VIEWPOINT

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2021 Outlook: U.S. Payments

The judgment to make about the pressure exerted by the COVID-19 virus on the U.S. payments business hinges not only on which changes are important, but which changes are permanent, or portend permanent developments beyond their implementation. The virus affected much, but from the standpoint of payments professionals it acted as an accelerant to processes and trends that were already in place.

Each year, Mercator Advisory Group discusses top trends anticipated for the coming year or two in an 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 2021.

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Introduction

There are important parts of the U.S. payments business that have not been affected over the past year by the global pandemic (we've found some of them and outlined them below), but many of the most important that *have* been affected will influence the payments business for many months, if not years, to come. Part of the challenge in predicting how the coming months shape up is determining the *extent* and *duration* of the change forced by the virus.

Under the pressure of the pandemic, the lock-downs imposed by governments globally, the ensuing unemployment, and virtual disappearance of some businesses (e.g., business travel and events), certain developments that were on the cusp of taking off did indeed become forces to reckon with. That's the important thing to remember. Bankers, merchants, and corporates responded to the pandemic with the tools at hand, and in some cases only began to appreciate the value of those tools when they represented lifelines to staying in business or staying profitable. However, the pandemic and its effects have been beneficial to some components of the payments value chain. QSRs, notoriously, did very well indeed. And the resilience of the U.S. consumer is evinced by the remarkable comeback of the economy.

Economic stability pre COVID made the U.S. and global payment trends easier to forecast because they were by and large predictable. These trends include:

- the increasingly rapid growth of digital in businesses where analog or hybrid processes and procedures prevail.
- the emergence of APIs and the fintechs who own them as forces to be reckoned with.
- a continual chipping away at the edges of the four-party model in credit card payments, demonstrated by the emergence of new lending forms, such as Buy Now Pay Later (BNPL), which, while likely to have garnered some attention last year, were certainly thrust into the spotlight by the virus.
- the addition to the payments mix of Faster Payments and Real-Time Payments, and the increasing importance of Pay Now as a category, evidenced by the unexpected and arguably secular shift to debit as top-of-wallet in U.S. consumer payments—including online.
- the emergence of a new class of financial institution (FI) in the form of neo-banks, which hope to grow on a deposit (liability) rather than a lending (asset) basis—at least initially. In the last regard the appearance of a regulatory challenge to the deposit basis of the open-loop prepaid business might call into question that business's long-term future, at least as presently configured.

In technology some of the most important movements (IoT, blockchain, crypto) were not affected by the virus at all.

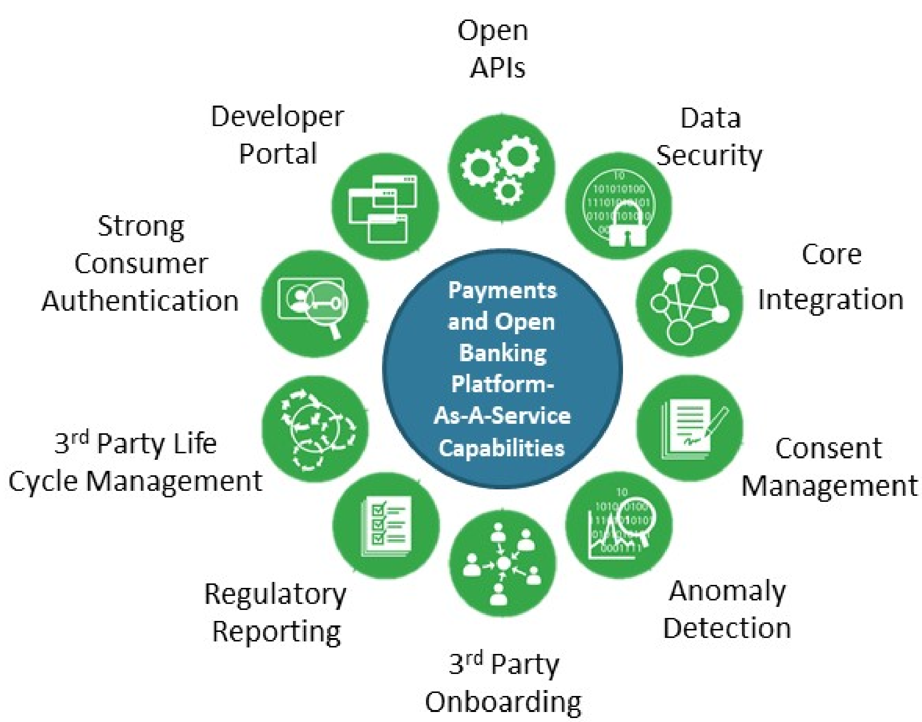
Emerging Technologies

The technologies most immediately impacted by the virus include mobile, contactless, order for pickup or delivery, and videoconferencing. Each of these is linked to behaviors driven by the pandemic that are likely to remain even after we've all been vaccinated. The pandemic has driven a large increase in video meetings and singlehandedly halted industry events. While there is an expectation that conventions and traditional face-to-face meetings will resume in the future, many workers will continue to report in from home and both internal company meetings and B2B meetings will continue to be conducted by video. This opens up a raft of possibilities while also highlighting infrastructure and technology issues.

The pandemic will expand greater interest in digital onboarding. This will in turn highlight the lack of a consistent method of conducting authentication across all the different physical and digital channels, which will either limit innovation or drive increased adoption of fintech solutions.

The implementation of a service-orientated architecture (also called microservices and often implemented in the Kubernetes environment) requires that every basic function be exposed as an API. These APIs are then linked together to create higher level services. This approach makes it easier to modify the application and add new capabilities (***Figure 1***).

Figure 1: APIs require significant management to operate safely and efficiently.



Source: Mercator Advisory Group

Other fintechs have entered the market with solutions that help the consumer create a digital identity that can be reused across multiple authenticators. In fact, some of these solutions go a step further and support the principles of self-sovereign identity (SSI). Several major suppliers, including Microsoft, IBM, and Mastercard, as well as government agencies and credit unions, have deployed solutions that support the SSI concepts. However, due to the pandemic, the urgent need to implement online solutions that embrace paper-based identity is likely to drive adoption of less complex solutions and that may slow down adoption of SSI-based solutions (see Distributed and Self-Sovereign Identity-Solutions Part 1[ii] and Part2[iii]).

Cybersecurity

It should come as no surprise that the shift in consumer behavior to mobile and online-based transactions has generated more criminal activity related to synthetic identity fraud, phishing to extract private information from consumers, and the use of fake or stolen payment credentials in e-commerce and commercial transactions. While Europe is implementing PSD2 in part as an effort to reduce online payment fraud and account takeovers, the U.S. has no national implementation plan and so our response is less focused and less coordinated.

Machine Learning Moves Forward

Machine learning platforms are now so automated that they are capable of ingesting data, building models, and even automating the best feature selection for the specific task at hand. The result is that machine learning based products and services continue to penetrate every operational area of business. This trend will continue and speed up over the next few years. More business processes will become automated or guided by machine learning and, as machine learning tools are designed to access the data stored in documents and databases, voice-activated assistants will become significantly smarter for a wider range of customer and employee issues.

Among Other Important Issues:

QR Codes and Alternative Payments: QR Codes are increasingly being deployed in smartphone applications and the top general-purpose wallets. Initially implemented in countries lacking a robust payment infrastructure, QR codes have made recent advances in the U.S. The QR code solution can be implemented easily at the POS by the merchant using existing hardware. QR codes enable transactions to bypass easily the traditional payment networks—an example of the erosion of the four-party model referenced above. A range of merchants from CVS and Walgreens to Crate & Barrel and Uber Eats have all adopted QR Codes.

A Breakout Year for Cryptocurrencies: Existing crypto exchanges have created walled gardens that enable them to address the regulatory requirements in the U.S. PayPal was the first major payments provider to take the plunge, but Visa and Mastercard are opening up their networks a little at a time, so that issuers willing to take the risk can connect traditional payment cards to the crypto assets held in properly run exchanges. This enables crypto to be burned anywhere Visa or Mastercard is accepted.

The Internet of Things: An IoT transaction is a real-time data-driven payment decision that at the time of the transaction does not involve a buyer decision. Instead, the buyer has previously authorized a plan for payments to be made automatically based on feedback from a sensor or automated data source. Examples include a smart ink order from a printer, a smart electricity payment, or a car insurance payment based on telematics devices. Our current estimates show that residential electricity accounts for $66 billion in IoT payments. Some $11 billion in IoT payments is made for IoT-based insurance. Approximately $7 billion in IoT payments is made for residential water service. In short, the IoT payments sector, while small compared with the larger payments market, is larger than most expect and is growing fast.

Tokens That Bind: In an effort to better secure e-commerce and mobile transactions, the payment networks have adopted tokenization, and their deployment of tokens continues to expand. The payment networks are implementing the EMV Secure Remote Commerce (SRC) specifications.

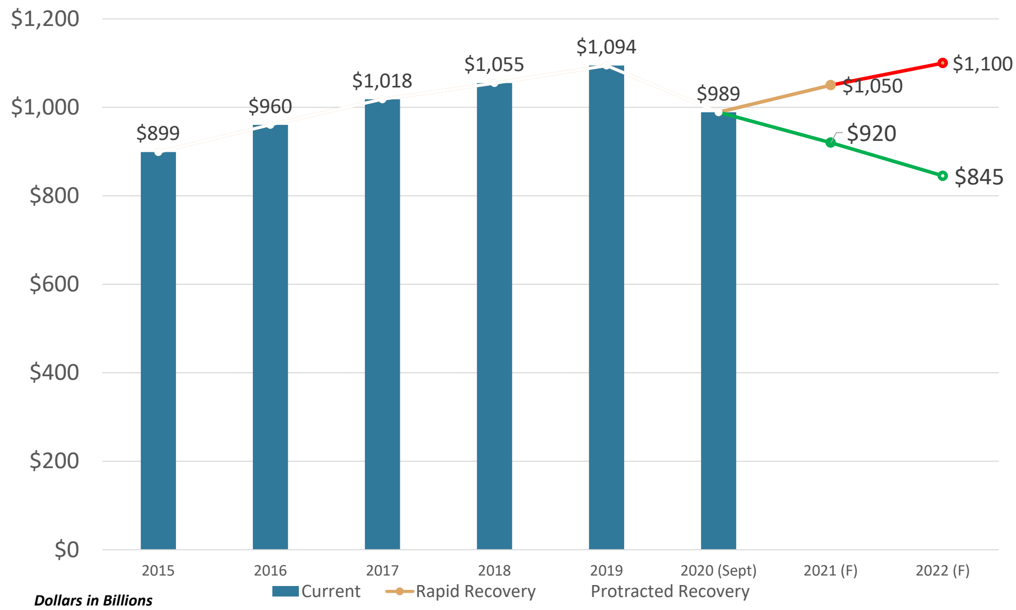
Credit Cards

Credit loss guardrails, established in response to the Great Recession of 2008-2010, positioned the U.S. credit card industry well for the current debacle. Current Expected Credit Loss (CECL), now a standard accounting procedure in the United States, and International Financial Reporting Standards (IFRS-9) required financial institutions to shore up risk recognition *before* the World Health Organization confirmed the first U.S. case of COVID-19 on Jan. 21, 2020.

In February 2019, with a 3 year phase in allowed, CECL forced credit card issuers to accelerate their loan loss reserves from a standard metric of 4% to just under 11%. The timing allowed credit card issuers to brace for the unexpected. Even though credit charge-offs did not surge as anticipated because of Coronavirus Aid, Relief, and Economic Security (CARES) Act directives to encourage debt forbearances, the allowance will protect against future losses. As a result, credit card industry income diminished to fund the credit loss reserve line.

Credit card issuers were prudent with credit line management and targeted line compression better during the COVID-19 pandemic than during the Great Recession. Rather than the aggressive knee-jerk to tighten open credit card lines, which fell from $3.7 trillion in 3Q08 to $2.9 trillion in 3Q09, a 21% decrease, credit card limits dropped only by $80 billion between 1Q20 and 3Q20, from $3.93 trillion to $3.85 trillion **(*Figure 2*).**

Figure 2: Revolving Debit in the U.S.: Two Business Cases



Source: Mercator Advisory Group

Credit card accounts were not a distribution channel for U.S. government stimulus payments. This action disrupted the typical mix of slightly higher credit volume than debit. In 2Q19, credit purchase volume was $756.0 billion, versus debit volume at $680.3 billion. In contrast, 2Q20 produced $596.0 billion for credit and $738.5 billion for debit.

The decreased credit mix has a negative impact to credit card issuer non-interest revenue lines. In the U.S. market, the average unregulated interchange for single message debit transactions is only $0.24, while credit card transactions are close to 1.85%, according to Mercator estimates. On the equation's interest side, credit card issuers felt the pain of reduced income as credit card revolving debt fell from a high of $1.1 trillion in 1Q20 to $988.6 billion in 3Q20. The indication is that consumers were less comfortable with carrying credit card debt in uncertain times. The trend continues with card spend categories that peaked on essential items and quickly declined for non-essentials.

From the highest conceptual level, the virus accelerated the pressure on interchange and advanced the accompanying erosion of the four-party model. The best example of this is BNPL, as distressed consumers looked for new methods to finance their purchases. Whether BNPL will continue to occupy center stage as the virus recedes is difficult to say. Some BNPL companies, notably Klarna, have been around for a long time. But consumers, who call the shots, are looking for choice; and merchants, at least, see interchange as impeding that freedom by limiting their payment acceptance choices.

Debit and Alternative Payments

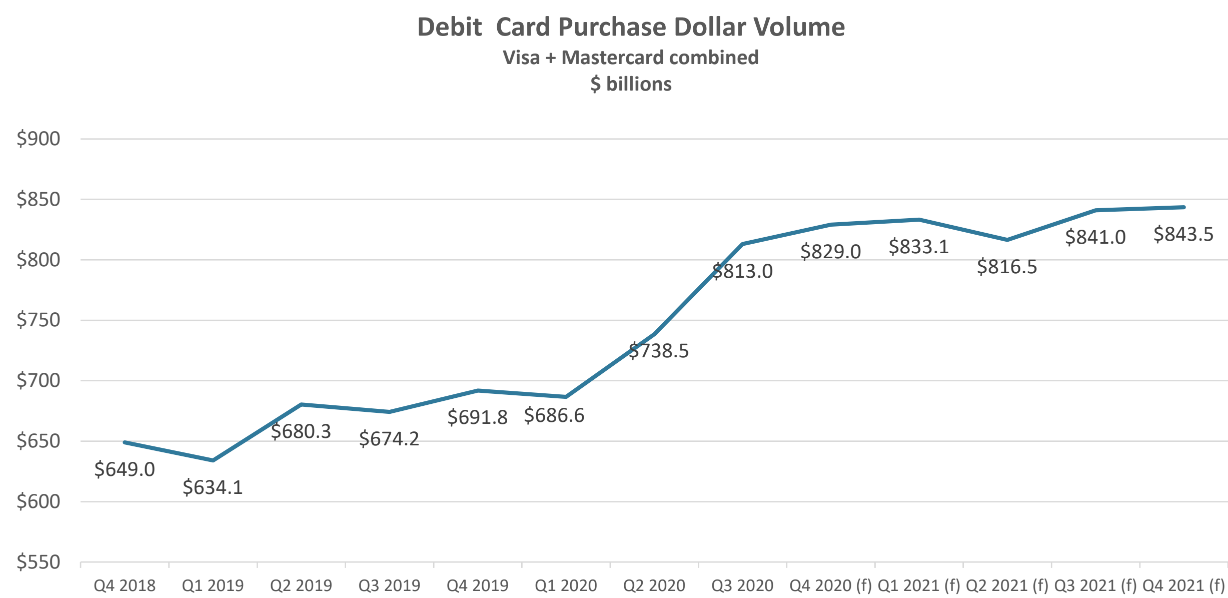
The Mastercard and Visa debit card market will see continued strong growth in 2021, realizing roughly 9% growth over 2020, and could achieve low double-digit growth if one or more additional federal stimulus benefit payments are sent to consumers.

As noted, consumers are relying more on debit cards and the funds they have, rather than credit cards, due to the weakened economy and negative financial impact experienced by millions in 2020.

Mercator's North American PaymentsInsights Survey found in June 2020 that half of all cardholders used credit cards less in 2020 than the prior year, a decline not seen since the Great Recession. More data regarding this topic can be found in Mercator Advisory Group's report, *Debit Card Abruptly Finds Itself Top of Wallet*.

While consumers are venturing out to make purchases more frequently than when COVID-19 first emerged, concerns about health continue, resulting in consumers shopping at fewer stores and maintaining a higher average debit ticket in the low $40 range. With the help of a vaccine, purchase habits in 2021 will return to more typical patterns. This means a shift of some transactions back to credit cards and an average debit ticket in the high $30 range, still higher than pre-pandemic levels (***Figure 3***).

Figure 3: U.S. Debit Card Purchase Volumes through 2021



•Note: Debit includes prepaid, Maestro, Interlink. Excludes Visa Direct and Mastercard Send

Sources: Mastercard and Visa quarterly financial report and Mercator Advisory group estimates

The shift back to credit card use will be gradual, as high unemployment and other financial problems linger. The increased use of debit in card-not-present (CNP) transactions for everyday purchases for delivery, picking up curbside, in-store or in-restaurant, will be payment habits that remain even as fears of the virus subside. Born out of necessity, shoppers have grown accustomed to the convenience these solutions offer. Consumers' digital purchases tend to be higher than in-person payments, so these new habits will help to support the higher per transaction value.

A key area of focus foe debit issuers is ensuring that debit card fraud solutions are targeted to respond to a larger proportion of remote transactions, including the growth of pick up in-store or curbside purchases. A review is also in order of how disputes are handled, plus the user experience and effectiveness of debit card alerts and controls capabilities.

Contactless

Contactless transaction growth was greater than 100% in 2020 as issuers, wanting to look tech-forward, issued cards with dual contact and contactless capabilities, and more than 60% of merchants adopted contactless at the point of sale (POS). Contactless was given a boost with the onset of the pandemic, as consumers appreciated the opportunity of contactless in card form and as a part of a mobile wallet to keep their distance from payment terminals. Continued high growth should be expected in 2021, however, contactless is unlikely to achieve a significant percentage of total debit card transactions.

Faster and Real-Time Payments Take Hold

Implementations to The Clearing House RTP network continued to progress. By third quarter 2020, there were more than 45 institutions in the network, reaching over 56% of U.S. accounts. The number of integrations in 2021 will increase significantly as core processors, including FIS, Fiserv, Jack Henry and Shazam, and tech firms, such as Bottomline, Finastra, Finxact, PayFi, Volante and others, provide the tools to help financial institutions integrate with the RTP network quickly, often within 90 days or less.

Most of these integrations by midsized and smaller financial institutions will initially include just the ability to receive transactions. The more demanding capability to send real-time payments, requiring around-the-clock staffing, will wait for the market to develop and the most important and profitable solutions to emerge. Other faster payment networks, such as the debit network push payments Zelle and Same Day ACH, will expand through organic growth and the development of new niche markets and channels.

Commercial and Enterprise Payments

The four general themes for commercial and enterprise payments in 2021 are as follows:

- Digitalization of financial operations has accelerated in 2020 and will continue as corporate inertia around such investments has been greatly challenged.

- Platform banking and services seem poised to gain traction given the need to gain efficiencies, the coming changeover in payments standards to ISO 20022, and the growing adoption of AI.
- Collaboration between financial technology companies (fintechs) and financial institutions will continue, with perhaps some consolidation as fintechs mature and banks deal with market risk.
- Risk management remains as the ever-present priority.

The digitization of cash cycle management involves systems and processes touching everything from procurement to payables, trade financing, receivables and reconciliation. Those firms that do a good job of understanding how to best organize these operations have a distinct advantage over laggards. In the past, there were technology firms that specialized in various point solutions. More recently, a fintech convergence of these separate capabilities has been happening through acquisition, partnerships and APIs. Banks and networks have interest in figuring out what they need to service their clients, and how to take advantage of existing and future collaboration opportunities.

The pandemic has driven much closer corporate scrutiny on the supply chain, working capital and cash flow management, especially as one moves down the food chain into smaller firms.

B2B payments have gotten the most attention on the fintech side of financial operations. As we have been covering now for some years, global non-cash payments growth has been on a steady rise of 12.5% CAGR from 2014-2019. This payables trend will continue and indeed accelerate in the middle market during 2020*.* However, the discussion has expanded into supplier payments acceptance and receivables automation as the full cash cycle is considered.

It is clear that B2B card acceptance has received a major boost, and the question becomes one of post-pandemic sustainability. Mercator Advisory Group thinks this is a permanent shift. The innovation around cross-border payments will also continue as the industry focuses on improving speed, transparency, cost and access. The recent announcement by SWIFT of a strategic shift into cross-border transaction processing on behalf of members is an important signal to the industry that banks expect to continue playing a major role in the space, despite the emergence of fintech alternatives.

This also includes the ability to eventually connect sovereign domestic real-time payment systems into a cross-border use case. Real-time payments as a solution are making progress across the globe, but for the most part are being used for person-to-person transfers, payroll related services and wallet-to-account transfers. We expect that 2021 will see increased B2B use cases as more banks enable the send payment capability. There should also be more substantial adoption of bill-pay use cases given that the Request for Pay messaging in RTP (Request to Pay in Europe) will be more widely launched during 2021.

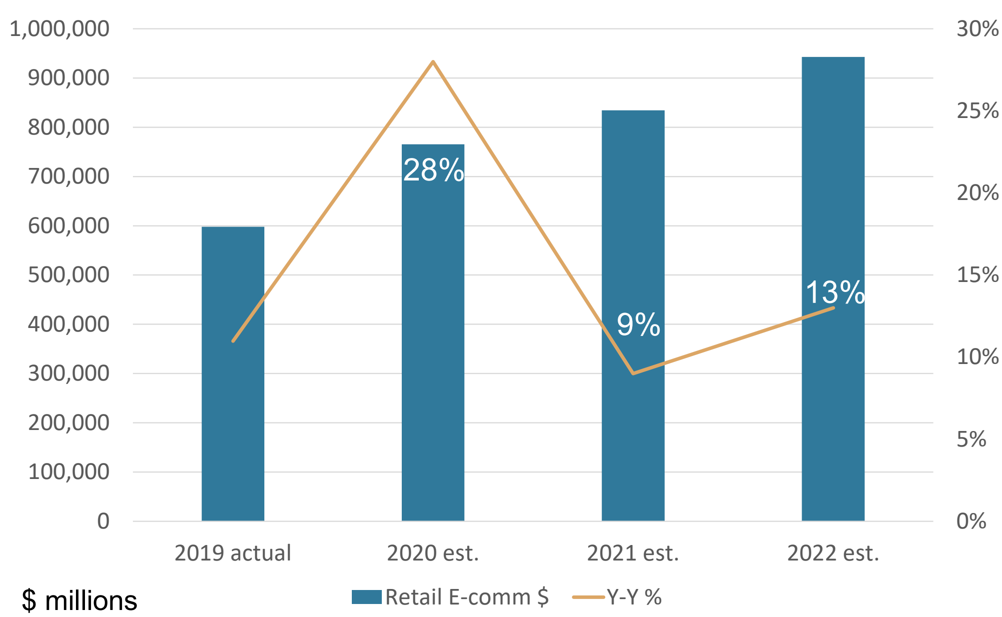
Merchant

As of this writing, nearly 15,000 stores have closed in 2020 and there will be more—the U.S. market remains overstored. For comparison, more than 9,000 stores shuttered in 2019. The pandemic has caused 100,000, (approximately 16%) of U.S. restaurants to close. This represents 3 million workers and $240 billion in lost sales.

A significant divergence occurred among retail segments. Winners were big box retailers, and losers were small independents. Most large grocery stores and big boxes such as Best Buy, Costco, Target, and Walmart were considered essential during the height of the COVID-19 shutdown. Most Main Street businesses and restaurants were not. For those that remained open, a key success factor was the ability to scale up rapidly the online channel and respond to the surge of online buying from stay-at-home households.

One example demonstrates how e-commerce has become the rising force of consumer commerce. During the first nine months of the pandemic, restaurant meal delivery firm DoorDash completed 543 million orders—that's triple the number of orders from the same period in 2019. They service 390,000 merchants (mostly restaurants), have 18 million users, and more than one million drivers (or dashers as they call them). And they still don't have enough dashers, needing a few hundred thousand more. These numbers are a case study in ramping up to meet digital demand (***Figure 4***).

Figure 4: U.S. E-Commerce Growth, 2019-2022



Source: Mercator Advisory Group

Digital payments and technology solutions that would have taken perhaps five years have been accomplished in less than one. The digital payments era has arrived in full force. Nothing, not even a global virus, can stop it. We foresee continued expansion of the tech trend and espouse a 3D Merchant Survival Strategy—Digital, Drive-up, and Delivery. These shopping and payments behaviors are now mainstream.

Legacy department stores will suffer the most from the 3D development, as they have not been able to pivot fast enough to compete for e-commerce business. This decline will have a spillover effect as shopping malls will be left with many empty spaces previously occupied by anchor stores. Bigger is better. Large chains, including big box, warehouse, and electronics stores, will dominate retail with their strong end-to-end omnichannel resources from order to payment to fulfillment.

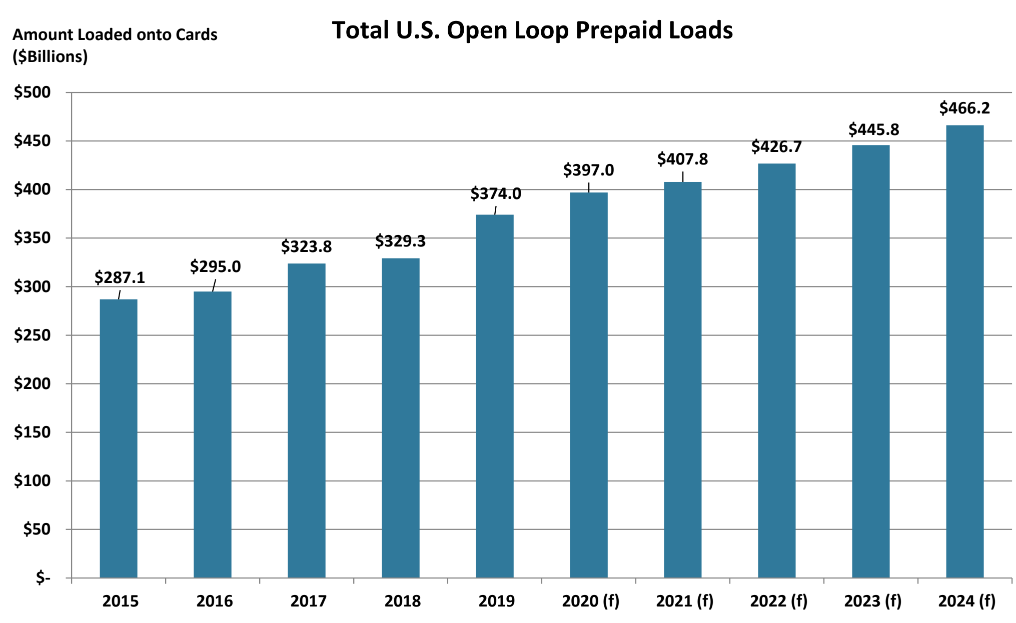
Recent numbers from the U.S. Department of Commerce show a 0.5% gain in personal consumption expenditures from September to October 2020, but data also reveal a decline in household income and an increase in jobless claims. Unknowns are future stimulus measures and new administration policies in Washington.

Mercator expects that online and mobile shop-and-pay will continue to grab share from in-store POS while in-store traffic decreases in contrast to online sales surge. E-commerce annual growth rate jumped in 2020. Mercator's e-commerce retail forecast shows a 28% annual increase for 2020 over 2019, and compound annual growth rate of 16.4% from 2019-2020. Mercator estimates 2021 to show a 9% rise over 2020's big surge.

Prepaid

Prepaid continues to occupy an important position in the U.S. payments ecosystem, though some regulatory headwinds might severely impact the open-loop variety. Nevertheless, pay-before remains a good deal for any number of applications, and innovation continues to happen in the space (***Figure 5***).

Figure 5: Total Amount Loaded on Open-Loop Prepaid Cards in the U.S.



Source: Mercator Advisory Group

A good example of this kind of innovation is the rise of the Earned Wage Access (EWA) cards. Already in use before the pandemic, EWA cards are experiencing robust growth, both as a result of the concept and because of the kinds of advantages afforded to employers and employees during the pandemic and indeed beyond.

The target market for EWA functionality is precisely that which is most severely impacted by the effects of the pandemic: unemployment, uncertainty and lack of household liquidity. This functionality permits employees to access funds they have already earned on an hourly basis for day-to-day and extraordinary expenses that are sure to occur. The result is a happier, more stable workforce and better retention rates for employers.

While not all EWA deposits are directed to a prepaid card, these instruments can be confidently said to have "taken off" under the pressure of the pandemic, as the 1099 economy becomes more and more important to workers of all kinds in the U.S. Another example of the importance of prepaid in the new normal is the outflow of government funds in the form of stimulus aimed to cushion the blow of pandemic-induced hardship.

With stimulus payments and innovations such as Earned Wage Access prepaid cards, Mercator Advisory Group predicts a continued upward trajectory for prepaid, especially as the plastic form factor is joined by digital access to pay-before funds.

Given the propensity of the Biden administration to up the ante on the stimulus amount per person as compared with its predecessor, increased government payments to consumers in the current year are a sure bet.

However, questions addressed to the Federal Reserve Board by The Clearing House, the ACH network owned by the nation's largest banks, could in fact upend the entire open-loop business. The questions throw shade at the entire notion of assets, rather than deposits or transactions, determining the size of a given FI or fintech. Right now, falling above or below the Durbin cut-off of $10 billion is a function of the amount of assets (loans) held by the FI. The ability to charge a higher interchange rate has enabled not only rewards programs but also substantial revenue for all involved. A new way of measuring bank size could disrupt this hitherto robust business.

Conclusion

The questions asked of the Fed by TCH are one example of a disruptive event that has nothing to do with the pandemic. Nevertheless, COVID changed much, and the virus will continue to reorder the world financial system. News from both Europe and South America indicate the devastation is far from over, and important businesses served by the payments industry—notably travel—will languish until a more stable environment is achieved.

There are three kinds of change to look for in 2021: the irrevocable, the ambiguous, and the unanticipated. Irrevocable change, to give an example, is the true emergence—under pressure of the pandemic—of the omnichannel shopper, who expects, and increasingly gets, the same speed and level of service from physical points of sale that he does from e-commerce. Of the ambiguous, good examples are the emergence of BNPL and debit as top-of-wallet payment method, though it is important to remember that industry pressures accelerated by COVID-19 were in place before the pandemic. Regarding the latter, while debit will continue to grow in importance, it is unlikely permanently to remain a leader even though consumers have grasped the importance of pay now in regulating their household position. Regarding BNPL, distressed consumers are looking for alternative methods of financing their purchases and BNPL fits a need in the current environment. The size of its role in the long-term is another story, given the cost to merchants, though merchants may consider the price of BNPL in fraud losses and per transaction well worth paying in exchange for completed orders, site traffic, and return business.

But what about unanticipated change? How can anybody expect the unexpected? With the exception of exogenous events such as the pandemic, very few events that emerge from within the payments industry are truly unanticipated. It is the form they take that catches everybody by surprise.

Take BNPL. It would hardly have taken off had not Klarna been standard equipment on many large merchants' and marketplaces' checkout pages. What BNPL's emergence portended was the consumer's desire for flexibility, and the merchants' desire to respond with solutions that may or may not fit in with the four-party model that has prevailed for the past 50 years.

While the argument implicit in TCH's questions to the Fed may be new, their source—the increasing pressure on interchange globally—is not. Preparing for the worst is not a bad motto for the payments business, remembering that the emergence of a deadly virus from central Asia was hardly on anybody's agenda.

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