The future of payments: Markers for success

The payments industry faces uncertainty on many fronts. Historically, it has been a business in which the incumbents were strongly advantaged and able to enjoy stable or growing revenue streams. Now, however, a disruptive mix of regulatory and consumer behavioral changes, emerging technologies and new competitive thrusts is presenting industry incumbents with unprecedented challenges. These changes are catalyzing new and shifting alliances, which in turn are creating fresh opportunities for industry entrants.

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In our previous issue we presented several scenarios for how the payments industry might unfold during the coming decade (see “Payments 2020: Scenarios for dynamic evolution,” *McKinsey on Payments,* March 2011). In this shifting environment incumbents must consider how best to defend hard-won market positions, and recent and prospective entrants must determine what they can do to successfully penetrate the market and grow their businesses.

Markers for success

There are six markers that incumbents and newcomers alike can use to define positioning and strategies for success. They can help incumbents adapt current value propositions (or create more defensible ones), and guide industry entrants in their efforts to make any new power shifts a sustainable reality. For incumbents the attainment of these markers will also define the major barriers to market entry, enabling them to better assess any threat of displacement by entrants. Instead of squandering management resources to fend off upstarts that have little chance of attaining meaningful scale, they can employ the markers as building blocks to help them more appropriately manage their respective partnership and acquisition activities. Each of these markers is soundly anchored in our fundamental beliefs about the enduring nature and dynamics of the payments business, as well as in our thinking about current industry disruptions.

Marker 1: Deliver significantly and not just marginally more customer value than the market alternatives

Payments is a business with high inertia and strong network effects. In such industries, the marginally better customer propositions of new entrants usually lose ground to those of incumbents that have already won broad acceptance. The founder of a payments start-up once poignantly said, “Building a marginally better payments mousetrap is a great way to lose money.” As the now ubiquitous QWERTY keyboard illustrates, consumers tend to grow comfortable with secure, reliable and relatively commonplace mechanisms, despite any drawbacks they may have, and payments systems are no exception. Consequently, consumers are reluctant to adopt new technologies—though they may offer advantages for other stakeholders—if the value for them personally is unclear or unappreciated. An excellent example of this is contactless cards, which allow buyers to wave their cards near enabled point-of-sale terminals instead of swiping them. While the benefits of contactless cards may be clear for issuers, networks and merchants, their advantages over swipe or chip cards (with which consumers are already comfortable) is marginal, and hardly sufficient to induce a meaningful shift in behavior. On the other hand, in unsecured consumer credit, new entrants such as Ferratum Group and Wonga in Europe have seen success in providing consumers with immediate and convenient access to microloans through online and mobile channels, despite higher interest rates.

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Marker 2: Build value propositions that go beyond cost reduction

As noted above, new payments mechanisms that generate cost savings for merchants, regardless of the amount, will probably not gain broad consumer acceptance on their own. Consumers simply cannot appreciate just how much a decrease of a few basis points might reduce the merchants’—and ultimately their own—costs; similarly, they have little concern about merchants’ ability to shave microseconds from cash register transaction times. This hardly means that cost-based propositions are irrelevant; only that success may also require delivering customer value that is functionally a step above current alternatives. In the U.S., for example, Starbucks consumers can register their pre-paid Starbucks cards online to receive free drinks, add-ons and promotions. Consumers can also download a Starbucks mobile application that enables them to pay with their registered cards using a quick-response matrix barcode on their smartphones. These approaches enable the company to guide its customers toward its preferred payment option by using economic and operational benefits, while also adding meaningful value for consumers.

The Canadian market offers an elegant controlled experiment in added value. Canada's debit card system, Interac Direct Payment, has historically been a zero-interchange system that charges consumers based on usage. By contrast, credit card interchange rates in Canada are higher, similar to those seen in the U.S. Despite the cost differential, credit card acceptance in Canada significantly exceeds that for debit cards. Merchants seem to find enough added value in credit cards to offset the cost of interchange fees.

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Marker 3: Penetrate niche segments first

It is generally advantageous for developers of new payments systems to target niche market segments, where acquisition costs are lower, before driving for broad penetration. Grandiose attempts to transform the global payments industry will likely lead to slow (and occasionally spectacular) failure. Globally, more than 400 payments start-ups came and went during the dot-com boom 10 years ago; fewer than five managed to survive. The most recognized of these is PayPal, which early on grew by tethering itself to the e-commerce giant eBay, for whom a unique payment mode with superior risk management was critically important to its success. In fact, PayPal displaced eBay's own payment solution, eventually becoming the principal way to pay on eBay. The cost of customer acquisition during PayPal's early growth, then, was essentially subsidized by eBay. This was a critical strategy for building PayPal's user base cost-effectively and gaining significant scale – among consumers as well as eBay's power-seller merchants. Notably, eBay sales remain a significant contributor to PayPal's business today. By contrast, many rapid national introductions of pre-paid e-purses in European countries did not lead to success. In fact, after incurring high rollout costs most European e-purse programs have been discontinued.

Marker 4: Leverage established infrastructure

The high fixed cost of building a payments infrastructure that will be reliable, secure, ubiquitous and convenient can be an insurmountable barrier to entry. Most successful payments solutions are therefore designed to leverage existing infrastructures. This pattern tends to hold true for most markets and applications around the world, whether applied to online payment modes in the U.S. that leverage ACH infrastructure, parking payment systems in Europe that use SMS capabilities, or open-loop prepaid cards elsewhere. A good example is Alipay, a large payments platform that facilitates cross-border online transactions in China and partners with Chinese banks for clearing and settlement. While the leveraging of established infrastructure is frequently a necessity, its attainment is insufficient by itself for success. Several cost-based point-of-service ACH solutions in the U.S., for example, clearly demonstrated this when they failed to gain traction and scale.

Marker 5: Adapt offerings to market context

The payments industry varies significantly from one market to another, chiefly because of differences in regulations, technology standards, consumer preferences and the relevance of established payment modes. Players that succeed in one market often risk failure by applying the same models in other markets, especially those that are in a different stage of evolution. Success usually requires that market entrants modify their business models to reflect marketplace differences. For example, mobile payments approaches such as in-aisle shopping comparison and purchasing draw customers in developed markets where smartphone penetration is high and growing; however, approaches will probably have to differ considerably in emerging markets, where feature phones or SMS-based technology prevail. In these markets, applications could enable unbanked consumers to pay their utility bills or receive government payments via mobile phones. Hybrid online and mobile solutions are also emerging to form new ecosystems; for example, consumers can purchase digital products within the context of games on social networks (Exhibit 1).

Marker 6: Tap adjacent profit pools to differentiate offerings and add value

Regulatory and technological disruptions will likely prompt an increase in business propositions that actually sacrifice payments economics in favor of generating greater value elsewhere. An example of this is Walmart's MoneyCard. In the U.S., Walmart is a sizeable and growing player in alternative financial services, offering consumers core

Exhibit 1

Hybrid online-mobile payments are emerging as a fast-growing payment option for purchasing digital offerings

Overview

Situation: Social networking sites and gaming are growing rapidly, and seeking ways to monetize their digital offerings, which represent attractive revenue sources

Complication: Entering and storing payment information disrupts the user experience and raises security concerns for those consumers who lack credit cards or have other security issues

Resolution: New providers are linking payments to users' mobile phone bills, streamlining the process and eliminating the need to enter and store credit card and debit card information on numerous Web sites

Advantages

No registration required

More security steps, e.g., PIN text is sent to phone and entered on Web site

Potential for small-ticket payments

Challenges

Limited transaction size on carrier bill unless credit card or debit card account is linked, e.g., $20 maximum charge

Economics for developers may be challenging, e.g., carriers charge 20-50% of purchase price, and require clear business case on monetization

Source: McKinsey analysis and company Web sites

services at lower prices. The MoneyCard provides open-loop prepaid capabilities with pricing that is consistent with the company's well-established commitment to being a low-priced leader. In this case, MoneyCard's link to the company's core retail business is a key part of the business model. When consumers cash their paychecks and replenish their MoneyCard balances at Walmart's in-store MoneyCenters they typically spend part of those higher balances before they leave the store (Exhibit 2).

More likely than not, we will see a continuing emergence of business models that sacrifice payments economics in various ways, whether to consumers, merchants or both. Prepaid card pricing, for example, could change further as issuers experience additional pressures, while monthly and other fees might even be eliminated. The reason for such changes is that many issuers have access to adjacent profit pools such as search, couponing, mobile applications and loyalty management programs that are closely tied to payment mechanisms themselves.

Tapping adjacent profit pools, however, could effectively transform the physical point-of-sale in several ways, blurring and eventually erasing the lines between payments and adjacent businesses. A catalyst for this type of change could be new business models that we now see emerging to improve the mobile commerce experience. Their focus ranges from demand generation to post-transaction loyalty management (Exhibit 3, page 8). Although several are still in their infancy, the blending of technological developments enabled by smart or enhanced

Exhibit 2

Walmart is reshaping prepaid card pricing

Walmart and prepaid cards

Walmart launched its MoneyCard in June 2007 in partnership with GE Money Bank and Visa

In February 2009, Walmart significantly reduced its MoneyCard pricing to stimulate usage and improve its ability to cross-sell MoneyCard with its check-cashing and other services

- Issuance fee reduced from $8.94 to **$3**
- Reload fee reduced from $4.64 to **$3**
- Monthly maintenance fee reduced from $4.94 to **$3**

Broad impact

American Express, Green Dot, and nFinanSe recently lowered and simplified their fees

Today's prepaid card pricing suggests a maturing industry, as established players compete on price, not just size and scale

Source: McKinsey analysis and company Web sites

Exhibit 3

Adjacent profit pools let players discount payments economics

	Pre-purchase			Decision-making		Transaction	Post-purchase	
Purchase decision process	Generate demand	Identify merchants	Compare merchants	Contact merchant	Finalize decision	Make payment	Review promptly	Build loyalty
How m-commerce can change buyer behavior	Enhances merchants' ability to target and personalize marketing communi-cations	Consumers can do local searches anytime	Review apps help users to find best local merchants	Ability to contact merchants for store locations, hours, directions, etc.	Can compare prices, obtain peer advice and browse competitor offerings	Pay via mobile device	Ability to immediately send reviews and location to users' social networks	Can trigger couponing and other loyalty programs
Examples	Cellfire: Sign up for specific deals and receive coupons based on triggers (e.g., location)	AroundMe: Find nearby stores with product and compare prices	yelp: Read reviews to find the best merchant out of all local options	Google: Use Google Local to get business information; Use Google Maps to map route	RedLaser: Use product barcodes to find nearby sellers, compare prices	tabbedout: Pay restaurant bill without waiting for server	foursquare: Share comments about local venues; Swipely: Publish and read reviews	CLOVR: Post-purchase offer redemption linked directly to bankcard

Source: McKinsey analysis and company Web sites

phones with changing customer behavior make this space well worth watching. Mobile-enabled consumer behavior shifts would bring new and difficult challenges for industry incumbents, partly because it is generally easier to compete with industry entrants than with well-established rivals who use their payments products as loss leaders.

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Industry entrants will continue to find it extremely challenging to compete effectively with well-established incumbents—especially with the banks, payment networks, acquirers and processors that have historically "owned" the payments business. The six markers for success defined here will help. They can serve not only as reliable markers to guide incumbents as they evolve their business strategies and create new value propositions to maintain their hold on the payments business, but also to guide those entrants eager to tilt at the payments windmill.

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