

Call to Action: Finding Your Way in a Changing Payments Ecosystem
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Hello and Welcome.

The card industry is undergoing enormous upheaval. Everyone in this room faces risks. Your businesses may be decimated. Your jobs may disappear.

But you also face incredible opportunities:

- to find the next growth path for your company;
- or to start a new venture of your own.

Some of you will make a lot of money during these years of creative destruction. For many of you, though, the next few years will be like going whitewater rafting. Your mission is to get to the bottom of the rapids, perhaps a little wet and bruised, but intact and feeling just great.

Now, many of you are also going through massive turbulence that comes from outside of the card industry. The subprime crisis is a tsunami that's sweeping through the banking and finance industry. More than 150,000 employees were let go in 2007. Last year, Wall Street wrote off more than \$90 billion in bad debt. The five largest banks saw their profits drop more than 60 percent. This financial crisis has a major effect on how you do your jobs. Some of your employers might even have balked at sending you to this extraordinary event this year.

I don't want to focus on the subprime crisis in my talk today. Like all financial crises it too shall pass. But when it does, the ground will still be shaking underneath your feet because you live in the payment card industry.

Today, I want to talk about the risks and opportunities from **three key sources** of disruption that will have a profound impact on how well you navigate the rapids ahead:

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| 1) The death of the associations. |
| 2) The rise of the web economy. And, |
| 3) The aging of the credit card that has been the industry's cash cow since the early 1980s. |

Then I want to close with some advice on how you can take advantage of the wonderful possibilities that are before you—and how to avoid some of the common pitfalls of conducting business in an industry that is undergoing rapid and disruptive change.

First, though, I want to give you a tour of what's happened to the payment card industry since the last Card Forum.

Change was the big theme for 2007. Lots of restructuring of payment card businesses. Lots of changes in financial relationships. Lots of new things.

Last April, First Data Corp went private. It's been undergoing a turnaround under the hands of private equity firm KKR for the last year. It even brought in a high-powered CEO Michael Cappelas from outside the card industry.

Three months later Morgan Stanley finally spun off Discover.

Then in September First Data spun off Western Union.

And just before Christmas, Synovus let TSYS out of its nest.

The biggest change of all came of course last month when Visa finally did its IPO.

There were also lots of big acquisitions.

The trend towards bank consolidation continued.

Last April, Bank of America plunked down \$21 billion for LaSalle. It picked up Countrywide earlier this year. Wells Fargo also bought Great Bay for \$1.4 billion.

FiServ picked up CheckFree for \$4.4 billion

And American Express beefed up its corporate card business by buying GE Money for a bit more than a billion.

The year has also seen a lot of partnerships between the upstart payment firms and the traditional ones.

Vivotech has been the energizer bunny, I think. It has gotten big guys like FDC, Nokia, and Citi, to partner with it, and its partnered with some of new kids on the block too.

Citi made a significant venture into the mobile payments world by partnering with Obopay and more recently working with Firethorn to bring credit card balances to the mobile phone.

Amazon hooked up with BillMeLater, the online credit alternative.

The last year has also demonstrated how tough the payment card business is to crack. We had some fatalities. Much ballyhooed micropayments startups like Bitpass and Peppercorn cratered. As did the biometric play Pay-by-Touch.

We've also had our share of hype this past year. Is there anyone that didn't announce a mobile payments initiative?

My guess is that the amount of money that payment card businesses have spent on their PR teams vastly exceeds the amount of sales that will get transacted on any of these initiatives anytime soon.

2007 may also be the year in which reality caught up with the hype for contactless. One sign .. American Express ditched the fob. I guess that people weren't excited about carrying a hunk of lead that they could only use to pay at a miniscule portion of merchant locations.

There were some major innovations on the product side last year.

Capital One sprung its decoupled debit card last summer. HSBC did too—in its case working with Tempo which used to be called Debit Man.

Finally, 2007 was the year of the data breach. The year began with TJ Maxx compromising data for almost 100 million account holders and ended with Her Majesty's Revenue and Customs compromising 25 million records.

Between this and all the advertisements on television about identify theft, we've succeeded in getting the consumer a bit freaked out.

So, with that as a backdrop, let's examine the three disruptions that I mentioned will shape – or shall I say – reshape the payments world over the coming years.

Disrupter Number One: Death of the Associations

The last two years have seen the death and reincarnation of the bank card schemes.

For roughly 40 years, from 1966 to 2006, MasterCard and Visa were associations of banks. The card networks did a bunch of things for their bank members. The banks paid for these services through fees. But the card networks operated on a more or less breakeven basis. No public

ownership. No quarterly earnings to the street. No mandate to make profits for themselves—only to help their bank members become wealthy from cards.

The bank card associations are now dead and buried. Each has been reborn as a publicly owned, for-profit corporation. Banks are still involved--but less so. And it isn't clear how much longer banks will have significant control.

MasterCard and Visa have the same names. They are still the two gorillas in the payment card ecosystem. But make no mistake. These are new gorillas. And there is every reason to believe that they will act much differently than the old gorillas that died at the IPOs.

How did we get here from there?

Let's be clear on who killed the two old gorillas. The merchants did it. But they weren't alone. Senator Sherman who authored the Sherman Antitrust Act of 1890 helped; so did some class-action plaintiff attorneys. Not to mention the U.S. Department of Justice.

Here's what happened.

The antitrust laws are suspicious of associations of competitors. The merchants have used that distrust to argue that the banks conspired to fix prices because it is the associations that determine the interchange fee. The merchants have an enormous antitrust case against MasterCard and Visa that's winding its way through the court system. Every year the case went on the associations were accumulating many billions of dollars of potential antitrust damages. They believed they could limit their antitrust liability by becoming publicly owned companies instead of an association of banks. You might think that makes no sense. But keep in mind that American Express can charge merchants whatever it wants without facing any antitrust issues. It's just the way it is. So, in essence, the old gorillas committed suicide to limit their exposure to these lawsuits, and turned their power over to new gorillas.

Let's look at the new bosses.

MasterCard did its IPO in May of 2006. Its success has astounded just about everyone. Its stock price has soared more than 500% since it opened at \$39 per share. Visa was smart in waiting because it had about two years to learn from its little sister's experience.

Visa IPO'd at \$44 a share about three weeks ago. Today, MasterCard has a market capitalization of almost \$30 billion and Visa has a market cap of about \$52 billion. So how are these new gorillas going to behave differently? We have more almost two year's worth of experience now with MasterCard. So let's take a look.

MasterCard hasn't made any big acquisitions. But it has more than 100 products in development. Many of these are focused on new ways for credit and debit cards to replace cash and checks. They've put a lot of effort into contactless with PayPass. That includes getting into new channels such as vending, parking, and airport concessions. It's trying make up for its laggard position in debit.

Lastly, it's making a big push into payments for B2Bs.

So, here are the implications:

Life is going to be a lot different with these new gorillas for several reasons.

First, the new gorillas have a boatload of cash. Like any publicly owned company they are going to use that cash and their new equity currency to buy things that help satisfy the Street's desire for growth. I think what they will go for are businesses that help them serve their primary customers—the banks. So that means processors and acquirers. And it means companies that can help them use the vast stores of data they collect.

Second, the new gorillas don't have the same loyalties as the old gorillas. They care about banks insofar as they are viewed as customers. But they will steamroll right over the banks if that's the right strategy for maximizing the value of their firms. We've already seen this with MasterCard. It's the engine for Capital One's decoupled debit card program. Can you imagine the old bank card association doing this? The bank-controlled board would have booted any CEO who even suggested this out into the street. There's a new 21st century term to describe this new business relationship—it's called "frenemy". That's when someone you do business with is both a friend and an enemy. If you are with a financial institution, MasterCard and Visa are your new frenemies.

Third, the new gorillas are always up for sale. This is an important point. It would have been very hard for anyone to have bought the old gorillas. But the new ones are publicly traded companies where the board has an obligation to consider the financial interests of shareholders. Microsoft made an offer to buy Yahoo for \$46 billion. They could buy MasterCard and have a few billion dollars in change left over. There are lots of things that could happen with MasterCard and Visa that would be transformational for the industry. They could be bought by a large bank like Bank of America, by a foreign card system like China Union Pay, or by an internet giant such as Google.

So what's going to happen over the next year or so with our new gorilla frenemies? Here are some things to consider.

First, I think you are going to see more action coming from MasterCard than Visa. It takes time to transform these organizations and MasterCard has a head start at living the life of a publicly

traded company. My guess is that you'll start seeing MasterCard start thinking seriously about major acquisitions in the next couple of years.

Visa isn't even a month old as a publicly traded company. Moreover, it has undergone a much more complicated transformation. Unlike MasterCard, it had to roll up a bunch of foreign fiefdoms and integrate them all into a firm organization.

Second, you are going to begin to see some action on the interchange fee lawsuits. These are a big, big deal for the payment card industry. If MasterCard and Visa lose these cases they could end up paying more than their current market capitalization in damages.

Remember I told you that they killed two old gorillas to escape antitrust liability? Well in late February a court concluded that the plaintiffs had a case for arguing that the new MasterCard gorilla is still liable. It will be a long time before this case gets to trial. But before then the court will rule on MasterCard and Visa's motions for summary judgment—essentially, to toss the merchant case before it even gets to a jury. If they win, their future is rosy.

The plaintiff lawyers will also file motions to certify the class so that they can represent all 4 million or so retailers. If they win that MasterCard and Visa will have a loaded shotgun pointed at their heads. At some point someone may blink and the new gorillas will reach a settlement with the merchants. The question is how many billions it will take to end the lawsuit and how low the card systems will need to take the interchange fee.

Third, watch what goes on in Europe. Visa Europe decided not to join the new Visa Empire, but to remain as a separate fiefdom. It is to Visa what Canada is to the United Kingdom. Except I doubt the head of Visa Europe would bow to Joe Saunders.

MasterCard's European operation on the other hand is tightly integrated into MasterCard. Some other dynamics are playing out across the pond. The Brussels antitrust regulators are mounting an attack on interchange fees. Those fees are in serious jeopardy in Europe. Yet they are the source of almost all of the profits from debit cards in most countries.

Visa Europe thought they could convince Brussels that they were home grown if they weren't part of an American-based Visa. But it isn't clear that Brussels is going to bite on this. Meanwhile, the European regulators have encouraged the creation of a new pan-European card system, a European Champion they can call their own—like Airbus or the BBC. One has started to organize itself. Whether it can crack the chicken and egg problem and fight entrenched competitors remains to be seen.

Disrupter Number Two: The New Web Revolution

Let's now talk about the second disrupter: The new web revolution.

Back in the late 1990s many seemed to think that the Internet was going to turn the world upside down. The dot.com heavy NASDAQ was filled with companies trading at 44 times earnings. And quite a few at infinity times earnings since their earnings were zero. VCs were throwing money like candy at companies with names like Boo.com, Kozmo.com, Yadaydayada.com and 360hiphop.com. The idea that you'd be buying everything from your milk to your appliances on the web didn't seem at all farfetched.

And lots of companies tried to create their own currencies for the web. Who needs cards when you can just pay with Beenz or Flooz?

That was all wrong of course. The dot.com bust wiped out \$5 trillion of the value of the Nasdaq traded companies. Thousands of Internet startups died. Many realized that these companies didn't have any idea about how to actually make money. And people understood that ideas that sounded good on paper didn't work in the real world.

Who wants to buy 50 pound sacks of dog food over the internet? And building warehouses and distributing these sacks, the old fashioned way, wasn't really the forte of the software savvy dot.com pioneers. Selling physical goods over the internet turned out to be more problematic than buying the latest Mariah Carey jingle from iTunes.

Seven years later a couple of things are very clear. The Internet really is going to turn the world upside down. It is one of the most profound technological changes to come about in the last century. And it is behind a wave of creative destruction that is making new industries and destroying old ones. Just look at the newspaper industry. This centuries-old industry is cratering as eyeballs and advertising flee online. But here's the other point. It takes a long time for technological changes to work their way through the economy. Electric power was introduced in the late 19th century. But the impact of this innovation echoed for many decades. The same is true for the internet. Be patient, it will change so much.

So what is it about the web revolution that you need to know?

To begin with, there are mobile phones. Most mobile phones will have a fast internet connection and a browser interface in a few years. Think iPhone. People will be constantly connected to the web. In many countries such as India and China the mobile phone will be the major entry point to the web for most people. Lots of business and personal activity will start taking place on mobile phones. Most mobile phones will have GPS and mapping software that will enable businesses to exploit complementarities between having a web presence and a brick and mortar presence. People will be able to search for the nearest fast-food joint. McDonald's will be able to not only give people directions but also give the consumer a bar-coded coupon for a discount on a Big Mac. The mobile phone will integrate advertising, product search, locational search, and the distribution of promotions.

There's one piece missing in this story and that's where you come in: the mobile phone will be the logical device for payments. People will use the web browser on the phone to pay for things online. And that might be enough to get things offline—they'll just pay online and show their receipt to the merchant. More likely, the world will move to where Japan and Korea are today: the mobile phone will become the form factor by which people make payments at the point of sales—maybe that will be through contactless chips in the phone, maybe it will be by something else.

This isn't around the corner in the US because the mobile phone ecosystem is currently highly dysfunctional. But things will sort themselves out in the next few years.

Let me make an important point here: this will lead to a massive disruption in the payment ecosystem. It provides an opportunity for new card systems like PayPal to get into the market generally. It also enables banks to buy top of wallet. Banks will be able to do deals so that their cards have the leading position on the mobile phone—maybe the only position. And it is likely to lead to the elimination of mag stripe readers at the point of sale. In fact, this is what would ignite the foundering contactless initiative. But don't be certain that contactless chips will become the standard technology on mobile phones once all this gets sorted out. That's too soon to know.

So who has a FaceBook page?

Leave your hands up. Who has a MySpace Page? Leave your hands up. How about any other social networking site like Linked In? I'm surprised at the low turnout. You all look so young.

So who has a kid with a FaceBook, Friendster, Bebo, or MySpace page? Many older people can't understand what this is all about. And many people tend to dismiss social networking sites as just places where kids put up embarrassing pictures about themselves. In fact, social networking is one of the most disruptive and exciting technologies to come out of the web revolution so far. It is displacing many other ways in which people used to interact including email, instant messaging, and phone calls. Social networking sites have become major destinations on the web.

MySpace is now the third most visited website in the United States—ahead of eBay, Amazon and YouTube. People are now just using this technology for more grown up purposes. MPD's President, Karen Webster, launched a social networking site in October, called livingconversations.com, for people who have been diagnosed with breast cancer to talk to breast cancer survivors many of whom are over 40, 50, or 60. These vertical social networking applications have become tremendously important. One of the companies we work with assembled a community of 3.5 million users on Facebook in the matter of months for a

marketing campaign that it was engaged in. Social networking will change many facets of life. For now, you guys ought to think of its possibilities for engaging in creative marketing to young people.

Data is key to almost everything that's going on in the web revolution. Google, eBay, Facebook, Amazon, and others have invested hundreds of millions of dollars in server farms all over the world that process all the data that's behind interactions on the web. The data they collect are immensely valuable.

Take Google. It has computers that read and index the entire web every day. It uses those data to make it easy for you to search for anything imaginable. And it saves and stores the data on all the searches you've done in the last 18 months. So it's learned a lot about you. And then it uses those data to help advertisers target ads to you when you search.

And Google isn't alone. Almost everyone in this room has multiple "cookies" on their computers that are tracking every web site you go to and those visits are being stored in a computer somewhere. The mission of Google Checkout is to collect data on what people are buying where. That enables Google to sell more targeted advertising to merchants at higher prices.

What does this have to do with you?

The payment card industry is sitting on a treasure trove of data. A lot of these internet companies would love to have those data. And frankly, they are really smart about how to eek great value out of mountain of data.

So, what are the implications of the web revolution to you?

First, it is a marketing channel. It enables targeted and efficient ways to reach your customers and to find new ones.

Second, the web-enabled mobile phone is a revolutionary form factor for paying for things.

Third, the web provides tremendous opportunities for innovation. There are lots of ways you can use it to develop new customer relationships. Social networking is just one of many new methods for creatively reaching out to customers.

Fourth, the web is a revenue channel. It provides new opportunities for acquiring and retaining customers.

Fifth, the web provides an extraordinary opportunity for you to monetize your data.

What does this tell us about the future?

I'd like to highlight just two things.

First... data. There is going to be a gold rush for transaction data. Payment card businesses are going to be thinking of creative ways to make those data more useful to merchants. They could always have done that. But the web has made “data analytics” cool. And everyone with any smarts is looking into this. But frankly those data are even more valuable to companies that do targeted advertising—like Google, Microsoft, Yahoo, AOL, and ValueClick to name a few. And those companies have more smarts on how to use those data to help merchants. They are going to be looking at ways to get those data. Google and eBay are doing it by setting up their own payment gateways. But someone may decide that it is better to buy than to build. My guess is that Google would pay MasterCard's market cap today just to get a data feed from Purchase.

Second ...the mobile web. The other point is that the mobile web is the killer application for the mobile phone. Imagine the iPhone 3.0. Now imagine the iPhone 3.0 with the ability to pay at the point of sale. And everyone is carrying a web-enabled phone just like this all day long. My guess is that this world is at least 5 years away, maybe more in the United States, but that is almost certainly going to be the world a decade from now in this country and sooner in other parts of the world.

Disrupter Number Three: The Aging Credit Card

Okay, so much for the future. Let's turn to the cold harsh reality of the present.

Many of your businesses have made their fortunes from the credit card. The credit card was a brilliant innovation. It bundled a payment method with a financing method. It had a tough childhood though. A lot of states had interest rate caps in the 1970s at the same time interest rates skyrocketed during the Carter years.

Credit cards took off like wildfire in the early 1980s in the United States. But they've gotten kind of old. There's intense competition among credit card issuers. There are limited growth opportunities. Everyone who wants a card pretty much has one. Young people seem to like debit cards more. And people aren't racking up credit card debt like they used to—maybe they will now that they don't have any home equity to tap into; maybe they won't if they are already knee deep in debt. But there's no doubt that profit and growth for credit cards has slowed.

It's a fine business. But it is a mature one. It is also attracting a lot of regulatory attention over cardholder pricing, and lots of regulatory and legal attention over merchant pricing. Then of course there are debit cards. These are growing like gangbusters. People obviously like having plastic that doesn't entice them to rack up debt. These have been a good deal for banks. They get interchange fees, plus debit cards are a nice convenience to offer checking account customers.

There are a couple of problems here. One is decoupled debit. Banks can issue debit cards that access funds held at another bank. And earn interchange fees on them. So banks can't be sure that they will earn interchange fees from their checking account customers. The other problem is that dagger that is hanging over the payment card industry—interchange fees provide the only significant direct revenue stream for debit cards and that stream is under serious, serious challenge.

Finally, prepaid cards are exploding too. But so far the lion's share of the benefits has gone to merchants using closed loop systems and not banks using the open loop system.

What's the implication of all this?

First, banks should be looking for a new cash cow to milk. Let me mention a company you all know that has been brilliant at finding new ways to make money.

American Express started in the mid 19th century as a pony express company. That wasn't such a great business to be in as the country developed an efficient mail and transportation system. Then in the early 20th century it invented the travelers check just in time for the boom in travel. It developed a new cash cow with its charge card in 1958. And it has grown it from there with innovative programs like membership rewards. So this can be done.

Now if I knew what the next cash cow was I wouldn't tell you. At least not without charging you a lotta money. But, I will share some thoughts with you.

Second, you should take an inventory of your core assets—your customer relationships, your data, your merchants, your lending savvy, and your marketing skill.

And, third, you should take a look at how you can capitalize on those assets in this new world of changing technologies and customer preferences. One of the new buzz words in the webosphere these days is “mash up”. You might want to think about mashing up credits card, customer and merchant information, advertising-supported media, social networking, and other innovations that are taking place these days.

Advice for 2008

I'd like to close with four pieces of advice for the next year.

First, leverage what's cheap. Many of your firms don't have a lot of cash hanging around these days. My guess is many of you had trouble getting your banks to pay for your plane tickets. And don't even think about submitting those minibar charges this year. This isn't the year for big ticket items. But there's good news with the web. It is really inexpensive to mobilize the web. Almost everything you'd want to do can be done with open-source programs that are essentially

free. There are a lot of new ventures out there that would find many of you attractive strategic partners. You should think about having relationships with some of the creative firms that could help with some of the mashups I've mentioned. This isn't the year to get married though. Do lots of dating.

Second, don't fall for the hype. Whenever markets are changing rapidly there's hype about the great new thing. That's because everyone knows there's going to be a great new thing. Look at Google or Facebook. The problem is knowing what it is going to be. The poster child for caution is Pay By Touch. You know, that payment system that started up a few years ago and attracted hundreds of millions of VC money, some \$300 million to be exact. Clever idea. You associate your fingerprint with a payment method. And then you pay at the point of sale by pressing your finger to authorize and be authenticated. But think about this. To crack the chicken and egg problem Pay By Touch had to persuade merchants to install new expensive point of sale equipment, and they had to persuade cardholders to switch to a new form factor. There wasn't enough value for merchants or cardholders to get either side on board. Pay By Touch hit the skids. And its marquee customer—Piggly Wiggly—just gave it the finger so to speak.

Third, don't hide under the covers. You might be tempted to just pull the covers over your head and see what the payment card landscape looks like in the morning. That's an understandable reaction. There's so much turmoil in the business it is hard to know what the right next step is. Unfortunately, few of your businesses have the luxury of just waiting it out. The next five years will see a radical transformation of this industry. You have to decide what you want to do, who you want to ally with, and where you want to fit into the new industry. Hide and you will die.

And lastly....don't forget what's made you great. You have been part of one of the most innovative industries of the 20th century. It is one that was built on solving complex data processing problems—and in coordinating millions of merchants and consumers throughout the world. Politicians and consumer advocacy groups complain about this industry. And sometimes they have legitimate grips. Most of the businesses in this room though have made money by offering great value to cardholders, to merchants, and to the other stakeholders in the payment card industry.

Keep on doing that and you will navigate your way through this beautiful storm that has engulfed the payment card industry at the beginning of the 21st century.

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