Nonbanks in the Payments System: Innovation, Competition, and Risk

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Session 2: Innovation
General Discussion
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Mr. Manfred:

We are now going to take questions from the audience for the general discussion portion of today's program. What I would like to do is collect some questions. Please tell the audience who you are and where you come from, and then ask your question. We would like to have two, three, or four questions and then open those to the panel for discussion.

Ms. Cathy Allen, Chief Executive Officer, Santa Fe Group:

Margaret, your point on payday lending is an important one in this state. We just passed legislation in New Mexico to put limits on payday lenders because we had, for the most part, nontraditional finance companies doing payday lending, and the interest rates were around 400 percent per year for the underserved market. Some of the stipulations on that are, first, it is a much lower cap on the interest rates, it is also when the payday lenders can require loans being repaid, and they can only roll over so many times.

Another part of it is the governor is trying to incent more traditional financial institutions—like BofA—to serve this market and to come up with some way to provide consumer loans or rollovers or bridge loans that will serve this market. There is much need for innovation and not technology innovation; it is, in fact, a policy and a product innovation.

If you could speak a little bit more to that, I think that is very important for the banks in this room to hear what needs to happen. What happened in New Mexico happened in Florida. It is happening in many other states, so it is the states that are going to take the lead on this, which will probably bubble up to some kind of federal position on this.

Ms. Margaret Weichert, Senior Vice President and Strategy, Innovation and Payments Executive, Bank of America:

I will not give any kind of formal point of view about payday lending per se, but I will share a few thoughts about the challenges that banks face in this space. Regulation is the least of our challenges. Litigation, brand impact are real issues—I don't know if anyone turned on the television yesterday, but Lou Dobbs was all over this issue. Given all regulatory oversight and all legal oversight banks face, even though banks comply with all regulations and laws, the potential brand impact of being associated with this underserved population is a risk. First Data, when they owned Western Union, faced some of the same issues. We have to think carefully as a bank about our broader brand.

That said, we are doing a number of things to try to serve that population. We have a program that is designed to drive some of these underserved markets that are heavy remittance users to get "banked," to get basic DDA accounts and become financially connected. We have a program called SafeSend, which allows consumers to send free remittances to Mexico if they have a demand deposit account with us. We also have a secured card program that is trying to provide some of that bridge loan capability. But some of you may know it was maybe two months ago we ended up in the papers because of that program.

What I am hoping to do in this space is learn and figure out how to economically do exactly what Cathy is suggesting without greater brand spillover or litigation or other kinds of unintended consequences.

Mr. Manfred:

Any other comments from the panel on that? Next question.

Mr. Nicholas Economides, Professor, New York University:

I have a question to Ben and René, which is essentially the fact that their main line of business is something different. They added this capability to their business. Generally, I would be concerned as an academic that a payments system gets closely associated with a company. With main businesses, it is really something different, like auctions for eBay or search for Google.

I would be concerned in two dimensions. First of all, are you going to try very hard to steer all your transactions to your particular subsidiary that does this business—that is, the payments system business—and the other way around? If I go to PayPal because I like PayPal, would I have a better chance? Would I be steered in some way to eBay versus alternative auctions by Amazon or Yahoo! and so on?

A very specific question on this vertical merger issue of PayPal: PayPal used to be an independent company; from your business point of view, why was it important that it was acquired by eBay?

Mr. René Pelegero, Senior Director of Industry Relations, Strategy, and Compliance, PayPal, Inc.:

Let me take the eBay piece. As you very well indicated, Nicholas, PayPal was started in 1999 as an independent company and was acquired by eBay in 2002. Since then, we have been working for a closer integration between the services that eBay sellers receive through PayPal. It is interesting to note that nearly 90 percent of all of the eBay sellers that accept PayPal do not accept any other form of payment. That is great synergy and part of the reason why eBay decided to acquire PayPal to begin with.

At the time, you may recall, eBay had its own payment mechanism, but it did not get adopted by the seller community as much as PayPal did. For eBay, the decision to buy PayPal became a very straightforward decision because it was a critical component for them in order to continue growing their business.

Since then, however, PayPal has remained operating as a stand-alone entity. We are a wholly owned subsidiary certainly, but we have been in the payments business since 1999, and all we do is payments. If you walk around the hallways of PayPal, the entire focus is on processing payments and nothing else. We are in a completely different campus, and we have our own management infrastructure. We do nothing but payments, so we are very much committed to that payments space. The folks over at eBay do have their own marketplace space.

If you were to hear one of our corporate presentations, we talk in terms of the power of three. The power of three relates to marketplaces, which are eBay plus a number of other companies of which eBay owns pieces or wholly owns, like Rent.com We even own a small percentage of Craigslist because the concept is just trying to bring people together.

The second part of that philosophy is provided by PayPal, which offers the opportunity for these people who have come together to actually transact.

The third and last part of the equation, which is a relatively new addition to the family, is called Skype, which is another way to connect people together.

So, that is how we look at ourselves. I do not think I have ever seen or heard the comment of us trying to steer somebody to eBay. Our infrastructure is just not set up to do that. As a matter of fact, one of the points we are trying to do is to become less dependent on eBay and to become more recognized across the entire merchant community.

Mr. Benjamin Ling, Head of Google Checkout, Google:

From the Google perspective, Google has been collecting and dispersing monies for more than six years and collecting billions of dollars in AdWords payments and paying out billions of dollars in AdSense payouts.

Although the consumer-facing aspect of Google is search, what Google is really is a combination of a search and advertising platform. That is the key core competency of Google. And one of the core competencies that enable Google to be profitable is the billing and payments aspect.

It is not a well-known fact, but Google collects payments in local currencies from advertisers in more countries than all other companies, except for Western Union. So, we collect money from a variety of different countries and advertisers. We disperse payouts to our AdSense publishers. The same billing and payments infrastructure and fraud infrastructure that we have used for years is the basis of Checkout.

The first answer is the public face of Google is a consumer search company, but really it is a search and advertising platform. And part of the advertising platform is a billing and payments platform, which is core to the company.

The second aspect of the question is, for example, for those using Google Checkout, would we steer them to using Google search? So, Google Checkout is really enhancing Google search. The main idea here, as we alluded to earlier, is to complete the search-find-buy cycle. We basically add to the Google search experience, making it easier to buy. So, Google Checkout is subsidiary to overall Google. The basic idea here is not necessarily to steer Google Checkout users to Google, but it is to allow Google users to complete their tasks that much easier, so they will continue to come back to Google.

Mr. Manfred:

Next question please.

Mr. David Yates, President, Europe, Middle East, and Africa, First Data International:

I listened with interest to René and Benjamin's comments on the amount of regulation they have to wade through in order to establish some of these innovative services. We at First Data suffer from some of those same problems when we try to do global acquiring. One of the things about which I am curious after sitting and meeting with many of the regulators from the United States and also from Europe is would you exhort the regulators to actively go about simplifying these regulations, or would you believe that might stifle innovation? What would you like to see?

Mr. Ling:

From a regulation standpoint, clearly regulation is useful for consumers to protect them against fly-by-night organizations. Some degree of regulation is necessary. In other cases, regulation is written in such a way that it is applicable to certain service providers and not necessarily to all service providers. Some loosening here would make sense and make it easier for innovation to occur.

The key takeaway is that some regulation is necessary. In certain cases, it may not be necessary to apply that regulation to new entrants because they are not necessarily providing service that the regulators believe they are providing.

Mr. Pelegero:

I see the need to simplify regulation firstly to bring about more consistency on how to address some of the same problems in different parts of the world. Innovation in many cases is indeed stifled by the addition of increasingly more complex layers of regulation. At the same time, despite the fact there are good corporate citizens like the folks represented on this panel and other companies out there, there are certainly a lot of companies that do not have the same level of scruples that allows them to take advantage of uninformed consumers, and therefore, some level of regulation, some level of monitoring, some level of supervising is required. But simplification would be a welcome thing for the industry overall.

Ms. Weichert:

I just wanted to jump in from one perspective. The big challenge here around regulation, and particularly when it relates to innovative technologies, is—Ben got it right—maybe some of the regulations were designed for different purposes. At the end of the day, there are risks and liabilities that may be introduced in the system. In the absence of knowing what those are beforehand, we have a nice “simplifying” framework that, if there is a risk that somebody else does not handle it, the banks are stuck with it.

There is a great recent example around ACH innovations. I had a startup business in this space. The banks were stuck with a pretty good amount of fraud chargebacks and returns from fly-by-night operators who were doing TEL transactions. Simplification and clarification are very good things, but perhaps a little scary in the absence of full knowledge of what might come.

Mr. Manfred:

I would address this to all the panelists. There is an inherent problem, it seems to me as an observer, with the rate of innovation and the definitionally trailing aspect of regulation. What we have observed with clients is, How do we fit into existing legal definitions of those rules? Is regulation a suitable tool, given the rate of change? Are there other examples to which we could look?

Ms. Hall:

The other example is in an even worse state than the banking industry, which is the telecommunications industry. This is really an unsolved problem. In many ways, the Europeans suffer from it more than we do because of their regulatory approach on the continent to things. They have to wait for the regulations sometimes to innovate.

Here, we have this problem that the innovations force the regulatory change. The classic example is what happened in the telephone sector with innovations in the 1960s and 1970s. Most of you do not even remember the days when you could not even buy a telephone and hook it up to your phone system, but that was the situation. The technical change basically forced that to go away.

I do not have a solution. It is a big problem. We could get some more examples from the panel. That will not be any problem.

Mr. Pelegero:

I want to add a couple of things to that, as well. We can also look at areas where deregulation has taken place and see the effects. I was at a conference last week, and someone was making the case that, if AT&T – the good ol' Ma Bell here in the United States, the big conglomerate—had not been deregulated and broken up, the cell phone we would all be carrying around today, if we had one, would probably be a big brick block.

The other example is, for those of you who are Americans and live in the States, how many of you flew into town on Southwest Airlines? That is an airline that grew out of the whole deregulatory process back in the late 1970s. There are sometimes good customer implications. It is a very interesting mix. I do not think I am giving an answer to the question, but I am just giving more examples of the constant tradeoff between consumer convenience, consumer benefit, and at the same time the possibility for risk. Certainly, many airlines that were not properly regulated had a number of incidents that also put consumers at risk as well. I am just trying to balance that picture a little bit.

Mr. Manfred:

Scott, do you have a comment?

Mr. Scott Peterson, Senior Vice President, Wells Fargo & Company:

I want to flip the table a little bit. We always focus on how we should regulate these emerging nonbank companies. Let's flip it the other way: How could we deregulate the banks?

We take with great interest the fact that Google now exceeds Wells Fargo in market capital. As our board looks at where we might make investments, let me pose a hypothetical. What would be the policy and consumer protection of regulatory issues if Bank of America were to buy Google?

Obviously, Benjamin and René, you have seen in Google, there are synergies between advertising and payments. And, René, you have shown there are tremendous synergies between online auctions and payments. You have made tremendous market capital price-earnings (PE) strides for your companies with us. Why wouldn't Bank of America be able to buy one of you? What would we have to do from a policy standpoint to make that possible? Wouldn't that be good for consumers?

Ms. Weichert:

Obviously I cannot comment on anything to do with mergers and acquisitions. The deregulation point is a really interesting one. What is fascinating to me, even around Check 21 legislation, was that it took 9/11 and planes sitting on runways for four days with no checks clearing for the United States to change the check clearing rules in a way that did not require check images to clear but at least enabled them to clear electronically.

I do not think I know the answer to Scott's primary question, and I actually look forward over lunch to see if any of the regulators or the central bankers have thoughts because a little less regulation would be good for the banks.

Mr. Manfred:

Luckily, no one appears to have keeled over at this suggestion. Any thoughts?

Mr. Peterson:

The fundamental question is—and it goes back to the gentleman from New York over here—where do you draw the line between commerce and banking? We are focused so much on how those in commerce are getting into banking, but when I raise the suggestion of banking getting into commerce and leveraging our substantial brands in selling other goods, everybody blanches. It seems like a double standard. That is really where the question is coming from. Where do you draw the line?

Mr. Pelegero:

In Europe, as stated earlier by Simonetta, that line between banking and commerce seems to be much more fluid. Tesco, for example, in the United Kingdom is able to accept deposits and issue payment cards. They are in the retail and banking business at the same time.

But here, we seem to insist that banking and commerce should not mix. I don't know if it goes back to regulations that came out of the 1930s and limits that were put on banking institutions as to what kind of business they could go in, but I think after nearly a hundred years, it might be time to revisit those things.

Mr. Manfred:

It was striking when discussing the debit card, in the framework around innovation that we posed earlier, we said this is a very effective device in a given venue. When you bolt on, not as a consumer but as a merchant, the access to those funds, that starts looking an awful lot like an account at ING or any other institution. That was enlightening to me or startling. Do I have a question in the back here?

Ms. Hall:

I have a comment on the question. I do not have this vision of at least the payments systems I see so far that they are very much into "banking." A lot of it is going through conventional credit card transactions. They are acting more as intermediaries that keep concealed the identity of their matchmakers—the identity of the buyer and the seller—the ones we have heard about. They are not actually heavily into banking per se. To the extent they hold money for the buyers or the sellers, then it starts to look a little like banking. But if they are not lending out that money, I would not call what they are doing "banking," I guess. The answer is the boundaries are fluid, and they are doing something that looks a little like a quasi piece of maybe something that banks do, but it certainly does not look exactly like banking to me.

Mr. Manfred:

Question here?

Mr. Philip Lowe, Assistant Governor, Reserve Bank of Australia:

I have two questions. The first one is to Margaret. I often hear bankers bemoaning the growth of Google and PayPal and saying, “We really should have been in this business, and we are losing out in the payments business from person to person.”

You seem to be suggesting that one of the reasons that the banks have lost out, if that is a correct characterization, is your shareholders would not allow you to develop those products. I am wondering whether I have misinterpreted you. If it is really the shareholders who would not let you do it, do you see scopes of the banks essentially fighting back and developing payment mechanisms for person-to-person payments that really can ultimately come to challenge Google and PayPal?

The second question was to Ben and René. They both talked about the very strong growth of Google and PayPal. In the scheme of things, these are both still relatively small payments systems. I am wondering whether you could each talk about the major challenges you see in further growth of these payments systems. Are they really on the merchant acceptance side? If they are, what are the issues there? Or are they on the consumer side of getting consumers to actually use your payment methods? Thanks.

Ms. Weichert:

It is a good question, and my answer is not an "either or." The first part of the answer is, as a business that generates $5 billion of earnings a quarter, our shareholders would not reward us for nurturing a business that was cash flow negative for four years. Nor would they likely support investing the kind of money that a startup like PayPal was able to invest in building a market that, over time, got "hockey stick" adoption. However, the issue is not that we should not have addressed that unmet need, which I actually view not as much as a person-to-person payment need, but a person-to-micro-merchant need.

So, Bank of America has a merchant acquiring business. If BAC could have figured out what PayPal fundamentally did—which is to underwrite a *portfolio* of risk when dealing with these micro-merchants—instead of making them fill out paper forms and put in DUNS numbers, have a five-day review cycle, and then because they haven't been in business for three years, the bank won't take the risk. Bank of America probably could have done something to meet that need differently.

What I really feel strongly about, and that pyramid I showed earlier is critical to it, as banks and particularly as banks of size, we have to recognize who we are. We have to invest in a way that is optimal for shareholder value creation. Niches are hard for large companies of any stripe, forget banks or nonbanks. Niches are going to be harder for eBay, now that they are the size they are, and Google. At least, eBay and Google are perceived by their investors as growth companies. It is a long-winded answer. If the banks had gone at the unmet need as banks, we probably could have done something in that space.

Mr. Pelegero:

I think Margaret is spot-on as it relates to how companies like ours have approached the marketplace. I had been around banks and financial institutions for nearly 20 years before I jumped across the divide and set my feet in the merchants' side in 1999, when I went to run payments for Amazon. The culture is so fundamentally different. That is what is required.

There were a number of banks that entered the person-to-person payment space. c2it from Citibank was one, for example. Yahoo Payments, which was completely underwritten by HSBC, was an HSBC product. So, there have been instances of banks penetrating, but the approach has always been very bank-like.

I remember when I opened up my first PayPal account. It was slick. Bing, bang, boom, done! Going through the whole process for Yahoo Payments at the time required me to page through several areas of nondisclosure, back to the regulation comment, which they have to provide because that is what regulations required.

We take, for example, a very different approach to accepting customers in. The banking industry's general approach is to put in all kinds of obstacles. If you jump across all of those obstacles, they will let you in. PayPal and many of these other newer companies pretty much let everybody in. We believe that, in general, people are going to be good 99.90+ percent of the time. But we have monitoring. We have models in place to identify the bad apples. Once they are identified, we kick them out of the system. A single individual cannot create systemic damage. But that kind of change in attitude is what consumers absolutely love.

We actually make consumers feel loved and taken care of. With some other approaches, you feel that you have to jump through all of these hoops. "Boy, am I privileged that I got an account here!"

Those fundamentally are some of the changes that are required as well. It is not only regulation but also cultural.

Mr. Ling:

To touch on the challenges we face, there is a question of whether there is consumer adoption or merchant adoption. With Google Checkout, we have been around for less than a year. The stunning thing is that merchant adoption and consumer adoption are not the challenges. In terms of merchant adoption, we have already signed up 125 of the top 500 U.S. retailers, or more than 25 percent of the market of the top retailers. We have millions of consumers who have signed up and are using the service on a daily basis. From a consumer and merchant acquisition perspective, this has been relatively straightforward, given Google's market presence in commerce.

The major challenge that Google Checkout has had is helping everybody understand that Google is a partner-driven company. In fact, we are not competing with banks and all of the related payment associations. That has been one of the major challenges, basically convincing everybody in this room that we are not competing with you. That has been significant because as the organization grows, different players become fearful, and we are a very partnership-driven company, as our CEO, Eric Schmidt, has said many, many times.

Ms. Hall:

I wanted to give a couple of bank examples. Part of it is culture, and it possibly also may be accounting, which is to say the way in which accounts are managed. I bank with a large bank. I am an early adopter when it comes to technology and things like that, partly because I was a computer programmer before I was anything else since 1963, which is a long time ago.

Two innovations, which are now older, from the banks' perspective, at least the way I see it, processing checks—particularly prior to 2001—is a cost. It is quite costly, and they should be, in principle, interested in things that can replace this and in getting consumers to use things to replace this.

Of two innovations that seem to be useful for this, one is a debit card, which can be used as a substitute for a check at a lot of local merchants. When my bank decided to introduce it, they associated a charge with this debit card. This is very strange because this reduced their costs, right? So, why should they then charge me? I had a choice—a debit card or a check—so I continued to use the check. This is where consumers' takeup does matter in a sense. Your innovation will not necessarily succeed unless the consumer actually perceives there is a benefit. So, it matters for your choice.

The second thing was electronic bill payment, which many banks first introduced, attaching charges to it. Given it is going to be a cost reduction for them, this does not make a whole lot of sense. But if you do your accounting, thinking of these things as profit centers and the costs are somewhere else in the accounting, you will not necessarily reach the right conclusion with respect to your shareholders. And that may be part of the problem. I am not really sure. It certainly is not a real niche product problem because ultimately these things would diffuse. It may take longer. The shareholders may have a quarterly perspective, which does make a problem for these innovations that take a while to diffuse. I don't think they are really niche. A debit card is not a niche product.

Mr. Manfred:

I would probably argue that charges on “cost savings innovations” are more about the internal business case than about the long-term value proposition because those are very much a reality.

By virtue of the fact that the organizers have put the microphones back in the stand and the signs say zero on them, I think we are done. I would like very much to thank each of our panelists and the audience for some great questions.