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# Pay by Bank

## An emerging payment option to disrupt the e-commerce experience in the US

# Contents



# Overview

In recent years, the retail payments landscape has consistently been subject to disruption through multiple forces of technology advancements, changing consumer expectations, and agile, modern fintechs. These forces continue to reimagine how consumers pay for goods and services, both online and at the point of sale (POS). While e-commerce in the United States is growing rapidly and forecasted to grow at 7% Year-Over-Year (YoY ) between 2023-27 to reach $2.5 trillion market size by 2027[1], POS has a relatively modest growth rate of 3% (2023-27), but has a significantly higher projected market size of $11.5 trillion by 2027[1].

Traditionally, payments at e-commerce or POS checkout have been dominated by cards, and more recently, digital wallets have also started capturing market share as a preferred payment method. As of 2023[1], in the United States, cards (credit & debit) accounted for the highest (51%) share of e-commerce transactions (by value), closely followed by Digital Wallets (37%). At the POS, cards (credit & debit) accounted for a majority (69%) of transactions, with digital wallets accounting for 15% of the transactions. Historically, preference toward card payments (and by extension, digital wallets) for online/POS payments has been driven by consumers' expectation for rewards that are funded through issuers' interchange and interest incomes.

However, with economic challenges including interest rates and inflation, credit card delinquencies reached a 13-year high[2], signaling increased financial stress, especially amongst younger and lower-income households.

From a merchant's standpoint, interchange costs, process inefficiencies (e.g., manual effort in reconciliation of remittance data), and operational expenses on Payment Card Industry Data Security Standard ("PCI DSS") compliance are pushing them toward other emerging payment methods that offer higher speed, better customer experience, and enhanced operational efficiency. Financially, cards acceptance has been costly for merchants with them paying 2-4%[3] of the transaction value as interchange fees, which are typically their highest operating cost after labor. Alternative payment methods that can lower the merchants' costs will always garner their attention.

The convergence of these shifts in the economy, market, and their impact on consumers and businesses has driven the rise of multiple emerging payment methods. The wave of technical developments in API-based banking and the industry push for faster payments has given birth to several new methods, such as Same-day ACH, and Real Time Payments (RTP). Continuing this trend of payments innovation, Pay by Bank is emerging as a new payment method that leverages these faster payments methods to facilitate money movement between a consumer and a business' bank account.

Put simply, Pay by Bank is an emerging payment method that allows consumers to make transfers directly between their bank account and a business' bank account through secure direct integrations between banks, typically over other methods, such as Same-day ACH. While consumers in the US can pay for their bills, subscriptions, and loan repayments today using their bank account, this option is largely unavailable when it comes to the online or POS checkout experience.

The next logical evolution of Pay by Bank can be for other use cases, such as Consumer to Business (C2B) transactions both online and at store checkout. However, Pay by Bank's adoption and scalability will rely on the active collaboration of ecosystem stakeholders, a uniform design and enforcement of consumer protection mechanism, and rules.

In this paper, we will explore the Pay by Bank method in more detail, focusing on the C2B use case at both POS and e-commerce checkout, what is needed for it to gain traction, and what are the key implications for payments value chain participants.

# What is Pay by Bank?

As a payment method, Pay by Bank allows consumers to pay for goods or services by authorizing funds to be transferred directly from their bank accounts, without having to use a credit or a debit card.

*Figure 1: Pay by Bank and Card Payment Transaction Flow*

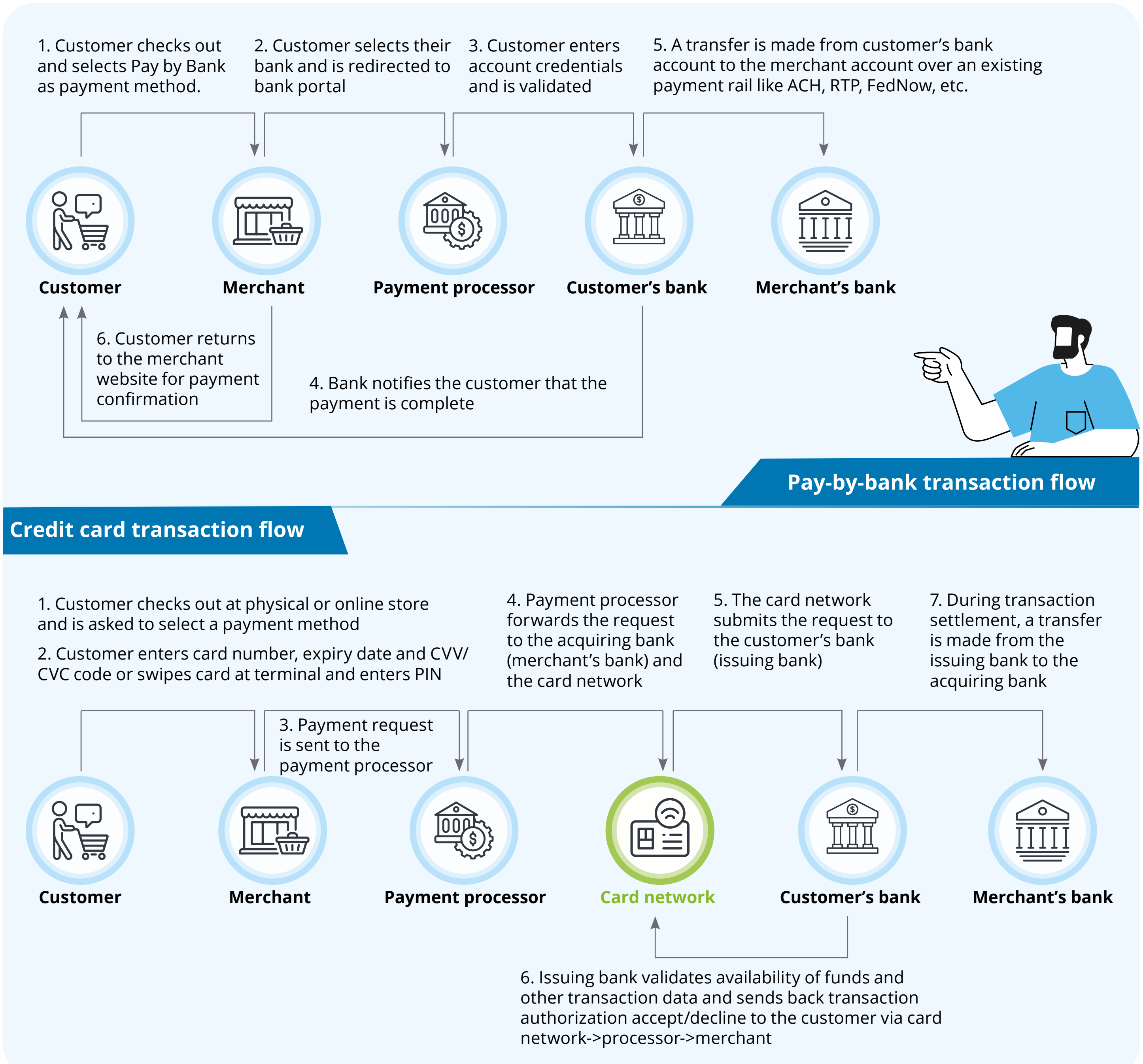
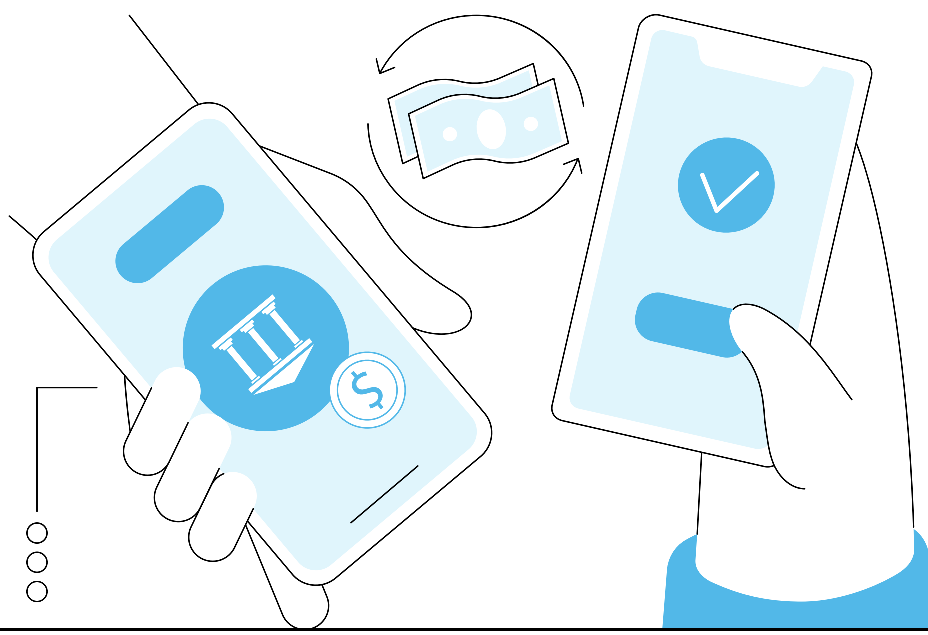


*Figure 2: Key Differences between Pay by Bank and Card Payment Transaction Flow*

| | **Pay by bank** | **Credit card** |
|---|---|---|
| **Stakeholder** | Customer's bank, merchant bank, payment processor | Customer's bank, merchant bank, payment processor, card network |
| **User Experience** | Smoother, requires less details from the consumer; can often be QR-enabled | Friction due to need to remember details; added risks of card theft and misuse |
| **Authentication** | Via banking credentials that are easier to remember | Via card number, CVV, expiry date; harder to remember |
| **Speed and Settlement** | Instant processing and settlement | Delayed settlements |
| **Transaction Fees** | Potentially lower transaction fee than cards, no interchange costs | Higher fees, including interchange costs charged by the card network |
| **Chargeback Risk** | Lower risk due to stronger authentication mechanisms | Higher chargeback risk |

Note: Transaction funding is a separate process between the consumer and their bank. Consumer may also decide to use credit/overdraft facilities.



Conceptually, Pay by Bank decouples the payment mechanism from the funding mechanism. On one hand, it can give customers wider choices to fund the transaction (e.g., cash/account, credit) keeping the user experience consistent. On the other hand, it can give banks and merchants new avenues to develop products and drive loyalty.

The Pay by Bank method can leverage existing methods, such as ACH and RTP (either through The Clearing House (TCH) RTP product or the Federal Reserves' FedNow product) for money movement between accounts. Existing Pay by Bank offerings in online e-commerce checkout have relied on ACH and Same-day ACH, both of which have Request-to-Pay capabilities. Moreover, ACH currently dominates the electronic payment landscape with annual transactions worth $77 trillion. However, with increasing adoption of instant payments, such as RTP, it will be feasible for Pay by Bank to be offered more broadly through other methods. TCH RTP witnessed transactions worth $42 billion[4] in the first quarter of 2024, and FedNow's increasing market reach for instant payments consequently bolsters the prospects for Pay by Bank's adoption. In essence, the growth and widespread acceptance of RTP serve as favorable indicators for the accelerated uptake of Pay by Bank solutions.

In principle, during the e-commerce payment or POS checkout process, Pay by Bank offers several benefits over other methods for customers, merchants, card networks and processors, and banks:

*Figure 3: Key Benefits of Pay by Bank*

| **Customers** | **Merchants** | **Banks** | **Card networks and processors** |
|---|---|---|---|
| • Reduced risk of stolen cards/credentials; eliminates need to remember card details<br>• Familiar technology (e.g., mobile banking apps)<br>• Choice between credit or cash as funding options<br>• Potential discounts/higher rewards at merchants | • Lower transaction costs, improved margins, and more durability recurring payments<br>• Virtually eliminates chargeback risks for instant transactions<br>• Boosts purchase conversions and curbs cart abandonment in e-commerce<br>• Ability to increase customer engagement through more personalized rewards | • Ability to extend banking services to previously unbanked populations<br>• Access to rich customer data and better cross-sell opportunities<br>• Ability to offer credit lines at point of sale<br>• Ability to offer value added services (e.g., bulk payments and scheduled payments) | • Ability for processors to offer a newer payment rail to clients<br>• Ability to offer value-added services across the transaction value chain (e.g., fraud management tools, etc.) |

While the advantages of Pay by Bank are apparent and the instant payments space is ripe for disruption, an ideal solution and its widespread adoption hinge on several critical factors.

# What is Required for Pay by Bank to Take Off?

To achieve the desired scale for any payment method, it is essential to have a clearly defined value proposition that caters to the distinct needs of each stakeholder—consumers, merchants, and banks.

## Unlocking Consumer Interest

- **Value-added services, such as credit lines:** Today, more than one-in-three Americans[5] engage in credit-based purchases, with a pervasive preference for credit cards. As an average consumer seeks to surpass their earnings in spending, Pay by Bank should offer competing features, such as Credit Lines, aligning its offerings with the prevailing trend of credit-centric transactions. As an example, India's Unified Payments Interface (UPI)[6], the instant payment rail, allows banks to issue "Pre-sanctioned Credit Lines" to customers via UPI, utilizing the same interface for seamless linking, secure PIN-based authentication, QR-based payments using the credit line, usage insights, dispute resolution, and easy repayment options.

- **Seamless user experience:** With more than 50% of consumers[7] emphasizing "convenience" and "ease of use" as critical reasons for using Account-to-Account (A2A) payments, the success of Pay by Bank hinges on a consumer-centric user journey and a smartphone-enabled (potentially QR-based) payments experience that is as seamless as the swipe of a card.

- **Rewards to drive loyalty:** Recent studies have also emphasized the importance of rewards and revealed that cashback is the most coveted cardholder benefit, with 50% of cardholders ranking it as their top preference[8]. This popularity stems from the inherent versatility of cashback redemption options (gift cards, direct deposits, etc.). Hence, banks and merchants may need a nuanced design approach to rewards—with simplicity and flexibility in accruals and redemption, and focus on high-income individual segments with higher impact.

- **Building trust through better fraud management:** Given consumers' comfort with credit card dispute and fraud management mechanisms, they may carry the same expectations for Pay by Bank. Hence, a unified framework for fraud and dispute management, which defines liabilities of each stakeholder in a fraud or dispute scenario, may be essential to give the consumers the same level of comfort and certainty as a credit card transaction. Moreover, recent initiatives by card networks aim to reduce fraud instances and alleviate consumer concerns. While merchants can potentially be charged a minor fee to fund these investments, the fee will not hinder the low-cost value proposition.

- **Build awareness:** With over two-thirds of Gen Z consumers[9] and approximately 24% of all consumers unaware[8] of the existence of such payment systems, the primary challenge to the widespread adoption of Pay by Bank is a lack of awareness. Bridging this gap through all stakeholders is imperative.

## Onboarding Merchants

- **Lower Acceptance Cost:** Many US merchants grapple with the burden of the highest swipe fees globally, amounting to a staggering $160.7 billion annually[10]. To help ensure sufficient interest from merchants, Pay by Bank will likely need to offer a low cost of payments acceptance, without compromising on the security features that are synonymous with cards.

- **Robust dispute management:** Another interesting proposition that makes card payments the bedrock of trust for merchants is a robust dispute resolution system and Pay by Bank offerings will need to mirror such capabilities. Small and midsize businesses (SMBs), accounting for over 99% of the US market[11] stand to benefit the most, as unlike large retail leaders, they generally do not have dedicated dispute teams and tend to rely on card networks.

- **Enabling merchants in improving awareness:** Moreover, a communication and awareness gap limits the public understanding and adoption of new payment methods. With over 36% consumers[8] citing a lack of awareness of how such payment systems work, merchants often find themselves burdened with the responsibility of educating consumers, despite lacking a comprehensive understanding themselves. All stakeholders must collaborate to educate and equip merchants with necessary resources to promote new payment methods effectively.

- **Ease of Integration:** As merchants embed Pay by Bank in customer journeys, they will also seek seamless, low-cost integration through third-party payments service providers.

## Pushing Banks to the New Normal

Banks' interchange income has been in regulators' crosshairs for a while now, starting with the Durbin Amendment in 2010. Of late, several European countries have implemented interchange caps (~0.3% for credit cards)[12], impacting banks' interchange revenue. Increasing likelihood of same happening in the United States will likely drive issuing banks to address loss in revenue and wallet share by offering alternative payment methods, thus building a case for Pay by Bank. Given the current administration's focus on reducing regulatory burdens on businesses, this may not happen for some time.

In a future that includes Pay by Bank, banks may need to pull several strategic levers to build momentum and counter the impact on interchange revenues:

- Explore alternative revenue channels, targeting:
  - Consumers through BNPL solutions at the POS, like credit lines and installment payments
  - Merchants through value-added services, such as bulk payments and scheduled bill payments
- Use the opportunity to build merchant partnerships and leverage all the transaction data generated to effectively cross-sell to consumers at the point of purchase
- Develop the capabilities to facilitate the growth of Pay by Bank, such as customer service, ability to address emerging frauds, harness consumer data to effectively cross-sell, etc.
- Educating existing consumers about Pay by Bank to secure a higher mindshare

Finally, the true success of Pay by Bank will depend on an industry-level collaboration between banks and acquirers to share and build common standards around this new payment method. Other global markets, such as Australia have shown the way, where banks collaborated to develop the New Payment Platform ("NPP"), anticipating the need to maintain a strong position in the payments sector.

# What are the Implications of Pay by Bank on Different Players?

As we navigate the growth journey of Pay by Bank, it's imperative to delve into the potential implications for various participants in the transaction value chain. As Pay by Bank scales, it may have significant implications on marketplace participants, who will need to adopt varying pathways to effectively navigate the winds of change.

## Consumers

Consumers should anticipate a redefined payments experience with Pay by Bank with seamless, real-time transactions, simplified bill payments, and improved transaction security.

The adoption of Pay by Bank may enhance the user experience. Functioning as an ACH payment, it will enable seamless sharing of financial data, facilitate secure bill payments directly from bank accounts, and alleviate the tedious task of manual entry of routing and account numbers for each bill payment. Additionally, use cases, such as Request for Payment can eliminate the need for consumers to set up merchants as payees, offering a user-friendly alternative (e.g., QR Code) akin to smartphone-enabled card-based transactions[13]. Payments experience is further enhanced and secured through familiar authentication processes, such as biometric scans, ensuring a smooth and secure payment process. Moreover, Pay by Bank's promise of secured data sharing can open not just a new way to pay, but also greater choices, such as access to lending based on rich transactional data.

Security will remain a paramount concern, especially as Pay by Bank gains traction. In certain markets, introduction of fast, real-time payments has been accompanied by frauds at the start. For example, in Brazil, the introduction of PIX services[14] saw a surge in frauds in the beginning. Consequently, the Brazilian central bank had to implement several restrictions around transaction and time limits, fraudulent account tagging, and other measures. Pay by Bank can be potentially enhanced with tools to analyze optimal payment initiation times based on historical behavior and risk patterns.

With Pay by Bank, consumers may also experience more creative merchant-driven rewards, driven by lower acceptance costs.

## Merchants

Pay by Bank offers several benefits for merchants, starting with a significantly lower cost of acceptance (~70% lower by some estimates)[15], potentially improving bottom line margins up to a few percentage points. Savings on interchange and access to data could also allow merchants to increasingly offer personalized rewards, helping build merchant brand loyalty versus card loyalty.

Beyond cost reduction, Pay by Bank promises better margins through reduced card frauds, chargebacks and reconciliation complexities[16], and better cash flow management through almost instant settlements. In the e-commerce realm, it acts as a catalyst for purchase conversions. Additionally, merchants can benefit from lower instances of failed Direct Debits, improving liquidity by accelerating payment cycles and allowing for early payment incentives and loyalty benefits for consumers.

However, there are drawbacks to the current method of offering Pay by Bank via ACH payments, primarily due to the fact that these transactions are revocable[17]. In essence, 'revocable' means that the payer has the ability to reverse or cancel the payment after it has been made. This can introduce a vulnerability to fraud, as individuals with malicious intent can exploit this feature by making purchases using someone else's account information and then claiming that the transaction was unauthorized. Consequently, the legitimate account owner may initiate a return (consumer-initiated returns), which can take up to 60 days to process, posing challenges[16], especially in scenarios involving the shipment of physical goods that might have already been sent and received. Moreover, there is the risk of bank-initiated returns due to issues like account closures or insufficient funds[xvi].

As methods such as Pay by Bank scale, the market can see a variety in the strategic responses from merchants. A few large-scale and innovative merchants will choose to reinvest savings on interchange to build strong loyalty programs, increase cross-sell, and improve consumer experience in the process. A study by Plaid highlighted a strong correlation of modest incentives on consumer behavior in preferring a payment method, such as bank payments. On the other hand, SMB merchants, with thinner margins and a limited consumer base, may just limit to improving their bottom line through these savings on acceptance cost.

In either case, we may increasingly see merchants working more actively with their bank and payments service provider to assess and embed Pay by Bank as a method in their payments acceptance stack.

### Banks

As Pay by Bank encroaches card payments, banks (especially large issuers) will feel the challenge of reduced interchange revenues, fundamentally altering their traditional revenue streams.

However, multiple studies have shown that in mature credit card markets, the introduction of a new payment method such as RTP had very little impact on card volumes[18] and significantly more short-term impact on cash usage, which saw a sharp decline. Hence, in the short run, banks may see limited impact on interchange revenue.

Smaller, regional banks stand to specially benefit from this, as these account-based transactions may open up new revenue channels, add previously unbanked consumers to their depositor base, and open opportunity to cross-sell other products.

In the longer run, banks may look to offer higher margin products via the POS, both online and offline. For instance, instant payments systems, such as UPI in India and PIX in Brazil have allowed banks to offer credit lines at POS, opening newer customer acquisition channels. This can also help drive down customer acquisition costs for such credit products. Additionally, larger control over consumers' transaction data can allow banks to better cross-sell other financial products based on spending and transaction insights on consumers.

### Card networks

Card networks are directly impacted by the volumetric movements of credit card transactions. As card payments continue to grow in the short run, there may be a limited impact on card networks' interchange revenues. However, in the longer run, the obvious benefits of Pay by Bank for all stakeholders may lead to a shift away from cards. This is much easier said than done as card payments are very easy, making the bar very high for replacement.

Card networks may need to think broader than being card payments facilitators and identify strategic opportunities in other parts of transaction value chain.

The market has already seen strategic pivots from card networks, leveraging existing and new partnerships to offer value-added services to enhance user experience and secure Pay by Bank payments. For instance, we have seen the introduction of value-added services[19] (e.g., Alias Directory Service, real-time A2A transaction monitoring, and Account Tokenization Service), designed to enhance trust, ease of use, and security. Adaptable and interoperable, they aim to accelerate the adoption of instant payments, offering solutions that are flexible and capable of supporting a wide array of use cases and requirements.

We may also witness strategic acquisitions by card networks, such as the acquisition of payments technology players that help penetrate account-based payments[20], highlighting the growing entrenchment of card networks beyond traditional card payments.

### Payment processors

The emergence of Pay by Bank transactions underscores the need for payments processors to continuously innovate and navigate the increasing demand for fast, easy, and secure payment methods among consumers and merchants alike.

Payments processors can be the cornerstones of Pay by Bank adoption and they may play a critical role in offering this method to merchants through:

1. Delivering low-cost integration of Pay by Bank for merchants, and handholding merchants on key changes, such as user experience, transaction pricing, and faster settlements and reconciliation. Integrating Pay by Bank should be quick, cost-effective, and nondisruptive for merchants.
2. Forging strategic partnerships with third-party niche firms (e.g., in analytics and fraud) to deliver a stronger Pay by Bank offering, riding the wave of democratiziation of capabilities via Open Banking.
3. Building and offering value-added services, such as consumer insights/analytics and leveraging the rich dataset generated via Pay by Bank transactions.
4. Pricing competitively (e.g., tailored pricing by volume) to incentivize merchants for higher volumes.

# Conclusion

The evolution of Pay by Bank presents an opportunity for banks, processors, merchants, and card networks to reimagine their roles in consumers' payments journey and unlocking deeper financial relationships with consumers. As this payment method gains popularity, there is a need for key players in the transaction value chain to better understand consumer behavior and motivations, present a compelling value proposition, and explore alternative revenue streams. When it comes to Pay by Bank, our Deloitte Payments Practice is well positioned to help you with market research, strategy development, product design and development, operations enablement, and more.

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