Payments Innovation

The 2008 Global Jury decides

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Payments innovation 2008 – the global jury decides

Innovation in electronic payments has been a hot topic in the industry for more than 25 years. Increasing customer acceptance of card and electronic payment methods built on convenience, ease of use and relatively good security, has delivered an unbroken pattern of year on year growth in almost all countries of the world. So with an infrastructure that is increasingly IT based rather than relying on real estate and people, surely a major focus on innovation could open up more opportunities and deliver even more growth. The high valuations placed on the MasterCard and Visa IPOs would suggest that many professional investors subscribe to this view.

And yet, look behind the hype and all of the frequent conferences speeches, does the industry manage innovation any more successfully than some of the more traditional legacy-constrained sectors? There is no easy answer to predicting which individual innovations will be successful, or else the venture finance firms would have a much better track record than they actually do. But it is possible to throw some light on how innovation does really happen in the payments industry

Global innovation jury

To do this, a number of key issues were considered in February 2008 by an innovation jury of 12 payments industry experts guided by an experienced judge. The jurors and the judge had career profiles that made them exceptionally well qualified to consider the issues. They came from nine different countries, and most of them had lived or worked in multiple countries. Several had held senior executive roles with the international payments schemes and major processors. Three of them are currently serving CEOs of growing companies and a number work for investment partners to the payments industry. And almost all of them had moved employer at least three times in their careers with frustration about being able to make developments happen as the most common reason. So, if any group of people had insight into the payments innovation process, it was this jury.

Innovation defined

As the jury made its virtual considerations, it was important to have a consistent definition of innovation. So, the following definition was adopted.

Innovation *is the turning of an invention or new concept into commercial success*

Innovation *is more than evolution*

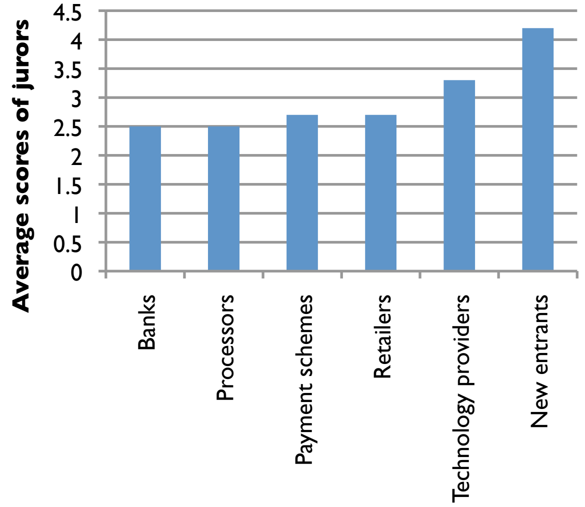
Innovation *is not confined to technology*

And for ideas to become successful innovations there has to be a viable commercial business model and the determination and means to implement it.

Who is best at driving innovation?

The jury considered the issue of who is best at driving innovation in payments, and the answer was very clear that it is new market entrants who are having the most impact. Of the players within the business, it is technology providers who are the most innovative. The jury took the view that the existing major players have invested too much in either shared or individual infrastructure to want to make major changes. And in many cases where the existing business model creates good profitability, why take the risk to change things?

- *"It's players on the periphery who are being truly innovative. Everybody else is too busy protecting the status quo"*
- *"Financial Institutions are not generally innovative, neither individually nor (especially) when they band together. Innovation often comes from "outsiders", or in response to fear of their encroachment."*
- *"VISA and MasterCard are not true innovators – they are merely marketing and supporting innovations from others – either banks or technology providers"*
- *"Banks and schemes lack the agility to innovate in a major way. Also, their huge scale means that early stage innovation doesn't move the valuation needle very far"*



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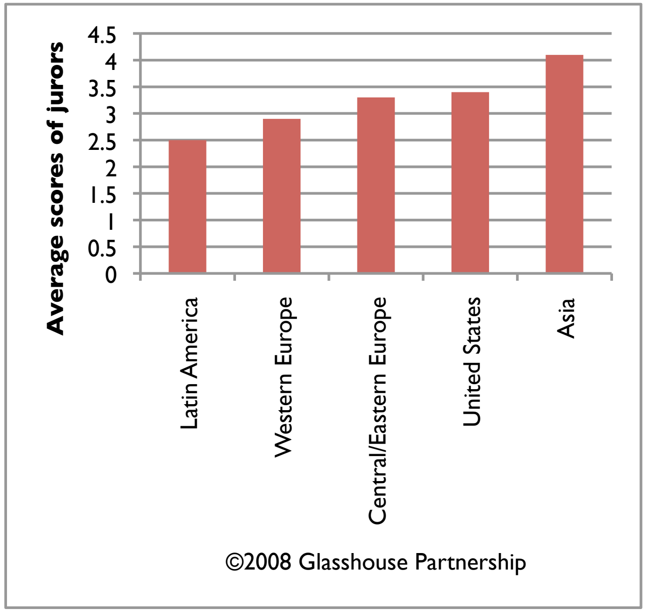
However, jurors added words of caution about the likely success of technology providers and new market entrants.

- *"Disruptive innovation almost always comes from new entrants, even though almost all new entrants will fail"*
- *"New entrants have ideas but not the power. Some Nordic banks are being successful in payments innovation"*
- *"Technology providers are more innovative but with limited success. Retailers and banks aren't innovating payments that much. The only really innovative new entrant that's successful is PayPal"*

Which regions will show most innovation?

In terms of which regions will show the most innovation, it was much more difficult for the jury to reach a decision, as it was felt that different regions would concentrate on different areas of payments. The consensus was however that Asia, with a great emphasis on the use of technology, would be the greatest driver of innovation. Next would be the US, and then those areas of Europe that do not have large legacy infrastructure investments. One juror argued the case that a mistake had been made in excluding Africa from the deliberations as recent mobile developments of real significance are happening there. In Western Europe, whilst SEPA should in the longer term create a more innovative environment, the jury were not convinced that the region is going to a global path-finder.

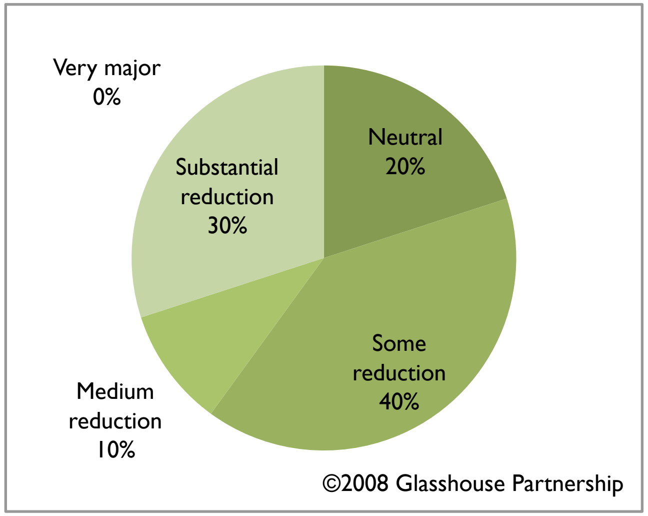


- *"Sorry about that mediocre score for Western Europe. SEPA's great, but ten years in the making seems more like evolution than innovation."*
- *"Asia will continue to see high levels of techno driven invention, but technology for the sake of it will probably struggle to gain traction, as it always has."*
- *"In the US, the conditions are right for innovation with a "free" market and a high level of pricing for card based payments creates an environment within which new products can find a commercial basis. The losers will be banks"*
- *"In Europe, the added opportunity is the ripping up of the rule book due to SEPA"*
- *"Asia (Korea, Japan) will lead on mobile payment (Europe has lost its potential lead in this area), US will lead on micropayment and contactless"*
- *"In emerging markets, with a high unbanked population, the retail sector may impact the relevance of the traditional bank".*
- *"Don't forget Africa, where M-PESA already has more than 1.6 million customers"*

The likely impact of SEPA on innovation

Given the SEPA developments, the jury gave specific consideration as to whether it will accelerate or hold back development. Leading industry figures in Europe have been divided on this issue, but the jury was clear that overall the impact will be negative in the short term. The jurors held slightly different view on the degree of impact, but the overall message was that in the short-term innovation will suffer as IT investment is diverted to the modernisation of infrastructure. However, in the longer term, the SEPA programme should create an environment in which innovation will increase.

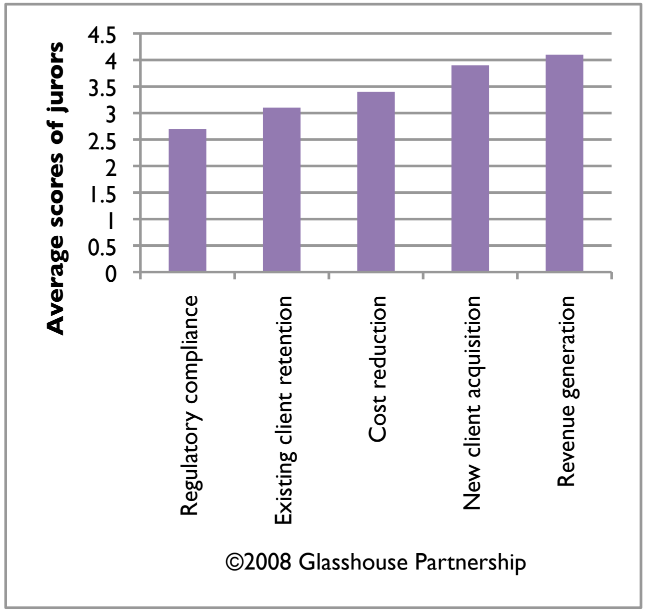
- *"SEPA by itself is soaking up much of the incumbent's IT spend"*
- *"SEPA itself is unlikely to reduce innovation, but since all development resource for a period will go in to SEPA development, this could reduce other innovation projects"*
- *"SEPA compliance and adaptation will occupy minds and budgets, in place of innovation, for a while. But the appetite will return, and the new competition and opportunity that results will produce innovation"*
- *"In the long run innovation will be increased by SEPA as barriers to cross-national players are removed"*
- *"SEPA creates polarisation where banks with deep pockets will consolidate payments processing; however, small banks will innovate more at the client service and delivery level – it's the only way they can survive"*
- *"Standards never reduce innovation – they support and facilitate innovation"*



What is the driving reason for innovation?

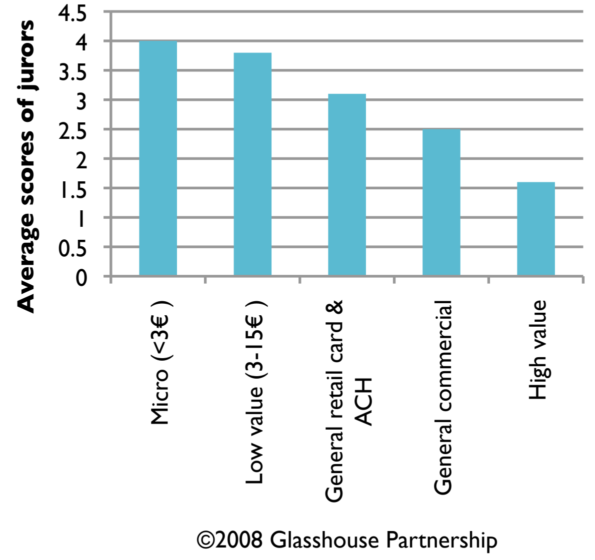
The question of what is the driving reason for payments innovation provoked some mixed reactions from the jury, but there was finally a clear result that revenue generation and new client acquisition are the strongest drivers. The feeling was that banks are highly motivated as always by cost reduction, but most of the innovation effort is targeted at revenue growth and customer base expansion. And whilst the growing burden of regulatory compliance is a real challenge for banks, there is less focus on developing innovative ways to address these requirements.

- *"For new entrants the opportunity to make a buck from either undercutting the incumbent or creating new opportunities is the greatest driver"*
- *"In most geographies, the focus for most large, established organisations is cost reduction and improved operational efficiency"*
- *"Customer acquisition is getting more and more competitive so this will be a key target for innovation"*
- *"The reduction in traditional revenue sources will create revenue pressures for innovation"*
- *"For processors, retailers and banks all of the reasons are present. They are all in the boat together, but against a background of regulators wanting cost-based payments, they are fighting to avoid picking up the cost. This holds back innovation"*
- *"Banks traditionally only do stuff if it gets rid of cost"*



Which payment types will see innovation?

The view of the jury on the payment types that will see the most innovation was extremely clear. The lower the value of the payment, the more likely will be innovation. Lower value payments continue to be inefficient and therefore a clear target for innovation. The relative failure of multiple previous low value payment initiatives has not dampened the case and enthusiasm for innovation in this area. In the commercial payments area, it was felt that innovation would centre on e-invoicing and not the payment itself.

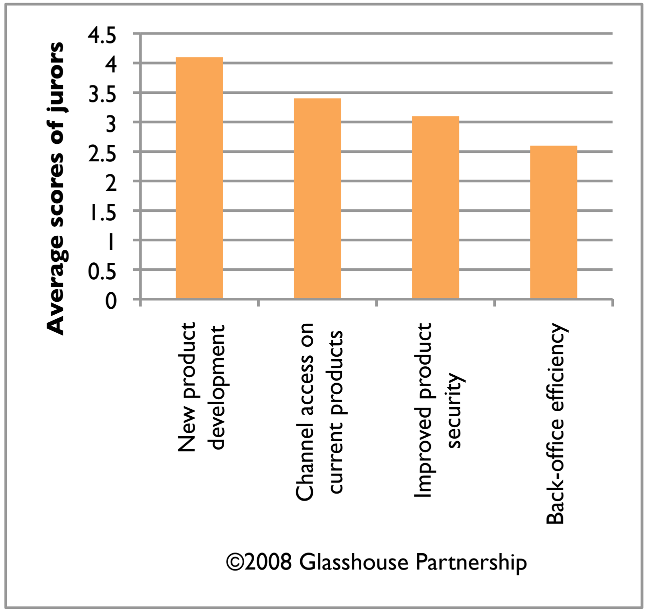


- *"The smaller the payment, the more you can innovate; the more valuable the payment, the less you innovate as you want trust and security"*
- *"Lower value payments will certainly get a lot of attention: they are currently unmet needs – micro payments in particular. This is an obvious area where mobile based systems may flourish"*
- *"Something will happen in micropayments… no-one has really cracked it yet"*
- *"The attack on consumer cash, and the pains of content players (whose business models are unravelling) will drive innovation in micro/low-value payments"*
- *"The sheer size of the micro/low value segment and the inefficiencies of current methodologies will attract more attractive and transparent solutions"*
- *"General retail payments will need to innovate to become profitable in a world of SEPA, competition and regulators".*
- *"Important drivers in commercial payments are e-invoicing and improved procurement processes"*

Where will innovation be targeted?

In relation to which aspects of payments products innovation would be targeted, the jury were clear that new product development is the key. Providing access to existing products through more channels continues to be important, but as multi-channel access is available now from many payment providers, the accent is definitely on new product development. Product security is still seen as important although there is quite some evidence of thinking that is not joined up within payment providers in this area….it only rises up the agenda when there is a security issue. And whilst back-office efficiency is important, especially for established players, it is not where most of the innovation effort is targeted.

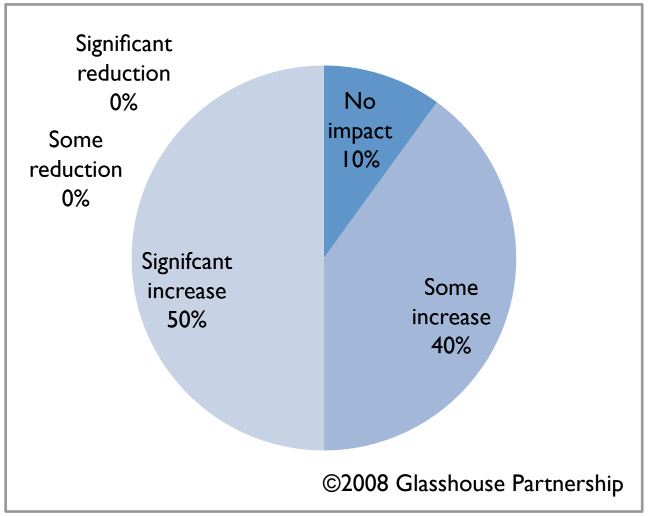
- *"It is new products that will bring in additional revenue, either from new customers or from selling more to existing clients"*
- *"New technologies such as contactless and mobile will offer a step change in consumer convenience and this should lead to new product propositions"*
- *"Back-office efficiency is more likely to be addressed by outsourcing to lower cost region than by process innovation"*
- *"All ID fraud and identity theft issues show up in surveys as top of mind for banks"*
- *"Improved product security should be top of mind for banks because if they lose the trust of customers, what else do they have? And yet, they seem to want to justify security investments on a business case business…are they serious?"*



How will lower interchange impact innovation?

Interchange on card payments is clearly under downward pressure from regulators globally and a recent study of the potential impact of European Commission actions calculated that more than 50% of card issuer income could be at risk. This has prompted many commentators to argue that the industry will have to retrench and that product innovation will suffer. This is exactly the argument made by the card schemes to the regulators. The jury does not believe this to be the case and clearly has the opinion that reduced interchange will force innovation to increase. The counter argument was that if interchange is forced down, new players find it impossible to survive the start-up period. Regulators need to consider this point carefully as low margin utilities do not have track records of continual innovation.

- *"Pressure on established revenue models (e.g. interchange) will create pressure to innovate. There's nothing worse than an easy buck to kill the initiative to innovate"*
- *"This is a tough one! Lower interchange does affect the innovation landscape, new entrants find it harder to undercut existing players. The reason I voted for high change is that it changes the environment and that will create change"*
- *"Reduced interchange will pressure incumbents to innovate but reduced interchange in the US, for example, lowers the price umbrella under which new entrants enter"*
- *"Just as with social lending (Zopa et al), new players are coming into the markets reducing the spread and changing the business model; in payments there will be innovation to work out how to be profitable in a zero percentage spread world*
- *"Interchange is a narcotic! Even if I have less of it, I still want it"*
- *"The choice is very simple. Innovate – or get out of the business"*



Is there one organisation that stands out as the most likely payments innovator in the coming years?

On this question, the jury were divided and could not reach a clear decision. Sadly from the 12 jury members and the judge, four could not identify any organisation as a likely payments innovator in the next few years. However, the remainder were more positive and identified the following organisations as likely innovators:

- Amazon
- Apple (2 mentions)
- Equens
- First Data (3 mentions)
- Google (2 mentions)
- PayPal (4 mentions)
- SIA
- Tennent QQ

In line with some of the preceding discussions, three of the jury suggested that there would be successful market entrants that are currently unknown.

Is there one innovation which would particularly benefit the payments industry?

As a final question, the jury were asked to consider whether there were any innovations that the industry definitely needed. The suggestions were as follows:

- *"Speeding up the ACH process in all major markets"*
- *"Real time ACH payments i.e. true faster payments"*
- *"Enriching transaction data with loyalty and CRM data"*
- *"Push payments because they generally have no credit risk and can be increasingly enabled with smart devices"*
- *"A working, privacy-sensitive 'national ID' of some kind to crack the authentication issue"*
- *"Virtualisation of payment instruments. Currently, merchants and consumers need to know too much about how the payments work (PINs, signatures, refund rights, etc) – simplification across instruments would greatly benefit all users. The complications of the inner workings of payment instruments can then be left to the providers: banks, processors etc.*
- *"Standards to allow end-to-end payments processing from consumer through corporate through bank and interbank and payments processor, e.g. straight through processing standard(s) for 100% interoperability"*
- *"Interoperable e-invoicing"*

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Payments Innovation Jury

The jury consisted of 12 payments experts currently living in Denmark, Dubai, Finland, France, Malta, Norway, Slovakia, UK and the USA.

Previous and current employers include COOP Retail, Deloitte, DNB, First Data, Honeywell Bull, IBM, Link, MasterCard, Moneybox, NCR, Nordea, Tietoenator, Tower Group and Visa.

Payments Innovation Judge — John Chaplin

Prior to joining Glasshouse, John Chaplin ran Visa's payments processing business throughout Europe, having previously held many other senior positions including CIO and Head of Strategy. He is currently advising one of the largest global payments processing organisations on their strategy for the Single European Payments Area as well as serving as a director on a number of technology company boards. He is also visiting lecturer on the MBA programme for Westminster University in London.

He is a well-known authority on the payments industry and how financial institutions should protect their brand reputation in turbulent times.

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