SPOTLIGHT REPORT USA

The 3 Key Trends in Payments

endava

Contents

Payment Market Dynamics

The Past Five years.... in payments have been transformative. A long-heralded move to digital payments, compounded over the last 18 months by a global pandemic, has seen the rapid emergence of agile start-ups compete alongside both legacy and Fintech providers.

The payments industry has attracted colossal investment from private equity and venture capital which has resulted in increasing deal volumes and growing valuations. It has also resulted in fierce competition and an unprecedented level of product innovation.

Endava's payments practice has always been a cornerstone of the business. From our start over 20 years ago, we have supported major banking and payments platforms. Over the years we have seen banking go mobile, account transfers become real-time, payments go touch free, and cross border payments become ubiquitous and affordable. With the unprecedented level of investment that has taken place, innovation is everywhere.
What follows is our view of what **the Three biggest trends** currently are, and how we think they will impact the payment ecosystem over the next few years.

TREND 1

The Maturation of Open Banking

INTRO

Open banking frees financial data and payments via secure API's, and allows them to be the driver of rich new ecosystems of personalised financial and business/personal lifestyle experiences. While data aggregation has been around for some time now and is moving from screen-scraping to open banking API's, the active management of monetary accounts and the movement of money is the new frontier welcomed by open banking API's and real-time payment rails.

This trend had a good head start in Europe, driven by government mandates. It is now starting to gain pace in the US, but without regulations setting the pace. Instead, the rollout in the US is aided by financial organizations coming together to set standards such as the Financial Data Exchange (FDX) set of data models for the growing number of open banking use cases.

DEEPER DIVE

For consumers we believe that open banking will be delivered through a marketplace of trusted providers giving consumers an unprecedented level of visibility and control over their financial life. As an example, a provider could enable a consolidated experience that allows the consumer to manage multiple bank accounts in a single place. This would allow the consumer to potentially use different bank accounts for different purposes. One account could be a day-to-day account allowing dynamic spending without any impact on reoccurring payments, which would be safely funded from a unique account, another one could hold savings for one or more future goals.

Dashboards will show trends and make suggestions on ways to save (e.g. cancelling/consolidating subscription services) and overall improve financial health. Should a potential overdraft situation hit, rules will determine whether to protect the other accounts or to temporarily move funds between them, to avoid overdraft fees and back again when funds are available.

Some of this occurs today within a single financial institution (FI) but we believe that open banking will make this mainstream and more ubiquitous, with accounts sitting at an FI best suited for each account's unique purpose. The provider would be viewed by the consumer as the manager of their banking world.

We see these "providers" initially being third party players, who know the most about creating a great consumer experience, but banks will be OR are jumping into the game, creating these services at "arm's length" from their own accounts and incorporating data from other banks and FIs. We also expect to see the creation of "FinLife" super-apps, which build on the above and create a one stop shop for finance, insurance, shopping, transportation, social media, and/or health services. We are already seeing this start with PayPal's announcement of its "Super App".

For businesses, similar multi-account products will be available from banks and third parties, with SMB (small and medium size business) use cases likely gaining the fastest traction. In addition, we see banking and payments becoming an integral part of accounting and ERP (enterprise resource planning) services. Accounts receivable and payable, along with payroll can drive the automated movement of money between accounts that are set up to maximize financial efficiency. Bridge loans can be anticipated, and money moved from providers on a just-in-time basis.

HEADWINDS TO GROWTH

Open Banking requires trust from data owners and regulators that data will be secure from breach and that it will not be misused. The key to building and maintaining this trust is the secure movement of data with the appropriate access and usage controls in place. Data owners will need absolute assurance that data will only be used for the exact purpose they signed up for, and only for the length of time they allow.

While there has been copious amounts of activity in API based data aggregation, we are still in the early days of using open banking to facilitate money movement between parties or FIs. These use cases will require a much higher level of trust from money owners. Whether the incumbent players can win this trust or whether a new, already trusted, entrant steps in to fill this role remains the big question.

Another big question is whether the volume of traditional payment cards will be put under pressure by the account-to-account transactions that will be made available to consumers through the upcoming FinLife apps. As direct push payments become as easy, or easier, to use as a card payment, will the core strength of cards (consumer protection via chargebacks) be enough to defend their market position?

WHAT'S NEXT?

We are still at the beginning of the open banking journey but have already started to see the emergence of a small number of trusted network providers that connect banks and FIs with third party apps and providers for open banking services. Several of the existing data aggregators are best positioned to take on this role; however, a few non-traditional financial service providers have also started to enter the space. Over the next years we expect to see an explosion of new entrants and then a subsequent consolidation in third party providers. In parallel, we will likely see the continued emergence of super apps from today's powerhouse players, each coming from their current strength and adding the other fin-life services.

On the business banking side, we believe a wave of payment integrations with major ERP systems will drive a new set of business workflows that optimize around real time money movement. Additionally, businesses will look to more integrated solutions that provide banking services that work in parallel with the tools they use to manage their business.

TREND 2

The Explosive Growth of Buy Now Pay Later

INTRO

While the practice of splitting a purchase into a small number of instalments (generally interest-free) has been around in pockets of the world for decades, its popularity and accessibility have skyrocketed over the past few years.

Buy Now Pay Later (BNPL) is admittedly the hottest trend in the payments market right now.

DEEPER DIVE

Consumers in younger demographics are staying away from traditional credit card products while spending more than ever on high quality, higher cost products. We see those demographics playing a key role in the emergence of a new generation of instalment or buy now pay later products. The younger generation is looking for a way to purchase over a limited period of time but wanting to avoid the revolving debt trap that many saw their parents and friends' families fall into. Underbanked, thin credit, and poor credit consumers also want to have flexibility in how they pay but have been cut out of the traditional credit card ecosystem.

This desire for a new type of short period fixed term credit is being met by a new breed of deferred payment providers. These companies, Klarna, Affirm, Afterpay, and Openpay, to name a few, provide an exceptional user experience and create relationships with consumers for ongoing credit on an item-by-item basis. Their approval model bypasses the traditional credit scoring, so it incorporates a high percentage of those cut out of the credit card ecosystem. It can also give a path into the mainstream credit world, as some providers use the BNPL payment history to help build a traditional credit score (e.g. FICO).

This new alternative to short term credit has been a sales accelerator for many retailers, helping some to grow rapidly and others to recover sales lost in the past 18 months. It started as an online-only offering and is now moving into the physical point of sale (POS) world. The recent partnership between Afterpay and Westfield shopping centers is counting on the BNPL flexibility to boost traffic as stores reopen. In almost every segment of retail, BNPL is now being offered as an alternative payment method.

For Businesses BNPL is now becoming a viable short term credit option, as small businesses are perfect candidates for the cash flow based acceptance models that are central to short term (pay-in-4) BNPL products. BNPL transactions in North America have grown from near zero two years ago to $55bn in 2021. Signalling the continued growth potential of BNPL, Square announced the acquisition of Afterpay last August. The acquisition is not just about acquiring the transaction volume, but more importantly, capturing the buyer data and owning the buyer relationship.

HEADWINDS TO GROWTH

The rapid growth of BNPL is also creating a challenge for retailers, who guard their relationships with their own customers carefully and are concerned about the margin erosion that these products could cause with their 4-6% average fees. These fees are acceptable with the assumption that BNPL is driving incremental sales that would not have occurred without instalment payments. However, if BNPL becomes the default choice for consumers who don't require instalments as a budgeting tool, instalment purchases begin cannibalizing existing sales and lowering overall profit margins. In the past, credit cards. and the even higher interchange of premium credit cards, were viewed as a positive due to the increased sales they brought.

The current view has changed drastically. It will be interesting to see if BNPL fees have a similar fall from grace to join credit card interchange as a villain.

Large retailers are approaching the challenges in two different ways. We are seeing some planning for their own BNPL experiences to counter the new entrants and to protect and deepen their relationships with customers. They are taking their private label credit experience and rebuilding their products to offer a competitive BNPL experience. Others, such as Amazon, are forging deep partnerships with the current providers, putting them in a position of having more control over data and fees.

Meanwhile, incumbent providers like Mastercard, and PayPal are moving in with their own lending at the point-of-sale products. PayPal has their "Pay in 4" product, and Mastercard just announced a network of lenders using its BNPL "Mastercard Instalments" that also ties into open banking for instalment plan approvals.

Beyond the large payment networks, traditional credit card issuers and revolving credit providers are also updating their products to offer more seamless fixed term instalments as part of their offerings.

The growth of the BNPL space has caught the eye of regulators, who are now working to ensure that consumers are getting the same protections covering traditional sources of credit. Since any provider of credit beyond four instalments is already regulated, the new focus will be on the “pay in four” products.

A key protection for consumers has been a lender bearing some responsibility for offering credit beyond what a consumer can afford. Credit bureaus mitigated this for traditional credit by keeping up with how many credit offerings a consumer has applied for. It will be interesting to see how regulators look at “no credit check” offerings that potentially let a consumer sign for many concurrent instalments that they collectively cannot afford.

Another regulatory question will be how much scrutiny will be put on the acceptance criteria, collections, and delinquency fees once the market for pay-in-four matures.

BNPL is a rapidly maturing trend for both consumers and small businesses that will bring on a significant amount of competition and regulation, but it also represents significant revenue opportunities for those that come out on top.

WHAT'S NEXT?

The BNPL space has seen such explosive growth in the last 18 months that some consolidation is inevitable. We expect to see more acquisitions and partnerships as incumbent players look to jump into the BNPL space and large retailers look for more control over BNPL offerings. This dynamic is likely to create fierce competition between incumbent BNPL providers, new entrants, and offerings from current credit providers (including retailers' private labels). The new payment type also directly competes with traditional payment methods and will create a new frontier in the battle to be "front of wallet" or "top of shopping cart".

If we look even further down the road, we believe that it won't be long before merchants start scrutinizing the cost of BNPL and its long-term impact to their margins and business model. This will likely lead to some degree of surcharging on BNPL purchases and the resulting fallout will put pressure on the BNPL fee structure. We should also expect headwinds in the space as regulatory oversight eventually catches up with the new payment type. Over time BNPL is likely to move toward being treated by regulators in the same manner as other types of instalment/revolving credit.

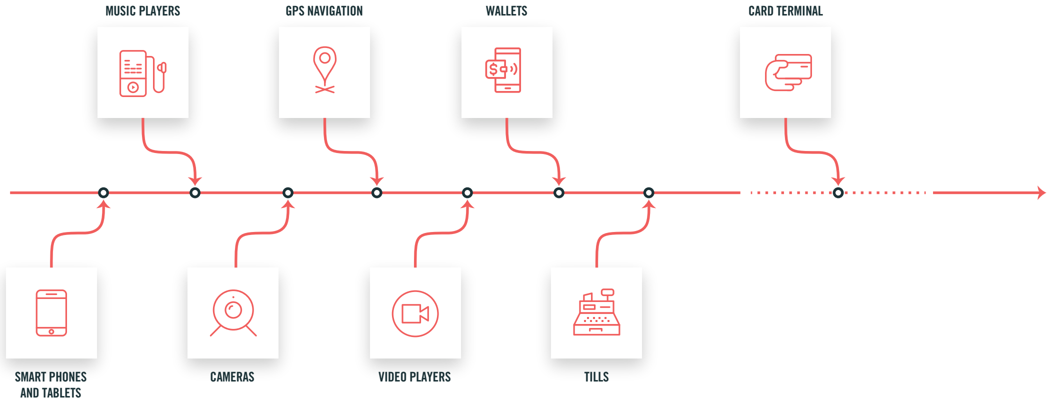
The Evolution of Payments Acceptance

INTRO

Over the last decade consumers have seen mobile devices transform nearly every part of their lives. Devices like the iPad have taken what once was specialist hardware, miniaturized and modernized it, and then replaced it by integrating its components into the device. Music players, cameras, GPS, and gaming devices are a few examples. This trend extends into payments as well. With the release of Apple Pay and the subsequent iterations of Google Pay and others, every mobile phone has quickly become a payment credential. Meanwhile web and app-based payments, using stored and tokenized credentials, have redefined the online shopping experience, where payments now add little to no friction to the process.

Businesses have also seen the benefit of this trend as companies like Square helped make every iPhone a payment acceptance device through their dongle and software. Today that has continued to evolve and modern Android tablets and iPads are frequently used to host custom payment acceptance software. For most businesses, the days of needing dedicated single-purpose payment terminals are over. This lowering of a significant barrier to entry, especially in developing countries, has led to a major growth wave among small businesses.

MOBILE DEVICES REPLACE SPECIALIST HARDWARE



DEEPER DIVE

This modern payment hardware trend started with point of sale (POS) devices being built using tablet technology and shipping with cloud connectivity enabled. Clover was an early leader in this movement that also brought the concept of an application store to the device allowing business to incorporate other services such as table management, scheduling, and eventually payroll. In the mobile phone space, Square started the move to a phone being a card acceptance device with the introduction of their card swipe dongle.

The next generation of these payment devices has begun to skip the need for accessories and enabled payment acceptance directly onto the device ("tap to phone"), with Apple's recent acquisition of Mobeewave[1] emphasizing this trend. These devices, combined with the growth of contactless cards and wallets (e.g. Apple Pay, Google Pay), and accelerated by the fear of Covid-19 being transmitted via cash handling, have significantly changed how payments are made and accepted, and will continue to do so in the coming years.

Another dimension of this consumer payment trend is the rapid growth in frictionless payments via apps. Most consumers first experienced "stored payment credentials" for on-line shopping, but the trend really began accelerating with the launch of apps such as Uber. These apps allowed a customer to focus on the core experience – taking a ride with Uber or ordering a coffee with the Starbucks app – and moved the payment to becoming an after-thought.

The COVID-19 pandemic then pushed things further as consumer usage of delivery services, such as DoorDash and Postmates, increased significantly. It became common behavior to order everything via a mobile app including grocery delivery, food delivery, or even in-person restaurant orders. This shift in behavior has set the stage for many consumers to pay for goods and services through an app, even when physically present at the location of the sale. Nevertheless, physical payment at the point of sale is not going away anytime soon, and contactless (tap to pay) usage will increase, but unlike Europe where we see almost 100% contactless usage, US will be split for the next few years between contact, contactless, and app-based friction free experiences.

[1] source - Bloomberg.com

HEADWINDS TO GROWTH

The pace of technology change continues to accelerate, and payment acceptance hardware and software will continue to grow and evolve. However, this rapid pace of change often comes at a cost. Consumer data breaches have been one of the most significant negative outcomes, and these continued breaches lead to distrust of digital payment solutions, weakening the adoption of some digital payment products.

Given the economic impact of data breaches on consumers and merchants, it is not surprising that government and industry regulation are also an important consideration. In many cases, the technology needed to facilitate a more modern payment experience is widely available. This puts an increasing burden on regulators and network operators to ensure that the technology is being used appropriately and that consumers are being protected and treated fairly.

WHAT'S NEXT?

It is impossible to know exactly what the next great payment technology advancement will be; however, we do have some ideas of what it will include. We see a potential future where the consumer checks in with an app and then has the payment seamlessly made when services are complete. Loyalty could be accumulated and applied automatically, and with the payment type pre-set and validated in the background, alternate payment methods (APM's), including BNPL, Open Banking and crypto payments, can gain significant momentum.

We also expect to see consumer devices become ever more critical in payment experience, and biometrics take over from PINs and passwords for authentication. This move will lessen the hardware burden on merchants and enable nearly anyone with a basic smartphone to facilitate payments. Additionally, payment credentials are likely to disappear from the purchasing experience as they are embedded in apps and connected devices. This move of payments from a primary to a secondary experience will allow the increase in use of Alternate Payment Methods for in person transactions. In time, it's likely the payment experience disappears even further into the background to become a financial transaction that occurs on behalf of the buyer and merchant, without either party having to manually initiate it.

Looking Forward

The next five years will see a continued acceleration of investment and interest in the payments ecosystem. Payments have evolved from being considered a critical business function of almost every commercial organisation, to becoming an extraordinary source of data and insight into the behaviour and needs of customers.

At Endava, we see payments not as a vertical capability, but rather as a horizontal foundation technology, cutting across many industries, such as:

- Insurance, where matching payment data to policies and claims can bring faster claims, better user experiences and improved efficiency in back-office finance operations.
- Transit and Automotive, with the shift to transit as a service utterly dependent on understanding who the users are and collecting payment as they travel.
- Retail, where managing friction and making sure consumers can pay however, whenever and wherever they want across channel is pivotal.
- Health, where identity, privacy and capability to pay are crucial access and success factors.

We anticipate a future in which payments are experienced through sophisticated digital channels, with data-driven decision-making providing frictionless transactions and new sources of credit, as well as creating ecosystems of value where connected systems allow new insights and opportunities.

With investment pouring into the sector, payments technology is a critical enabler of digitization and operational efficiencies across a number of verticals. Ultimately, Payments are increasingly connecting consumers and businesses – a foundational capability that supports the future of enterprise.

ABOUT THE AUTHORS

Glenn Geil
SVP PAYMENTS DELIVERY

Glenn has over three decades of experience in both retail payments and banking. He is responsible for delivering strategy and development services to Endava's global payment industry clients ranging from PayFac's and Acquirers to Real-Time Payment facilitators and Crypto-Currency exchanges. When he isn't challenging himself to help clients create innovative payment solutions, Glenn likes the challenge of hiking up the likes of Rainbow Mountain and Machu Picchu.

Scott Harkey
EVP: FINANCIAL SERVICES & PAYMENTS

Scott has spent the last 20+ years helping companies in the financial services and payments space transform their business using technology. After spending the first 15 years of his career working in leadership positions at several top US banks, he joined the executive team at Levvel to help drive the company''s go-to-market strategy and build an industry vertical consulting approach. In 2021, Levvel became part of the Endava family, and Scott joined the Endava sales leadership team to drive US sales growth in BFSI and continue to help shape how the company goes to market. When he is not helping Endava shape how we go to market, Scott enjoys being active in the great outdoors and supporting musicians through his own record label.

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