MEETING A CHANGING PAYMENT SYSTEM

by Steve Brown

Lending and borrowing can sometimes be a controversial monetary exchange between two participants. While lenders seek return on their capital, some have even argued that charging interest is immoral. We agree that in today's low interest rate environment, the return on all asset classes is immoral, but for less obvious reasons. In the beginning of human commercial transactions, people bartered. These early transactions were complicated and lending and borrowing had impracticalities. In fact, the first recorded use of coins was around 600 B.C. by the Lydians. The use of money made exchange, storage and measure much easier. After the use of coins, humans developed checks, then paper bills, then plastic and now electronic money. The benefit of paying with plastic is many, including the need for less cash, the ability to keep more savings in interest bearing accounts, convenience and safety. In fact, many small businesses have been financed primarily through the use of plastic payments (or payment cards). Payment cards are only useful when consumers are willing to use them and merchants are willing to accept them (called the two-sided platform). The first payment card was issued in 1949 (Diners Club) and was issued free to cardholders. At that time the card was accepted by only 14 New York City restaurants. Before Diners Club, vendors issued cards to customers that could only be used at the issuing vendor's business. Today, two issuers dominate the payment card industry - MasterCard and Visa. The value of their network is a function of the number of people using their cards and the number of merchants that belong to the network. The barriers to entry are enormous, since users want payment cards accepted by many merchants and merchants will only accept cards held by many cardholds. Both MasterCard and Visa are deeply entrenched. Visa and MasterCard are "co-optitives" in that they both cooperate and compete against each other. They compete in obvious ways and cooperate when it comes to contract payments, fee processing and setting standards and rules. In contrast, American Express is outside of the MasterCard/Visa co-optitive. For example, Amex differs in that it does not offer much in the way of revolving credit. Despite all of this evolution over time, payment cards are undergoing yet another transformation. The electronic fund transfer (EFT) network can process PIN debit transactions without a physical card. This calls into question the need for plastic cards at all. Instead of plastics storing personal information, consumers can use PINs, biometric systems and/or smart phones to verify identity. American Express has already introduced smart cards with embedded computer chips - however, the chip still resides in the Amex blue card (instead of in an Android or Apple phone). The benefits of consumer electronic funds transfer are many. Transactions can be accomplished without contact, as merchants do not need to swipe cards and you do not need to roll down your window to make a payment driving through a toll booth. Arguably, security can be enhanced through biometric verification. Upstarts that could never challenge the payment card networks are winning customers by disrupting the industry through consumer electronic transfers systems. While there are approximately 5B payment cards in the world and only 2.5B cell phones, the proliferation of the latter is much faster. In fact in many developing parts of the world, adoption has gone from paper currency directly to electronic funds transfer payment, bypassing payment cards almost completely. In a rapidly changing m-commerce world, MasterCard, Visa and Amex will be challenged to maintain current market dominance.

BANK NEWS

More Fed Action

The FOMC in its minutes indicated it would likely announce a new bond buying program in Dec. to replace Operation Twist, in an effort to increase jobs growth.

Competition

Bank of America has launched a competing product to Square called Mobile Pay on Demand. The service allows small businesses to swipe credit cards using smartphones.

Settled

A subsidiary of Bank of New York (Ivy Asset Management), agreed to pay $210mm to settle lawsuits that claimed it concealed warnings Bernie Madoff was a fraud when it gave advice to clients that invested with him.

Expensive Cities

A report by Bankrate.com finds the five most expensive cities in the U.S. in order are: San Francisco (median monthly costs of $2,497); New York ($2,069); Boston ($1,834); San Diego ($1,746) and Washington, DC ($1,735).

Life Events

Research by Forrester finds 43% of people are more likely to purchase a financial product around so-called life event such as marriage, having a baby, buying a business, changing jobs, retirement, etc. If you can figure out when that is likely to happen you might be able to boost sales and cross sale opportunities.

Unethical Behavior

Back in 2007, a Goldman Sachs commodities trader reportedly hid an $8.3B position that caused the firm to lose $118mm. The trader reportedly fabricated trades and then obstructed the firm's discovery of the issue. He admitted his misconduct and was fired by Goldman, but was just named in a complaint filed by the CFTC in federal court.