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Exploring the new face of retail payments

by Katy Jacob, business economist, and Anna Lunn, associate economist

At the Chicago Fed's 2011 Payments Conference, held on May 19–20, participants discussed how changes in consumers' behavior in the wake of the financial crisis and recession can translate into opportunities and challenges for both traditional and nascent payment providers. They also focused on the impact of payment innovations and new consumer protection regulations.

Some materials presented at the conference are available at www.chicagofed.org/webpages/events/2011/payments_conference.cfm.

At this year's conference, retailers, consumer advocates, bankers, academics, and technology experts discussed how consumers have changed their payments behavior while facing a weak economy with high unemployment. Consumers' new payments behavior may lead to opportunities for traditional payment providers—like large financial institutions and card networks—as well as new nonbank ones—like technology firms and retailers. Partnerships between traditional and new payment providers are leading to innovations that may be better suited for some in the current economic climate. For instance, technology firms (some focusing on mobile technology) and social media projects are offering new ways for payment providers to reach consumers with and without traditional bank accounts. The financial crisis and recession have prompted not only consumers to change their behavior but also lawmakers to enact new payments regulations to protect them. Historically, the U.S. has had a market-driven approach to payment services, but recent economic forces and a greater call for consumer protection have made regulation a more salient factor for the payments industry.

Consumer preferences

In his keynote speech, Richard Oliver, Federal Reserve Bank of Atlanta, stated that during the late twentieth century, the payments industry was in an environment where banks faced little competition for consumers; the pace of innovation was slow; the government did not intervene much; and consumers did not require a lot from their payment providers. However, over the past decade, that environment dramatically shifted: Nonbank players began to aggressively compete with banks to provide payment services; the pace of innovation accelerated as new technologies emerged; government regulations became stricter; and consumers demanded more from their payment providers. Oliver explained that all of these changes were reinforced by the recent recession. Consumers got used to relying on payment services that cost them little to nothing. Conference participants noted that as fees for payment services rose recently, consumers felt slighted. Banks and other payment providers raised their consumer fees to reflect the costs of making improvements to their payment technologies and security measures. They made these improvements to keep up with market innovations and comply with new government regulations and industry guidelines.

Katy Jacob, Federal Reserve Bank of Chicago, noted that the rising costs of providing payment services are indeed a significant industry challenge. While many consumers have weathered economic

setbacks that have made them more aware of the terms of their relationships with their payment providers, many of their payment preferences have remained the same. Consumers still want the same speed, convenience, ubiquity of acceptance, and rewards from their payment choices as before—all at the same low cost. But for the payments system to run smoothly and efficiently, consumers must have confidence in that system and in the myriad of parties that run it. Thus, foregoing upgrades in technology and security is not an option, said Jacob, despite consumer pressures to keep payment fees low. Sujit Chakravorti, The Clearing House, reiterated that customers developed high expectations from their payment options in the past and they continue to expect rewards from using payment instruments like credit cards. While payment providers continue to search for ways to offer added value, the general consensus of the conference was that rewards are more costly for payment providers today than in the past, so companies have to develop other strategies to increase or maintain their customer bases. Bob Hunt, Federal Reserve Bank of Philadelphia, offered one general principle to keep in mind as these strategies are developed: Payment transactions usually reflect preexisting relationships that individuals have with other individuals or firms, so payment providers should incorporate those relationships into the payments stream to better serve their consumers.

Ruth Judson, Board of Governors of the Federal Reserve System, stated that consumers' payment choices are largely determined by their household budgets and the cost and convenience of the payment options. Eric Reese, Chicago Transit Authority (CTA), gave a specific example: A large segment of the CTA's ridership is lower-income and lacks bank accounts, so such CTA passengers rely on cash as their primary form of payment. Even though the CTA offers slightly cheaper fares for using electronic payments, many of its customers continue to use cash. Laura Chambers, PayPal, said that many people care a great deal about what funding device they use, and it can be counterproductive for a company to attempt to change these personal preferences.

In contrast to Chambers, John Drechny, Walmart, argued that most consumers are very adaptable when it comes to payment options. For example, if a merchant does not accept a payment type, consumers will use another form of payment, even if it is not their first choice. That said, it becomes much more difficult to reach and keep consumers if payment options are offered by merchants or providers and then taken away. Neil Platt, CashEdge, contended that the biggest struggle is to convince consumers to try a new payment type; he observed that once they sign up for a new service, they quickly become comfortable using it. Concurring with Platt, Paul Tomasofsky, Secure Remote Payment Council, said that investors must be patient with companies developing and executing new business models as they take time to change consumers' preferences. Lisa Greco, AppleTree Credit Union, argued that most consumers will switch to a new form of payment if given enough incentive to do so. Her financial institution introduced a large discount on interest rates for consumers who committed to using automatic electronic payments for loans while it also started charging significant fees for loan check payments. These clear incentives for consumers to adopt electronic payments had a ripple effect on the efficiency of the entire credit union, enabling it to survive the recession.

Although basic consumer preferences may have remained largely unchanged, as Jacob and Chakravorti explained, speakers spotted new trends in consumer behavior. Tim Murphy, MasterCard Worldwide, said that since the recession, consumers have been doing more research before making their purchases and they have been searching for discounts. In addition, consumers have begun to demand more information about how certain forms of payment work, and they have become interested in increasing their level of financial literacy. Andy Rowe, Bank of America, stated that in the past, many customers tended to not keep track of what they could afford; instead, they relied on banks to impose limitations. As the economy worsened, consumers perceived that banks had failed them in that regard. Some consumers started to view merchants or nonbank companies as the more trusted parties in a payment transaction. Emery Kobor, U.S. Department of the Treasury, claimed that the new trend of nonbanks driving payment transactions represents a dramatic shift in the market. While banks used to lead payment innovation, they often now serve as third parties to nonbank firms that control the payment services.

Conference participants noted that consumers are increasingly using alternatives to potentially more expensive forms of payment like credit cards to help them gain and maintain control over their spending and financing. Merchants at the conference noted that, while consumers are still more likely to use credit cards for large-ticket items, they usually use cash, checks, and PIN-based (personal-identification-number-based) debit cards for smaller transactions. For example, Susan Ehrlich, Sears Holdings Corporation, reported that her firm's Kmart chain has seen a sharp increase in PIN-based debit transactions. Greater incidence of cash, check, and PIN-based debit transactions implies that consumers are less willing to incur and carry very expensive credit card debt. This wariness of credit card debt may also help explain the increased use of prepaid cards since the recession, which both Drechny and Ehrlich reported. Ehrlich also discussed how Kmart has seen great success in its layaway programs, which have recently experienced double-digit growth. As the discussion focused on the rise of cash

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transactions since the recession, conference participants offered many different opinions on the overall costs of the cash economy. Large merchants, such as Walmart and Sears, view cash as a relatively efficient payment option, since they are able to recycle cash and achieve efficiencies of scale; however, others find that the cost and security issues associated with handling cash are quite problematic.

Reaching new markets

The cash economy is important because it reveals an undercurrent in the payments market—the presence of consumers who do not have formal relationships with financial institutions. Yazmin Osaki, Federal Deposit Insurance Corporation (FDIC), said that a 2009 FDIC survey[1] showed that 7.7% of households in the U.S. are unbanked and 17.9% are underbanked. While the number of unbanked households in the U.S. might seem low, more people in the world are unbanked than banked, Kobor pointed out. Osaki explained that cost is often the deciding factor for many consumers in whether or not they start or keep a relationship with a financial institution. Individuals who have never had a bank account say that they have never opened one because they do not have enough money, and the unbanked who have had a bank account say that accounts generate too many fees, Osaki reported.

While cash has become more popular recently, technology may increase consumers' access to alternatives to credit cards. For instance, Lewis Goodwin, Green Dot Corporation, said that prepaid cards can provide an alternative way for consumers, especially the unbanked, to store value and make payments in a poor economy. In addition, Hunt commented that successful payment providers are taking established payment platforms, such as payment card networks, and creating logical extensions of those platforms to deliver more services. Former competitors are entering into joint efforts to provide better, more integrated payment services. For example, Platt explained how CashEdge, which allows consumers to make electronic transfers between bank accounts, is partnering with banks, not competing with them, to improve transfer functionality. Joe Hurley, Discover Financial Services, described another example where payment card and automated clearinghouse (ACH) networks are collaborating, rather than competing, on products such as decoupled debit cards,[2] which can give rewards to consumers who are hesitant to use credit cards.

Moving to mobile

The payments market has moved beyond the provision of simple credit and debit cards, however. Payment providers have been especially interested in finding new ways to reach underserved groups. Allen Fishbein, Board of Governors of the Federal Reserve System, reported that demographic groups with fewer banking relationships are more likely to own mobile devices than those with more banking relationships, so mobile services may allow the unbanked (or underbanked) to gain (more) access to financial services. However, Murphy cautioned that mobile payments are not necessarily about financial inclusion in the U.S., since most innovations in this area have been for smartphones, which are primarily owned by more affluent consumers.

Nonetheless, Dave Wentker, Visa, argued that the prevalence of mobile phones and smartphones has created an immense opportunity for payment providers, as long as those providers choose the right time to invest in infrastructure developments—i.e., when it is plausible to achieve a critical mass. Paul Rasori, VeriFone, explained that some of the infrastructure needed to make mobile payments even more popular is already in place; e.g., his firm provides retailers with sophisticated point-of-sale technology that enables secure electronic payment transactions for many forms of payment, including mobile devices. Chambers said that much of Internet commerce is actually conducted via mobile devices, as opposed to computers, so sales completed on mobile devices may actually be underreported. Chambers also remarked that mobile payments change the nature of competition, since payment providers are competing not only with each other for consumers' time, but also with nonfinancial software companies that make entertainment applications, such as games. Extending the discussion on mobile payments, Erin McCune, Glenbrook Partners, highlighted the growth in digital currencies, which are used primarily to purchase digital goods in virtual worlds (accessed through computers and mobile devices) but can also be used to purchase real-world goods.

Regulation and legislation

Changes in the payments market have spurred new regulations and legislation, such as the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act). Kobor remarked that in the past, the ongoing account relationships between banks and their customers distinguished banks from the vast majority of nonbanks; but such relationships are no longer the exclusive domain of banks. Thus, regulators must now consider how to provide consumer protections when payments are offered by previously unregulated entities.

Several speakers discussed how regulation is often, by nature, reactive. The extremely fast pace of change in retail payments makes it difficult for policymakers to

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stay on top of issues related to pricing, competition, and term and fee disclosures. Indeed, Chakravorti stated that if governments regulate too early as new payment methods are being rolled out and popularized, innovation may be stifled.

In his keynote speech, Michael Barr, University of Michigan Law School, contended that in the past, regulators did not adequately protect households and investors. Barr argued that the new regulations are intended to correct the deficiencies in the previous, unrestrained financial market. He noted that in order to provide consistent beneficial regulation, regulators need to consider the incentives of financial service providers, as well as the welfare of consumers. Melissa Koide, Center for Financial Services Innovation, said the Consumer Financial Protection Bureau—created under the Dodd–Frank Act—can help ensure payment providers will offer high-quality innovative products with effective financial disclosures.

Duncan Douglass, of Alston & Bird, argued that the current regulatory environment has created too much uncertainty in the payments space. Given this uncertainty, some firms might be less likely to invest in infrastructure or innovative products and services while they wait for rules to be finalized. Tim Willi, Wells Fargo, concurred, stating that investors are holding off on making major investments in the payments industry as they wonder about regulators' next moves. Moreover, some conference participants contended that it is possible that the new regulations could harm the very consumers they were meant to protect. For instance, Goodwin said he was concerned that excessive regulation could disenfranchise consumers—especially those with few payment options. If regulations require more identification information to set up an ACH account, some consumers might be reluctant to use prepaid cards, leaving them with fewer options overall. Murphy countered this point by stating that prepaid card fees are less expensive than PIN debit fees under the Dodd–Frank Act, which in turn provides incentives for the government and other entities to move to prepaid programs.

Rowe contended that consumers do not want the government to tell them how to pay for any given transaction; however, they do want transparency from their payment providers, clear term and fee disclosures for using particular payment products, and more knowledge about their rights and responsibilities when using them. Barr said that financial disclosures might need to be changed over time; while disclosures can help some consumers better understand financial products and gauge their risks, too much complex information may slow down others' decision-making about which products to use.

Conclusion

Achieving a balance between healthy competition and effective regulation in the payments space can be difficult. The amount of regulatory change currently taking place in the U.S. payments market is unprecedented. Some have argued that this development is positive. Barr stated that healthy markets rely on good faith, trust, and transparency, which the recent regulations encourage. Tomasofsky argued that the high level of public discourse about financial institutions being generated by the new legislation is healthy for the economy and the country.

That said, many conference participants said they preferred a more traditional market-driven approach, where companies focus on new strategies to address consumers' unmet financial needs. As Oliver stressed, such strategies will likely be more difficult to develop in the current economic and regulatory environment. He argued that banks must be willing to sponsor innovation that may be disruptive to their usual ways of doing business. So, banks may need to be more open to collaborations with nonbank players that yield new products with a global reach.

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[1] For more on the FDIC survey, see www.economicinclusion.gov.

[2] A decoupled debit card is a debit card that is not issued by, and not tied to, a particular retail financial institution. Rather, it is issued by a third party and connected to a consumer's bank account through ACH.