Payments wave, commerce ocean: The arrival of the mobile wallet

Two waves in the ocean are talking to each other. The front wave tells the second that it's frightened because it is about to crash into the shore and cease to exist. But the second wave shows no fear. It explains to the first: 'You are frightened because you think you are a wave; I am not frightened because I know I am part of the ocean.'

Daniel Gottlieb, *Letters to Sam: A Grandfather's Lessons on Love, Loss, and the Gifts of Life*

Kausik Rajgopal

The payments industry has historically operated relatively discretely within an ecosystem of bank and bank-related issuers, acquirers, processors and networks. These players not only built the industry, they were also instrumental in developing the standards and rules guiding participation. Now, however, the old arrangements are rapidly fading and a new industry order is taking their place.

How will this sea change reshape today's familiar industry structure? Like the wave about to crash ashore in the passage above, players in the payments value chain are grappling with their place in the world. They are coming to grips with the fact that their industry is part of a far broader commerce ecosystem. And they are no longer insulated from the forces reshaping commerce in areas including regulation, technology, retailing and even consumer behavior (see "Payments 2020: Scenarios for dynamic evolution," *McKinsey on Payments*, March 2011).

While such momentous change may sound like a major challenge for industry incumbents, it also presents substantial opportunities. Globally, payments industry revenues in 2011 were approximately $900 billion. The addition of potential commerce-related economics, including offer delivery, personalized marketing, and related business models, could increase those revenues nearly sevenfold.

An earlier article in these pages explored the emergence of alternative business models in the payments industry and identified their respective success markers (see "The future of payments: Markers for success," *McKinsey* *on Payments*, June 2011). As commerce and payments business models converge at a more rapid pace, however, it appears that success will pivot increasingly on capturing and deepening consumer interest in mobile wallets. Why? Because the ubiquity of smartphones places unprecedented computing power at the fingertips of millions of consumers. Today's smartphones function not only as communications devices, but as search tools, storage for merchant offers, price comparison mechanisms, peer-to-peer money transfer systems, payments devices, gaming consoles and social sharing tools. Meanwhile, mobile wallets are enabling merchants and manufacturers to market their wares in more efficient and relevant ways. The new reality is that well-designed and delivered mobile wallets are highly relevant to both consumers and merchants, and therefore support commerce on an extremely broad level.

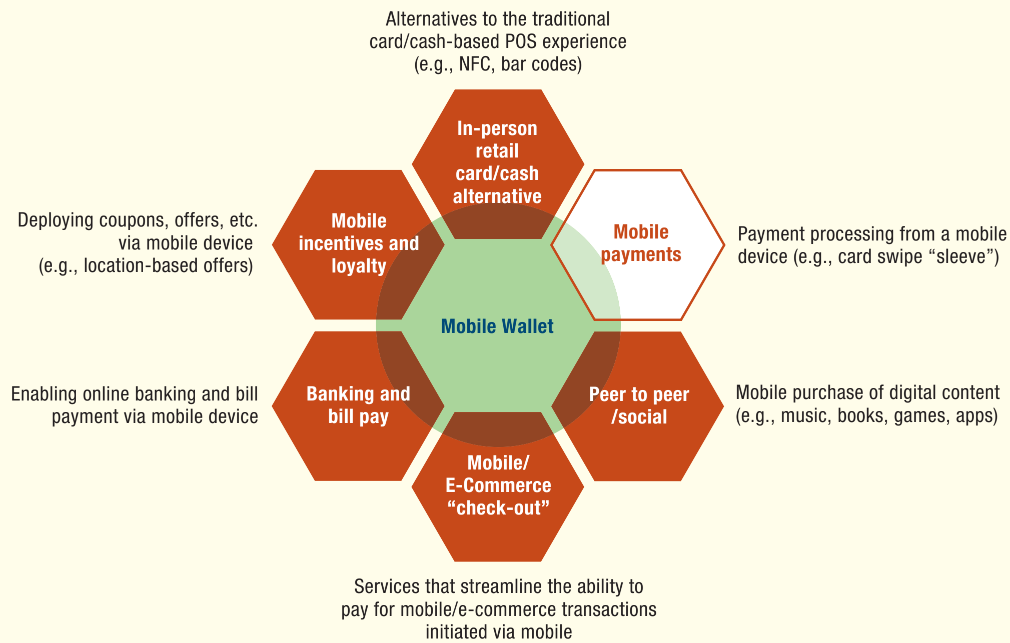
Defining the mobile wallet

The mobile wallet is still in its early stages of development, but when combined with smartphone technology it promises to soon enable widespread payments acceptance that could also be closely integrated with other capabilities. Current discussion about mobile wallets centers on what they can and should include. McKinsey's recent consumer and merchant research suggests that compelling mobile wallets would have at least the following five supplemental capabilities (Exhibit 1).

Exhibit 1

The mobile wallet presents diverse commerce-related capabilities extending well beyond payments

Potential mobile wallet applications, examples



Source: McKinsey Payments Practice

1. *Alternatives to traditional cash and card payments:* In the retail setting, this means prepaid stores of value. Stored value will be important because some consumers are diehard users of cash for retail purchases, even as electronic payments growth continues apace. For these users, a mobile wallet cash substitute will be important to motivating broad usage. McKinsey research suggests, too, that stored-value instruments also appeal strongly to customers who want the increased control such devices provide.

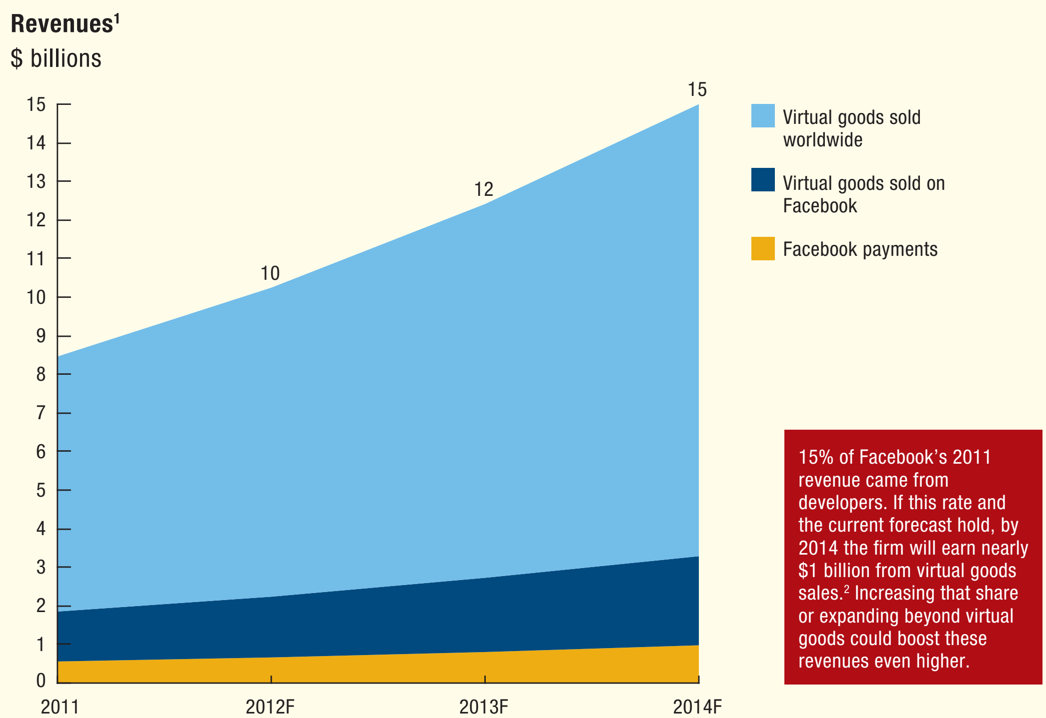
2. *Mobile incentives and loyalty management:* These two marketing tools can now be delivered in more personalized, relevant and location-sensitive ways. As mobile wallets mature, breakthroughs will require offering consumers incentives other than price alone, which would appeal to merchants as well.

3. *Mobile banking and bill payment:* While these are well-established capabilities for many banks, aggregators such as Intuit's Mint offer the potential for a front-end interface with customers.

4. *Mobile and electronic commerce checkout:* Over time, the forms of commerce (in-store, mobile and online) will converge as customers increasingly search for goods and services and make purchases using their phones. The ability of shoppers to seamlessly engage with sellers and complete their purchases with these devices will be differentiators of mobile wallet offerings.

Exhibit 2

Sales growth of virtual goods could generate nearly $1 billion in payments revenue for Facebook by 2014



[1] 2011 is actual and 2012-2014 are forecasts

[2] This revenue-sharing agreement went into effect in May 2010 and expires in May 2015

Source: S1 SEC filing; McKinsey analysis

5. *Peer-to-peer payments, transfers and social layers (such as sharing purchase experiences):* These include the mobile purchase of digital content; for example, buying virtual goods on Facebook, a rapidly growing capability (Exhibit 2). Additionally, Facebook's "social graph," which shows how its users are related to one another, provides accurate customer insight for money-transfer service providers. Facebook's payments subsidiary is already licensed to process money transfers in at least 15 U.S. states (some states do not disclose issuance of these licenses, so Facebook might be licensed in even more states).

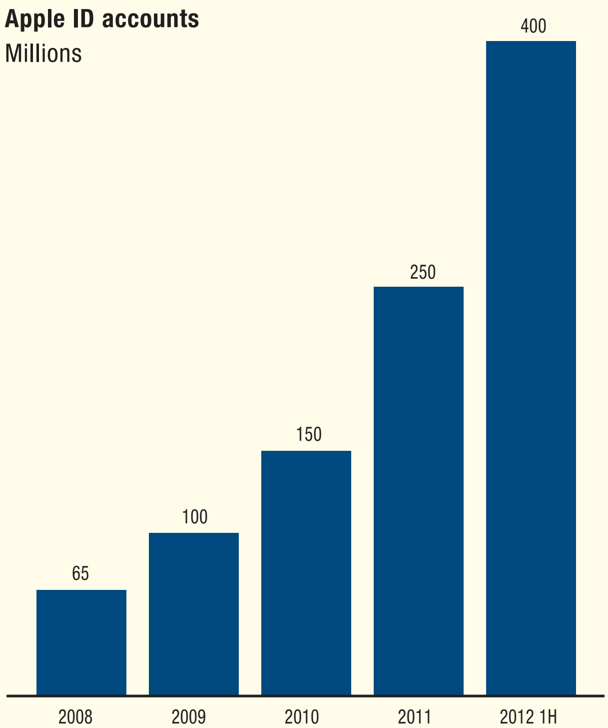
Keys to success in the mobile wallet game

The capabilities identified above provide entry points for non-traditional players to create compelling mobile wallets, and to thereby disrupt the traditional payments business. However, not all entrants will succeed. Winning in the mobile wallets game will require certain core strengths, whether existing or acquired, that will enable translation of the above capabilities into winning and usable value propositions for consumers, merchants and others in the payments ecosystem. These strengths include:

- **Large-scale consumer relationships:** A prominent example of this is Apple, whose consumer customer base has been growing at a 56 percent CAGR (Exhibit 3). Apple currently stores customers' payment information under unique Apple IDs, enabling Apple customers to make

Exhibit 3

Apple is leveraging its vast and growing consumer base



Apple's virtual goods stores

Customer payment data is saved under Apple ID, enabling double-click payment for digital content at Apple iTunes, iBook and Mac App stores

Works on any Apple device and for buying accessories at Apple's retail stores

Most transactions (e.g., individual iTunes) involve micropayments of less than $1.30

Apple aggregates payments before submitting them to networks, thereby providing short-term credit until payments clear

Apple saves on interchange fees

Apple has sold more than 16 billion songs on iTunes

Source: Press search; Apple Web site (03/02/12) simple double-click payments for digital content via its iTunes, App, iBook and Mac App stores. This EasyPay feature is an example of how the company leverages

Apple could extend its EasyPay feature to include third-party retailers, thereby providing a mobile payment capability that does not require installing or upgrading in-store hardware. This could ultimately disrupt the traditional payments model.

its vast set of retail customer relationships. Apple could also extend its EasyPay feature to include third-party retailers, thereby providing a mobile payment capability that does not require installing or upgrading in-store hardware. This could ultimately disrupt the traditional payments model, which assumes that points of sale are largely fixed and merchant controlled. Recently, Apple also introduced its Passbook application for iPhones and announced that it has 400 million consumer relationships, which gives it substantial issuing scale potential in the payments arena. Passbook electronically stores virtual items, such as coupons, offers and gift cards. In many ways, it is a mobile wallet prototype that could integrate payments with marketing and purchase incentive capabilities.

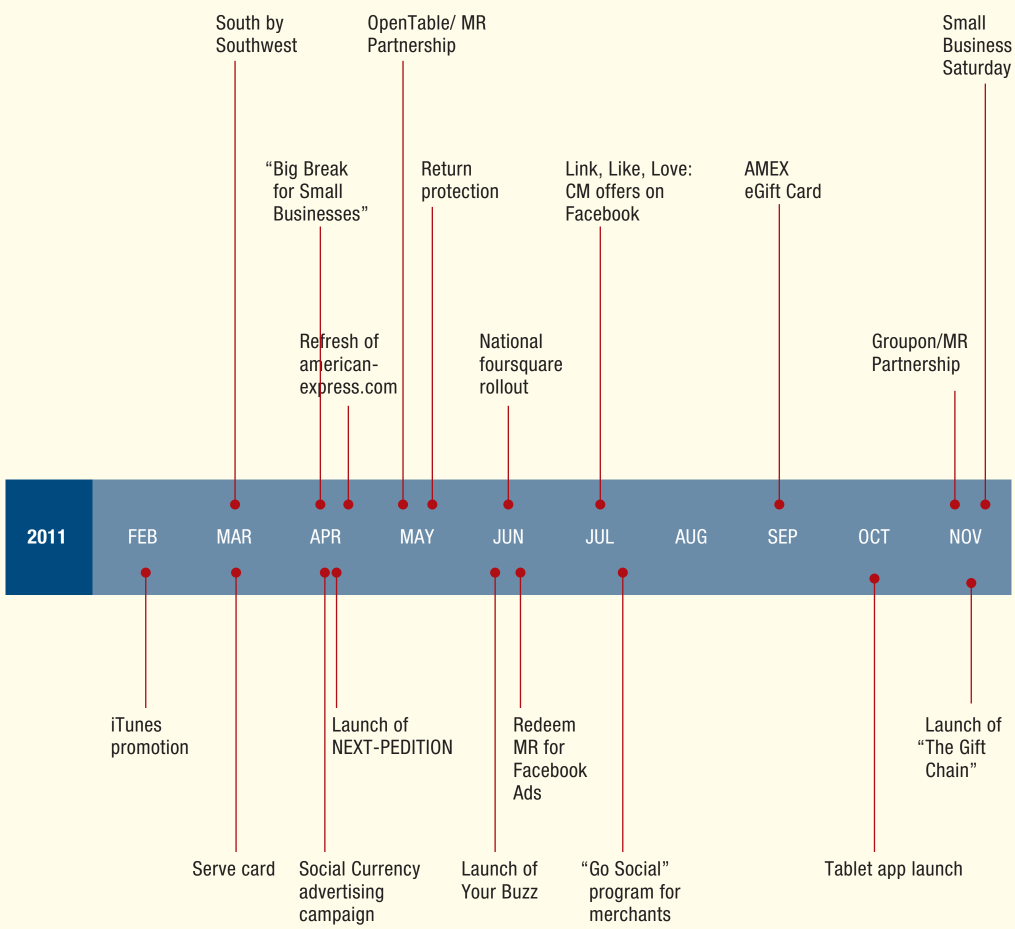
- **Brand equity and trust:** While networks, such as Visa and MasterCard, don't sell products directly to consumers, they nonetheless have built an impressive and valuable asset – globally accepted brands that evoke trust and familiarity. Their powerful brands position the respective networks well for building more direct relationships with consumers and merchants by creating or participating in mobile wallets. Such wallets could attract participation by a broad range of banks that issue a variety of payment instruments. Importantly, those wallets could also make use of established systems for clearing and settling payments. McKinsey's recent research on consumer mobile payments will continue to provide fresh insight into what drives consumer adoption of mobile payments and usage in seven markets. (For more on mobile payments see "Pathways to growth in mobile payments," *McKinsey on Payments*, June 2012.)
- **Risk and fraud management:** Often overlooked in terms of relative importance in the mobile wallet race are risk and fraud management – historically, critical capabilities that have provided an advantage for industry incumbents. Newer players, however, such as PayPal, have established their own impressive advantages in this arena, particularly in mobile and electronic commerce. In its early days, PayPal surpassed eBay's own payments system to become *the way to pay on eBay*. PayPal still maintains this advantage for electronic and mobile commerce transactions. As mobile wallets proliferate, consumers' early experiences with merchants regarding risk and fraud will be an important determinant of success.
- **Alternative pricing models:** Mobile wallets that merely add another layer of inter-

mediation that merchants must subsidize will find little favor. By contrast, wallets that support merchant-funded rewards, whether subsidized by a player's core business or through other sources, will have better chances of sustaining themselves. Google's Wallet, which stores alternative forms of payment with no increased cost to merchants, would offer this advantage. To be sustainable, however, it will need to generate sufficient value (in terms of transactional and other data) that Google's core business can leverage.

- **Compelling complementary partnerships:** The range of capabilities that fully functional mobile wallets need will often require building or expanding player partnerships. Several traditional industry players already recognize this and are positioning themselves to stay ahead of the game. For example, American Express has developed a wide range of partnerships with companies ranging from FourSquare to Groupon that are broadening its digital reach, distribution and consumer appeal (Exhibit 4).

Exhibit 4

American Express has entered a series of partnerships to enhance customers' digital experience and expand distribution



Source: Press searches

- **Data analytics:** Electronic and mobile commerce already generate and enable the daily analysis and application of vast stores of data. Successful mobile wallet providers will not only be able to manipulate the data they collect, but also use it to develop differential insight. Amazon has done this for more than a decade, not only as a retailer, but also as a provider of cloud platform and Web services to other merchants. This will likely be a major differentiator for Amazon because it will underpin its consumer relationships and enable the company to personalize offers, coupons, rewards and loyalty management initiatives.

The winners in mobile wallets might not be its strongest or most strategically savvy players, but rather those who respond best to industry change and market feedback.

- **Flexibility and adaptability:** The winners in mobile wallets might not be its strongest or most strategically savvy players, but rather those who respond best to industry change and market feedback. The payments business is filled with surprises, and no player (regardless of size) knows for certain which applications or value propositions will ultimately be most compelling to consumers. For example, today's consumers use applications developed for peer-to-peer money transfers – such as Barclays' Pingit and Commonwealth Bank's Kaching – as popular balance-checking mechanisms. Both traditional and non-traditional players will do well to recognize the likelihood of unpredictable shifts in consumer behavior, and to prepare backup plans that are as robust and thoughtful as their opening acts on the mobile wallet stage.

* * *

The well-defined and well-bounded payments industry is rapidly becoming history. Indeed, it is becoming part of a much wider commerce ecosystem that comprises a host of well-established players and entrants, each flexing their unique strengths as they pursue what is fast becoming the holy grail of commerce: the mobile wallet.

Many of the capabilities that mobile-wallet victory demands have thus far resided beyond the realm of the traditional payments industry. Participants therefore need to make skillful use of the core strengths discussed above. No current player possesses a sufficiently strong advantage to be seen as mobile wallet's inevitable winner. Banks and other traditional incumbents do, however, enjoy several distinct advantages. Among these are *owning* the consumer payments relationship and related stores-of-value, well-recognized and trusted payments brands, and historically strong capabilities in counterparty, credit and operational risk management.

At the same time, these players also have large revenue streams to defend and carry the weight of legacy infrastructures that were often cobbled together during decades of acquisitions. Non-traditional players, by contrast, are free of these burdens. So they often can begin by challenging the prevailing thinking about how commerce might operate once mobile wallets are prevalent.

However the mobile wallet evolution unfolds, success will require four major actions: first, carefully consider the possible scenarios that could arise in mobile wallets while recognizing that many uncertainties exist; second, develop and implement a partnership strategy that integrates the components of a compelling wallet; third, revise the firm's M&A strategy to include the acquisition of any required capabilities that are non-traditional and complementary to the core business; and fourth, invest in innovation to refresh established franchises and avoid being wedded to historical revenue streams. It could take several years for the fog to clear on the mobile wallet horizon, but the strengths and actions noted here will likely power the ships that most successfully navigate the commerce ocean.

Kausik Rajgopal *is a director in the San Francisco office.*