Eight Trends Shaping the Payments Industry

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Modern Human-Centered Payments

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Eight Trends Shaping the Payments Industry

The financial services industry has been indelibly changed by the pandemic's impact on how people interact and transact, and how businesses prosper and grow. The industry is also being disrupted by the ability of fintechs and big techs to disenfranchise banks and credit unions with innovative, engaging solutions that are reinventing financial services – especially payments – and how they are delivered.

Knowing that change and disruption will continue to impact and threaten the fundamental business of banking, there is unprecedented strategic thinking and planning happening in banks and credit unions of all sizes. To help you consider and analyze these changes, we'll share Jack Henry's point of view on eight important trends shaping the near- and long-term future of payments and financial management solutions.

1. Interchange Income is at Risk

- Banks and credit unions need to begin diversifying their business and revenue models to accommodate a significant decrease in interchange.
- They should also ensure their card technology providers can help them respond to the dynamic regulatory environment by optimizing operating efficiencies, reducing operating expenses, and maximizing near- and long-term card program performance.

> *In the digital era, vendors need to clearly demonstrate their commitment to openness through an open API strategy and the development of cloud-native solutions.*

2. Digital Engagement – The Top Priority for 2021

- Digital reinvention takes a village of innovative technology partners, so banks and credit unions need a disciplined approach to evaluating the merits of their existing partners and potential partners and systematically matching distinct capabilities to their unique goals for digital engagement.
- In the digital era, vendors need to clearly demonstrate their commitment to openness through an open API strategy and the development of cloud-native solutions.
- A commitment to vendor consolidation – leveraging more solutions from fewer partners – will also generate important tangible and intangible benefits.

3. P2P Leads Payments Innovation

- Banks and credit unions cannot compete with the fintechs and big techs reinventing payments without offering real-time payments.
- Banks and credit unions must realize "alternative payments" are no longer alternatives – providing money in the exact moment of need has evolved from a competitive distinction into a competitive necessity.
- If banks and credit unions innovate now, they can capture or recapture their fair share of P2P engagement since most consumers still trust financial institutions more than the emerging payment providers. This is largely based on the belief that banks and credit unions will be more accessible and willing to resolve fraud-related issues.

4. Embedded Finance Means Everyone can be a Bank

- BaaS is another technology-driven trend that is threatening traditional banking as more consumers choose who provides their financial services based on brand affinity.

- Banks and credit unions must begin offensively planning their open banking strategy and carefully consider the sweeping impact to their competitive environment when virtually any company can offer traditional financial services inside their customer experience.

5. The Reinvention of POS

- Digital innovations are reinventing POS, like they did with P2P payments, and banks and credit unions are once again being disenfranchised.
- Merchant relationships are at risk knowing fintechs and big techs have a “payments first, traditional financial services later” strategy.
- Being relevant in POS means banks and credit unions must carefully monitor the reinvention of merchant services and modernize their payments infrastructure to support dynamic POS strategies and technologies.
- The time for POS innovation is now while banks and credit unions are considered more accessible and responsive than most alternative payment providers.

Digital innovations are reinventing POS, like they did with P2P payments, and banks and credit unions are once again being disenfranchised.

6. The Reinvention of B2B Payments and SMB Banking

- Capitalizing on the unique and urgent opportunity with SMBs will require banks and credit unions to understand what financial services they need in the new environment reshaped by digital innovation and the pandemic, and to strategically bundle and competitively price those services.
- Banks and credit unions can successfully compete in the significant SMB market with an offensive strategy that leverages existing account relationships and provides modern payment and financial management solutions that support the unique needs of SMBs.
- After the reinvention of P2P payments, fintechs are reinventing B2B payments with a proven “payments first, traditional financial services later” strategy.

7. A New Presidential Administration Means New Financial Regulation and Oversight

- The Biden administration is focusing on equality, social justice, debt, and consumer protection which will inherently translate into more stringent regulations for banks and credit unions.
- Every change in presidential administrations means new priorities, inherent uncertainties about evolving regulations, and challenges fully understanding and complying with complex regulations.
- New financial regulation and oversight impacts the bottom line with banks and credit unions required to dedicate more time, resources, and technology to ensure compliance.

8. Flexible Payment Options Support Financial Health and Debt Reduction

- Banks and credit unions must understand the profiles of financially distressed consumers and small businesses and offer modern payment solutions and flexible payment options that can prevent missed payments, avoid late fees and penalties, protect credit scores, support quick recovery from delinquencies, and help them better manage ongoing expenses.

Interchange Income is at Risk

Debit interchange is an important source of significant and recurring revenue, but it may be in jeopardy. Senator Dick Durbin, namesake of the 2008 Durbin Amendment, claims that Visa and Mastercard make routing transactions to the debit networks more difficult and discriminatory for small merchants. He has proposed legislation that would reduce the transaction fees charged to those merchants.

Durbin's proposal also means fintech interchange is at risk. The proposal addresses the routing discrepancies with unregulated debit transactions, specifically transactions requiring tokenization or PIN-less routing. It would require dual routing on all debit transactions and would cap interchange revenue for payments processed by fintechs like PayPal and Venmo, and big techs like Amazon, Apple, and Google.

Banks and credit unions need to begin diversifying their business and revenue models to accommodate a significant decrease in interchange.

It would also mean that neobanks and fintechs that are solely dependent on unregulated debit interchange, either directly as issuers or indirectly through BaaS models, would be challenged to replace this critical revenue stream.

Interchange generated by credit transactions associated with digital and premium rewards programs could also be capped.

With Democratic majorities in Congress, the proposed legislation will likely be enacted. If debit and possibly credit interchange are more closely regulated and capped, card revenue for the average bank and credit union with less than $10 billion in assets could decline by 25% to 35%.

It's also important to consider that credit card usage and revenue will decline as digital wallets and closed loop payment systems like Venmo, Square Cash, and Cash App become more popular.

Banks and credit unions need to begin diversifying their business and revenue models to accommodate a significant decrease in interchange. They should also ensure their card technology providers can help them respond to the dynamic regulatory environment by optimizing operating efficiencies, reducing operating expenses, and maximizing near- and long-term card program performance.

Digital Engagement – The Top Priority for 2021

The pandemic environment clearly demonstrated the need for digital reinvention and rewarded banks and credit unions that had embraced digital as the emerging banking channel-of-choice and penalized those that had not.

According to a recent Celent study, digital engagement is the top strategic priority in 2021 for diverse financial institutions. In the study, 97% of financial services executives consider enhancing digital self-service capabilities to be their top priority and are planning their IT spending accordingly.

Based on the study results, most financial institutions plan to increase digital-focused IT spending:

- 88% will invest more in online and mobile banking
- 65% will invest more on digital payments
- 54% will invest more on digital lending

These investments are making 2021 a busy and important year for industry-wide innovation.

Respecting that digital reinvention takes a village of innovative technology partners, banks and credit unions need a disciplined approach to evaluating the merits of their existing partners and potential partners and systematically matching distinct capabilities to their unique goals for digital engagement. In the digital era, vendors need to clearly demonstrate their commitment to openness through an open API strategy and the development of cloud-native solutions. A commitment to vendor consolidation – leveraging more solutions from fewer partners – will also generate important tangible and intangible benefits.

Statistics in this section from:

Top Technology Priorities for Retail Banks in 2021, Celent (January 2021)

P2P Leads Payments Innovation

With 65% of financial institutions planning to invest more in digital payments during 2021, most of this investment will be focused on P2P payments.

P2P payments are becoming habitual, with 125 million people in the U.S. making P2P payments last year and 70% using a new digital payment method for the first time during the pandemic. Among banks and credit unions, 85% expect these behavioral changes will be permanent including the demand for P2P payments. According to a *Business Insider*, there were 82.5 million P2P payment users in 2020, up 34.2% from the prior year.

Payment innovators like PayPal and Venmo have set the expectation that P2P payments are real-time. If banks and credit unions are going to meet this expectation, they need a modern payments infrastructure – a payments hub – that enables seamless real-time payments. Partnering with a payments hub provider generates important benefits including:

- Significantly quicker, less expensive, and more efficient ready-built conduits to the instant payment networks (Zelle®, RTP®, and eventually FedNow℠)
- All the required network-specific data feeds
- Streamlined network certification and onboarding
- Expedited time-to-market
- Network-specific settlement, clearing, and dispute management

Today, banks and credit unions cannot compete with the fintechs and big techs reinventing payments without offering real-time payments. And these payment innovators are extending their reach well beyond payments. Several of the dominate providers of P2P payments, including PayPal, Square, and Apple, are offering traditional financial services like direct deposit accounts, debit and credit cards, lines of credit, and more with the strategic goal of displacing banks and credit unions as the primary financial services provider. They are also expanding into POS payments with NFC technology, QR codes, and e-commerce buy functionality. These fintechs and big techs are essentially operating as neo-banks and it's safe to assume they will continually introduce new value-added features and enhanced experiences for their extremely loyal and engaged users.

Today, banks and credit unions cannot compete with the fintechs and big techs reinventing payments without offering real-time payments.

However, it's important to consider that funds residing in payment accounts are not insured by the FDIC like the funds held in demand deposit accounts. But many consumers will continue using these services instead of traditional banking services based on the usability and cool factors.

Banks and credit unions must realize "alternative payments" are no longer alternatives – providing money in the exact moment of need has evolved from a competitive distinction into a competitive necessity. If banks and credit unions innovate now, they can capture or recapture their fair share of P2P engagement since most consumers still trust traditional financial institutions more than the emerging payment providers largely based on the belief that banks and credit unions will be more accessible and willing to resolve fraud-related issues. Case-in-point, during the third quarter of 2020, Zelle processed $84 billion in P2P transactions largely originating in banking channels while Venmo processed $44 billion.

Statistics in this section from:

Top Technology Priorities for Retail Banks in 2021, Celent (January 2021)
COVID-19: Tracking the Changes in Bank Technology Strategy, Wave 3, Celent (September 2020)
The Embedded Finance Explainer, Business Insider Intelligence (January 2021)
Top 10 Trends in Retail Banking & Payments, 2021: Seizing Opportunities to Transform, Aite (January 2021)

Embedded Finance Means Everyone can be a Bank

Embedded finance or Banking as a Service (BaaS) is the rapidly emerging software distribution model that is promising – or threatening – to reshape the financial services industry. BaaS allows any non-financial company to embed traditional financial services into its customer experience through strategic partnerships with fintechs and large banks.

Stripe provides an ideal example of the impact and significance of BaaS. Stripe was launched to provide small businesses with a digital payments solutions. It has now expanded its technology stack through BaaS partnerships to provide financial services typically offered by banks and credit unions including interest-bearing, FDIC insured checking and savings accounts, treasury management, debit cards, and more. Stripe represents another "payments first, traditional financial services later" strategy that paid off. In August 2019, the company was valuated at approximately $35 billion and as of February 2021 it was valuated at $115 billion.

BaaS is another technology-driven trend that is threatening traditional banking as more consumers choose who provides their financial services based on brand affinity.

Embedded finance companies are projected to reach a market cap of $7.2 trillion globally by 2030 and to grow from $22.5 billion in revenue in 2020 to $230 billion by 2025. It's estimated that 40% of payments and 20% of lending will be done via BaaS by 2030.

Projected growth of BaaS in the U.S. is estimated at $3.6 trillion by 2030. The appeal of BaaS is largely driven by the expense and difficulty acquiring a banking license. For example, Varo Money invested three years and approximately $100 million to acquire a national bank license. BaaS is a much more cost-effect approach that enables banks to "lend" their licenses to non-financial entities and provide them with access to the proven technology needed to offer specific financial services.

Payments are the most popular service in embedded finance. Through payments as a service (PaaS) virtually any company in any industry can embed payments into its digital presence.

A combination of factors is supporting the growth of embedded finance:

- Young consumers are increasingly open to using non-financial companies for their financial needs.
- The growing presence of big tech firms in financial services will create a huge market for embedded finance.
- BaaS generates opportunities for fintechs to create solutions for a wide range of industries beyond banks and credit unions which supports a unique and important diversification strategy.
- Increased funding for embedded finance is expected, with many investment and venture capital firms showing interest in adding embedded finance companies to their portfolios.

BaaS is another technology-driven trend that is threatening traditional banking as more consumers choose who provides their financial services based on brand affinity. Banks and credit unions must begin offensively planning their open banking strategy and carefully consider the sweeping impact to their competitive environment when virtually any company can offer traditional financial services.

Banks and credit unions must begin offensively planning their open banking strategy and carefully consider the sweeping impact to their competitive environment when virtually any company can offer traditional financial services.

Statistics in this section from:

Retail Banking Top Trends 2021, Capgemini (January 2021)
The Embedded Finance Explainer, Business Insider Intelligence (January 2021)

The Reinvention of POS

Consumer demand is once again flexing its muscle to change the POS landscape, and the change is being enabled by fintechs, big techs, card networks, and bank giants.

The digital experiences offered by fintechs and big techs as well as the pandemic environment have dramatically changed consumer behavior. Eighty percent of consumers have changed how they pay based on the level of convenience they expect in the digital era and their COVID-related safety concerns, and 67% of businesses have started accepting new payment methods in response to those changes.

The initial change in POS was the shift to contactless payments:

- Domestic contactless payments have increased 150% since March 2019.
- Visa contactless transactions have grown more than 100% year-over-year.
- Mastercard contactless transactions have grown more than 40% growth in the first quarter of 2021.
- Seventy percent of businesses now registering for payment services are new to card payments.

And now the POS evolution continues with contactless payments shifting to contact-free payments including in-app, online, voice-driven, digital assistants, and biometric cards.

A few examples of the evolution to contact-free payments include:

- Apple acquired Mobeewave and MagicCube as the backbone of its i-Accept service which allows contact-free payment via any smartphone.
- Mastercard is developing a cloud-based solution that will enable payments to be acceptance via any smartphone.
- Chase introduced QuickAccept, which provides a smartphone card reader and makes same-day deposits to business checking accounts. Chase is also offering digital onboarding, supports relationship-based pricing, and is waiving monthly fees based on checking account balances or credit card spending.

The card industry is also in the POS change game with biometric cards entering the market. Visa and others are piloting dual-interface credit and debit cards which are chip- and contactless-enabled cards. Cardholders enroll their fingerprints which are securely stored on the card. When a cardholder places their finger on the card sensor during a transaction, the card senses if the scanned fingerprint is the same as the one stored on the card and approves or declines the transaction based on the match. Biometric cards are compatible with existing payment terminals that accept contactless- or chip-based payments and the biometric sensor is powered by the payment terminal.

Offering non-card real-time payments, like Zelle® and RTP®, as POS payment options is also an emerging option. Programs that financially motivate consumers to use non-card payments for in-person and online point-of-sale purchases and incentivize merchants to accept those payments are growing in popularity. However, the impact on issuing and acquiring interchange income must be carefully considered.

Digital innovations are reinventing POS, like they did with P2P payments, and banks and credit unions are once again being disenfranchised. Merchant relationships are at risk knowing fintechs and big techs have a "payments first, traditional financial services later" strategy. Being relevant in POS means banks and credit unions must carefully monitor the reinvention of merchant services and modernize their payments infrastructure to support dynamic POS strategies and technologies. And the time for POS innovation is now while banks and credit unions are considered more accessible and responsive than most alternative payment providers.

Digital innovations are reinventing POS, like they did with P2P payments, and banks and credit unions are once again being disenfranchised.

Statistics in this section from:

The Payments Industry Managing Through and Beyond the Pandemic, Celent (December 2020)

The Reinvention of B2B Payments and SMB Banking

The pandemic exposed two important SMB needs:

- Modern POS and e-commerce solutions that support the seemingly overnight changes in consumer behavior.
- Digital B2B payment and financial management solutions that can expedite receivables, streamline payables, and improve cash flow.

Fintechs have expertise in many areas, including identifying significant market opportunities – SMBs with less than 20 employees represent 98% of all U.S. businesses. The size of this market and the inherent potential have already attracted more than 140 fintechs who are now offering or developing innovative digital B2B payment and financial management solutions.

Historically, the SMB market has been underserved by many banks and credit unions and fintechs are ready to fill the void. But banks and credit unions have the unique and urgent opportunity to become the growth engine for SMBs by leveraging the trust most small business owners have in traditional financial institutions and their position as the provider of primary bank accounts.

Banks and credit unions can successfully compete in the significant SMB market with an offensive strategy that leverages existing account relationships and provides modern payment and financial management solutions that support the unique needs of SMBs.

Capitalizing on this unique and urgent opportunity will require banks and credit unions to understand what financial services SMBs need in the new environment reshaped by digital innovation and the pandemic, and to strategically bundle and competitively price the modern services SMBs need including:

- **Real-Time B2B Payments** – The ability to send and receive real-time B2B payments will generate important benefits for SMBs, including expedited receivables, streamlined payables, and improved cash flow. Most SMBs believe digital B2B payments will soon be the new normal and 70% are willing to pay fees for real-time payments. The reinvention of B2B payments is long overdue – waiting for checks to arrive in the mail, making deposits, and waiting for funds availability in the digital era seems archaic.
- **Integrated Receivables** – Managing receivables has become more challenging in the digital ear as new payment channels have evolved. Most SMBs now receive a combination of checks and digital payments which must be aggregated and processed. Most digital payments are received without remittance information so they must be manually matched to receivables. Supporting SMBs with an automated straight-through payment processing solution for all payment types makes the receivables process more efficient and less labor-intensive, time-consuming, and error-prone. An integrated receivables platform also enables SMBs to accurately forecast and better manage cash flow which is a mission-critical task. According to the U.S. Bureau of Labor Statistics, 20% of small businesses fail in the first year, 30% in the second year, and 50% within the first years. Most owners of failed small businesses attribute cash flow issues as the primary reason for failure.
- **Merchant Services** – Digital innovation and the pandemic dramatically changed consumer behavior and merchants were forced to quickly respond with modern POS and e-commerce solutions. But the evolution of POS isn't over as technology moves payment cards from contactless to contact-free to biometric, for example. Banks and credit unions can successfully compete by modernizing their payments infrastructure with the appropriate innovations like accepting non-card, real-time Zelle® and RTP® payments as POS options. When merchants partner with fintechs like PayPal for payment services the merchant's bank loses merchant services revenue and the entire relationship is at risk. Case-in-point, 39% of SMBs currently use PayPal to manage their day-to-day finances.

- **Dedicated SMB Financial Solutions** – Aite Group estimates that 35% to 40% of small businesses currently use consumer or consumer-like banking solutions. SMBs need financial management solutions that provide the distinct functionality for their unique needs. For example, a consumer online bill pay solution doesn't provide the features businesses need like entitlements and permissions that enable appropriate employees to make payments and dual signature requirements that ensure payments have the proper approvals. With financial management solutions, one size does not fit all.

Banks and credit unions can successfully compete in the significant SMB market with an offensive strategy that leverages existing account relationships and provides modern payment and financial management solutions that support the unique needs of SMBs. After the reinvention of P2P payments, fintechs are reinventing B2B payments with a proven "payments first, traditional financial services later" strategy.

Statistics in this section from:

Designing Digital Financial Services that Work for US SMBs, 11FS (January 2021)

A New Presidential Administration Means New Financial Regulation and Oversight

A new presidential administration means new regulatory oversight.

The Obama administration focused on stabilizing the financial system after the great recession. The Trump administration focused on economic growth. And now the Biden administration is focusing on making the financial industry just and financial services more accessible and fair for all socioeconomic segments. ***The Biden administration is focusing on equality, social justice, debt, and consumer protection which will inherently translate into more stringent regulations for banks and credit unions.***

The Consumer Financial Protection Bureau (CFPB) is expected to become a more aggressive watchdog under the Biden administration and initially focused on four key initiatives.

1. **Consumer Protection in the Wake of COVID-19** – The CFPB will focus on the financial impact of COVID-19 including debt collection, student loans, payday loans, overdraft fees, credit reporting, and racial equity. The enforcement of financial regulations protecting consumers are expected to intensify and the monetary penalties for non-compliance are expected to increase.
2. **Promoting Equality Through Fair Lending** – The expected regulatory environment for payday lenders could endanger their business model. New regulations could require these lenders to verify income to ensure borrowers have the income to pay back the high-interest, short-term loans. The CFPB has issued a statement encouraging financial institutions to provide consumers with small-dollar loan options to lessen reliance on predatory payday lenders, and several banks, including Varo and Bank of America, have already complied.

Every change in presidential administration means new priorities, inherent uncertainties about evolving regulations, and challenges fully understanding and complying with complex regulations.

3. **Possible Overdraft Fee Restrictions and Financial Data Sharing** – An array of overdraft fee restrictions, including how often the fees can be charged, are expected and could eliminate billions of dollars in fee income for banks and credit unions. With 9% of accountholders paying 79% of all overdraft fees, according to the CFPB, these fee restrictions are intended to protect the most vulnerable customers. The Biden administration is also planning to establish a government-backed consumer credit firm as an alternative to the private sector companies that generate credit reports.
4. **Aggressive Debt Collection Efforts** – The CFPB is investigating Venmo for allegations of unauthorized fund transfers and its collections processes. PayPal is being investigated for the way Venmo treats customers who the company says owe it money for transactions that went awry, including threats to enlist debt collectors on individuals with accounts overdrawn due to scams. Fintechs and big techs can expect an exponential increase in regulatory oversight.

Every change in presidential administration means new priorities, inherent uncertainties about evolving regulations, and challenges fully understanding and complying with complex regulations. New financial regulation and oversight impacts the bottom line with banks and credit unions required to dedicate more time, resources, and technology to ensure compliance.

Statistics in this section from:

The Payments Industry Managing Through and Beyond the Pandemic, Celent (December 2020)

Flexible Payment Options Support Financial Health and Debt Reduction

During the pandemic, consumers and businesses are accumulating debt as purchases shift from debit to credit cards. Buy now pay later (BNPL) plans are also being used more frequently. More debt means there will be a growing need for flexible payment options and access to digital financial management solutions that enable better expense and cash management.

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In February 2021, U.S. consumer debt increased at an annual rate of 7.9% to slightly above $4.2 trillion. Consumer revolving debt, which is largely comprised of credit card debt, increased 10.1% in February 2021 to approximately $974 billion. Non-revolving debt, which includes loans, increased by 7.3% in February 2021 to over $3.2 trillion.

During 2020, 6% of U.S. consumers made a purchase using a BNPL service from companies like Affirm, AfterPay, and Klarna with striking generational preference. Just 1% of consumers over the age of 55 used a BNPL service in 2020, however nearly one in five Millennials made a BNPL purchase. Among BNPL users, 80% have at least one credit card, which means the growth of BNPL will cannibalize debit and credit card use and further reduce interchange revenue. Legacy payment firms including PayPal and American Express are also introducing BNPL services.

Banks and credit unions must understand the profiles of financially distressed consumers and small businesses and offer modern payment solutions and flexible payment options that can prevent missed payments, avoid late fees and penalties, protect credit scores, support quick recovery from delinquencies, and help them better

manage ongoing expenses. For example, offering real-time payments helps with payments prioritization and offering delayed payment options or the ability to spread payments over a longer time frame are very beneficial for many consumers.

Today, small business owners make up large portion of delinquent accounts. Forty-one percent of delinquencies are consumers with business accounts which indicates many delinquent consumers are small-business owners or individuals transitioning into entrepreneurship. Financial institutions should identify if any of their delinquent consumers are small-businesses and offer them appropriate solutions to help them better manage cash flow and liquidity.

As debt continues to accumulate, banks and credit unions can expect:

- Consumers and small businesses will be looking for solutions (i.e., BNPL) to help them manage debt and improve their financial well-being.
- Fintechs and big techs have innovative debt management solutions on their drawing boards that support their plans to displace banks and credit unions as the primary financial services provider.
- Rising debt will motivate the current regulatory environment to help consumers possibly at the expense of financial institutions.

Statistics in this section from:

Current US Consumer Debt, The Balance (April 2021)
How Apple Pay Helps 'Cheat' Banks Out Of $250 Billion In Payments, Forbes (February 2021)
Get Paid First: Delinquency and the Financially Distressed, Javelin (December 2020)

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