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CAN RETAILERS WIN THE MOBILE PAYMENTS WAR?

WHY CARD ISSUERS SHOULD CARE

PART 2

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This is the second part of a white paper speculating on where mobile POS payments are headed. The first part suggested that retailer-specific apps will likely gain material traction versus open wallets. Part two addresses how retailer-centric mobile payments might impact card issuers.

In part one, we suggested that retailer-specific mobile payment apps (e.g. Starbucks) are likely to gain material consumer traction versus open wallets (e.g. ISIS, Google Wallet) due to their loyalty functionality. Retailer apps have several advantages:

- SKU-level data and manufacturer funding allows for superior "offers" to consumers
- Implementation does not depend on NFC in the phone or the POS terminal
- Loyalty programs are already in place at major retailers

Retailers will be motivated to roll out such apps, not only to build loyalty, but also to avoid attrition to their direct competitors.

Since consumers may be loyal in some retail categories and price-sensitive in others, both models can co-exist, even with the same consumer. However, open wallets will lack insight into categories where the consumer opts for the retailer app, undermining their analytic power. If the retailer app provides enough value, it may actually convince a price-sensitive consumer to become loyal as the rewards for loyalty may be more valuable than playing the field.

Eventually, the offers arms-race will force retailers to look for new sources of value – both to fund offers and to build margins. One place they will look is payments costs.

Interchange has been difficult to impact historically – except in the courts (Wal-Mart) or in Congress (Durbin). Interchange is protected both by network dominance and by the rich rewards programs offered on some cards. However, in mobile POS payments, these protections are not as strong as they once were. Retailer apps will likely try to undermine interchange revenue streams. This is the main topic of part 2.

DIFFERENT TOOLS FOR DIFFERENT RETAILERS

Different retailer segments will have different levers to manage payments costs. In general, the tools depend on their average ticket size and the frequency of patronage:

Merchant payment strategies
(Large retailers)

	Frequency of patronage	
Size of ticket	High	Low
High	Check/ACH strong-holds (Recurring payments) (e.g., Utilities, Loans, insurance, telco)	Credit card strong-holds (Discretionary spend) (e.g. Department stores, specialty retailers, discount stores, entertainment)
Low	Debit strong-holds (Everyday spend) (e.g., Supermarkets, gas stations, drug stores, QSR, transit)	Cash strong-holds (Casual spend) (e.g. taxis, newsstands)

CASUAL SPEND

By definition, this group does not lend itself to proprietary retailer apps – the consumer will not be loyal because they don't visit enough and don't spend enough when they do. As a result, this could be a market where open wallets succeed. The wallets won't generate enough insights in this area to reward the consumer with offers, but they might be able to arbitrage the payments costs using PayPal-like tactics to fund a prepaid digital change purse.

Note that Uber and others are trying to aggregate the taxis vertical with a category specific wallet rather than a retailer specific or open wallet. Beyond this approach, we do not expect this segment to be material to any mobile wallet's business case.

RECURRING PAYMENTS

This sector is dominated by loan repayments, utility payments, and telecommunications payments (phone, internet, cable, and mobile) although there are POS segments like gym memberships. Of course, no lender we are aware of (credit card, auto, mortgage, HELOC or otherwise) accepts either credit or debit, so lenders already have 100% success in steering.[1]

Utilities (gas, electric, waste disposal, water) get a flat 75¢ per transaction interchange rate which limits the value of steering in the first place. The other recurring payment categories like telecommunications, insurance and other

1 Some have experimented with debit in collections where its immediacy outweighs its cost

subscriptions allow credit card payments but they emphasize direct debit (ACH) over cards. Further, apps do not have the same role in cementing loyalty since these spend categories already contract for long periods. There seems limited likelihood of incremental steering via apps.

DISCRETIONARY SPEND: A PRIVATE LABEL CREDIT CARD (PLCC) REVIVAL?

Retailer apps are likely to increase the relevance of PLCC cards:

- Retailer apps usually register just one card
- PLCC programs carry no interchange, reducing payments costs by anywhere from 1.5%-2.5%

Today, consumers often take the PLCC card to get an initial discount but then go dormant. But, if the card is auto-loaded on the app, the consumer would use it by default on all subsequent transactions. The app then provides the retailer with both a lower cost transaction and a more frequent marketing channel. A final bonus is that PLCC payments "blind" statement-based offer engines like Cardlytics to the activity of the retailer's most loyal customers.

One obstacle to this could be the banks that actually issue these cards.[2] They might resist such a strategy as it encourages transactors to use the card – and transactors generate no issuer revenue. However, if the apps also deliver paperless statements and no-plastic issuance, the cost of hosting transactors will decline and the issuers may view them more favorably.

In the open wallet model, PLCC cards have pluses and minuses for retailers. They still provide a persistent marketing channel for loyal customers. However, they also expose the PLCC transactions to the open-wallet offer engine. More importantly, some open wallets carry interchange (e.g. PayPal, Google), which will negate the no-interchange advantage of PLCC. Retailers will prefer that PLCC be delivered within their own app.

Retailers can offer rich incentives to embed the PLCC in the app, because this *permanently* reduces interchange for that customer, not just for the initial transaction. For example, if a customer spends $500 per year at the retailer and currently uses a card with all-in costs of 2%, that is $10 of annual payments cost. Converting that customer to PLCC could have a 5-year NPV of $40+, before upsell benefits. By tracking spend and card type within the app, the retailer can precisely calibrate a promotional offer that makes economic sense and will be valued by the consumer. This is virtually impossible for most retailers in today's world.

The net result could be a shift in spend from debit & credit to PLCC, reversing a long term share decline for this payment method.

EVERYDAY SPEND: AGGREGATION

While PLCC is a solution for high-ticket retailers, it is not typically available in low-ticket categories, like QSR, gas and supermarkets[3]. Here aggregation can achieve some payment cost reduction. Payment transactions generally incur both a fixed and a variable fee – aggregation reduces the number of *fixed fees* paid. On credit cards, this fee is typically

[2] PLCC cards are usually issued by a bank under contract with the retailer. The leading issuers include GE Capital, Citi, COF, ADS and Chase

[3] Gas in an exception. Most major fuelling brands have a private label credit, but most of these programs predate the wide availability of general purpose cards and such programs have been in decline for many years

10¢ for standard interchange plus a couple of cents for the network fee – for regulated debit it is 22¢. For very small ticket transactions, interchange can drop to 4¢ on all but the highest status cards.

Starbucks is the best known POS aggregator; their program funds many small payments with a single, large prepaid charge. For example, it might consolidate ten $5 charges into one $50 load. This reduces fixed fees by $0.60-$1.10 per recharge or 1.2-2.2% of transaction value. The savings are even higher on regulated debit transactions – $2.20 or 4.5% of transaction value. That funds a lot of free lattes when Starbucks' production cost per cup is under a quarter.

iTunes is another famous aggregator using a different method. iTunes doesn't have a prepaid account, but instead holds transactions for a time, in case the consumer makes more purchases in the interim. They then submit a consolidated transaction for settlement. It accomplishes the same objective albeit by taking on more risk.

The Starbucks method has been copied by Dunkin' Donuts, frozen yogurt chains and others – including Facebook Credits and other online venues. It is likely to become a standard in all such businesses as the savings are material and/or can be plowed back into loyalty benefits. Implementation is aided by vendors who offer the functionality on a white label basis.

ALL SEGMENTS: ACTIVE STEERING

Aggregation and PLCC both reduce payments costs, but are only useful in select segments. A more universal solution is steering – actively moving a consumer to a lower cost payment method, likely ACH. The two most successful US steering examples are PIN debit and PayPal. Pre-Durbin, many retailers programed their POS terminals to always ask for a PIN. This shifted spend from 50%-50% Signature/PIN to 90%+ PIN. There was rarely any customer pushback. PayPal famously steers to ACH by making it cumbersome to register a credit or debit card. About half their customers opt for ACH as a result.

Until recently steering was prohibited by the payment networks; however, recent anti-trust settlements permit merchants to steer between card products and between networks; they can offer discounts and, in some cases, surcharges. They can use soft tactics like asking for debit when the customer offers credit, or hard tactics like refusing certain products. The only thing they absolutely can't do is steer between issuers within a network – but since all issuers get the same interchange, this is of limited value anyway.[4]

Most retailers have been reluctant to steer at the POS because it requires training cashiers in proper steering etiquette and it can slow the line. Retailers also didn't want to upset customers who might have a preference for a particular card – they don't know at the POS whether the customer is loyal or casual and whether the steering might influence future visits.

In an app-centric world steering takes place *away from the POS* – so it doesn't slow the line or require training. The app tracks consumers' in-store purchase pattern, what card product they register, what offers they typically respond to and their basic demographics (e.g. Zip Code). This data can be used to construct an attractive steering offer. For example, if the retailer knows a customer is brand-loyal and uses a high-interchange credit card, they could make an offer to switch to debit or ACH in return for long-term discounts on their favorite products; or special cashier lanes; or free home delivery; or early access to sales merchandise. And some of these have no real cost but are high-value to the consumer (e.g. early access to sales).

Retailers can also choose whether to steer a consumer to ACH or Debit. ACH has the advantage of virtually no cost for a clean transaction, but with higher NSF risk. Debit is higher cost, but avoids NSFs. The retailer can tailor its steering choice based on prior spending patterns and prior card type (high-interchange credit cards are likely to represent lower NSF risk).

[4] Note that Chase Merchant Services may change this. If other large issuers follow Chase's lead, they effectively become networks instead of issuers and merchants can steer among them

Further, the merchant can keep the original credit card registered in the wallet, in case the DDA-based method doesn't clear. In this way, they lower interchange costs without incurring credit-risk – optimizing the issuer. Our family recently received an offer like this from our grocery home-delivery supplier.

The savings from payment steering would be material. For ACH, most merchants would save interchange and network fees approaching 2% of sales value, which could represent 10-100% incremental sales margin. If consumers switch to regulated debit, all but ~$0.30 would be saved. But will customers take the bait?

MERCHANT OFFERS VERSUS CREDIT CARD REWARDS

The biggest obstacle to steering is credit card rewards. These can be very rich and earn high cardholder loyalty. However, *all these rewards are already funded by the retailer via interchange*. So an individual retailer's steering offers can always have higher value than the card issuers' and still save some payments cost.

Constructing such offers is tricky. PayPal has succeeded in converting up to half its customers to ACH through "nudge" tactics – they make ACH the default option and make it extra work to register a payment card. Both Nordstrom and Target already have debit cards that settle via ACH as do many smaller chains. So what might work for a broader group of retailers?

It is not always a matter of paying more to appeal to cardholders. Retailers can target different cardholder propositions with different strategies. Here is a profile of card rewards usage from a recent proprietary Oliver Wyman survey on consumers' primary card:

	Transactor	Revolver	Total
No rewards	8%	15%	22%
Cash back	21%	7%	28%
Aspirational	35%	14%	50%
Total	64%	36%	100%

22% of cardholders get no rewards today. Most of these are revolvers who may have opted for lower borrowing rates rather than spending incentives. Many of these consumers are better off using debit or ACH to avoid additional finance charges on their cards. Such customers ought to be willing to switch to a DDA-based method for any marginal incentive the retailer provides.

Another 28% use cash-back rewards that typically pay about 1% of spend. For such customers the retailer could simply steer the consumer to ACH or debit and match the benefit, while still coming out 60-80bp ahead.

The remaining 50% of cardholders earn aspirational rewards, most commonly airline tickets and hotel stays. This is both the hardest segment to steer and the one with the highest interchange – up to 2.5%. This group is not monolithic, as some cardholders redeem for cash-like instruments like gift cards. Another subset are revolvers who may not spend enough to earn material rewards within a reasonable period. However, they may play "hard to get".

For this segment, a steering strategy must trade off short-term gratification versus long-term aspiration. The retailer could offer a rich, one-time incentive to switch from the high-reward card – similar to what we described in PLCC. If the incentive is coupled with some sort of premier status, such as early access to sales, the option may be even more appealing. Effectively the cardholder can opt for the retailer's rewards versus the card issuer's rewards.

CAN IT WORK?

It is hard to predict how much volume these tactics can shift. Even Starbucks has only converted 10% of its customers to the app model over the last 2-3 years, while another 20% use the card-based version. It isn't clear why the other 70% don't participate. Certainly the credit line and deferred payment benefits of credit cards will still make them attractive to many consumers. Some of a retailer's customers will simply be unwilling to enroll in a loyalty program. This caps the steering opportunity in the short run.

Certainly not all volume is steerable but some is. The applicable short-term subset is probably the most loyal 20% of customers at each in-scope retailer, but, these consumers account for 40% of in-store spend.

The key point is that barriers to steering in an app-based world are not as high as in the mag-stripe ecosystem. The risk will start small but build over time.

HOW MIGHT ISSUERS FIGHT BACK?

PLCC & cobrand issuers don't need to, as these trends play to their strength. They might even help the retailers launch apps and the associated analytics. Such analytics are similar to what sophisticated card issuers already use to manage their business. Cobranding with high-value retailing brands may become more attractive. Most of these cards already waive interchange in-store so they are attractive to the retailer, but they didn't historically provide a compelling out-of-store proposition. If cobrand provides higher status in the loyalty program it may encourage such spending. This is basically the proposition behind Airline cards.

For general purpose cards, issuers need to make rewards propositions less transparent. Cash-back cards in particular are easy to steer against and may suffer as a result. On points-based cards, issuers can merchandise their points programs in more sophisticated ways so that each point has a perceived value much higher than actual cost, but this requires investment in analytics by most issuers.

Issuers might also base card benefits on total spend rather than annual fee. In frequent flier programs, upgrades and boarding order is based on your status, which must be earned by actual flying. In contrast, cardholders pay an annual fee in return for a menu of "free" benefits. Issuers might shift their programs towards earned entitlements, such as superior access to seats at cultural events or privileged access to "hot" restaurant reservations or airline club memberships, etc. This would encourage cardholders to concentrate spend.

CONCLUSION

Many of the historical impediments to steering have been undermined by recent anti-trust agreements and the emergence of retailer apps. We anticipate a growing realization by retailers that they can move the needle on POS payments costs by incenting for low-cost, DDA-linked payment methods within their apps. Card issuers have only a few levers to fight back and all of these have economic costs. They face the choice of undermining margins or losing volumes. Not an appealing tradeoff.

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