VIEWPOINT

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2020 Outlook: U.S. Payments

Virtualization of payments is accelerating and expanding into new areas like the internet of things and 5G, forcing payments industry participants to become more agile.

Each year, Mercator Advisory Group discusses top trends anticipated for the coming year or two in Outlook by each of the practices except for Primary Data. The present document summarizes those Outlooks in the context of the larger themes we are studying in 2020.

By Aaron McPherson,
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2019 in Review and Mercator's New Research Initiatives

The Mercator Advisory Group Outlook for 2019 identified four major trends that we believed would have the greatest impact on the payments industry: global payments, faster payments, customer acquisition and retention, and risk and fraud management. Below we discuss the progress of these trends during the past year and Mercator's new research initiatives to enhance our coverage of these and other payments trends in 2020 and beyond.

Global Payments

We embarked on several initiatives to strengthen the depth of Mercator research in global payments. First, we expanded our consumer research to encompass Canada and began to release survey reports focused on Canada in fall 2019. In 2020, we will go further, extending the surveys to Europe in a new Primary Data product called *European PaymentsInsights*. Along with this initiative, we took the opportunity to rebrand Mercator's existing Primary Data products to make the names more consistent and intuitive. CustomerMonitor Survey Series is now *North American PaymentsInsights* and *European PaymentsInsights*. The Small Business Payments and Banking Survey is now *Small Business PaymentsInsights*. And the Customer Merchant Experience Survey is now *Buyer PaymentsInsights*. Current subscribers to renamed North American PaymentsInsights survey will automatically receive the new Canadian reports; European PaymentsInsights is a separate offering.

We also completed the first draft of a global payments model, which we developed concurrent with these initiatives. The model provides historical data and forecasts for 27 major economies around the globe. For now, it is limited to payment volumes and gross dollar volume for all major payment methods: credit cards (consumer and commercial combined), debit cards (including open loop prepaid cards), closed loop prepaid cards, ACH (credit transfers and direct debits), wire transfers (real-time gross settlement, or RTGS), checks, and ATM (ABM) cash withdrawals. We expect to publish a global forecast report in each relevant research advisory practice by mid-2020, which will be the first time these forecasts are available to our membership. Early access to the data is available through inquiry as part of membership. Future development of the model will include separating consumer credit and charge cards from commercial cards, and separating faster payments from overnight ACH.

While there is demand for forecasting in a separate open loop prepaid category, doing so is difficult and complicated by the nature of network reporting and by the fact that so-called challenger banks and banking as a service (BaaS) platforms often rely on enhanced prepaid platforms to provide basic transaction banking functions through a debit card. We may provide a separate estimate for restricted open loop prepaid cards, such as gift and payroll cards, but this will depend on building out new sources. Currently, the global payments model is based primarily on central bank reporting, beginning with the Bank for International Settlements (BIS) "Red Book." We also draw on network reporting, and in the future we will build direct relationships with market infrastructure providers, as we have already done with our U.S. prepaid benchmarks. Mercator Advisory Group's research directors carefully review the statistics and make adjustments in the Mercator global payments model based on industry information available to them, and we are continuously enhancing and upgrading the model.

Faster Payments

Faster payments continued to be a hot topic in 2019, with the Federal Reserve announcing its intention to build its own faster payments infrastructure under the brand FedNow, expected in 2023–2024. This was a reversal of the Fed's previous policy, which was to let the private sector lead development. Midsized and smaller banks had complained loudly about having to provide customer data to their largest competitors (which owned the principal real-time networks, Zelle and The Clearing House RTP system). In addition, the core providers (FIS, Fiserv, Jack Henry, and others) experienced difficulty in signing up these banks for Zelle and RTP, since the banks were waiting to see what the Fed would do. Now the suspense has been lifted, but only partially. With FedNow still in startup mode and building its team, and with legislation in Congress both for and against the project, the timeline is uncertain. There are some signs that banks are waiting to see how FedNow develops, but The Clearing House and Zelle have systems ready to go, not to mention alternatives such as Same Day ACH and competitive offerings from Visa and Mastercard. Nonbanks, such as PayPal, Venmo, and Uber are using the faster payments rails to offer their own consumer-facing services, so the competitive environment is growing increasingly complex.

Customer Acquisition and Retention

Customer acquisition and retention have been a focus for traditional banks in the United States as challenger banks such as N26 and Revolut seek to enter the U.S. market. They are also a focus for traditional retailers striving to fend off Amazon and integrate mobile and online channels into a hybrid model. Some expressions of this in 2019 included mobile order and pay, order online and pick up in store (which is often faster than Amazon), autonomous checkout (really more of a 2020 item, but with Amazon Go serving as a proof of concept), and the introduction of kiosks in quick service restaurants. The Apple Card, with its tight integration with the iPhone, made significant improvements to the customer experience, and in 2020, we expect to see traditional large issuers emulate some of those features in their own apps.

Risk and Fraud Management

Risk and fraud management continued to be a dynamic field in 2019, with new threats emerging through the criminal misuse of artificial intelligence (AI) and machine learning (ML). For example, fraudsters got better at creating synthetic identities that draw on the characteristics of genuine customers without actually stealing an individual identity. Self-sovereign identity (SSI), as championed by the Sovrin Foundation and others, emerged as a revival on long-standing efforts to create a federated identity system (that is, an identity that can be shared by many different companies), but without the need for sponsorship by a single company and with far greater ability for individuals to control the release of their private data.

EMVCo continued to roll out the next generation of its online risk tools, including 3D Secure 2.0 and Secure Remote Commerce (SRC). There was a snag in Europe as regulators questioned whether 3D Secure 2.0 conformed to the strict new security rules enacted as part of the revised Payments Service Directive (PSD2), but those concerns were resolved and the rollout has continued. However, merchants' resistance remains strong because of bad memories of 3D Secure 1.0 and continued tense relations between merchants and the major card networks. Thanks in part to the new security rules, we do expect 3D Secure 2.0 to be rolled out first in Europe and then in the United States.

Looking Forward to 2020

For 2020, Mercator research continues to focus on global payments and security but introduces technology and platforms as new themes. Technology is obviously a broad theme, but Mercator research is focusing on innovations in a number of areas that will affect payments: 5G telephony, the internet of things (IoT), fiat currency-backed cryptocurrencies (also known as “stablecoins”), AI and ML, and biometrics. Our Emerging Technologies Advisory Service has built a model for IoT payments that is presented in the recently released research report titled *IoT Payments: How the Internet of Thing Is Influencing Payments*. A forecast for IoT payments will debut later in the year.

Digital platforms merit attention because of the growing importance of digital or virtual wallets as well as the growing use of cloud-based services to support everything from customer service to banking. Aligning closely with 5G and IoT, platforms will be the way payment card issuers, mobile operators, and streaming services monetize these trends, and they will have digital wallet functionality that reinforces the importance of a card’s being top of wallet.

Originally, digital wallets were largely application-specific (like a card on file), but now we are seeing the rise of ecosystems on top of platforms that can use a common digital wallet to store payment information. This is particularly important for IoT devices, which generally do not initiate payments on their own but rather provide sensor data and voice input that is used to construct transactions on a platform in the cloud. For example, Amazon Echo enables a consumer to order goods from Amazon but does not contain any actual payments data. Instead, the order is put into a special cart on the Amazon platform, which also stores information identifying the consumer’s preferred source of funds. Depending on how the individual configures the purchase settings, the platform can either fulfill the transaction on its own or present a cart for approval through the Amazon app or website. Similarly, smart printers can order their own ink when they run low, but again they do not directly create a transaction. Instead, they notify the printer manufacturer’s platform, which creates the order and charges the user’s source of funds for resupply.

The same basic process occurs with 5G, except that it may be the mobile operator itself that creates the platform and fulfills orders. 5G, with its support for extremely high data rates, gives mobile operators a third chance to provide a mobile wallet, with relaxed net neutrality rules allowing them to compete with streaming services and digital content providers by providing video content at higher speeds and greater resolution. In 2020, we will see little of this, but the 5G infrastructure is being built out, and this will become a major influence on the market in subsequent years.

Other Major Trends Anticipated for 2020

- ***Mercator foresees continued economic strength for 2020.*** The downside risk of the longest expansion since 1854 cannot be ignored, however, although our fears for the economy in 2019 did not materialize and the U.S., in fact, ended the year with strong job numbers and stock prices.
- ***Specifically, we expect credit card issuers' results to continue to improve in 2020*** as return on assets (ROA) continues its rebound from 2018. The Federal Reserve reversed course on interest rates in 2019 due to global economic weakness, but this did not result in a corresponding decrease in credit card interest rates; in fact, rates rose, putting issuers in a strong position for 2020. Credit losses remain low at 3.59%.
- ***Demographic shifts continue to shape the payments industry.*** Millennials and digital natives are replacing baby boomers, who are retiring, and this shift will drive continued growth in mobile payments, digital wallets, and digital channels in general.
- ***Financial technology (fintech) companies continue to grow market share.*** Recent analysis by the rating firm DBRS and TransUnion[i] indicates that fintech companies now have a larger share of personal loan balances than do banks. Today, fintechs are accountable for 40% of personal loan balances, and banks are accountable for below 30%. Virtual lenders such as Goldman Sachs offer consumer debt consolidation. Specialized companies, including Affirm, provide financing at the point of sale. Marketplace lenders such as Prosper and Lending Club, which focus on peer-to-peer lending, pose a challenge for credit card issuers on multiple fronts.
- ***The effects of the megamergers of 2019 will ripple out across the payments ecosystem in 2020*** even though the mergers will not be replicated. Fiserv's acquisition of First Data has put First Data's client relationships in play, with Bank of America Merchant Services announcing its intention to go its own way.
- ***Apple made a splash with its own credit card, raising the bar for user experience in mobile context*** although the actual value of the card offered in partnership with Goldman Sachs has been hotly debated. (Mercator sees it as primarily a co-branded card, similar to the Amazon Chase Visa.) The underwriting criteria for the card appear to be extremely aggressive; whether this is just buying volume or indicative of the benefits of Apple's knowledge of its customers remains to be seen. However, we expect more "bigtech" firms, especially Google and Amazon, to introduce payment products in 2020.
- ***Combatting e-commerce fraud was a big focus in 2019***, with EMVCo introducing a second version of 3D Secure as well as Secure Remote Commerce, standards for "click-to-buy" buttons that allow merchants to provide extra data to improve authentication and fraud mitigation. EMVCo is facing resistance from merchants as well as delays from issuers, but we do expect general rollout in 2020.

- ***Contactless, or "tap-and-go" payments, took off in 2019, and we expect continued growth in 2020.*** The primary drivers of this trend are: (1) the failure of the merchant-led digital wallet initiative, the Merchant Customer Exchange (MCX), which had been holding up the enablement of Near Field Communication (NFC) readers on payment terminals; (2) the introduction of NFC chips on popular mobile handsets; (3) the success of merchant mobile wallets (not MCX-driven), which educated consumers on the idea of paying with a mobile device; (4) the popularity of mobile order-and-pay, which usually integrates mobile wallets; and (5) the reintroduction of contactless chips on plastic cards, which began with credit cards but rapidly expanded into debit cards. Features like the ability to automatically associate purchases with reward memberships and the greater integration of cards into mobile wallets (see Apple Card) are accelerating the trend. There is still a lot of room for growth, so we expect this trend to continue into 2020.

- ***We expect to see more convergent technologies in 2020 as "brick-and-mortar" retailers respond to competition from e-commerce.*** Besides greater use of self-service through kiosks and mobile devices, mobile order-and-pay with pickup in the store is one way that traditional retailers are competing with Amazon, although some, like Kohl's, are partnering with the online behemoth by becoming physical locations where customers can pick up or drop off packages—and, Kohl's hopes, buy a few items while they are there.

- ***Some industries, like quick serve restaurants (QSRs) and groceries, are demonstrating growth of platforms,*** like delivery services and common kitchens that resemble open banking and banking as a service. There are even some restaurant brands that are little more than branding and a menu, acting as virtual restaurants. We expect these trends to accelerate in 2020 as part of an overall trend of virtualization. Financial institutions can learn from what merchants are doing in this market space. Challenger banks are already playing in this area, some of them being little more than a brand and a set of policies, everything else being done by an outsourced platform.

- ***Litigation of the status of prepaid cards will continue in 2020.*** The prepaid card market was impacted by a major new set of regulations from the Consumer Financial Protection Bureau (CFPB) in April 2019, and PayPal is now contesting whether it should have been classified as a prepaid provider under the rules. Another area of litigation is the Comptroller of the Currency's special purpose national bank charter for fintech companies, which was intended to bring fintechs under a limited regulatory framework but has encountered resistance from states that do not want their stronger regulations superseded by a federal agency.

- ***In a related move, several legacy prepaid platforms are restructuring themselves as "banking as a platform" providers.*** The purpose is to enable nonbanks and "neobanks" or "challenger banks" to compete with traditional banking institutions. Among these are platforms operated by Green Dot, i2C, Sutton Bank, Galileo, and others. We expect to see some major bank adoption in 2020, particularly from Europe, where open banking regulations have facilitated the growth of challenger banks focused on digital channels rather than physical branches. These BaaS providers join existing competitors such as The Bancorp Bank and Meta Payments Systems, which have acted as "arms merchants" (our term) in enabling nonbanks to participate in the payments market.

- ***The European Union's new rules for payments and banking, beginning with the revised Payment System Directive, PSD2, open a path for nonbanks to participate in the banking and payments system.*** PSD2 also includes rules for Secure Customer Authentication (SCA), which have proven difficult to meet for many providers. EMVCo's own Secure Remote Commerce and 3D Secure 2.0 standards were initially found not to be in compliance, but this has been addressed. Still, the deadline for compliance has once again been extended, this time to December 2020, making this a live issue for the current year. Since many financial institutions are not yet compliant with the open banking regulations, the authorities have maintained a light touch on enforcement so far. This will probably change in 2020, with ripple effects around the world, particularly for multinational banks.

- ***Jurisdictions like the U.S. and Hong Kong, although not specifically covered by PSD2, are nonetheless proceeding with open banking initiatives*** using application programming interfaces (APIs), standard catalogs of functions that third parties can access to do things like retrieve bank account balances and initiate payments. In the U.S., the use of APIs has been driven mostly by the private sector, since there is no federal agency with power to mandate open banking and payments. However, the growing use of services like Yodlee and Plaid by financial institutions and fintechs alike has created urgency among large financial institutions to establish standard APIs to prevent customers from having to provide their private online banking credentials. This has been a bumpy ride, with Plaid and others experiencing outages when banks have "upgraded" their security schemes, requiring them to sign agreements with the banks to ensure uninterrupted service. Some common rules of the road would be useful here, but no entity currently has the power to establish them. We expect the use of open APIs to become ubiquitous in 2020, albeit behind the scenes for most customers, who generally have no idea how their person-to-person payments or account aggregation work or do not work. Open APIs will also become much more common in corporate banking as a way to facilitate treasury integration and the use of the faster payments systems mentioned above.

- ***Cross-border payments is another area that will see substantial development in 2020*** as legacy correspondent banking networks strain to keep up with demand. Cryptocurrencies such as Bitcoin and various central bank initiatives (particularly in China) are one way to address the market, especially in countries that lack a strong banking sector. A new generation of service providers has established proprietary networks of banks to enable on-us cross-border payments, and the integration of national faster payments systems is an obvious opportunity.

- ***Private cryptocurrencies, such as Ripple and JPMorgan Chase's JPMCoin, are being adopted widely as major banks lend credibility and trust to what has often been a haven for corrupt and poorly managed firms.*** JPM Coin is reported to have 345 bank participants is a "stablecoin." That means it is backed by a basket of reserve currencies and actively manages the portfolio so as to maintain a stable valuation, something that is not possible with public cryptocurrencies like Bitcoin and Ethereum. Facebook infamously launched its Libra initiative in 2019, to widespread regulatory and governmental condemnation. The disapproval was not due to an inherent defect in the Libra coin but to Facebook's worsening reputation for privacy and misinformation. Facebook has since stepped back somewhat from Libra and is focusing on its own linked wallet, Calibra. 2020 will reveal whether Libra can recover from its disastrous start and gain bank membership. Regardless of what happens with Libra however, the idea of an independent stablecoin is now firmly rooted, and other companies and associations will attempt to learn from Libra's errors for their own rollouts.

Conclusions and Recommendations

Fundamental disruptors such as faster payments, faster wireless speeds, smart devices, banking and payments platforms, and megamergers will come into their own in 2020, putting even more pressure on banks, credit unions, retailers, and processors to adapt. Our principal recommendations for 2020 are as follows:

- Banks and credit unions would do well to forge relationships with nonbanks, particularly mobile operators, consumer goods manufacturers, retailers, car manufacturers, and content distributors. All of these parties are developing payments platforms, and card issuers will need the understanding and tools to ensure that their card remains top of wallet. Explore collaborative reward programs that will incent cardholders to use your card with a specific platform or seller.
- Expect central banks around the world to take a greater interest in sponsoring their own stablecoins. Following the botched rollout of Libra, other competitors are likely to try to seize the initiative by launching their own stablecoins. Do not count Libra out, though; although Vodafone is the latest defection, the concept and technology are solid, and once the Libra Foundation rebuilds trust with regulators, it will make another attempt. Cryptocurrencies never really die.
- Explore self-sovereign identity, and see how you can support it. We at Mercator Advisory Group believe this is the way forward, for customer satisfaction, privacy, and regulatory reasons. Financial institutions have a strong reservoir of trust, and SSI represents a way to reinforce that as well as a revenue-raising opportunity.
- If the economy does start to show signs of weakness, that is an opportunity to jump ahead of the competition. Use reserves built up during the good times to invest in a strong position for the future. This may be a hard sell to investors and boards, but there any many good investments right now.

References

Click here for complimentary download of the 2020 Outlooks by Mercator's six research advisory services:

2020 Outlook: Credit

2020 Outlook: Debit and Alternative Products

2020 Outlook: Prepaid

2020 Outlook: Commercial and Enterprise Payments

2020 Outlook: Emerging Technologies

2020 Outlook: Merchant Services

Endnotes

[i] https://www.dbrs.com/research/350589/us-unsecured-personal-loans-marketplace-lenders-continue-to-expand-market-share

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