THE FUTURE OF RETAIL BANKING
A PARADIGM SHIFT IN CONSUMER PAYMENTS

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1. Introduction

Regardless of who or where we are, we make or receive a variety of payments everyday. Whether it's cash for a newspaper, a debit card at the supermarket, a check to pay for electricity, an automatic debit to our savings account for the water company, a credit card to pay for the hotel while traveling, salary deposited to a bank account or a wire transfer from a relative overseas, payments can be made in many ways. Of course, the actual method for payments varies by country and person. Whereas a majority of payments are made by cards or electronic transfers in developed countries – and still by check in some countries like the United States - the vast majority of payments tend to be made with cash in developing countries. In Sri Lanka, with barely 0.1 credit or debit cards per person compared to an average of more than 3 cards for every man, woman and child in Singapore, cash payments remain king.

Banks have worked to speed up the shift to electronic or plastic card payments by promoting cards as an alternative to cash or checks. In countries like the United States where check processing is extremely inefficient, bank promotions and cardholder attitudes have resulted in a shift whereby cards are used for a large percentage of consumer payments, with the number of debit card transactions exceeding credit card transactions for the first time ever in 2005. In Sri Lanka, banks have also promoted credit cards to their customers.

In developing countries such as Sri Lanka, however, there have still been a multitude of barriers to transactions moving from cash to plastic card or electronic channels. The large percentage of the population does not have a bank account, so cash remains a preferred means for transactions and debit card usage is consequently low. Even when debit cards are issued, for example as deposit access devices for salaries from companies, they are frequently used just for ATM withdrawals. Income levels in developing countries are relatively low, so many individuals do not qualify for credit cards. And the lack of an extensive telecommunications infrastructure means that it would be hard to reach potential cardholders in any event with traditional payments devices. The net result is that the vast majority of transactions are conducted with cash.

The paradigm is shifting, though, as electronic payments become easier, faster and cheaper and as the benefits of payments increase.

2. The New Paradigm

The new paradigm is one of multi-device electronic consumer payments whereby consumers anywhere will be able to replace cash with easy-to-use, easy-to-understand electronics or chip cards payment devices. Rapid shifts in technology are making this new paradigm ever more imminent, and bankers will need to act quickly both to take advantage of the shift as well as to avoid disintermediation.

3. The Need for Change

The shift toward plastic and electronic payments is increasingly driven by customer needs rather than just bank promotions. Consumers, company owners and financial institutions all benefit as transactions move towards electronic and plastic card payments channels. Cash has a variety of downsides, as we'll see, and replacing cash with plastic cards or electronic payments can result in significant benefits to all parties involved.

For consumers, cash is inconvenient and prone to disappearing. When a consumer has to get cash from a company or a bank, carrying it takes extra space, and it may well disappear due to theft or loss. If a consumer doesn't have enough cash, they may lose out on a bargain at a sale, have to go out of their way to withdraw cash at an ATM or be embarrassed when they don't have enough cash to make a payment. Consumers need and often want a better alternative so they can increase convenience, purchase flexibility and safety.

While companies also lose cash due to theft or cashier errors, they also face the reciprocal of the consumer dilemma. Shops lose out on sales and revenue when consumers don't shop at a store because they don't have enough cash with them. Further, companies face an added expense for transporting cash to or from the bank, counting cash, and processing checks or other forms of payment. Many companies thus want to shift to electronic or plastic card payments in order to increase efficiency and reduce costs.

Financial institutions have tremendous opportunities to grow revenue and relationships if the payments paradigm shifts. Plastic card or electronic payments create new streams of revenue through fees and interest charges. Customers are likely to have multiple relationships, and cards can yield an unparalleled source of demographic information about customers, so banks can leverage the payment channels to develop other asset and liabilities relationships. And non-cash payments made via plastic card or electronic means are tremendously more efficient than cash as well since these electronic payments are automated.

Even at a broader national level, plastic and electronic payments have benefits as they can increase transparency. Whereas cash is very difficult to track, plastics and electronic payments help anti-money laundering and anti-terrorism initiatives, and the government can identify income more easily.

With this multitude of benefits for all parties involved in a variety of types of consumer payments, from buying bananas at the corner stand to multi-million investments, the time is ripe for a paradigm shift in retail payments.

4. Technology Enables a Shift

Fortunately, technology is coming to the rescue to enable the paradigm shift. It only remains for financial institutions – or other companies, if financial service providers don't act rapidly enough - to grab the opportunity and make the change happen.

Before focusing on the technology, though, it may help to imagine what an ideal payments situation today would look like if we could make it happen. While opinions may vary, some common themes are easy to envisage. First, payments should be convenient and easy to understand. Requiring extensive training of customers on how to conduct transactions, particularly if education levels are low, will create barriers to usage. Second, payments should be made with a mechanism that consumers are already familiar with or that doesn't require significant consumer education. Third, payment devices should be easy to use. High-tech initiatives like mobile banking on a mobile phone have often failed at least in part because they're too difficult. Fourth, additional costs to banks should be minimized. Financial institutions are constantly under margin and competitive pressures that reduce extra funds available for investment in new technology unless there is a clear benefit. While there undoubtedly other needs related to payments that one can consider, these 4 fundamental concepts seem to be keys to success.

To achieve a paradigm shift that enables consumers to move to electronic payments, financial institutions need to make key strategic decisions about the investment they will make and services they will provide. Waiting is not an option – unless, of course, banks prefer to be sent off and left out of the game in the near future. New entrants to the retail finance market in Sri Lanka that have already introduced such services in other countries can introduce them domestically, telecommunications companies are eager to increase their revenue by providing additional services and other service providers to the payments industry are waiting to step into the breach if the companies that currently dominate financial services in the country don't move quickly.

So, what changes will enable this paradigm shift? The key concept is that leaders at financial institutions can no longer just think only about swiping rectangular plastics with a magnetic stripe at a terminal to make payments. Rather, banks should fully consider and fully leverage the tremendous developments in payments technology to maximize their opportunities and revenue.

First, the mobile phone is increasingly becoming a payment device. In Sri Lanka, the number of mobile phones is continuing to increase rapidly beyond the 3.3 million phones and 17% penetration rate recorded in 2005. Yet they're rarely used for payments. In the Philippines, on the other hand, consumers can use a mobile phone to:

- Make a purchase at a merchant
- Have a relative who's working overseas send money to my mobile phone

- Withdraw cash at a merchant, reseller or sometimes even an ATM
- Top up value on the phone at a reseller or the telecommunications company
- Send money to a friend or relative domestically in the country

These and other payments services on the mobile phone have made the phone even more of a must-have device – not just for phone calls, but also for payments. As mobile phone penetration grows and since these phones can be used in ever more locations, not just in the Philippines but in other countries as well, the opportunities become even greater. In some countries, financial institutions have taken advantage of this trend by providing the deposit or withdrawal locations, deposit account linkages or other services. In other countries, financial institutions have been disintermediated as the telecommunications company provides all these services when the financials institutions have not been willing to step up to the plate to provide the services quickly enough. Moving into mobile payments will create a new payments paradigm, but banks can only play a part if they move quickly.

Second, EMV smart cards with a computer chip on the card are enabling new security methods and applications. In some markets, EMV cards have been introduced primarily to combat fraud. In most of these cases, however, it has been difficult to develop a strong business case to justify the card based on fraud reduction alone. A new way paradigm beyond just financial services can create a cost-benefit case that justifies the implementation. Rather than a single standalone payments application on the card, multiple parties may need to come together to make EMV smart cards financially viable. For example, cooperation between a bank, an insurance company, a hospital, a supermarket with a customer rewards program and even an airline frequent flyer program could create a powerful combination. Admittedly not all components may be applicable to everyone in Sri Lanka. But only by thinking "outside the box" to develop a multi-function program can the investment be fully justified. Banks can take advantage of the opportunity by developing new partnerships and becoming a fast mover towards implementation.

Third, contactless cards are beginning to take off in some markets. The "card" can actually take a multitude of forms. Near-field-communications (NFC) means that a mobile phone can actually become a contactless "card" too. And along with standard plastic cards with a chip and antenna on them, contactless "cards" can also be a keychain fob or take another shape. While the cost of contactless cards and card readers can still be a barrier to mass implementation, the 'tap and pay' feature that makes contactless cards easy to use, faster than cash and less prone to errors can make it a viable alternative for some merchant sectors. Banks can take advantage of change in these selected market sectors by installing readers and issuing contactless cards.

Fourth, new terminal functionality also shifts the paradigm to enable ubiquitous payments. Many bankers continue to think of a terminal as a device used to swipe credit cards for payments. In many markets, though, the terminal has become much more. Merchant can use terminals to enable their customers to top up mobile phone, pay rent on houses, purchase cinema tickets, print vouchers, give rewards to high value customers, send remittances or perform a multitude of other payments functions along with making ordinary purchases. Mobile terminals using VSAT (satellite), fixed line or mobile phone connections can be used virtually anywhere. All these types of transactions can be performed in virtually any location using simple magnetic stripe cards. So in locations where EMV smart cards or contactless cards may be too complex or costly, simpler magnetic stripe cards being used in multi-function, remote-telecoms-connected terminals can still enable a payments paradigm shift.

In some countries, enlightened government policies have been a key facilitator in the payments paradigm shift. For example, in one country the government mandated that companies could only take tax deductions for business entertainment if they paid with a card, and transparency increased. In another country, the government provided funding for payments technology solutions so that the country could remain a technology leader. There are undoubtedly a variety of other options available. This is not to say that government intervention has always been beneficial. Rather, limited and enlightened government policies have in some cases enabled a faster paradigm shift that in the end benefited consumers, merchants and financial institutions as well as the government.

What, then, is the potential change these technologies can make happen? Let's go back to our "ideal scenario" to see if it meets the test. By implementing even just some of the technology-driven changes – whether via mobile phone, contactless cards, EMV smart cards or easily connectable terminals - payments can be made conveniently throughout the country. Mobile phones are already commonplace, understood, and easy to use. Tapping a contactless card on a reader is also easy to understand. Second, payments can be made devices that consumers are already familiar with or that don't require significant consumer education. Cooperation can minimize the cost to banks, and the additional revenue from new types of payments can benefit banks and their partners alike. And even better, the range of payments that can be done using handheld consumer devices – remittances, merchant payments, person-to-person payments, tickets and lots more – cover a vast range of the types of payments currently made using cash.

5. Change Requires More than Technology

Taking advantage of the shifts in technology requires significant shifts at financial institutions. Among these changes, three factors stand out.

First, banks must embrace the technology rather than continuing business as usual. It is often far easier to continue with variations on a theme. Modest changes enabling new co-brand cards, new rewards programs, installment payments or other relatively small changes to existing products are much easier to make than major shifts. The investment is smaller and implementation may be easier for these small changes. Yet small changes may only beget small rewards, and competitors who move faster may easily take away customers from slower-moving financial institutions. By fully analyzing the true paradigm-shifting technology, selecting an area to focus on and implementing changes effectively, banks can take fully advantage of the opportunities.

Second, banks must enhance operations processes to support the changes. New technology requires new process flows, new risk management techniques and new customer service channels, to name but a few of the areas of focus. Banks will need to redesign current policies, procedures and processes to enable the efficiencies, services and benefits that this new technology can provide.

Third, banks need to shift their focus towards cooperation with other payments enablers rather than continuing to act independently. Installing the new technology often requires more than just financial services companies to be involved. Mobile payments and many aspects of the new terminal technology are dependent upon working effectively with a telecommunications service provider. Contactless cards are dependent upon merchants seeing the value in the cards. And smart cards have rarely been cost-justified on a stand-alone basis, so working with other partners to put multiple applications on the chip may provide the cost justification needed to move forward. When evaluating as well as implementing the technology, banks must work with these partners to make the paradigm shift work.

6. Imminent Change to a New Payments Paradigm

Complacency and acceptance of the familiar remain perhaps the greatest barriers to change. Yet, the paradigm for consumer payments is shifting quickly, and only by moving fast can financial institutions in Sri Lanka fully realize the revenue, efficiency and other benefits of the coming paradigm shift in payments.

It is understandable that many financial institutions seem to prefer simply to continue with variations on a theme, making gradual and easy shifts under the current paradigm rather than shifting the paradigm. It's easier! The lesson from other countries, though, is that taking the easy route and only making simpler changes has meant that some banks have fallen behind or have even been left out. In the Philippines, some banks are struggling to find a way back into a mobile payments market that is dominated by the telecommunications companies. In Singapore and Hong Kong, banks are similarly struggling to find their place in a contactless payments world that is dominated by transit companies. Examples abound in other countries as well. Further, local banks in Sri Lanka especially risk being left behind as multinational players bring their best practices from overseas. Only by leveraging experience from other markets and making change happen are local banks likely to maintain a strong franchise in the retail payments business.

Yes, a paradigm shift is truly underway in payments. Whether the payments are local, national or international, consumers are already using new technology to enable new payment channels. Rapid implementation of phone and chip card payment devices, enabled by multi-function terminals, will only make the shift happen faster.

Embracing the new technology can result in more customers, greater efficiency, increased competitiveness, higher revenue and other benefits. Bankers need to make strategic decisions now in order to stay in the game. While one may not see the results clearly until after the fact, the impending impact of these changes is readily apparent if we look closely and the need to make strategic choices quickly is quite evident.

The choice is clear – act now, or risk being left behind as the consumer payments paradigm shifts.