advantage of this store of information to better understand their customers. However, it provides banks with a tool to help merchants do the same.

3.2.2.2 How This Works

Here is an example of how this could contribute to the success of EMV-compliant contactless card rollouts:

- In some regions, merchants POS systems are becoming EMV-compliant, but merchants are not fully convinced of the value of this migration for their bottom line. It could improve security at the POS, but in many countries, those benefits are not likely to meet the investment of POS hardware, POS software and training staff.

- The card industry is keen on accelerating cash replacement. Banks and card programs are rolling out contactless cards to do so. However, merchants that are migrating to EMV are not in the mood to add another layer of investment.
- EMV and contactless payment adoption can be driven by PIVASs using the hybrid model.
- An EMV-compliant card would store cardholders' shopping patterns on the chip (for example, how many times the cardholder has used a card at a specific retailer or whether the person has shopped at that retailer). This information could be combined with aggregated data on cardholders shopping in the catchments of this retailer.
- As a result, the retailer will have a platform to deliver tailored promotions at the POS that account for its marketing strategy and the activity and preferences of the customer. The promotion or message can be delivered via a POS receipt. An example of a vendor operating such a program is Welcome.
- In other words, the payment infrastructure can support the acquisition and retention activity of merchants, a strong demonstration of the value of the card infrastructure.
- This would support the adoption of contactless card programs by merchants that value speed at the POS – but most importantly that are looking to deliver more-meaningful promotional materials. With the cash replacement effect of contactless payments, the value of the program is enhanced as more information is collected in the system.

3.2.2.3 A Better Type of Interaction

For banks taking this route, the opportunity is to accelerate acceptance for their card programs and, most importantly, change the nature of the interaction between acquirers and merchants.

To start with, banks must be in full control. Privacy and regulatory issues, which can emerge with the use of customer data, are strong. For immediate and retrospective individual models, consumers must opt in, while banks must ensure that merchants do not use personal customer data for other purposes, such as developing independent promotional offers.

This implies that (for example, to define how the promotions are offered, such as the number of payments to be made to trigger a promotional offer) the retailer must contact its bank. This changes the nature of the acquiring relationship. This is not any more limited to technical and pricing discussions than it is to tailoring marketing offers to improve retention and customer acquisition. The merchant services' relationship moves to the realm of advisory services.

3.2.2.4 Distribution of Nonbank Payment Services

Combined with PIVASs, an acquirer will increasingly have to distribute payment services from third parties or take part in packages that combine their services with nonbank payment providers' services – and to be perceived as serving the best interest of merchants to become a full payment advisory services provider.

An example of such an initiative is the Payments as a Secure Service Commerce Center in the United States, a financial management solution for small and midsize business (SMB) users of Windows Vista. The payment service providers involved in the solution include Chase Paymentech, PayPal, CIT, BankServ and the Internet Commerce Corporation.

The presence of PayPal, the dominant non-card-based remote payment system in the United States, and Chase Paymentech, the largest card acquirer in the United States, is an important development. They are part of a solution that will integrate payment flow to support cash management requirements of SMBs and enhance loan origination.

3.2.3 Stronger Integration Between Issuing and Acquiring Necessary

The combination of PIVAS and the distribution of third-party products will contribute to turning banks' merchant service operations into a trusted advisory service. But this will only happen if the acquiring side works more closely with the issuing one.

The objective for banks is to build a virtuous circle. Payment instruments, including emerging payment instruments, will collect information to support PIVAS and therefore entice merchants to support banks' payment initiatives. As a result, the issuing and acquiring sides will benefit from such an arrangement.

However, what matters is defending the card industry against pricing pressure from merchants by demonstrating the value of the card network to merchants as well as the objective to assist each bank to differentiate itself from its competitors.

That's why sourcing decision makers in banks must tread carefully. Banks with acquiring and issuing operations have a distinct advantage to bring those services to market faster and be more responsive to requirements from consumers and merchants, provided the operations are working alongside.

As a result, it is not just about economies of scale. Of course, a bank with large acquiring and issuing operations has an edge, but for smaller banks, they must ensure that they take into account the evolution of the acquiring model in their decision to outsource some of their payment services.

As illustrated by relationship rewards, on the issuing side, it's about payments and retail banking. On the acquiring side, it's about processing payments, marketing, cash management and lending services. Payment services are a relationship gateway for the bank, and outsourcing part of the relationship must be a well-thought-out decision.

To achieve closer collaboration across business units, a payment orchestrator is needed to facilitate the integration of payment information across payment services and business units. The payment hub concept is such a solution.

The objective is to design a payment architecture that is flexible enough to accommodate additional payment services while reusing as much as possible from the existing library of services.

4.0 Recommendations

Bank payment strategists, product managers and LOB heads should:

- Reward customers in financial terms for their use of payment services and the extent of their banking relationship. Relationship rewards are what cardholders are looking for and one way to make it more difficult for them to make comparisons of card offers. They therefore act as a defense against commoditization.

- Introduce PIVAS to reduce pricing pressure from merchants and initiate a virtuous circle for retail payment operations. Merchants must actively support card programs and emerging payment solutions, but they are challenging the pricing model for the interchange. It's time to introduce services such as PIVAS to convince them of the real value of bank-sponsored retail payment networks.

- Transform acquiring services into payment advisory services for merchants. The acquiring relationships are mainly based on pricing. This must change. The distribution of innovative packages featuring nonbank payment providers and support of promotional and marketing activity for merchants will move merchant services to an advisory role.

Bank payment technologists should:

- Actively push those payment services innovations, which will raise the profile of payment operations and provide ground for obtaining capital to renew the payment architecture. Payment architects are well aware of the needs to consolidate payment processes. However, building a payment architecture is highly challenging and requires strong project management skills and funding. Using value-added services as one of the arguments to obtain capital is essential. This will help change the perception that payment operations are a cost to manage, turn them into a growth engine and consequently provide more grounds for capital investment.

- Use BI, analytical and dynamic pricing tools to ensure cost transfer and revenue recognition across LOBs. Those applications will support incentives to encourage collaboration across those LOBs, notably between the issuing and acquiring operations.

Third party card processors should offer banks solutions that support relationship rewards and PIVASs. Payment processing services are not just about economies of scale. Offering banks an ability to reward their customers holistically and demonstrate value to merchants will contribute to margins.