OLIVER WYMAN

MAKING PAYMENTS WORK FOR YOU

HOW MERCHANTS CAN OPTIMIZE PAYMENTS FOR GROWTH

AUTHORS
Elizabeth Costa, Partner
Robert Mau, Partner

MARSH GUY CARPENTER MERCER OLIVER WYMAN

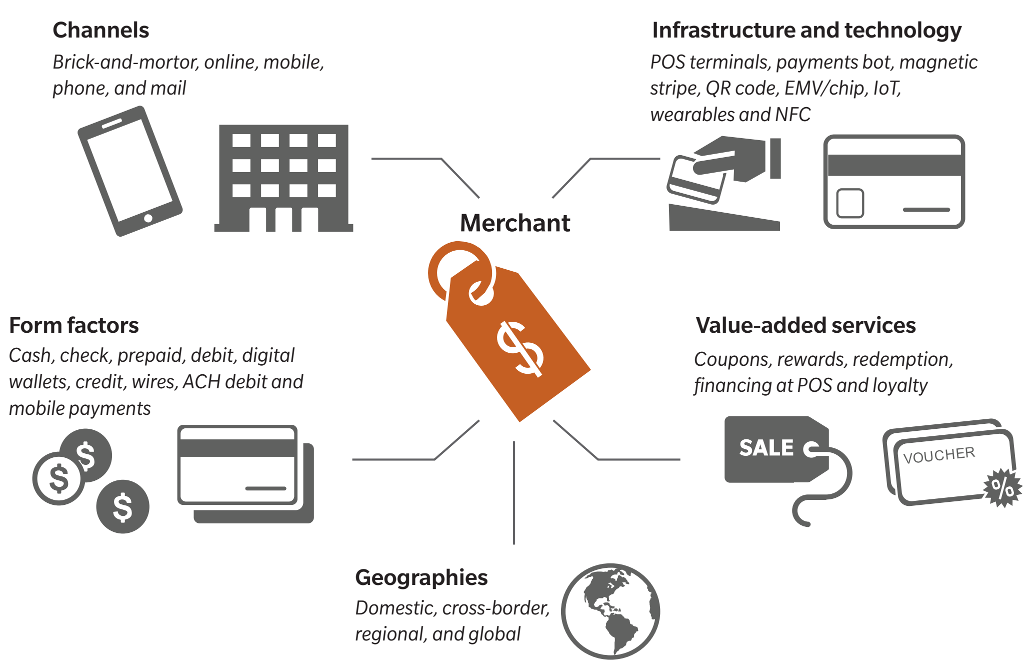
MARSH & McLENNAN COMPANIES

INTRODUCTION

Payments have historically been the last step of the purchase process for a merchant and an experience they were willing to cede to banks. This continued as the first wave of digitization took place with 'Consumer 1.0' – when consumers demanded products and services that minimized disruption to their daily flow. However, a new digital transformation is underway that is enabling 'Consumer 2.0' – where consumers demand products and services that are integrated with their daily lives. With this evolution in consumer expectations, the leading merchants (and service providers) understand that payments can no longer take a back seat!

Today more than ever, an integrated and seamless payments experience is a critical part of a customer shopping journey, strengthening relationships, and driving growth. However, merchants' approaches to their payments experiences vary significantly. This is in large part due to increasing complexity as consumer preferences, shopping trends, payment form factors, and the underlying infrastructure evolve rapidly.

Exhibit 1: Payments ecosystem for merchants



It can, at times, be overwhelming for merchants to decide how to balance their many payments priorities to frame a realistic and successful payments strategy, and once defined, how they should execute on it. Answering both proactive and reactive questions is a good starting point in developing a payments strategy.

Exhibit 2: Example payments questions merchants are asking

PROACTIVE	REACTIVE
Staying ahead of the curve	**Responding to developments**
• How can payments support or enhance my vision for customer experience?	• What payments experiences are my competitors offering?
• How should I strike the right balance between fraud management and customer experience?	• How can I lower my fraud rates? What types of fraud are attackers employing against me?
• How can I use payments as a strategic lever to enable seamless, personalized interactions with customers?	• What is the right way to think about my own proprietary forms of payment vs. 3rd party forms of payment?
• Which partners/providers are best suited to support my future strategic direction?	• What implications do the global trends in data protection have for my payments strategy?
• What does a future-proof payments security approach look like, considering advancements in technology, regulations and cyber risk management?	• What are the payments specific security flaws that my competitors have been impacted by? How can I protect myself against these risks?

Merchants that develop and follow a holistic payments strategy reap significant benefits such as lower payments costs, higher topline revenues, enhanced loyalty from customers, and differentiated customer experiences to drive greater competitive advantage.

Amazon is an example of a merchant who is leading the way in blending payments with experience. They have stepped up their efforts in payments-related initiatives via a series of new launches and product expansions, to control and transform customer shopping journeys, with the ultimate goal of capturing larger market share and profitability.

AMAZON PRIME RELOAD	• Offers 2% cash back to Amazon Prime customers for balance reloads from a bank account onto their Amazon prepaid account
AMAZON CASH	• Offers a prepaid account for unbanked or underbanked customers that can be used for purchases on Amazon.com. Customers can preload cash without any fees to their Amazon accounts through a number of participating merchants, including CVS Pharmacy, Speedway, GameStop, and others
AMAZON PRIME REWARDS VISA SIGNATURE CARD	• Relaunch of the Prime Credit Card, targeted at Amazon Prime customers to encourage loyalty. Card users are entitled to a 5% cash back for purchases made on Amazon and 1-2% cash back on purchases made at other merchants
AMAZON LENDING	• Launched in 2011 and targeted at Amazon sellers based on their transaction history and working capital requirements, this product has now surpassed $3 BN USD in originations since inception, and $1 BN USD in the past year (as of June '17)
AMAZON PAYMENTS	• Enables Amazon customers to make payments on 3rd-party eCommerce sites via their Amazon credentials, with $6 BN USD in processed volume in 2016. Provides a revenue stream and, more importantly, a rich data stream on spend off Amazon

Source: Goldman Sachs Equity Research: "Future of Finance Payments Ecosystems" - August 3, 2017

These payments developments provide major benefits to Amazon:

- Enabling Amazon to lower its payments costs
- Driving additional revenue from interest income on lending and interchange on cards
- Opening up new segments of customers to shop on Amazon
- Providing Amazon with more data and insights into customers' shopping habits to enhance the shopping experience and drive loyalty

Amazon's initiatives illustrate how merchants can turn payments into a competitive advantage. As it pertains to managing payments costs, merchants that take a renewed focus to address this have achieved savings of 10% and more. Savings levels can vary based on geography, contract terms, payments mix and other factors. Merchants such as Macy's and Kohl's have leveraged payments to boost revenues and profits. Branded credit cards constitute ~39% of Macy's total annual profits and ~35% of Kohl's profits[1]. Starbucks, an early pioneer and now a leader in mobile payments, has relied on payments as a strategic lever to drive loyalty. It has ~9 million mobile paying customers constituting ~30% of total volume. Its Mobile Order and Pay offering that allows customers to order ahead with their smartphone via the Starbucks app accounted for 10% of transactions in 2017[2].

These examples highlight the benefits that merchants can realize by focusing on payments. However, deriving increased value from payments requires careful thought and execution. With payments evolving rapidly, establishing a robust payments strategy will require merchants to separate signal from noise.

How can merchants separate this signal from noise? To begin, it is important to have an understanding of recent transformative trends shaping payments. Having a holistic view of the many factors impacting payments on a global scale is an important starting point for developing a comprehensive payments strategy.

1 Morgan Stanley Research: "US Internet, Retail and Banks – What's in Your Wallet? Amazon? – March 2017

2 Starbucks Q3 and Q4 FY17 Earnings Release

TRANSFORMATIVE FORCES SHAPING THE PAYMENTS ECOSYSTEM

The payments landscape has evolved considerably in recent years and is still undergoing significant transformations, driven by five key factors. These factors have the ability to influence and shape a merchant's payments strategy for the future.

1. ARRIVAL OF NEW ENTRANTS

Disruptive new providers are challenging the established industry structure and radically changing the payments ecosystem. Non-traditional players have drawn a significant amount of attention over the last few years, driven by a dramatic rise in private equity and venture capital funding. This has several implications for merchants, both positive and negative:

- There has been a proliferation of new customer-facing payments solutions introduced in the market – forcing merchants to critically analyze the preferences of their most valuable customers to inform investment priorities
- Partnerships with digital upstarts and innovators can help merchants get access to better and faster technology (such as real-time fraud detection and monitoring) which allow them to improve their back-office processes without building the capabilities in-house
- New entrants may look to own customer relationships by delivering a 'marketplace' experience. Merchants that partner with these new entrants to streamline checkout, or to offer contextual commerce for instance, may end up having to forego a part of their customer ownership in the process

2. TRANSFORMATION OF PAYMENTS SOLUTIONS

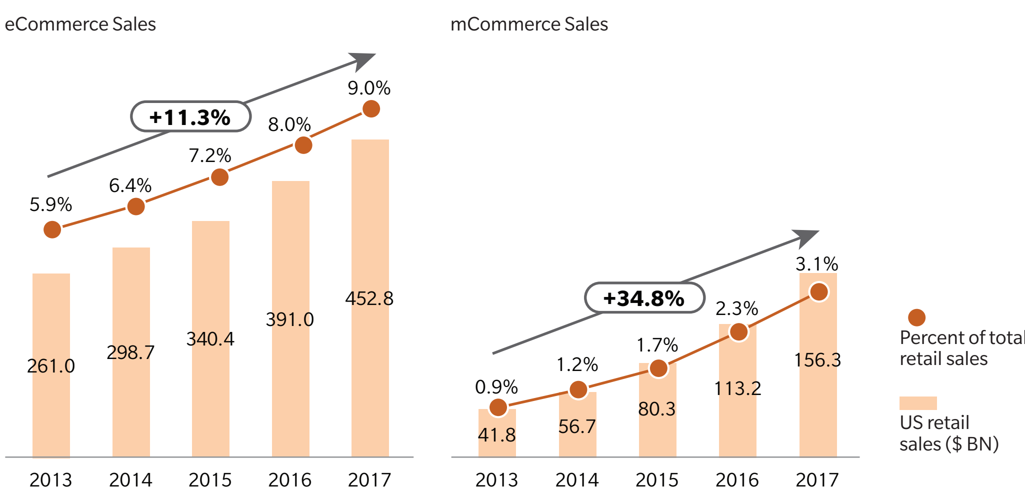
New technologies have enabled today's checkout processes to be increasingly invisible, having now been integrated seamlessly into consumers' lifestyles and purchasing habits. Innovative payments solutions now utilize mobile, cloud, Internet of Things (IoT), or even blockchain technology. Merchants can recapture the payments experience to remain competitive and stay top-of-mind. Examples could include:

- Increasing app-based functionality and interoperability
- Investing in proprietary forms of payments and creating preference during shopping
- Provisioning payments forms such as proprietary cards automatically into digital wallets
- Strengthening loyalty programs, including seamless 'earning and burning' of rewards
- Adapting faster/real-time payments solutions
- Offering installment loans/POS financing to increase conversion of shoppers to customers

3. EVOLVING CUSTOMER EXPECTATIONS

Successful adoption of new technologies or solutions requires exceptional value propositions for customers. A growing number of customers today expect to shop, pay, and send money anywhere, anytime, from any device – quickly and seamlessly. The figure below highlights the explosive growth in eCommerce and mCommerce over the past five years.

Exhibit 3: Annual growth rate of e and mCommerce in the US



Source: eMarketer, 2017

These constantly evolving expectations drive innovation, and leading merchants will face increasing pressure to include value-added features such as loyalty and personalized interactions to strengthen customer relationships. And it's not just consumers who are demanding increased payments innovation. Businesses are also more demanding, prompting payments companies to strengthen the speed, security, and transparency of their global solutions for B2B payments.

4. STRUCTURAL INDUSTRY SHIFTS

The arrival of new players, products, and infrastructures poses increasing regulatory challenges, since boundaries are constantly pushed by new entrants. The pace of change for rules and standards has increased in order to keep up with global innovation. For instance, while surcharging is banned in the UK beginning 2018, it is allowed and practiced in other geographies. Faster payments solutions are now coming to fruition in the U.S., although the providers, infrastructure and capabilities differ from other markets that also offer faster payments. As yet another example, regulatory changes in Europe under PSD2 now allow merchants to have expanded roles in a broader array of payments services.

Since it is difficult for technical specifications and regulations to be standardized across geographies, merchants will need to adapt their payments practices, or build unique payments strategies by region. Cross-border payments gain specific significance in such an operating environment, introducing not only an additional layer of complexity around fraud, compliance, and the number of payments providers, but also providing opportunities for increased revenues and diversification for global merchants.

5. IMPORTANCE OF DATA

Customer data is integral to payments and is an invaluable source of information and ownership. Permissions and usage of data have become major battlegrounds. Innovative merchants as well as vendors are leveraging payments data to develop targeted marketing, risk management, fraud prevention, underwriting solutions such as POS financing, and more. Imagine knowing where your most loyal customers are making purchases when they aren't shopping with you. Merchants can use transaction data from their proprietary forms of payment to find out, and feed it directly into marketing engines. Many merchants however do not have robust enough tools and systems, or the right analytics, to be able to tap into this wealth of data.

Additionally, privacy concerns are increasingly important to customers and managing data comes with challenges of security and ethical use. Regulatory considerations around data and their degree of robustness vary across markets. As merchants continue to find new ways to gather data, there is a need to account for key considerations such as consent, portability/sharing, personalization (to offer differentiated services) and security. Options of token vaults and the complexity of data retrieval and ownership (e.g., for processing refunds/returns) must also be considered.

These five transformative forces are foundational to the evolution currently underway in payments, and should therefore be incorporated into your thinking as you develop your payments strategy.

DEVELOPING YOUR PAYMENTS STRATEGY

Payments strategies often have multiple objectives: cutting costs, growing revenues, and deepening loyalty. Many merchants have several or all three of these components as part of their payments strategy:

1. Managing the total cost of payments to lower overall expense
2. Driving top-line revenues by streamlining and enhancing the customer's overall shopping experience
3. Integrating payments more tightly with customer loyalty as a key lever of business growth

The goal is to ensure that the core payment capabilities are optimized, and then expand the thinking from purely 'enabling transactions' to 'creating a better customer experience', as shown below.

Exhibit 4: Key components of a comprehensive payments strategy for merchants

Manage total cost of payments

- Evaluate current vendor relationships and costs to lower cost of acceptance
- Implement alternative acceptance models and forms of payment
- Encourage lower cost forms of payment at checkout
- Reduce cost of fraud and chargebacks

Use payments to increase revenues

- Identify opportunities for value added services
- Consider opportunities to enhance user experience, perhaps facilitated by 'invisible payments' or by leveraging proprietary forms of payment
- Evaluate additional sources of revenue such as installment loans/POS financing

Leverage payments as a loyalty tool to grow business

- Integrate loyalty with payments across the business to create a "frictionless" and seamless omni-channel experience
- Own the customer relationship and user experience; reduce disintermediation
- Accumulate rich data and use it to personalize customer messaging and customer interactions

Source: Oliver Wyman

1. MANAGE TOTAL COST OF PAYMENTS

Payments costs are often at the top of the list for a merchant to optimize. Key questions for merchants on managing the total cost of payments include:

- What is my true cost of acceptance? How can I get a single, consistent reporting view of payments across my businesses?
- How do my payments costs vary by payment type, network, and channel?
- How should I optimize vendor relationships?
- How do my contractual terms with processors compare against others in my industry?
- Should I standardize processing fees across corporate entities and geographies?
- How can I steer customers to our preferred payment method(s) at checkout?
- How can I reduce the cost of fraud and chargebacks?

Costs can vary by geography, form of payment, services provided, and industry of the merchant, as shown in the figure below. These factors are inter-related and understanding how each of them affect the cost of the transaction is essential for merchants to accurately size the optimization opportunity for their business.

Exhibit 5: Factors influencing the cost to a merchant for accepting a card transaction

Geography: National regulations plus competition can heavily influence pricing. For example, in the U.S., statutory caps exist on debit interchange levels, while in the EU, such caps exist on both debit and credit interchange levels for domestic transactions. Additionally, payments mix (customer preference for options such as bank transfers/debit card/credit card/wallets) differ significantly by country, as does the availability of local card schemes

Cross-border vs. domestic: Cross-border transactions are typically more expensive than domestic transactions, representing ~40–60% higher costs in the US and 5–8x higher costs in Europe. Thus, depending on the transaction mix, retailers' payments costs for the same level of sales can be very different

Merchant industry/channel: Interchange varies by industry; for example grocery stores may have lower interchange rates than general retailers. Payment costs also vary by technology and channel. For example in the US, card-not-present interchange fees are higher than card-present rates

Card brand/type: Card schemes such as Visa and Mastercard have different credit card tiers, such that the interchange levels are higher for premium cards than basic cards. Differences also exist across card brands and across card types (small business/commercial/consumer cards)

Source: Oliver Wyman

2. USE PAYMENTS TO INCREASE REVENUES

Payments represent more than a cost to merchants; payments can also play a key part in driving revenue growth. Key questions for merchants on using payments to increase revenues include:

- How should I refine my checkout process to minimize cart abandonment?
- How should I strengthen my proprietary forms of payment?
- What value added services can I offer?
- Which alternative forms of payments should I accept to increase sales?
- What factors need to be considered in evaluating whether to expand to distributed commerce? How much control do I need to give up for an increase in sales?

As a starting point to generating growth through payments, merchants should be looking for ways to create unique checkout solutions for customers in keeping with their brand. These can take different forms as shown below:

Exhibit 6: Revenue drivers for merchants using payments

OPPORTUNITIES	DESCRIPTION	BENEFITS
Alternate forms of payment	• Enabling global customers to pay as they prefer	• Higher cross-border sales • Higher conversion/ lower abandonment
Contextual commerce	• Ability to purchase when/ where you want • Leverage single sign-on for easy check-in and check-out	• Easier UX leads to seamless checkout
Financial services	• Linking payments to: – Credit (installment loans/ POS financing) – Other value added services (e.g. DCC)	• Higher customer spending power • Opens up fee income possibilities
Targeted surcharging	• Charging a fee for more expensive forms of payments or in certain markets	• Ancillary revenue stream • Manage acceptance costs
Proprietary forms of payments	• Payments mechanisms which facilitate shopping and larger average ticket sizes (e.g. co-brand/private label credit card)	• Higher average ticket, greater shopping frequency, longer tenure • Enhanced loyalty and spend reporting • Lower payments costs

Source: Oliver Wyman

A strong payments infrastructure is critical to allow for an integrated shopping journey in a seamless, cross-channel way, including purchases, pick-ups, and returns. If a merchant has different payments platforms for physical and online operations, this can complicate reconciliation, inventory tracking, refunds, and also obscure the true cost of payments. Similarly, relying on a fraud engine that is optimized for card-present transactions at your store, but not for online or mobile card-not-present transactions can lead to higher false positives/declines or higher chargebacks – and ultimately, lower revenues.

Merchants must evaluate how payments can play a larger role in delivering their unique experience, developing an integrated set of payments solutions and offerings across purchase channels to drive higher sales.

3. LEVERAGE PAYMENTS AS A LOYALTY TOOL TO GROW BUSINESS

Payments can serve as a hook for merchants to drive penetration and go beyond the typical loyalty program.

Key questions for merchants on using payments with loyalty as a tool to grow business include:

- How can loyalty be integrated with payments to enhance and streamline the customer experience?
- How can payments protect my customer relationships, while enhancing customer experience and my brand?
- How can I offer a differentiated rewards value proposition using payments?
- How can I leverage payments data to deliver customized experiences and offers to customers?

Merchants know that an underwhelming checkout can lead to lower customer satisfaction and reduced customer loyalty.

Exhibit 7: Customer journey when focus on payments experience is low

A customer finds a product at a merchant that he/she likes...

...compares prices online and finds the merchant priced competitively...

...but at checkout finds the payments experience underwhelming. Some examples include:

- Preferred form of payment is not offered
- Payment is declined
- Sensitive information is required
- Guest checkout not offered
- Customer transferred off-site for checkout
- Additional shipping costs applicable...

...and abandons the purchase

Source: Oliver Wyman

With online cart abandonment rates as high as 60% – 80%[3], this level of lost sales is untenable, especially in an increasingly challenging retail environment. A similar analogy holds true for physical stores, where the use of EMV chip cards and slower Point-of-Sale (POS) hardware terminals can cause a poor customer purchase experience, impacting customer satisfaction and ultimately store traffic.

On the other hand, a robust checkout experience can strengthen customer loyalty, as illustrated below.

Exhibit 8: Customer journey when a good payments experience leads to stronger customer loyalty

Easy payment and checkout drives preference...

...preference drives loyalty...

...loyalty drives targeted marketing...

...which drives margins and growth

20–50% larger ticket when using merchant's payment methods

~70% of consumers have private label/store credit cards, which can drive loyalty and customer experience

Targeted marketing

- Win customers from competitors
- Products and channels aligned to interests

Significant margin improvement due to

- Cost reduction
- Revenue drivers

Source: Oliver Wyman, Morgan Stanley Research: "US Internet, Retail and Banks – What's in Your Wallet? Amazon?" – March, 2017

An effective way for merchants to drive greater top-line revenues is to integrate rewards earning as well as redemption into the payment and check-out process, and to create personalized experiences and services that can help drive customer loyalty. Publishing relevant offers, coupons, and messaging linked to consumers' payment preferences, and shopping patterns will optimize the return on advertising spend. And stronger loyalty means more repeat business – and higher growth for merchants.

3 VWO eCommerce Cart Abandonment Report 2016

CONCLUSION

Payments have been undergoing significant transformations in recent years – from being viewed simply as a cost of doing business, to becoming a key enabler of an integrated and seamless shopping experience. Leading merchants such as Starbucks and Amazon have made significant investments to refine their payments strategy and are shaping the future of shopping through an integrated, streamlined payment experience.

Whether it is to optimize costs, enhance customer experience, or drive growth and revenue, it is important to address these key questions for your business:

- What are the key objectives of my payments strategy?
- How can I better manage my total cost of payments acceptance?
- How can I use payments to increase my revenues, either directly via income from proprietary forms of payments, or indirectly via stronger customer experience?
- How can I leverage payments as a loyalty tool to grow my business?

The time to act is now. Payments can be a key lever in increasing your revenues and growing your business overall, while also providing opportunities to reduce your operating costs.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AMERICAS
+1 212 541 8100

EMEA
+44 20 7333 8333

ASIA PACIFIC
+65 6510 9700

AUTHORS

Elizabeth Costa
Partner in the Americas Retail Banking and Payments Practice
elizabeth.costa@oliverwyman.com

Robert Mau
Partner in the Americas Retail Banking and Payments Practice
robert.mau@oliverwyman.com

www.oliverwyman.com

The authors would like to acknowledge and thank their colleagues Rick Oxenhandler and Rohit Suresh for their valuable contributions.

CONTRIBUTORS

Rick Oxenhandler
Principal in the Americas Retail Banking and Payments Practice
rick.oxenhandler@oliverwyman.com

Rohit Suresh
Payments Specialist in the Americas Retail Banking and Payments Practice
rohit.suresh@oliverwyman.com

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