THE BROOKINGS INSTITUTION

THE FUTURE OF CONSUMER PAYMENTS: AN INITIATIVE ON BUSINESS AND PUBLIC POLICY DISCUSSION

Washington, D.C.

Tuesday, September 16, 2008

OPENING REMARKS

P R O C E E D I N G S

MR. CHENAULT: Thank you, Bob, for those kind words, and let me also extend my thanks to The Brookings Institution for sponsoring today's conference.

Good morning. It really is a pleasure for me to join you to discuss the payments industry. Now you're going to be hearing several perspectives today from a number of distinguished speakers, and it certainly is an honor for me to be among them. I have spent most of my business career within the payments industry, so what I hope to offer you today is an insider's perspective.

The payments industry that I know is both global and dynamic. It is without a doubt a highly competitive industry, one that is rapidly innovating and evolving. It is an industry that exists in various stages, largely depending on geography. Now in some markets customer needs are simple. Products are basic and providers are few. In other countries, customer demands are greater. Products are high-tech and the competitive landscape is quite diverse. But regardless of its evolutionary stage in any given market, the purpose of the industry remains the same, to facilitate the conduct of commerce and improve the efficiency of day-to-day transactions among consumers and businesses.

Now as we all know, the global environment is evolving at an accelerated pace, not just for payments, but for all businesses. So even though I know my industry well, I also know that to stand here today and attempt to predict the future of payments is an assignment fraught with peril. I'll concede right up front, there is no crystal ball in my New York office. We have no psychics on retainer that I know of. But while I can't predict the future with certainty for you today, I can offer you my perspective on trends that are currently underway across the industry, trends that will likely shape the evolution of payments over the short, medium, and long term. Now before I look ahead, however, I want to first take a moment to look back, specifically to look back to how we became a payment company.

Now while I'm always on the lookout for opportunities to showcase our employees and our company, let me assure you that this history lesson is not intended to be self-serving. It is relevant today because I believe our own history offers insight into how the overall industry has evolved, and how even today it continues to reinvent itself to meet or anticipate the needs of customers.

Now our founders include two names that are well known throughout the business world, Henry Wells and William Fargo. And in 1850 we opened our doors as an express company, a freight company.

We moved packages and currency for people across states and across territories. Think Federal Express with stage coaches; that was us. Now as the United States expanded during the latter half of the 19th century, so did the needs of customers. Goods and materials were not just being shipped between states, but to the rest of the world as well. And in response, we expanded our own corporate geography, setting up freight offices in a number of international capitals. Now as the country prospered, more and more of our citizens wanted to see the world, so we formed a travel agency to help them go overseas. International journeys, whether for cargo or people, had to be paid for. And at this point in history, there was no means of payment that could easily cross borders, so we created our own, inventing both the traveler's check and the money order. By the 1950s customers demanded greater financial flexibility, both at home and while traveling. And as you heard, to meet this need we launched our first charge card in 1958. And we really are proud to celebrate our 50th anniversary, and we are continuing to innovate.

Now as a former history major, I always look for ways to learn from the past. And while I've gained many insights from studying my company's 158-year history, two are relevant for today's conversation. The first is the importance of driving change, not only in your own company, but through your industry. We've shown the flexibility and resolve to reinvent ourselves, adapting to customer needs in a changing marketplace. And given the dramatic pace of change we're seeing across the industry today, this capability is clearly an important asset for any payment company to have.

Now my second takeaway is that at its core, the payment business is dependent on a very basic element and that is trust. Trust that your payment will be correctly handled, trust that your interest and assets will be protected, trust that someone will be there when you need help, whether it's shipping gold from New York to San Francisco, having a merchant accept a traveler's check half a world away, or using a credit card to make an online purchase. Payments is clearly a trust business. Now I want to acknowledge upfront that confidence in the payments industry has eroded over the last couple of years. The credit card industry, in particular, has fallen short of the mark in some of its practices. And any assessment of the future of payments must recognize this. The Federal Reserve Bank and other regulators are working to address specific card practices, and I compliment them on their efforts. As I'll discuss later on, I recognize and support their hard work in striking a balance, and certainly an appropriate balance, to protect consumers without curtailing innovation and competition that exists across the industry.

Now before discussing some of the trends currently underway across payments, let me first offer up some basics on the industry. The term "payments" may sound simple, but it actually covers a lot of ground, and the industry offers extensive choices. Payment transactions can involve a number of parties and take a number of forms, ranging from simple to complex. For a basic transaction between a buyer and a seller, consumers can choose to pay now, pay later, or pay in advance. Within each category, there are many choices of product. For example, if a buyer wishes to pay at the point of sale, they can use cash, which involves only the buyer and the seller. Or they can pay by check, which typically involves five parties: the customer, their bank, the seller, the seller's bank, and the fed. Or they can use a debit card, which involves a seller, a buyer, their banks, a debit network, and potentially a processor or two. Now given the broad array of choice in a typical developed market, it can be hard to track and keep track of what the term "payment" actually includes. So here are a couple of cheat sheets that may be helpful as you listen to our panel of experts this morning. First there are basic product definitions, depending on whether a payment is made now, later, or in advance, covering everything from wire transfers to credit cards, you can see that payment users have a range of options. And over the past few years, I've also added an overlay to this list, that of emerging payments which can cover all types of transactions. Payment companies such as my own, along with other providers and technology companies, are developing new products and access devices that rethink traditional formulas. Online products, mobile devices, and contactless payments to name just a few are responding to or oftentimes leading customer demand. So in many cases, these innovations are improving the ease and efficiency of customer transactions, and they clearly have the potential to significantly impact the industry.

Now another basic fact about payments is the diversity of its participants, and there are many players across the industry from large companies providing multiple products and services to specialty processors who perform a single function. Now here's another cheat sheet of mine, which gives examples of the various parties involved in different types of transactions. In some cases, including the customer and the merchant, there can be up to seven different participants or companies touching a single payment transaction. Now just to provide perspective, here are examples of some larger players within each of these product and processing categories in the U.S., and as you can see, in most cases payment transactions are sliced and diced among many companies and processors. Some have a niche within a specific area of processing and look specifically to expand their volumes and scale. Others focus on the end-user, offering value and services to the payment customer be it a consumer or a business. Now looking across this landscape, ourselves and Discover are the only providers that have a material presence across multiple pieces of any payment chain. Both of us issue products, we acquire merchants, we process transactions, and we operate networks. In our business model, for example, our objective is to serve high-spending, affluent card members, providing them with premium value and loyalty programs and unique merchant offers. At the same time, however, we look to improve our operating efficiencies by growing our volumes and expanding our scale. But an issuer, acquirer, and processor -- being all three -- gives us the flexibility and the means to invest and implement a wider range of innovations and, therefore, meet a wider range of customer needs.

Now that is, of course, just a snapshot of the industry today. Over time, new competitors will certainly join the marketplace, particularly in the emerging areas I mentioned earlier. Already companies such as Verizon, Bill Me Later, and PayPal are adding innovations and options to the industry and to customers.

Now given the global growth underway across payments, there is clearly room for new approaches, and I expect new providers, technologies, and geographies will further expand the marketplace. Now beyond new entrants, I also expect that we'll see more partnering across the industry. Participants will partner with each other to develop new features and technologies that can provide customized services with maximum efficiency. Now some people here today may not view payments as a growth industry. May be you saw announcements from some of my U.S. peers that they were diversifying into other product lines because they consider the U.S. card industry to be slow growth. Now that's one view, but I believe it is a narrow view. It only considers one payment product within a range of product options. It only considers one market across a vast global map. I hold a different view. I believe the payments industry as a whole offers a tremendous amount of long-term potential for reasons that fall into three categories: product penetration, technology, and their geographic presence. Now that's not always a clean break across these growth drivers, but here are some examples of what I'm seeing.

First is product penetration. Even within a developed economy such as the United States, electronic payment products still have a lot of unused runway. Among U.S. consumers, it is estimated that cash and checks still account for more than 55 percent of spending. For U.S. small- and mid-size businesses, that number is 85 percent. Now this translates into two business opportunities. For a product provider like us, it means the chance for increased volumes, particularly in specific industries such as healthcare and in other categories that do not currently accept plastic. For the financial system as a whole, it means the opportunity to further improve processing efficiencies and drive down costs by taking even more paper out of the pipeline.

The second trend that will drive growth in electronic payments is technology, the most significant example of which is the internet. For years futurists have been adamant that we will become a cashless society, one where a swipe or a tap will buy you a newspaper or a morning bagel. The payments industry as a whole is clearly making strides in this direction. But consumers aren't concerned with meeting what the futurists say is going to happen. There is certainly a significant number of product pilots that we have seen over the last few years, but consumers still remain committed to cash for certain purchases. Just as the futurists of 50 years ago thought we all would be in flying cars by now, a cashless society is another prediction that seems to be falling by the wayside. The exception to this is the one truly cashless society that exists today, and that is the virtual world. Cash and checks are essentially non-players when it comes to the internet. So anyone conducting business online is automatically driving the growth of electronic payments. Online commerce will continue to grow robustly over the next 5 years, albeit at a somewhat slower rate than the adoption years of the late 1990s. And this growth in online spending will clearly drive growth in payments. Now here's one example from the U.S.: In 2007 U.S. retail consumers spent $150 billion online, a large number, but still a small proportion of their total spending of $4 trillion. But while cash and checks still account for the majority of consumer offline spending, as I noted before, their online spending is 100 percent electronic. With online purchases expected to grow at a compounded rate of 19 percent between now and 2012, the opportunities for payment providers will expand significantly. Now this sizeable business opportunity is attracting a significant number of new players into the field, with retailers themselves, real-time credit products, and companies such as PayPal joining traditional credit and debit providers. The competition is bringing innovation, efficiency, and growth in the payments marketplace, something we will all benefit from.

The third trend that will drive the growth of payments over the medium- to long-term is geography. While certain developed economies have been using some form of electronic payment for years, a number of significant economies continue to be primarily cash centered. Among this group are the BRIC countries, which offer the broad opportunity of high economic growth along with specific opportunities in payments. Economies evolve differently as they develop, and that will no doubt be true for a number of these cash centric markets. For example, new technologies may make it possible for countries such as China or India to skip steps taken by Western economies. Instead of progressively moving from cash to checks to plastic, advances in wireless telecom may allow them to vault past the need for a physical card or check and go straight to the electronic account number. But while their devices and means of access may differ from other markets, I believe their overall development will follow a consistent trend. Even allowing for differences in culture and technology, this trend is quite clear. It has consistently been seen that as per capital GDP increases within a country, the number of electronic payments rises substantially. As a country's educational levels rise, as personal income grows, as technology becomes more available, the use of electronic payments expands, all of which highlights the growth potential of the markets on the left side of the chart.

Now as a payment provider, I look at the size and scope of this opportunity. I want to attack it immediately. But then I quickly recognize that income growth alone will not be sufficient to drive growth in payments because as I said a few minutes ago, the payments business is not just about transactional capabilities. It also depends on trust. Businesses and consumers are not going to generate the level of growth implied here without a strong level of trust. And not just trust in payment providers such as ourselves, but also in a wide array of people and institutions, including taxing authorities, the banking system, the currency market, and regulators. Moving away from a cash-based economy requires a basic level of government and corporate infrastructure. It requires a popular belief in the equity of national policies and their fair implementation. Without these basics in an economy, even the most innovative payment products will have trouble competing with the age-old cash under the mattress. But more important than the impact on the payments industry is the greater impact on the country itself. Without trust in the basics, economies can be hampered, the potential of a society will be limited, and individual growth and productivity will be restrained. Now this trust is essential. It is a prerequisite to generating and sustaining any degree of long-term economic growth. And as someone who heads a large global payments company, I spend a lot of my time on technology investments, processing costs, and telecom capabilities. But one of the most significant roles is I am the steward of our brand. Given our long history, we have a unique legacy to uphold, a legacy of service, quality, and integrity. And as a result we place a great deal of importance on this fundamental idea of trust. My view is that while the global payment system must be open and flexible enough to allow for many different players, it must always be based on integrity and trust. Payment providers, therefore, must be accountable for living up to relatively high standards. Providers who undermine trust clearly limit their own growth potential. For example, I don't believe a company has much of a future if it earns the majority of its revenues when customers make a mistake or don't conform to a rule. Gotcha pricing is not the way to build a long-term sustainable business model or to maintain long-term customer relationships and trust. I believe a company's long-term health is only assured when customers receive value for their money and feel they are treated well. At our company we do not take action -- we do take action, I want to be clear here, when customers fail to pay their accounts on time or they bounce a check. We don't think that's good behavior. But as I said earlier, because of our brand and our desire to retain customer relationships, certain practices don't make the cut, for example, universal default. This is a practice of raising the interest rate for a customer on your own product because they are delinquent in paying someone else. They remain current with you, but their rate gets raised because of problems with another lender. Now a number of companies adopted this practice and generated higher short-term revenues as a result. But we made a conscious choice several years ago to not implement this practice across our card base. To us it just didn't feel right. Universal default and a number of other practices have attracted criticism to the industry. And as an industry, we must respond to these criticisms if we're going to restore the trust necessary for a healthy marketplace that can foster innovation and long-term growth.

Government plays a crucial role in bolstering public confidence by maintaining a reliable and balanced regulatory framework. As industries change and evolve, so must this framework. Now an example of this is the work currently underway at the Federal Reserve and other regulators to update rules governing the credit card industry and to strengthen consumer protections. Now we may not agree with all the proposals being considered by the fed, but we do recognize why they're taking actions, and we support their efforts. The new rules being proposed by regulators are sweeping, and they will make the most important regulatory change for our industry in at least 25 years. It is our hope that these changes will bolster trust, trust in the regulatory system, and trust between consumers and payment providers. We believe regulators recognize the need for balanced action and the industry's concerns about unintended consequences. We believe the fed will be open to industry comments and that their final guidelines will appropriately protect consumer interests, while at the same time supporting appropriate access to credit within a competitive marketplace. Now our mutual goal needs to be to stop the abuses that exist today. Strengthen consumer confidence, and to do so without impeding the growth and development of innovation, choice, and value that will benefit consumers in the future. Now I believe the payments industry is at a very exiting point in its evolution. It's a journey that has been characterized by ongoing innovation, heated competition, and high customer expectations. The industry also has enormous breadth. It's not a pure standalone business. Yes, it has its own products and issues, but at the same time it's imbedded into multiple industries across multiple markets and used by multiple customers for almost every type of commercial transaction that exists. The breadth and diversity has attracted vast numbers of providers, ranging from large global companies to local banks and credit unions. Trillions of dollars, Euros, Yen, and RMB get transferred and settled each year. And across the industry, payment systems operate with exceptional efficiency and provide strong value to customers.

Now some providers offer low-cost and large-scale, others offer high-value and service. Some, like my own company, are combinations of both. Now given this range of products and providers, I believe it is a misnomer to call the payments industry a commodity. The term "commodity" implies a sameness that just doesn't exist. It implies mass production and low-value add. The global payment system that exists today is far from a commodity. Today's system is a facilitator of global commerce. It is a driver of business growth. It is a means of developing national economies on behalf of all citizens. For all these reasons, I believe payment systems should be viewed as economic assets, not as utilities. To insure the future growth and continued innovation, the industry should remain open and not restricted by inappropriate barriers. Regulation will occur, but the regulatory approach to payments should be one that sustains trust, while at the same time encouraging productive value-added growth on behalf of consumers. This industry clearly has a great deal of untapped potential, and I am very excited about our opportunities to realize this potential, and I look forward to the challenge. Thank you.

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

/s/Carleton J. Anderson, III

Notary Public # 351998
in and for the
Commonwealth of Virginia
My Commission Expires:
November 30, 2008