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PAYMENTS INDUSTRY INSIGHTS JOURNAL

COVER STORY

The Future of Money in 2020

What consumers want from their banking relationship, and why banks may have to work harder to deliver it

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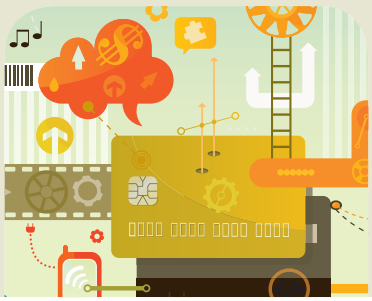

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Envisioning Possibilities

"The future belongs to those who see possibilities before they become obvious."

Working to transform the status quo can be as intimidating as it is exhilarating. But this quote from John Sculley, former president of Pepsi Co. and CEO of Apple, aptly sums up our feelings about the evolution of payments. It involves working toward a future vision of progress and possibilities — some of which have never been thought of before.

This issue of n>genuity is dedicated to emerging trends discussed during the Money2020 Expo, held at the Aria Resort and Casino in Las Vegas from October 22–24. This event brings together innovators in emerging payments and financial services as a community of leaders who will change the way consumers and businesses conduct commerce.

In this issue, we profile a variety of topics that are reshaping payments. Our cover story explores the future of money in the year 2020 — what consumers will expect from their banking relationship and why banks may have to work harder to deliver it. You'll also find articles on why banks should play an active and collaborative role in the development of mobile payments, the rise of mobile wallets and how to better manage risk for the mobile, on-the-go merchant.

You will read about small businesses' need for cash management tools, access to credit and why micro-financing is as relevant in the United States as it is in emerging markets. Additionally, we explore why credit card usage is evolving along with consumers' new spending and saving habits and why the time is ripe for credit unions to reenter the card market.

We hope you'll find this issue of n>genuity insightful and informative. Stay connected to *n>genuity* by subscribing online at *www.ngenuityjournal.com* so you can be aware of the newest special features, podcasts, timely news and pertinent research you've come to expect from our journal.

As always, we welcome your feedback on articles in this magazine, or anything else that's on your mind, by e-mailing *ngenuitymagazine@tsys.com*. We hope you'll enjoy the read.

Sincerely,

M. Troy Woods
President & Chief Operating Officer
TSYS

The Future of Money in 2020

What consumers want from their banking relationship, and why banks may have to work harder to deliver it

BY> JESSICA HARRIS

We're all technological whiz kids these days. The dawn of mobile banking has brought with it a demanding consumer who knows what he or she wants. The immediacy and connectedness of the Internet — combined with the ubiquity of mobile phones — have resulted in consumers expecting far more from their banking relationships.

It is therefore vital that we understand what consumers want from their banking relationship and why they have become so enamored with it.

We all know that smartphone penetration is on the rise, with multiple open platforms and apps with rich interactivity. Consumers are increasingly comfortable with mobile, online and social media technologies, and banks should look to prioritize their new product investments in alignment with their customers' preferences.

It is therefore vital that we understand what consumers want from their banking relationship and why they have become so enamored with it.

The convenience factor

"It boils down to convenience," says Terri Ferrise, vice president of the Financial Services Organizations division of Minnesota-based Cachet Financial Solutions. "Technology helps support the need of today's consumer — especially Generation Y — who wants more control and instant gratification. They want everything easier and faster and on their own terms."

Ferrise says that today's consumer views face-to-face relationships as more unpredictable, more time consuming and less convenient overall.

Banks will need to rethink and reinvent their current line-up of products and services as new third-party competitors continue to encroach on their shrinking customer base.

New Haven, Conn.-based Miles Lasater, president and COO of Higher One, explains further. "The Internet has provided consumers with a culture of instant gratification, and they want answers now without having to wait in line or on the phone. The technological relationship allows them to simply search for their own answers instead of having to wait for someone else."

The future of money

It's no surprise that consumers want richer, cooler and more convenient and elegant banking experiences. "There will be less bricks and mortar — fewer banks, branches and ATMs," explains Ferrise. "Banking will no longer be about a place you go; it will be something you do, wherever and whenever via your mobile phone or tablet."

The current decline in branch traffic that we are seeing is set to continue, according to Portland, Ore.-based Joshua Reich, chief executive of Simple and another speaker at Money2020. "Over the next decade we'll see another 50-percent drop," he says. "Coupled with the on-going financial crisis, consumer trust in banks will also continue to decline," he adds.

Working harder for customers

Ferrise explains that this means banks will need to work harder for customers by 2020, because the customer will come to rely on them less. "Banks will need to rethink and reinvent their current line-up of products and services as new third-party competitors continue to encroach on their shrinking customer base."

And technological innovations will also continue, according to Reich. "Innovations from broader NFC and EMV adoption in the United States are set to transition toward more convenient forms of person-to-person payments," he explains.

However, he warns that innovation must come for the right reasons. "Regardless of the technology, success will rest on whether the innovation truly solves a consumer pain point instead of simply being innovation for the sake of innovation, or worse, innovation for the sake of further entrenching the current sad state of customer-bank relations."

About the Author

Jessica Harris has been writing about financial services for seven years, with a focus on financial risk for the last two years. She is based in London, where she writes daily news, features and financial profiles.

The Changing Landscape of Mobile Payments

Why this is not the time for banks or merchants to sit on the sidelines

BY> ANDY DRESNER AND CHAITRA CHANDRASEKHAR

Mobile payments are expected to be ubiquitous in the global retail payments arena in the next few years, and the time is right for banks to develop their strategies.

While overall infrastructure and marketing investments required for this sector could be material, the rate of consumer adoption is still arguably an unknown, making the return on investment particularly uncertain. Incumbents in the legacy payments ecosystem — such as issuers, acquirers, networks, processors, terminal vendors and merchants — all want to ensure their positions are enhanced in an emerging mobile ecosystem, while insurgents (mobile network operators, mobile operating system owners and startups of every variety) are hoping to swiftly cannibalize revenues and intermediate the incumbents.

The mobile payments model in developed markets like the United States builds on legacy payments infrastructure rather than displacing it. Most people have debit cards, and many have credit cards. Almost all retailers have point-of-sale (POS) terminals, and prepaid cards serve narrow unbanked segments like immigrants and teenagers. As such, the telco-centic mobile payments models common in the developing world have limited relevance. We should not expect parallel infrastructures to develop in competition with legacy networks. Even Square and PayPal leverage cards at their back-end even as they try to jockey for position at the POS.

In other words, mobile payments will be deployed as an enhancement to, rather than a replacement for, the legacy payments infrastructure. A threat to incumbents' traditional revenue streams still looms, but not in the form of competition for balances or transaction volumes.

Rather, the issue is for control over the interface that sits between the consumer and the legacy payments infrastructure — the mWallet.

The rise of the mWallet

The emerging mobile payments ideal in developed markets is a smart phone app called the mWallet, which contains details of a consumer's payment account. This app initiates payment via an onboard near-field communications (NFC) chip. The chip communicates payment details to a contactless reader at the POS, leveraging existing standards established to speed up debit and credit card payments. Mobile NFC simply embeds the chip in the phone instead of the card. This technology has the benefits of multiple payment options (as more than one card may be held in the mWallet app) and enhanced security (as the consumer must log in to the app for each transaction).

mWallets go beyond contactless plastic in one crucial way — they intend to seamlessly serve up customized ads and offers to their users. In theory, mWallet vendors will track consumer spending patterns, both online and off, to understand a consumer's shopping preferences. This intelligence will be made available to merchants who can make targeted offers to receptive consumers. The offers can even be proximity-based, since the GPS chip in the phone allows the offer to be timed for when the consumer is near a particular merchant location. It is no surprise that Google is first to market here with its Google Wallet, leveraging both Google ads and offers technology and its Android smartphone OS.

Mobile payments will be deployed as

an enhancement to,

rather than a replacement for, the legacy payments infrastructure.

Potential hurdles

While the potential of mobile NFC and the mWallet looks attractive, there are notable hurdles to fast and widespread adoption:

1. Smartphone ubiquity. Smartphones with NFC will take time to achieve ubiquity. Not only will it take time to replace the current installed base of instruments, but mWallets need to function across the three major OS platforms: Apple iOS, Google Android and Microsoft/Nokia (Windows Phone/Symbian).

2. POS terminal upgrades. It will simply take time for retailers to upgrade their POS equipment with contactless readers. Many will wait for the natural replacement cycle of their existing terminal kit.

3. Merchant vertical (industry) adoption. The contactless plastic initiative was aimed at small-ticket, high-frequency venues like fast food, transit, taxis and drug stores, and it did not really expand to merchant verticals beyond those. The proposition was targeted to the needs of these sales environments, reversing liability while waiving the need for a signature on low-value transactions, therefore improving line speeds. Gas stations, an arguably similar vertical in some respects, did not effectively adopt contactless plastic due to the cost of upgrading pumps. High-ticket verticals saw no advantage to this technology and didn't adopt. Mobile NFC will need to provide a compelling proposition to overcome challenges to merchant buy-in.

4. Consumer behavior. The contactless plastic initiative did not succeed in transforming consumer buying behavior given its focus on transaction speed. The question around mobile NFC is whether smartphones are a more convenient form factor ("I already have it in my hand") and whether the ads and offers model is a compelling value proposition for influencing buying behavior.

The impact on merchants

Merchants have a fair amount to fear from mWallet initiatives. The wallets embed conventional payments fees, which merchants already view as too high. Additionally, merchants' favorite two payment methods, PIN debit and private label credit cards (PLCC), are actually disadvantaged in mWallets: PIN debit cannot be used at all, and PLCCs are likely to decline faster as consumers set a 'default card' in the wallet to reduce complexity.

Also, mWallets use the merchants' own customer data to facilitate ads and offers from their competitors. Essentially, mWallets will train consumers to look for discounts before buying. In other words, mWallets undermine consumer loyalty by design. To add insult to injury, the merchants are the ones funding the POS upgrades that facilitate the whole ecosystem.

Now is the time for banks to realistically assess their own operating environments, strategic assets and growth appetite to make the best bets in this field of play.

Amidst this largely threatening scenario, there are merchant-friendly options emerging; in particular, the Starbucks mobile payments paradigm. The Starbucks app is proprietary, so data sharing is not an issue. It works using existing bar-code scanners, so no POS upgrade is required. In fact, the app actually reduces payments costs by aggregating many small transactions into a few bigger ones. And it is tightly coupled to an existing loyalty program.

The Starbucks app has generated more than 60 million transactions to date. It avoids the downsides of 'open' mWallets while delivering real value to consumers. Dunkin Donuts just rolled out a similar program, and other merchants also seem to like this approach as the Merchant Consumer Exchange (MCX) consortium's client list clearly demonstrates. Starbucks itself continues to push the envelope, now accepting Pay With Square at their POS while taking an equity stake in the company.

The big open question is how many merchants will go the proprietary route and how many will simply take all NFC wallets. If enough merchants abstain from contactless investments, the 'open' mWallets will never get a foothold. However, if enough merchants do install NFC readers, the proprietary wallets may fade away. At present, contactless investment is picking up, but far from ubiquitous.

Assessing banks' strategies

In the short run, banks do not have much to lose from mWallets. A consumer still needs a debit or credit card to use mWallet technology, leaving banks with their legacy revenue streams intact. ACH is a potential threat as demonstrated by PayPal, but it is not clear how many consumers would go that route.

The real threat for banks is longer-term. Can the mobile networks and operating system providers extract rents for mWallet usage or placement? This kind of intermediation is a perennial question for banks, having fought off similar threats from aggregation services (e.g., Yodlee), personal financial management software (e.g., Intuit), electronic bill payment vendors (e.g., Checkfree) and others. In all cases, the insurgents ended up co-existing with the banks rather than 'eating their lunch.' Mobile payments may be no different.

We believe a key issue for banks is not what they stand to lose through mWallets, but what they might gain if they could control the technology. The revenue from ads and offers contemplated by Google and others would help offset bank revenue losses in the United States from the Credit CARD Act, the Durbin Act and Reg E regulations. Furthermore, the bigger banks could deliver more value to customers than their smaller brethren because they have more data — and this might offset the revenue advantage that Durbin gave to the smaller

banks. Services like Cardlytics, Linkable Networks and Offermatic already use payments data to serve up ads and offers on statements, but there is more potential in mobile delivery. For example, big banks might create their own closed-loop networks that link their customers with proprietary offers.

With myriad dynamics shaping the future of mobile payments, now is the time for banks to realistically assess their own operating environments, strategic assets and growth appetite to make the best bets in this field of play. It is not the time to sit on the sidelines.

About the Authors

Andy Dresner is a partner and payments expert in Oliver Wyman's Retail & Business Banking practice. He advises the world's leading financial services firms on issues of strategy, profitability, growth and technological innovation in the payments arena.

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Expanding Loyalty Programs from the Wallet to the Point of Sale

Call it merchant-funded rewards or transaction marketing — by any name, it provides measurable returns on marketing investment

BY> JESSICA HARRIS

Consumers are a demanding bunch, and rightfully so.

In these times of austerity, consumer spending is what keeps the economy flowing and businesses afloat. And with austerity comes the desire for deals and discounts. So it is only right that today's consumer has increasingly come to expect such deals to be delivered to them on a plate — or a smartphone, tablet, PC, TV and so on.

It is this increase in consumer-owned screens and the continuing enhancement of channel complexity that is creating an ever-increasing number of touch-points for consumer discovery and consumption. These increases demand sophisticated approaches to win the hearts and, more importantly, minds of today's deal-hungry consumer. Offers and loyalty approaches need advertising and marketing to connect them with the consumer, and the effective ones have the capacity to disrupt the decades-old interchange regime.

"Our industry is tearing down some of the historic animosity between retailers and financial institutions," says Scott Grimes, chief executive of Cardlytics, an Atlanta-based transaction marketing company,

New business models supporting the

24-hour commerce culture

are re-inventing deals, offers and loyalty in an effort to keep their customers happy.

who will be speaking on this subject at Money2020 in Las Vegas in October. "Retailers are able to grow their businesses more profitably and with more confidence. Financial institutions are tapping a new course of economics for their customers and for themselves."

Jason Gardner, Money2020 speaker and Emeryville, Ca.-based chief executive of Marqeta, a multi-merchant prepaid debit card company, agrees that change is afoot. He points out that a shift in mindset has occurred.

"In the old regime, merchants saw themselves as the distribution channel for their suppliers' brands, so the thinking was 'Why not use supplier-funded rewards to drive store traffic?' In the new world, merchants see themselves as consumer brands in their own right with a real stake in managing the economic dynamics of consumer interaction."

Consumer-funded rewards

This merchant view opens up a number of scenarios where it makes sense from a return-on-investment perspective to complement supplier coupons with rewards funded by the merchant directly, Gardner adds.

Such merchant-funded rewards and card-linked offers enhance consumer payments, which drives the convergence of advertising and marketing with the completion of a purchase. So what is the consumer experience, and who is bringing these rewards to market?

"The consumer experience needs to be fast, frictionless, mobile and relevant to their everyday spend," says Gardner. "Today the consumer interacts with ubiquitous form factors that aren't new but are far more powerful than in the past."

He explains that neither the consumer nor the cashier want to learn how to use something new — and they don't want a confusing experience.

Grimes thinks that merchant-funded rewards — or transaction marketing as he prefers to call it — are the way forward. "We believe transaction marketing will become a multi-billion-dollar industry for one single reason: It provides superior and more measurable return on marketing investment for large and smaller retailers. Every day we work with retailers to shift more of their budgets away from traditional media like direct mail and television to transaction marketing."

Reaching savvy consumers

Consumers have also shown themselves to be a pretty savvy bunch. They are happy to invest the time it takes to hunt down rewards and in return they will show loyalty to the retailer that offers them the best value. New business models supporting the 24-hour commerce culture are re-inventing deals, offers and loyalty in an effort to keep their customers happy. "We bring a typical customer 20 to 25 offers per month," says Grimes. "New customers at a

retailer typically save 20 percent while returning customers save 5 to 10 percent depending on the vertical."

Gardner also gives an example of what consumers can enjoy with merchant-funded rewards programs: "Our grocery merchants provide an 'always on' set of offers, giving an extra 4 to 7 percent of store value in exchange for consumer pre-payments of $50 to $500. With our auto-reload feature, consumers can develop a new habit, switching from either an existing primary grocer or multiple grocers down to one sole provider. Consumers can plan on extra money for the things they buy every day, and merchants can plan on consumers coming back. Everybody wins."

About the Author

Jessica Harris has been writing about financial services for seven years, with a focus on financial risk for the last two years. She is based in London, where she writes daily news, features and financial profiles.

Even in the United States, Microfinance Fills a Need

Why developing countries aren't the only ones poised for microloan growth

BY> CHRIS COSTANZO

Microlending is said to have originated in Bangladesh, and is still most often associated with impoverished borrowers in extremely poor countries. Perhaps surprisingly, the practice also has a long history in the United States.

Microloans make small amounts of capital available to borrowers who typically lack credit history, collateral or steady employment. The loans have been credited with alleviating poverty, while also supporting entrepreneurship among the world's most downtrodden. Bangladesh's Grameen Bank is widely known as the first modern microfinance institution. In the 1970s, it developed a methodology that parcels out credit to groups of borrowers and relies on peer pressure to ensure payback.

Not many people realize that microlending first stirred in the United States at around the same time. Shore Bank in Chicago, now operating as Urban Partnership Bank, opened in 1973 to provide capital to business owners who did not qualify for financing at other institutions. Over the years, a number of similar U.S.-based organizations have come into being, seeking to expand microlending to specific geographic areas and demographic groups.

Gaining momentum, yet still underserved

The concept gained momentum in the United States in the 1990s, thanks to favorable government policies and funding. In 1991, a leading provider, Accion International, brought its microlending model to the country and now serves borrowers in nearly all of the 50 states, making it the U.S.' largest microfinance network.

Despite these advances, the microfinance market in the United States remains underserved. According to the Aspen Institute, microfinance customers received $68 million of credit in 2008, only a tiny fraction of the U.S. credit market. Further, only 2 percent of potential U.S. microfinance customers are being served, compared to 17 percent in the developing world, Aspen says.

It turns out that many of the reasons microfinance is strong in other parts of the world also apply in the United States. For one, the number of people living in poverty is substantial; it reached 46.2 million (or 15.1 percent) in 2010, according to the U.S. Census Bureau. That's the highest number since 1959, the first year in which poverty was tracked.

In addition, more than one quarter (25.6 percent) of U.S. households either do not have a bank account or rely heavily on non-bank financial services providers, according to a 2009 survey from the FDIC, making them prime customers for microcredit. Finally, small businesses are rampant. According to the Association for Enterprise Opportunity, 88 percent of U.S. businesses have four or fewer employees and 70 percent have revenues of less than $100,000.

Financial institutions' reaction

Financial institutions appear to be attuned to opportunities related to microlending. By a large margin, senior-banking executives in a recent survey said small business lending represents the best opportunity for revenue growth over the next 12 months. In the survey, released in June by the American Banker Executive Forum in partnership with TSYS® and Tata Consultancy Services, 58 percent of bankers cited small business lending as a growth opportunity. This was compared to 49 percent for commercial and industrial lending and 41 percent for mortgage lending. By contrast, only six percent of respondents saw credit card lending as a growth opportunity.

The problem, of course, is that banks' interest in small business loans does not necessarily extend to microloans. According to the Small Business Administration, the average size of the general business loans it approved in 2011 was $624,000. U.S. microloans, meanwhile, average about $7,000 and range from about $500 to $35,000, according to Accion USA. While that amount is far higher than the average microloan extended in developing countries, it is well below the threshold at which most U.S. banks will make a business loan.

An opportunity for alternatives

The reluctance of U.S. banks to address the microfinance market has created an opportunity for other approaches. The discount retailer Walmart, for example, now offers bank services, including check cashing, wire transfers and prepaid cards at about one-third of its locations. Through its Sam's Club division, the company also fills a gap left by banks by offering loans in amounts between $5,000 and $25,000, in partnership with Superior Financial Group. In keeping with the needs of the typical microfinance customer, the retailer also offers an array of free or low-cost financial education and management tools along with the loans.

Slowly, such efforts should **help engage** the millions of potential microfinance customers in the United States who have yet to be served.

Payment card heavyweight Visa® is also putting its influence behind microfinance. Visa is working with Kiva.org to extend microloans to small businesses in the United States. Kiva, which operates a microlending website that connects individual and institutional lenders to low-income borrowers, began applying its international experience to the United States in 2009.

Recently, some banks, including Regions Financial Corp.® of Birmingham, Ala., BB&T Corp. of Winston-Salem, N.C. and U.S. Bancorp® of Minneapolis, have begun addressing the unbanked market by offering products like prepaid cards and check-cashing services. Like prepaid cards, technologies like mobile phones and the Internet make it possible to more efficiently reach greater numbers of the unbanked population. Slowly, such efforts should help engage the millions of potential microfinance customers in the United States who have yet to be served.

About the Author

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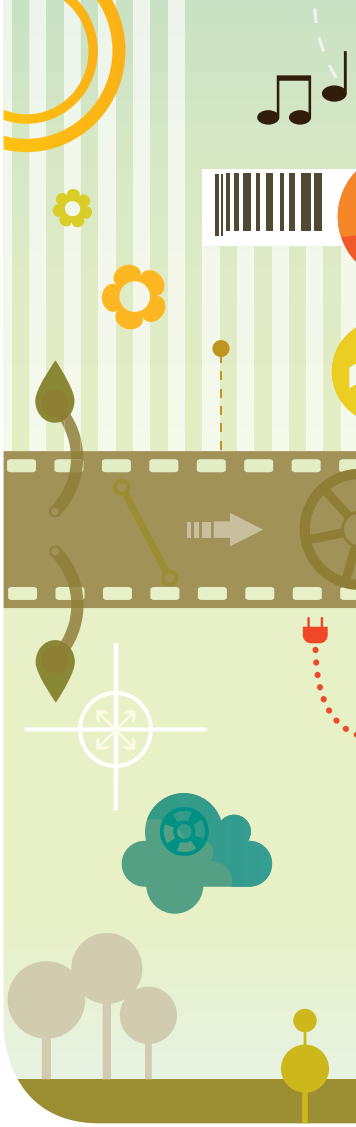


Managing Risk for Merchants On The Go

How acquirers are meeting the needs of — and underwriting — this new group of merchants

BY> RAYMOND CARTER

Mobile point-of-sale terminals (MPOS) have quickly become mainstream, with a dozen or more companies in the United States trying to mimic or exceed the capabilities and pricing offered by Square and Intuit's GoPayment.

From a revenue perspective, the businesses and individuals attracted to these products behave very differently than traditional merchants, which requires modification to the manner in which risk is managed. MPOS presents unique risks, and acquirers are responding by taking innovative approaches to risk management, although it is too early to determine whether these new approaches sufficiently mitigate risk.

The acquirer (ISO or aggregator) is making a healthy margin on each transaction, especially signature debit transactions in which the interchange was recently reduced. Therefore, the issue is not the margin on an individual transaction but whether there are enough transactions per merchant for the acquirer to make a profit on each account. The lower number

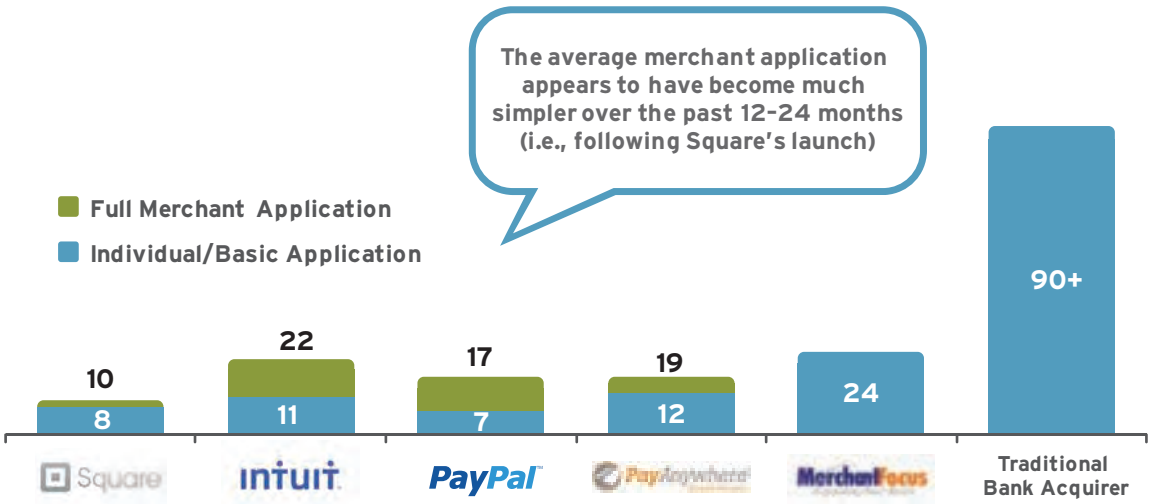
of transactions per new account requires new thinking in the back-office underwriting functions to reduce cost. Technologies used in other parts of the payments industry can enable acquirers to better validate the identity of the person or business applying for an account and assess risk on the device being used. This reduces fraud risk on accounts sourced from the Internet channel.

Since customers applying for MPOS accounts are typically micro-merchants processing card-present transactions with low volume per merchant, the acquirer is able to minimize and diversify credit risk across a broad spectrum of customers, reducing the need for strict underwriting. Additionally, by minimizing the hassle factor by asking fewer questions when a customer signs up for anything via the Internet, acquirers are able to board at a lower cost that many merchants would not qualify for through a traditional underwriting process.

How to assess risk for mobile vendors

MPOS' first impact on risk is the number of questions asked on the merchant account application. Historically, the number of data fields on a merchant application has been in the 90+ range. As shown in the chart on the next page, today's successful MPOS acquirers are down to 10-25 questions and appear to be continually looking to reduce that number to single digits. The goal is to set a minimum standard for information gathering that both meets compliance requirements, such as the USA PATRIOT Act, and only asks the key questions that could be used to obtain information from third parties that may disqualify the applicant.

Number of Questions/Topics on a Merchant Application



The second impact on risk is the reality that a much lower percentage of customers applying for an MPOS account, versus a traditional merchant services account, actually activate and process real transactions. Also, unlike traditional merchants, many MPOS customers perform a transaction shortly after receiving the device just to see if it works. Many customers then become inactive for a long period of time (or permanently) because many of the pricing options do not require them to use the device or pay a minimum fee. In the traditional non-MPOS environment, the merchant would be charged numerous monthly and, potentially, annual fees once the account is activated by the acquirer.

Because of this phenomenon, acquirers are able to reduce up-front underwriting efforts and focus resources on the subset of approved accounts that subsequently prove to be real merchants by performing a series of transactions. Applications can be processed through a high-level screen upon receipt to weed out only those that cannot meet liberal standards, such as obvious fraudulent applications or career criminals. The bulk of underwriting is deferred until a new merchant self-qualifies as a potentially profitable account by performing a certain number or dollar amount of transactions. This enables the acquirer to substantially reduce the overall cost of underwriting. Acquirers are required to have a Know Your Customer (KYC) process in place, and typically use information provided by the applicant to third-party sources of information. This has historically been a manual process, but new technology by companies such as IDology and Lexis Nexis can perform this function in real time using challenge questions and Dynamic Knowledge-Based Authentication, which speeds the process and reduces manual labor.

Location, location, location

The advent of Internet transactions spawned fraud, which resulted in the development of technology to scrub transactions and identify potential fraud. One such technology evaluates the computer or device used to conduct the transaction and determines whether it has characteristics that may indicate a higher probability of fraud. For example, geo-location determines whether the computer is located in the same geographic area as the address of the applicant, and device fingerprinting

The lower number of transactions per new account requires **new thinking** in the back-office underwriting functions to reduce cost.

determines various characteristics of the computer and whether it has been used in the past to apply for other accounts. This enables acquirers to determine whether a device used by the applicant to apply for an MPOS account has potentially fraudulent characteristics.

The advent of MPOS is changing merchant characteristics, and the shift in their demands is driving innovation in merchant underwriting as acquirers struggle to manage profitability.

About the Author

Raymond Carter is a principal with First Annapolis, specializing in commercial risk and compliance associated with electronic payments, which includes strategy development, risk management, compliance, merchant acquiring/transaction processing, commercial lending, business and portfolio valuation, buy- and sell-side advisory support, financial analysis and planning. Clients include domestic and foreign banks; transaction processors; independent sales organizations; private equity firms; major retailers and manufacturers; non-profits; regulatory authorities; healthcare companies; and other non-bank entities affiliated with the financial services industry.

As Spending and Saving Habits Evolve, So Does Card Usage

Banks and retailers see credit on the rise as consumers recover from the recession

BY> CHRIS COSTANZO

When the recession came along a few years ago, consumers responded by slowing down credit card spending. Now with the economy improving, the picture has become more nuanced, with consumers turning in more equal measure to credit and debit/prepaid cards.

In 2009, the public's disregard for credit cards was palpable. Credit card volume plunged by $289 billion that year, while debit/prepaid volume rose by $212 billion, according to a June report from MasterCard®. Clearly, consumers were seeking to reduce their credit card debt and also exercise more control over their day-to-day finances through greater debit usage.

By 2011, both card types were experiencing similar growth. Credit card volume increased by $185 billion (9.5 percent) that year, while debit/prepaid volume increased by $199 billion (10.7 percent), MasterCard said. The shift indicates consumers became more confident about reaching their financial goals and began moving away from reactionary cutting.

Smarter spending and saving

At the same time, consumers became more aware of the potential consequences of their spending. Stung by the recession, they had learned to selectively pay down their debt and better balance their needs and wants when spending. Prassad Iyer, a MasterCard vice president, summarizes the overall shift this way: "While 2009 was the year of cutting back and 2010 was the year of spending on necessities (with some affluent consumers increasing discretionary spending), 2011 was the year of financial optimization, or smarter spending and saving."

Consumer interest in exercising greater financial control is apparent to financial institution executives as well. A survey of senior banking executives, released in June by the American Banker Executive Forum in partnership with TSYS® and Tata Consultancy Services, found that banks are most interested in offering personal financial management (PFM) tools to their customers over the next 12 months. With 40 percent of executives expressing interest, PFM tools emerged as the most popular initiative, edging ahead of even mobile-related offerings.

When MasterCard further analyzed the increase in credit card volume in 2011, it found that most of it (75 percent) was due to an increase in spending as a result of higher prices and improved consumer confidence. However, a small

portion of credit's gain (2 percent, or $3.7 billion) came from consumers moving their debit card spending to credit cards.

Similarly, some of debit's gain (1 percent or $2.6 billion) came from consumers moving spending from credit to debit. This back-and-forth movement indicates a fluid relationship between credit and debit, which shifts as consumers' circumstances change. "The two-way flow should be viewed as an opportunity to develop or enhance solutions relevant to the consumers making these shifts," Iyer writes in his report.

Capitalizing on the debit or credit choice

MasterCard recommends taking advantage of the two-way flow by positioning credit and debit/prepaid cards as complementary. Consumers who mostly use debit and prepaid cards, for example, sometimes need credit lines to manage their monthly cash flows. Financial institutions can better serve this population with multi-application cards. Meanwhile, consumers who use mostly credit cards tend to be more affluent, and financial institutions can better serve these cardholders with person-to-person payments that let them track expenses while getting the benefit of float.

Another big opportunity for financial institutions, according to MasterCard, is to accelerate the movement away from cash and checks. MasterCard found that nearly 50 percent of household expenditures are made with cash and checks. Paying teen-agers, nannies and other household workers were high on the list of reasons consumers use cash.

Cash also continues to have a healthy presence at the point of sale, though its dominance there is waning. According to Javelin Strategy & Research, cash continues to be the most widely used payment option for in-store purchases, though average transaction values for cash are lower than for purchases made with credit or debit cards. Cash generates 27 percent of total retail point-of-sale (POS) purchase volume, compared to 31 percent for debit cards and 29 percent for credit cards.

Looking forward

By 2017, Javelin forecasts that cash's share of retail POS volume will decline to 23 percent. Likewise, it expects that the total share of paper checks at the POS will decline from 7 percent in 2012 to just 4 percent. Financial institutions can advance the winding down of paper-based payments by developing partnerships, rewards programs and new products that nudge users away from cash and checks at the POS, MasterCard says.

Another big opportunity for financial institutions, according to MasterCard, is to accelerate the movement away from cash and checks.

The card association also urges the development of mobile technology to support small-value transactions between individuals and service providers like babysitters, gardeners and handymen. Mobile devices offer the ability to immediately and effortlessly track spending and savings, making them a good fit for the growing number of consumers interested in better managing their finances, Iyer notes. By focusing first on mobile person-to-person payments, financial institutions can drive incremental payments volume while also getting consumers more comfortable with the idea of mobile payments at the POS.

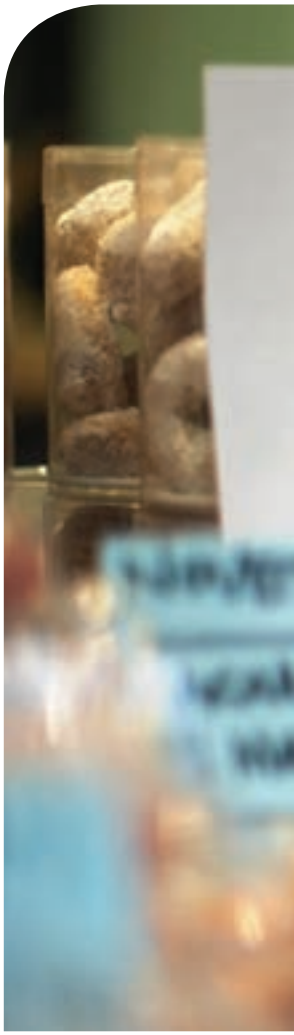
About the Author

Chris Costanzo, a former reporter and editor of *American Banker,* is a freelance writer in Maplewood, N.J.

Factors Influencing How Small Businesses Accept Payments Today

Giving the back office the attention it deserves

BY> JESSICA HARRIS



Operational incidents can affect large and small organizations alike. But in small businesses especially, the back office needs to be given the attention it deserves — particularly when it comes to accepting and making payments.

Most small businesses will need a line of credit. In fact, many small businesses have financed company purchases for supplies and inventory through a personal credit card in order to better manage their cash flow.

"But on top of this, businesses also need to accept credit cards for payment from customers," said Virginia Ann Holman, TSYS group executive. "It is critical to understand the cash management and credit needs of these businesses to help them grow and succeed."

Online solutions

Myriad new solutions are available for accepting payments, making payments and managing money, and small businesses can benefit greatly from familiarizing themselves with such offerings.

"Technology continues to create efficiencies in the world of small business," says Noah Breslow, chief executive of On Deck Capital and speaker at the upcoming Money2020 in Las Vegas in October. "Tools such as online banking, online bill paying and online merchant account management can not only save a business owner significant amounts of time and hassle, but they can also create new opportunities."

These technologies can help businesses succeed by accepting and keeping track of credit card payments more efficiently.

Rigorous tracking

Sam Hodges, co-founder of Endurance Lending Network in San Francisco, explains that rigorously tracking financial transactions is critical and often frustrating for most small businesses.

"It's often hard for a small business owner to have a clear, real-time picture of their current accounts and cash flow," he explains. "It's hard to manage what you don't measure.

Moreover, this situation makes it harder for lenders to get a clear picture of how a small business is credit-worthy."

Borrowing money

It's clear that businesses borrow money for a variety of reasons, and new forms and venues for borrowing have recently emerged. "Over the last few years there has been a profusion of interesting alternative lending businesses," says Hodges, who is also speaking at Money2020.

"These companies are riding a few important waves. One is the real-time availability of traditional and non-traditional credit scoring factors. Another is the tightening of restrictions on traditional bank lenders, which makes it harder and harder for banks to make small-business and consumer loans. Also to be considered is a willingness on behalf of individuals and small funds to invest increasingly large amounts online," he explains.

Breslow describes this as an exciting time for small business owners when it comes to financing. "Technology is creating entirely new ways for merchants to access capital and is giving business owners faster access than ever," he says.

About the Author

Jessica Harris has been writing about financial services for seven years, with a focus on financial risk for the last two years. She is based in London, where she writes daily news, features and financial profiles.

Brick by Brick: Why Steady Growth Is Key for Credit Unions' Card Programs

If you build it, they will come? Not necessarily. Executives share advice for credit unions issuing cards in-house

BY> RAY BIRCH

Entering or re-entering the credit card market is not a slam dunk, and simply offering the plastic and opening branch doors isn't the solution. The result of this approach, says Tim Kolk, owner of TRK Advisors, can mean many disappointed credit unions (CUs).

"I sometimes run into this 'Field of Dreams' thinking — if you build it they will come. Not true. You have to work at building the credit card base, each nickel and dime. It's a grinding business due to the heavy competition. You need a strong plan and people committed in your organization."

Just the numbers, please

When first issuing its own credit cards, the typical credit union can expect to capture 2 percent of its membership in the first year, 4-5 percent after 24 months, and then 7 percent total after year three, says Kolk. "By the end of the third year, you could well have earned back your investment, and then start making money in year four."

Kolk estimates that it can cost $150 to get one new account on the books, noting the need to do some higher-cost marketing, like direct mail. "That's about what you will pay per account by the time you do your mailing, credit scoring, screening and underwriting."

It wasn't cheap for Omega Federal Credit Union to get back into credit card issuing, says CEO Troy Garvin. He adds that in addition to the entry costs outlined by Kolk, the CU needed to spend time and money making sure demand is there. Omega performed detailed member surveys and checked in with its call center and front-line staff closely before issuing its credit card, which is now penetrating the Pittsburgh-based membership well ahead of projections.

"You don't want to launch unless you are certain the demand will be there," cautions Garvin. "There are employee time costs involved with launching, which the credit union does not always factor in, as well as the man hours to continually manage the program and make sure it grows. It's a pretty big undertaking. So if your research tells you that out of the gate you will only get a few hundred thousand dollars in balances, maybe you need to rethink the decision, especially if your members like their current (third-party) card program."

Catch the second wave

Omega experienced a great deal of pent-up demand, and the tremendous success the CU is enjoying now — almost at its year-three projections in less than 12 months — is due to low-hanging fruit. Garvin says the real work begins when trying to reach the second wave of members who may not be unhappy with their current card, don't use their card much or don't carry much of a balance.

Garvin says the solution is not one many credit unions may want to hear — hard work and marketing. "You have to throw marketing dollars and staff time at capturing the second wave," says Garvin, who shared that the $87-million Omega is spending

The solution is not one many credit unions may want to hear —

hard work and marketing.

$18,000-$20,000 annually on marketing. "You have to go at this with all forms of marketing — online, newsletters, lobby posters, handouts, cross-selling at teller stations, running balance transfer specials, special rates and no-fee promos. You have to entice this group to bring them back."

Kolk assures that there will be the 'easy gets' up front, but what will make the program pay off in the long run is differentiating the card from the competition, tailoring the card to the needs of the membership and careful underwriting. "The card has to add value to the member in the way they see it. Some may be rate-focused, some rewards-focused, some will respond to outstanding local service."

Kolk advises that CUs conduct research to first determine the one or two unique needs or characteristics of their membership, tailor the card to those, and then market, market, market. Staff also must be trained on these selling points and how to stress them during conversations with members. "There will be members who want a third thing, but until you have the first two locked in, better to leave the third for later," says Kolk.

MORE ADVICE FROM TIM KOLK, OWNER OF TRK ADVISORS

> "Make sure you have strong operating controls in place because I have seen financial institutions' card programs grow quickly and then blow up. It's possible to add risky accounts. If you add accounts too quickly and don't spot the dangerous ones, and don't know it for a year or three, things can go very bad when growth slows down and the risk catches up. I have seen a handful of financial institutions that did not have good controls in place and then rather than having a growing, value-added income-producing asset, they have something they have to fix. The average charge-off rate for credit cards is 2.5 percent per year. But I have witnessed those who have re-entered the market who have seen charge-offs climb to as high as 10 percent in year three."

> "Do a rigorous processor evaluation first. Don't fall in love with the first one you meet."

MORE ADVICE FROM OMEGA FCU CEO TROY GARVIN:

> "Important to bringing cards back in-house was first moving to a new core processing system that allowed us to more effectively cross-sell new cardholders and new members, as well as provide a high level of card service. We recently moved to a sales and service culture, and the core system flags teller and call center screens when members who present cross-sales opportunities stop by or contact the credit union."

> "Accessing credit card data in real time was essential. If your members are complaining about the service they are getting from a third party, you better have your ducks in a row when you take this business back. With our new system, we are not batch processing anymore. So if members come in or call about their card being declined, for example, we can see immediately why that has happened. Our tellers do not have to access another system, and within a few clicks they will have the answer for members."

> "After six months we had CUNA Mutual Group, an insurance and financial services company, come in and do their risk assessment on the program. It's free. They look at lending and disclosures and do a full risk assessment against industry best practices. They told us where we stood and pointed out where we had just a couple small things to improve. I recommend doing this after you have built up a little steam with the program, but don't wait until you go full blown. This is just a check to make sure you have things in order. It helped us out a lot."

About the Author

Ray Birch is a reporter with *Credit Union Journal*. He has more than 10 years of experience covering the credit union movement, and is responsible for covering the cards industry for the Journal. Birch has been a writer and editor for more than 30 years, having also managed communications for Johnson & Johnson's Ethicon Endo-Surgery business unit.

60 Seconds with Jonathan Gill

Jonathan Gill, vice president, EMEA at CA-Arcot® shares his thoughts on the challenges and benefits of moving away from paper to secure electronic documents, and how consumers will communicate in the future

How do you think companies will communicate with customers in the future?

Besides paper, email has been the traditional way of delivering electronic documents, but the world is changing to use more varied channels. Given the amount of time people are spending on social media, banks have a better chance of getting their attention if they can communicate with them in that medium. Important communications to consumers are better delivered to their social media accounts than their email accounts.

Mobile devices are another trend that is catching on, making them a necessary consideration for any communication solution. Users will expect the ability to mix multiple media and devices to get the same information if they choose, depending on what is the most accessible to them at any given point in time.

Why consider sending electronic documents instead of paper documents?

Businesses often consider electronic documents because of the cost savings when compared with printing and delivering paper documents. The cost of postage is increasing worldwide, especially here in the UK.

However, sometimes the greatest financial benefits come from sales and marketing. Imagine if you could include targeted marketing as part of the day-to-day communication of electronic documents and let customers submit documents for a new loan without the normal delays of the post office. This convenience to the customer could have a major impact on the results of your marketing campaign.

Are there other reasons besides the cost savings?

Certainly, and one of the most important is access. Electronic documents can be stored on computers and mobile devices so they are easily searchable and can be stored for a longer period of time than what a bank can offer.

Another reason is to provide more value within an electronic document. This could include letting a customer make staged payments from within a credit card statement, redeeming loyalty points or even paying a credit card with a debit card, all within the document itself. There are many other advantages that may surprise people. For example, in the areas of compliance and collections, wouldn't it be useful to know whether a customer had received and opened a document? And last but not least, there are also clear environmental benefits of printing less paper and reducing physical deliveries.

If we already have electronic documents, why not just download them from a website?

The fact that most banks have not succeeded in delivering more than 20 percent of their statements via their existing electronic document method is a clear indication that consumers have consistently opposed the electronic documents. Downloading the document requires going to the website, logging in, finding the statement and downloading it. This is much less convenient that simply receiving it in the post or via email. They are also afraid of being phished and losing control of their bank account. This has made it impossible to gain the benefits of eliminating the paper delivery even after a decade of persistence on the banks' part.

So how do we go about making it secure?

Encrypting any document with a password is easy, but they are very easy to crack. The trick is to find a way to send an electronic document over a public network — such as email over the Internet — but to encrypt it so that the wrong people cannot open it while making it convenient and secure for the right person to open it.

About the Author

Jonathan Gill is responsible for CA Technologies Arcot Advanced Authentication sales in Western Europe, the Middle East and Africa. He joined Arcot in 2006, and has overseen the rapid growth of the company's advanced authentication unit in EMEA. Gill has also held leadership and senior sales positions in the UK, most recently at IBM Software Group, where he was key to developing their security software propositions in the UK financial sector.

Policymakers at Work:

Payments regulations and legislative news from Capitol Hill

BY> SCOTT TALBOTT

The fervor of elections has reached a crescendo with the second session of the 111th Congress being nearly halfway over.

The coming election is in full swing as the conventions have ended and the campaign for the general elections takes center stage. Plus, the federal regulators continue to implement the Dodd-Frank Act, now in its third year of existence.

The big issue facing Congress is the fiscal cliff that faces the nation at the end of the year.

Unless Congress acts before Dec. 31, 2012, the following actions will occur automatically:

> **Sequestered Budget Cuts:** $1.2 trillion, split between defense and non-defense spending, will kick in on Jan. 3, 2013.

> **Expiring Income Tax Rates:** All of the current tax rates on personal income are set to expire on Dec. 31, 2012.

1. The 10 percent individual income tax bracket would rise to 15 percent;
2. The 25 percent individual income tax rate would rise to 28 percent;
3. The 28 percent individual income tax rate would rise to 31 percent;
4. The 33 percent individual income tax rate would rise to 36 percent; and
5. The 35 percent individual income tax rate would rise to 39.6 percent.

> **Capital Gains and Dividends Rates:**

1. The 0 percent and 15 percent tax rates on long-term capital gains will rise to 10 percent for lower

tax brackets and to 20 percent for higher tax brackets; and

2. The current qualified dividend tax rates (0 percent for lower tax brackets and 15 percent for higher tax brackets) would rise to the ordinary income tax rate for all individuals.

- **Estate Tax:** The estate-tax exemption drops from $5 million back to $1 million, and the maximum estate tax rate rises to 55 percent.

The conventional wisdom is that Congress will pass a temporary 6- to 12-month extension/continuation of existing laws and then return in 2013 to work on a final solution. Also, the current debt ceiling of $16.4 trillion will have to be increased to allow the federal government to borrow to pay its operating costs.

Game changer settlement on credit cards

Years of litigation and negotiation have drawn to a close with a settlement of a 2005 lawsuit between the networks, issuers and merchants. The terms of the settlement include:

- $6.6 billion total payment to merchants, with two-thirds paid by Visa®;
- Where permitted by state law, the right for merchants to surcharge, within certain limits;
- A reduction of 10 basis points in credit interchange rates for eight months; and
- Agreement that Visa will meet with merchant buying groups that seek to negotiate interchange rates collectively on behalf of similar categories of merchants (e.g. independent drug stores).

With a settlement this large, some detractors are expected. Some merchants have expressed their concerns. If the number of retailers who opt out reaches 25 percent, the settlement can be revisited. However, most observers believe the settlement will not be held up. In general, all the terms of the settlement should be finalized before the end of next year.

About the Author

Scott Talbott is a senior vice president for government affairs for The Financial Services Roundtable, a trade association representing 100 of the largest financial services firms in the country. He is based out of Washington, D.C.

Separating Hype from Reality in the World of Mobile Money

How companies can win the battle against disintermediation

BY> ALASTAIR LUKIES

There is much talk about how banks are being disintermediated by new entrants in the payments space. How much is hype and how much is reality? To answer this, ask any teenager how important their bank account is or where their account is based. Chances are, they simply don't care.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The mega-trend of the 21st century is the empowerment of people via connected mobile devices.

Generational shifts are taking hold. As someone who works in both the United States and the UK, I wrote a check a total of one time in the past year. For my parents, the check was a tangible symbol of their primary relationship with their bank. I doubt if many children today will learn how to write a check. They move money, connect with friends and explore brands digitally with the phone in their hands, not a pen and paper.

What we are witnessing is a fundamental change, not only with banks and financial institutions but payment processors, merchants and handset manufacturers. Whether we like it or not, new brands are emerging in the mobile payments and mobile wallets space that are acting as 'money vaults' for consumers. Many of these brands are not and never will be banks. Money has changed. We have changed.

The threat to banks

The threat to banks from disintermediation or being disenfranchised is real as other players experiment with and create new channel distribution opportunities. Previously, the branch, online bank, automatic teller machine or call center was an easily controlled portfolio of supply chains managed by a bank as it connected directly to its consumer. This is no longer the case — at its core, banking is in flux.

While banks have traditionally been core and key providers of banking services, that role is being challenged on multiple fronts for the ownership of the customer transaction, customer relationship and customer experience, particularly in a world where money is increasingly more digitized. We are in a state of transition as money itself changes in our hands. Mobile technology is just one of many catalysts fueling this shift.

The ability of a mobile handset to help consumers manage how they bank is unravelling in ways we could scarcely imagine even a few years ago. The opportunities, when combined with mobile payments and commerce, create mobile money that is compelling for consumers and businesses alike as they bank, pay and shop.

In May 2012, Gartner forecasted that the worldwide value of mobile payments transactions is expected to surge 62 percent to $171.5 billion this year from $105.9 billion a year ago. In the United States alone, Javelin Strategy & Research sees 111 million consumers using mobile banking in 2016 while Forrester Research forecasts U.S. mobile commerce revenues to hit $31 billion in 2016.

Getting digitized by mobile

After keys and wallets, the mobile phone is now one of the three most important 'must-carry' items most of us never leave home without. Nevertheless, on a planet with nearly seven billion people and six billion phone subscriptions, only around one-third have bank accounts. This means that for billions of people, their mobile handset, whether a smartphone or more traditional handset, is the first tangible way in which they interact with financial services. Consumers have never had more power at the touch of a finger to find and engage with what they want. In the words of Web thought leader Mary Meeker, "The mega-trend of the 21st century is the empowerment of people via connected mobile devices."

With this empowerment comes a huge uplift in choice — more brands and more places to store value as money becomes mobilized by technology. New players are rapidly emerging to exploit myriad opportunities to create mobile customer acquisition and engagement channels across financial services. Many of these challenger brands simply did not exist a few years ago or were never associated with the traditional domain of financial services. However, that doesn't mean they are necessarily small or pose a limited disintermediation threat; in fact, these disruptors have significant cash resources and pose significant displacement risk.

Therefore, it is critical that financial service providers ensure that they are leading the way in shaping the emergence of mobile money. Given their bank-grade infrastructure and heritage, financial service providers have such an important role to play, and they must make sure that they are not losing ground in a space that many would argue they should own. Essentially, this strategy involves defending and extending their role in the payments industry through an integrated, collaborative and networked approach to mobile money.

Success through collaboration

Success will ultimately hinge on delivering bank-grade security via mobile money apps and offering solutions that consumers don't have to be told are compelling.

Consumers will gravitate to the services that give them what they want, when they want it. Enabling platforms that succeed must be ubiquitous and utterly simple to use. The scalable propositions will be those that work across any handset, network operator or merchant.

While some players will and do experiment with closed-loop approaches requiring their customers to have a particular phone, specific bank account or access to a pre-determined phone network, that approach simply does not help the financial services industry protect and promote its increasingly vulnerable position. We have seen too many times how financial services that do not support an open ecosystem struggle to convince key stakeholders fundamental to their business model. A collaborative network approach is so much more conducive to creating value for all.

At the heart of this effort, we are really talking about people's money. Now is the time for banks to really strengthen their hand in the mobile money space.

About the Author

Alastair Lukies is CEO and co-founder of Monitise, with a proven track record of turning visions and concepts into real businesses. He founded the company in 2003. Three years later, Monitise was recognized as a 'Technology Pioneer' by the World Economic Forum, and in June 2007, he was named Entrepreneur of the Year at the 2011 Growing Business Awards. Prior to conceiving, financing and successfully building Monitise, Lukies was a co-founder of epolitix.com, the portal for Westminster, Whitehall and the devolved institutions.

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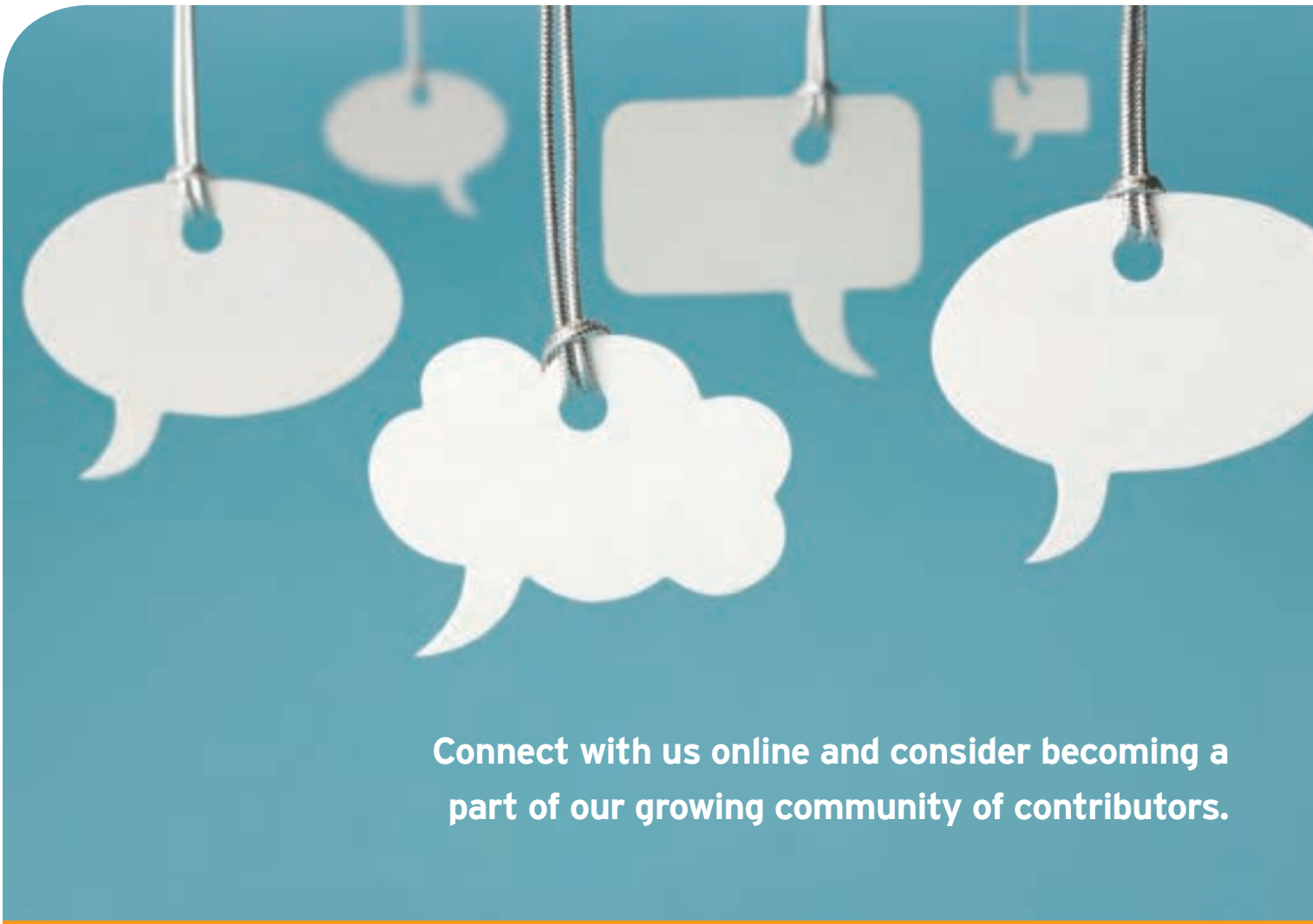

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