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# Is the retail payments industry headed for disruption?

Credit cards, search-to-purchase and the law of  
unintended consequences

Produced by the Deloitte  
Center for Banking Solutions

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## Foreword



When the Deloitte Center for Banking Solutions was launched, we promised to provide insight and strategies to solve complex issues that affect the competitiveness of banks operating in the U.S. While we recognized that many firms provide client-centric solutions to business challenges, we knew that some issues are so complex that they require a new approach—a different kind of dialogue.

For the last year, Frank Sui and Howard Weinberg, two principals at Deloitte Consulting LLP, have been engaged in just such a dialogue with leading payments organizations. In numerous discussions with senior executives, Frank and Howard have laid out a story that reads like a business version of a sci-fi horror movie—well-respected organizations that have been the leading players in an industry are blind-sided by upstarts who come from nowhere and completely disrupt how an industry operates.

Luckily, Frank and Howard have outlined a happy ending for the script. While they see a serious disruption coming to the payments industry in the form of search-to-purchase players, their tale ends with ways the established players can gain a competitive advantage.

This report outlines their thinking on credit cards, search-to-purchase and the law of unintended consequences. I hope you find it both interesting and valuable.

A handwritten signature in black ink, appearing to read "Don Ogilvie". The signature is stylized and written in a cursive-like font.

Don Ogilvie  
Independent Chairman  
Deloitte Center for Banking Solutions

Since June 2006, we have been meeting with financial services executives to discuss the potential impact that search-to-purchase players could have on the retail payments industry. We believe search-to-purchase payments may be the innovation to turn the retail payments industry on its head.

Online companies such as Google, Yahoo, and Baidu are more successful than many would have anticipated at their inception. While most financial institutions are familiar with these online search-to-purchase enterprises, we've learned that it's hard for some financial services executives to grasp the potential these online companies have to change the framework of the payments business.

This is not an easy concept. In many of our meetings an "a-ha" moment takes place—when the significance of the search-to-purchase threat clicks. We believe the retail payments industry is underestimating the long-term effects of ecommerce, and has not taken these online brands seriously enough. We also think there is opportunity to capture a larger share of the online market that is being overlooked.

We hope this report helps you get to your "a-ha" moment. Please call us to discuss how your organization can prepare for this impending payments shift.

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"Overshoot"—the term used to describe when companies offer more features and functionality than the most demanding customer segment can absorb or will pay for—is a sign that a product or market is vulnerable to disruption. We believe that retail payments for consumers and merchants are in "overshoot" and vulnerable to "disruptive innovation"—our term for an innovation that changes the competitive framework—from online search-to-purchase companies. This article outlines our views as to why the retail payments industry is in "overshoot" and vulnerable to disruption, notes how search-to-purchase is changing the framework for the retail payments slice of a transaction, and provides insight into ways retail payments players can leverage their brand recognition, infrastructure, volume and profitability to help turn the search-to-purchase experience to their advantage.

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There are various examples of mature industries shaken up by new entrants. Industries subjected to "disruptive attackers" range broadly from steel rods to software operating systems to retail banking. These disruptors often have structural advantages that address a valuable, unmet need or compete by offering fewer features for a lower price. There are also many examples of companies that correctly perceive such threats, yet still spend millions on strategies that fail in spectacular fashion. We believe a very potent form of disruption is the innovation that can change the competitive framework itself. These innovations are often missed or discounted by industry leaders until it's too late. We've seen this in software, technology and telecommunications: a new player gains a foothold in an undemanding segment, learns and improves capabilities, moves up market without competitive response from incumbents and ultimately turns the industry on its head.

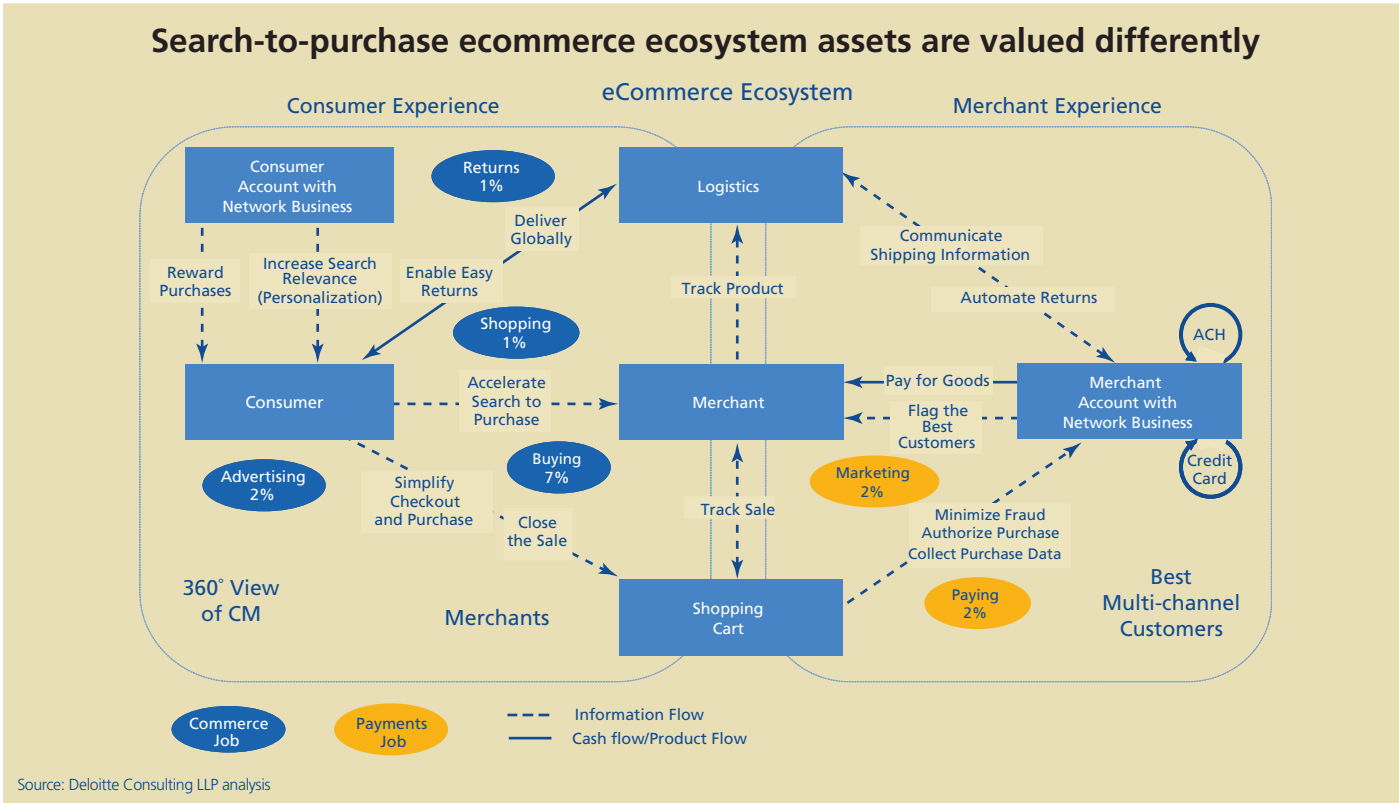
We believe the retail payments industry is vulnerable to this kind of disruption from online search-to-purchase players. Credit card companies are showing classic signs of "overshoot," which makes them vulnerable to disruption, especially disruptive innovation. We believe retail payments companies are underestimating the long-term impact of ecommerce and the vitality of the search-to-purchase business model. Numerous studies project that online purchases will grow to approximately 30 percent of all retail sales over the next 10 years – a market share significant enough to change the base of competition in the retail payments industry. Additionally, credit card companies are misjudging the power of Internet brands and the immense structural advantage they have online. Most importantly, in our opinion, retail payment companies are missing an opportunity to expand profit margins by capturing a bigger share of the online search-to-purchase market.

## Retail payments is in “overshoot” and vulnerable to disruption

The results of a review, conducted by Deloitte Research, of research on hundreds of companies, tell us that “overshoot” is a sign that a product or market is vulnerable to disruption. Our detailed analysis reveals that retail payments for consumers and merchants are in “overshoot.” The payment experience works very well for both sides. For consumers, there is a dizzying variety of options, perks and rewards. They can pay online, pay from their PDA, even pay from their cell phone. Benefits, rewards and fast, problem-free payment transactions are expected and delivered. Life is easy—the customers’ wants are met.

Merchants are also in overshoot. Our primary research on merchant needs indicates that their payments requirements are well satisfied. Fraud has been minimized and payments at the point-of-sale are very convenient. Merchants tell us that they are not willing to pay more for new functionality at point-of-sale such as contactless payments, improved fraud detection, or other improvements: They won’t pay more for a faster swipe.

Enter search-to-purchase companies like Google, Yahoo, and Baidu. Typically, their business template depends on attracting consumers by enhancing the online shopping experience and attracting merchants and advertising dollars who want to reach those same web surfing customers. They’ve identified several “commerce” jobs of value to both merchants and consumers and set about solving them. In contrast, credit cards are a relatively simple, but highly profitable, business system. Over the past 30 years consumers have moved from cash and checks to credit cards, with retail payments companies profiting from the transaction fee. The search-to-purchase business model involves a richer set of “jobs” with the transaction being just one of many activities. As a small part of the online shopping experience retail payments companies are vulnerable to envelopment by the search-to-purchase business model. There is real risk of the transaction disappearing into the overall search-to-purchase function.



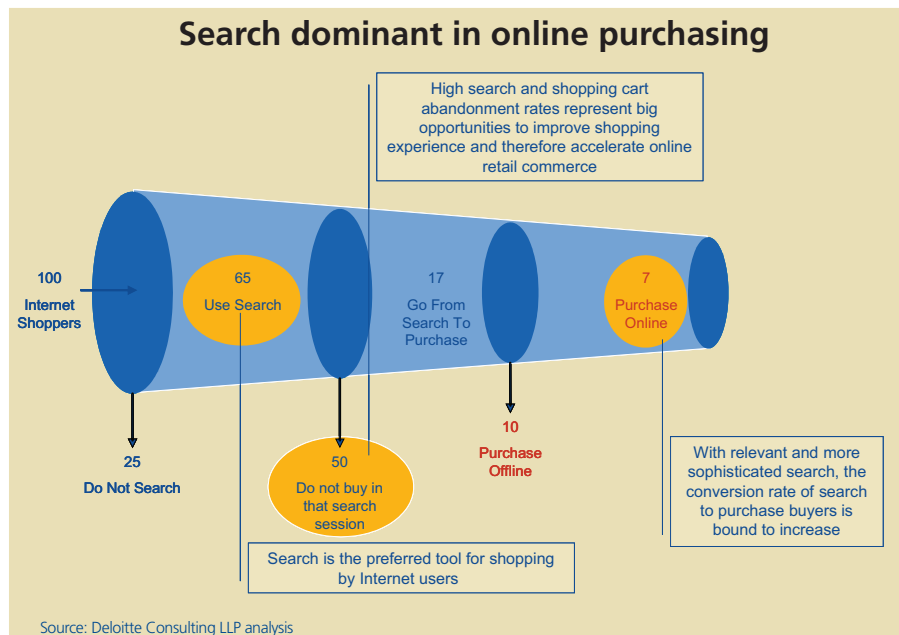
## Impressive growth of search-to-purchase

A critical point in understanding the disruptive potential of search-to-purchase firms is determining if online buyers are a niche market or if search-to-purchase is poised to gain a real foothold. Are online buyers a separate and small category or are consumers across all market segments moving toward online shopping? If so, what does this mean for retail payments companies? Online purchases continue to rise as a percentage of overall retail sales. Currently, they are only about nine percent of retail commerce.<sup>1</sup> Even accounting for the continued predominance of local commerce, we estimate that by 2017 more than 30% of all retail commerce will be online.<sup>2</sup>

A second important factor for analyzing the disruptive potential of search-to-purchase companies is the number of people who use search engines to facilitate their purchases. Based on Comscore's data of several million website users and their shopping patterns, we analyzed and concluded that 65 out of 100 online shopping intentions begin with a search.<sup>3</sup> Given the power dynamics of the Internet, it is extremely unlikely that search-to-purchase's market share will decline. We believe the convergence of these two trends means that within 10 years, one out of every three dollars spent by consumers on retail purchases will begin with an online search. The dynamic growth of search-to-purchase supports the view that today's search-to-purchase companies are not niche players, but are quickly gaining a foothold in the consumer market and, by default, retail payments. We believe the search-to-purchase business model, which encompasses the payment as a small part of the overall purchase experience, will eventually change the base of competition.

What the search-to-purchase businesses have done in the retail payments arena is identify what merchants will pay more for – and with their business models, they are structured to provide it. Search-to-purchase companies, with their richer set of ecommerce jobs, have a different view of the retail purchase and transaction. The question search-to-purchase players have asked and answered is: What “hard problems” will merchants pay for and which “hard commerce jobs” are most valuable to consumers? We believe the answer is closing sales easily.

Not surprisingly, merchants consistently told us that their biggest commerce challenge, one for which they would gladly pay, is finding new customers. Innovations by search-to-purchase players are solving this valuable job. An unintended consequence of those innovations is an increasing merchant perception that the convenience of retail payments at point-of-sale is no longer a “hard” or valuable job—consequently, the merchants would apply pressure to pay. By contrast, merchants equate the costs associated with search-based advertising with that of a commission-based salesperson—one who works 365 days a year and brings in new customers constantly without ever calling in sick. For that level of closed sales, merchants will gladly pay more commission. Solving this difficult, valuable job is at the heart of search-to-purchase's disruptive potential.



## The structural advantage of the search-to-purchase business model

Search-to-purchase companies have several structural advantages over credit card companies. They already control more than 80% of the online market.<sup>4</sup> Their brands are well known and highly regarded by consumers. We believe their most significant structural advantage lies in their business model itself. Search-to-purchase views the entire shopping experience as a continuum from the first search through to the final purchase, which enables the search-to-purchase organization to envelop the payment transaction within the shopping context. Because search-to-purchase firms make their money primarily from merchant advertising fees, rather than on transactions, the potential profits are much greater. The profit margin for solving the merchants' commerce problems and delivering new customers and/or closed sales is two to three times that of the payments transaction fee. Data shows merchants will pay between 7-9% for delivery of a sale vs. 2% for merely processing the payment.<sup>5</sup> The large search-to-purchase companies are recognized for continuously tailoring their systems to increase their ability to deliver the closed sale and collect this high-margin revenue.

This structural advantage of search-to-purchase over retail payments has significant strategic implications. The large search-to-purchase companies are in a position to use this economic advantage to subsidize both the consumer and merchant to drive more search-based advertising. For example, Google has implemented a merchant loyalty program. The more search-based sales that go through Google Checkout, the more the merchant earns in free Google search-ad credits that in turn drive more sales.<sup>6</sup> In our opinion, the large search-to-purchase companies will continue to reinvest in enhanced search and other features valued by consumers.

## The Internet is winner take all

Companies that are able to survive and build leading two-sided platforms on the Internet follow Power Laws in terms of relative share. In layman's words, this means Internet two-sided platforms are typically "winner take all" competitions, where one or two large players end up dominating the entire space. In the ecommerce search-to-purchase sector, most structural advantages accrue to Google and Yahoo, not the retail payments organizations. Despite their relative youth, both companies have extremely strong brands. In a recent study, Google ranked first as the most powerful global brand, displacing Microsoft among technology companies. Yahoo ranked forty-second.<sup>7</sup> These two companies account for more than 80 percent of the search-engine business. It is highly unlikely that anyone will emerge with a better, faster search engine. Our analysis of Internet competition and multi-platform dynamics indicates that dislodging these two firms from their primary position is improbable.

The multi-sided, platform-driven nature of the ecommerce ecosystem has vital implications for retail payments growth and profitability. Examples of multi-user networks that ended up being served by a single platform include fax, VHS, iPod and Microsoft. Many players expect Google and Yahoo to be subsumed by Microsoft, which is investing heavily on the search engine/search-to-purchase market.

We believe this view is a misreading of the economic, brand and ecommerce dynamics at play. Google and Yahoo are already the industry leaders in search-to-purchase. They already have over one hundred million loyal users, a large, global advertiser base, service options and extraordinarily high brand recognition.

The right question may not be "How will Microsoft envelop Google?" but "Is Google the next Microsoft?"

## Will retail payment companies be “collateral damage” in the search-to-purchase market?

In our opinion, the large search-to-purchase companies are not interested in a better payments experience, per se. Google Checkout is misinterpreted by many as a move into payments. Yet, why would Google enter a business that earns lower returns on capital compared to the core search? Rather, adoption of Google Checkout is important in enhancing the consumer commerce experience and for closing the search-to-purchase loop. Google Checkout gives the merchant definitive return on investment on an AdWords campaign and thereby provides a tool that can drive additional AdWords spending. Google Checkout has also been shown to enhance the consumer’s search-to-purchase experience and drive more repeat purchases and increased basket size—which may explain why Google<sup>7</sup> has waived all merchant transaction fees for Google Checkout through 2007.

Search-to-purchase players are focused on solving consumers’ and merchants’ biggest challenges throughout the commerce process—searches, purchase, payment and check out. They have a stake in enriching and improving the search-to-purchase experience so that the consumer can find the product(s) he or she wants via the search toolbar with as few clicks as possible or via targeted search-based advertising and customized offers from the merchant.

## Win, lose or draw—co-existing on the Internet

The challenges and unique aspects of the platform-mediated Internet networks are illustrated by the two different approaches, trajectories and fortunes of Netscape and Adobe. Both were faced with the same challenge—Microsoft’s dominance of the operating system market and its commensurate ability to bundle other services. Once Microsoft offered a given service for free as part of its operating system the other, stand-alone players were disintermediated. Netscape, even though many considered its product to be superior, was unable to compete with Microsoft. After Internet Explorer was bundled with the company’s other applications, consumers used it by default. Explorer was easy and convenient, already on their desktop. Netscape lost its market share and today is a marginal player.

Adobe chose a different strategy. Rather than attempting to win in a head-to-head competition with Microsoft, its strategy was to co-exist. Instead of fighting to preserve its proprietary technology, Adobe’s open standard allowed it to move “up market” in the more lucrative writer’s market. In essence, Adobe ceded part of its market share to Microsoft in order to preserve its leadership among the most profitable customers.

## Advantages and opportunities for the retail payments industry

Conventional wisdom holds that the idea of the leading players in the retail payments industry being enveloped and subsumed by the large search-to-purchase companies is unthinkable. Yet, we believe, the retail payments industry will continue to see ongoing pressure on the interchange rate in the future. And, our close look at the business drivers of search-to-purchase, and how their expanded value proposition for consumers and merchants delivers an advantage in the long run, indicates this outcome is entirely possible.

We believe the end game of ecommerce search-to-purchase will be a duopoly. In all probability Google and Yahoo will remain the premier search-to-purchase brands and continue to control 80-90% of their market for the foreseeable future.<sup>8</sup> The dominance of search-to-purchase in the ecommerce arena—we believe it will account for 30% of all retail sales by 2017—will take growth away from retail payments companies. It's important to note that this threat hasn't arisen vis a vis traditional competition, but as a by-product of the search-to-purchase business model. Unfettered by the constraints of traditional competition, the door is open to co-existence, collaboration and opportunity. The question for retail payments companies is whether or how they will take advantage of this eventuality.

The retail payments industry has tremendous assets in terms of brand recognition, infrastructure, volume and profitability. Credit card company brands, consumer trust and merchant relationships are significant. In terms of turning the search-to-purchase experience to their advantage, the millions of merchants already affiliated with the retail payments companies is the proverbial trump card. It is hugely expensive to identify and recruit new merchants. And, we believe, identifying new merchants all along the spectrum—especially in the lucrative area of small local businesses—is integral to improving the search-to-purchase experience. For example, while there are approximately 800,000 online advertisers, there are at least 20 million small merchants who aren't utilizing online advertising at all.<sup>9</sup> Most of these small businesses are already associated with the major retail payments companies. The large search-to-purchase companies will likely pursue these small merchants to improve the search experience beyond national retailers and to move into local search, a business which Google's CEO states should be as large as online search.

The first step in taking advantage of the emergent ecommerce buying model is a change in perspective. The online payment experience must be viewed through a different lens. In order to obtain a larger share of the 7%-9% merchants will pay for a sale, retail payments companies need to make significant adjustments. They must think beyond the transaction itself—they should be asking themselves hard questions and looking at their own business models to see where they have a strategic advantage and how it could be leveraged in the online platform. Retail payments companies should also consider restructuring bank/merchant relationships to help subsidize advertising, further strengthening the bank-merchant relationship and preventing disintermediation. Hard questions would include:

- What assets do we need to compete in the search-to-purchase space?
- How are our assets valued by different players?
- What are the 'jobs' that we can do better?
- How should we educate our people to understand the changing ecommerce game?
- What new 'value' can we offer merchants?
- What would collaboration with the large search-to-purchase companies look like?
- How would a closed loop partnership work?

The ability to deliver millions of merchants is a huge advantage. The retail payments companies should capitalize on those relationships in their efforts to lessen the impact of the disruptive innovation posed by the search-to-purchase business model.

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## About the Center

The Deloitte Center for Banking Solutions provides insight and strategies to solve complex issues that affect the competitiveness of banks operating in the United States. These issues are often not resolved in day-to-day commercial transactions. They require multi-dimensional solutions from a combination of business disciplines to provide actionable strategies that will dramatically alter business performance. The Center focuses on three core themes: public policy, operational excellence, and growth.

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## Endnotes

- 1 Deloitte Consulting LLP analysis.
- 2 Deloitte Consulting LLP analysis.
- 3 Deloitte Consulting LLP analysis.
- 4 ComScore study.
- 5 Deloitte Consulting LLP analysis.
- 6 Google news release.
- 7 Brand Z ranking, Millward Brown, 2007.
- 8 ComScore study.
- 9 Deloitte Consulting LLP analysis.



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## Center for Banking Solutions

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The Deloitte Center for Banking Solutions (the "Center"), located in New York City, is part of Deloitte & Touche USA LLP and was formed to further research on and develop solutions to solve complex issues that impact the competitiveness of banks operating in the US. Don Ogilvie, former president and chief executive officer of the American Bankers Association (ABA) for two decades, is the Independent Chairman of the Center.

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