US banks react to rapid developments in payments

As the payments sector develops at a rapid speed, there is a great challenge ahead for traditional financial players in the US, such as banks, to respond. The challenge is exacerbated by a general push in the sector towards speeding up payments. Linda Odom and Judith Rinearson of Bryan Cave look at how traditional financial institutions and organisations are responding and whether it will be enough for US institutions not to be left behind.

Rapid advances in financial technology are changing the payments playing field. Once given little attention and left largely to banks, changes in systems and expectations were measured in years. Today, evolution in payments can be measured in weeks, as new providers, platforms and payment tools are proliferating at an accelerating pace. Disruptors in the payments market have put unprecedented pressure on banks and other traditional players and it is not clear how the dust will settle[1].

Faced with both significant opportunities and serious challenges in a market that is evolving at breakneck speed and in unpredictable ways, these traditional United States institutions have responded. However, one must question whether the response is adequate to prevent American banks and other payments players from falling behind in the global market.

In 2013, the Federal Reserve took the first step in addressing the problem by issuing a consultation paper as part of a public-private collaboration. It set forth the primary goals in devising a new payments structure: (1) speed, (2) ubiquity, (3) security, (4) efficiency, (5) cross-border improvements, and (6) collaboration[2].

These goals and concerns were reflected in an industry survey conducted by ACI and Ovum in late 2014. It showed that the appetite for collaboration is great, as 90% of financial institutions responded that they want to work with retailers and billing organisations to cut costs. 79% of those responding cited the need to give customers a broader range of payment options and a better customer experience. Many respondents expressed a desire to simplify the global payments value chain, eliminating intermediaries. However, security remains a concern for over half the industry and may be acting to limit necessary investment and innovation[3].

One encouraging finding of that survey for the banking industry is that retailers and billing organisations view banks as the most capable provider of payment services[4]. However, this potential advantage is precarious, as banks are faced with a range of challenges in this sector. Indeed, a survey of US millennials (ages 15-34) revealed that 33% of them believe that within the next five years, they will not even need a bank[5]. The hegemony of banks in the payments market is not a given.

Banks have faced challenges to their control over the payments market in the past, but previous challengers could not gain the footing needed to be successful, with a few exceptions such as PayPal. However, commentators such as McKinsey & Co. suggest the ongoing disruptions to the market present a much more serious threat. Global investment in FinTech has been soaring over the past several years, going from $3 billion in 2013 to over $12 billion in the first six months of 2015. Payments are at the epicentre of this revolution and it is estimated that a third of venture capital investment is going towards payment innovation[6]. Even more ominous for the banking industry is the fact that the barbarians at the gates are not just startups. Giant entities such as Apple, Microsoft, Amazon, Facebook, Alibaba and TenCent are also offering payment products. Such companies have vast resources, established customer bases and contacts with countless merchants and retailers. The frequent transactions engaged in by the customers of such non-bank disruptors makes the addition of new payments options easier, allowing such entities to create an ongoing payments business over a unimaginably short period of time[7].

In the midst of all of this change, comes a further development: an intensive focus on speeding up payments. This is partially fuelled by the explosion of smartphones and related apps. McKinsey projects that growth of app-based payments will rival browser-based payments by 2020[8]. Technological innovations by a host of non-bank players have led to seamless and personalised experiences for customers and merchants. Customers increasingly expect that their financial transactions will be easy and quick, whether it is paying the babysitter or an invoice. But this expectation is not limited to individual consumers. Corporate expectation has also changed in the digital age, with corporate leaders looking for real-time management solutions[9]. This expectation for speed is pushing the payments market towards real-time transactions at a pace that the existing platforms may not be ready for.

Finally, the cross-border payments system is stuck using 20th century technology that makes it both inefficient and

frustrating. There is no reason for this to be the case in this digital era and the failure to update the system has opened the door for new players to enter the payments field. There are a variety of competing solutions and this will be an important area of innovation going forward, as the Fed has recognised[10].

In light of all of this, the response of the major US payments platforms seems inadequate to the challenges the banking industry faces, although at least some action is being taken.

NACHA, the National Automated Clearing House Association, has finished a multi-year effort and announced much-heralded rules and standards, which would adopt Same Day ACH rules and standards, with requirements for things like mandatory participation by member banks that would assure mass acceptance among its users. This proposal, which was approved by its members in May 2015, will be phased in, beginning in September 2016, in a three-step process[11]. This is an important step for ACH transactions, but one has to wonder whether it is sufficient in an increasingly real-time digital world.

At the same time, The Clearing House ('TCH') is taking steps to speed up its payment rails. In December, TCH announced a partnership with VocaLink, which will allow money to be moved between TCH member banks in real-time and hopefully assist in the creation of other real-time applications in the future. However, this system will not be implemented until sometime in 2017[12]. This step towards a real-time interbank system is an important one, but it must be recognised that the US is behind at least fifteen other countries, representing 45% of the global credit transfer flows, which have already migrated to modernised infrastructures[13]. TCH is working towards a real-time CFPB-compliant payments system, adding real-time payments capabilities, announcing a deal with FIS, and appears committed to a major infrastructure change that will apply to both domestic and international transfers[14].

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Finally, the Federal Reserve Bank has established two public-private Task Forces, the Faster Payments Task Force and the Secure Payments Task Force. Leaders have been appointed and draft criteria for evaluating new systems have been released[15]. It is important for the Fed to demonstrate leadership in this area but certainly unclear whether this approach, which hopes for implementation in 2019 and ubiquity in 2021, is sufficiently nimble to lead the way in a market that is evolving at warp speed.

It may be that the ultimate problem facing US banks and entities like the Fed and NACHA is that the US has a pre-digital payments platform and it is unclear whether adapting the current system will be the answer or if a new infrastructure will ultimately be required[16]. For example, there is currently great interest in the blockchain technology, which underlies Bitcoin, with large corporations such as Microsoft and all sorts of banks and non-banks exploring its possibilities. Perhaps if issues such as the security issue inherent in an open network can be addressed, this will be the future. If not, another platform may emerge.

However, all is not doom and gloom for US banks. Many clearly recognise the demands and dangers of the evolving payments marketplace and are not waiting for entities like NACHA or the Fed to lead the way. There are countless examples of banks working to increase their technological capabilities in this area. A long-standing example is ClearXchange, a bank-owned service that allows customers to send money using a cellphone number or email address, which was begun in 2011 and has expanded over the past four years as major banks have joined. This will provide the possibility of real-time payments and fund availability to customers of banks who are members of the network. Other banks are acquiring new technology, conducting their research and development, partnering with other institutions or acting as incubators for new tech technology[17]. All of this bodes well for the future of the payments industry in the US.

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4. Ibid, p. 6.
5. McKinsey & Co., 'Global Payments 2015; A Healthy Industry Confronts Disruption,' p. 15.
6. Ibid, p. 15.
7. McKinsey on Payments, October 2015, pp. 3-4.
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9. Ibid, pp. 26-28.
10. Ibid, pp. 23-26.
11. PYMNTS.com, 'Faster Payments Tracker,' p. 5-7.
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13. Ibid, pp. 19-21.
14. PYMNTS.com, 'Faster Payments Tracker,' p. 10-11.
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16. McKinsey & Co., 'Global Payments 2015; A Healthy Industry Confronts Disruption,' pp. 19-23.
17. Ibid, pp. 17-19.