Nonbanks in the Payments System: Innovation, Competition, and Risk
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Session 2: Innovation
Moderator Remarks
Moderator: Lee Manfred, Partner, First Annapolis

Mr. Manfred: [remarks correspond with <u>handout</u>]

Thanks very much. I am just going to highlight a few themes from Bronwyn's paper.

First Annapolis research on payments innovation particularly struck a cord with me. I did not put these as major themes or conclusions because I did not want to debate whether they were the right ones. These are just selected ones that I thought were interesting.

I will tell you this is admittedly from a business more than an academic or regulatory perspective. In one of our prep calls, we had an exchange about different forms of payments innovations, at which point Bronwyn said, "Well, you are thinking about that like an MBA!"

I am guilty of that. I am not an academic, but I am also coming at this from a perspective of a dyed-in-the-wool early adopter and one with college-age kids.

You have a handful of slides with First Annapolis' logo splashed all over them. I really wanted to focus on five key themes pretty quickly. The first one is the premise around the general purpose technologies of personal computing in the Internet arena. When we

step back to look at payments innovation, I was struck by the number of payments innovations and the rate of innovation since the creation of the automated clearing settlement networks by Visa and MasterCard, which were fundamentally built based on available, cheap, and reliable telecommunications. "Rate of innovation and diffusion" is a term that continues to accelerate, as we will see.

On page 2 is a framework for thinking about innovations. There are a bunch of these out in the world by a lot of smart people. I chose to think about this in terms of three basic types of innovation, and those are on the vertical axis: products, processes, and what I called "utility." Some would say the third type of innovation is organizational, which frankly did not work for me. I think utility is germane to the discussion.

On the other axis is the nature of the innovation, those sustaining innovations, which continue the existing model, and disruptive or radical innovations, which create a new model. I arbitrarily, and by no means exhaustively, populated the table for example purposes. Reasonable and intelligent minds might disagree with where these are populated.

One of the observations is that some of what I classify as radical innovations absolutely is the product of banks as opposed to nonbanks, the most obvious examples of those being credit cards and ATMs. Many others are nonbank-sourced. On the more sustaining-innovation

side, again, interestingly many of the sustaining innovations—as Stu pointed out earlier—have originated within nonbanks. I am speaking particularly about the risk management area for credit fraud and collection management. These elements have profoundly changed the way that banks do business with their customers.

Product design is another category of what we will call "sustaining innovations." I did want to point out a couple of specific examples that are interesting. In the utility example, we consider PIN point-of-sale debit as being an innovation of new utility. So, we created the infrastructure for ATM withdrawals, transfers, deposits, and the like and migrated that for similar utility at the point of sale.

The other payments innovation that I wanted to point out here is interesting because the creators or innovators of the E-ZPass system do not even think of E-ZPass as a payments innovation. E-ZPass is owned by a consortium—get this—of 24 toll-collecting government agencies, who themselves created a consortium. The statistics are mind-boggling: tens-of-millions of daily users, billions of dollars. The sole purpose is to reduce the infrastructure to put more cars through tunnels, over bridges, and the like. The reason I raise E-ZPass is, again, it is a fabulous technology with wonderful utility that is very difficult to see extended into other payments venues. It works really well at what it does, but extending that into other applications—taking

your little transponder to the point of sale—is a hard value proposition to envision.

The next three points go together. I was interested about the conversation around the network effects, influencing innovation, introductory subsidies to spur usage, switching costs, standards and interoperability in the learning curve. These points help illustrate why some payments innovations are attractive in a given niche, a given environment, but lack the ability to become adopted as a true mass market, general purpose utility and therefore displace current systems.

Third is the concept of radical innovations being more from new entrants. Just being contrary because it is fun to do, I would argue that few of the "radical innovations," particularly recently, are actually so. The vast majority of payments innovation from, say, late 1999 and forward are derivative-type innovations, meaning they are built on or enhanced or sit on top of existing payments structures.

Finally, that consumer-user demand piece. We believe payment innovations are supply-driven. Consumers do not wake up in the morning and say, "Gee whiz, I would love to pay somebody using a text message."

We have to explain how to use it and demonstrate the utility for a particular purpose. Creating that demand and creating its acceptance require creating value across the payments value chain. We tried to illustrate that—and I am not going to go through each of these, but

starting on page 3 are a couple of slides about how we at First Annapolis evaluate for our clients new payments applications.

Those range from innovators to potential investors, as well as legacy companies. Many of the same concepts Bronwyn covered in her paper in more mundane, earthy terms. What we look at is that consumer experience. I boiled these four bullets down to what my mom says, "Why do I want to do that?"

Is it a good deal for the consumer? What is the value proposition? Does it really solve a problem? Or what problem does it solve? Purchases on the Internet is one obvious example of that.

The third is what makes it special. The source of competitive advantage is a big deal. Is the advantage sustainable? So, is it truly better, faster, less risky, etc., or does it merely change the pricing paradigm? We think that is a critical element in evaluating new propositions.

Finally, does it have the legs to make it work? This has nothing to do with economics. Does the company or the innovator have the resources and partners and capabilities to make it work?

My anecdote from Internet Silliness Round One late 1990s-early 2000s was a teen card product, which armed with—true story—$21 million of venture capital was setting out to create a new consumer payments brand. We had a very sobering meeting with them in their conference room where we explained to them that Visa and

MasterCard had spent that much yesterday on promoting their brands … and, oh, by the way, they had been at it for 30 or 35 years. Their strategy was different 30 days later, which is a good thing about that era.

We apply those standards on page 4. Again, this is a simplistic example, but it is an assessment of a micro-payments solution, which said another way is an aggregation tool. Again, do not spend a whole lot of time trying to parse through the numbers because the names and the numbers have been changed to protect the innocent. But the process we apply is to take this new product, this innovation transaction, and compare it with the most likely substitute. What are the other means or the existing means by which a consumer is going to do that transaction? We do that both along economic and qualitative means. This solution addresses the problem of high fixed transaction costs relative to the size of an online micro purchase.

Our analysis of it illustrates two problems. One is that the very proposition is price-driven, meaning it is subject to stroke-of-the-pen risk—that is, the other guy changes his price and the value proposition goes away. The other issue illustrated here is that because it is a derivative solution, the other support functions around disputes and adjudication that are resident in existing systems have not been built into this new application. In fact, the overall experience of the participants is unsatisfactory.

One last point is around banks and nonbanks. The last couple of slides in this deck look at the mobile banking and payments sector, which we break down into two pretty distinct universes: the SMS text-based messages and near field communication messages. We see these as fundamentally different applications—SMS being appropriate for bill payment, person-to-person payments, paying somebody something at a particular time, and NFC being much more like an RFID-enabled card, but for point-of-sale purposes. While both are mobile applications, they represent very different applications.

On page 6, the most interesting discussion is around the networks. The existing payments networks—we have used Visa and MasterCard as examples—that is not an exhaustive list compared with the networks owned and controlled by the mobile network operators.

Our hypothesis at this point—and the fun about being a consultant is you get to make hypotheses—is that the capabilities and the scope of these networks are very different and have different utilities. Therefore, we believe in the near term that cooperation between traditional payments system networks and mobile network operators will be required to make mobile payments robust, user-friendly, and commercially successful in the United States. Together, that has the potential to be very, very powerful. I do not think our existing structures are going away in my lifetime, but I will tell you we are

watching this arena extremely closely because we think it is going to be very interesting.

With that, I am going to stop and turn it over to Ben Ling to talk about his perspective from Google.