

Paradigms Lost¹

The Art of Managing Payments in the 21st Century

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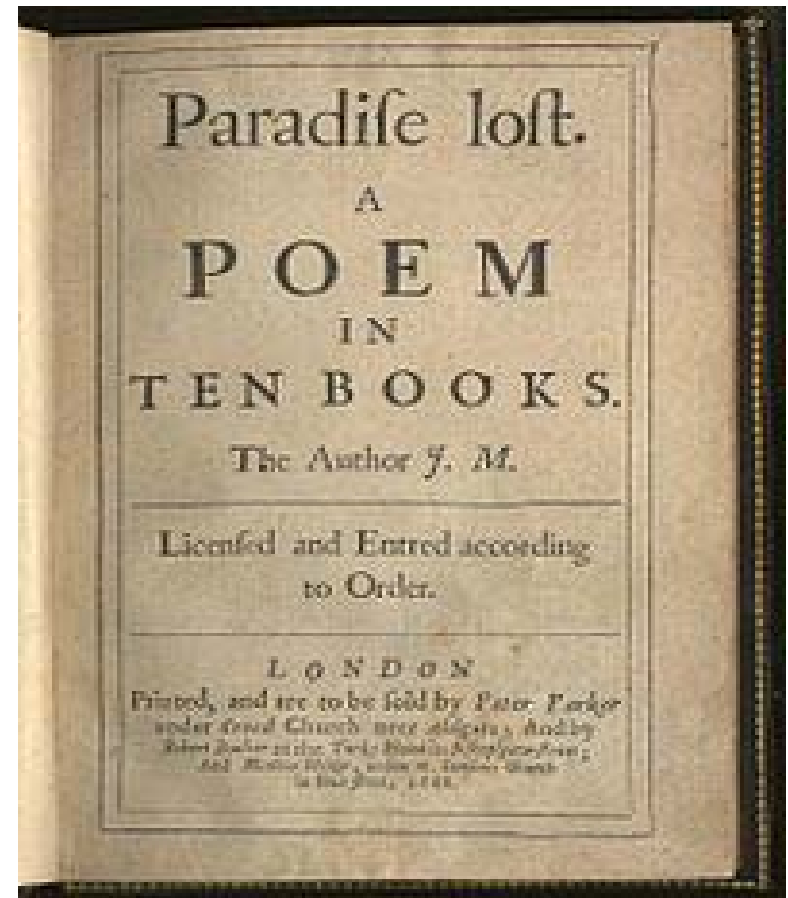
FRB Chicago Payments Conference

May 19, 2011

1. With apologies to John Milton

Lessons From Literature

- Milton's epic poem, *Paradise Lost*, dramatized the Biblical theme of the Fall of Man
- His 1667 work was comprised of 10 books and 10,000 lines of verse
- And featured Satan and his minions as the key players in the battle for heaven and earth
- Focus on Paradise in the Garden of Eden



First Edition, 1668

Payments Paradise-the 20th Century

Depending on Your View

- Well established, bank centric methods of payment
- Gradual pace of innovation and change
- Extended usefulness of payments technology
- Healthy, but manageable competition
- Limited engagement of government in payments regulation
- Constant volume growth in all payments methods and generally favorable economic conditions
- Passive, reasonably non-demanding customers
- Highly domestic payments world

Paradise Lost -the 21st Century

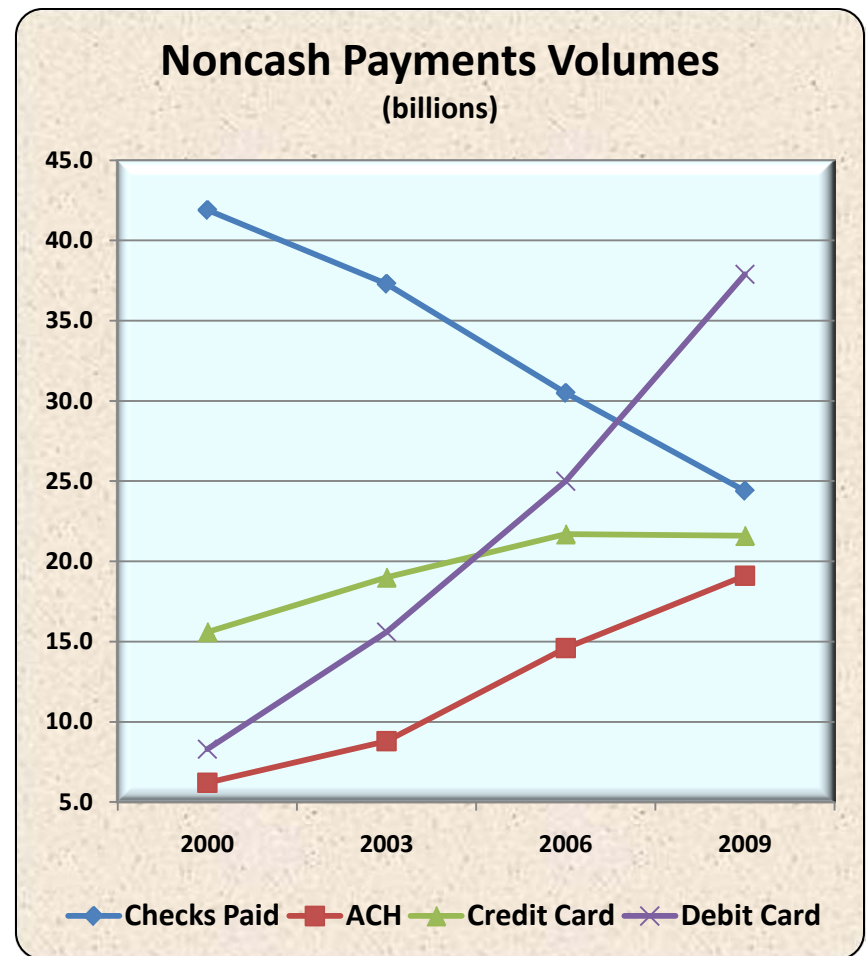
Depending on Your View

- Emergence of aggressive non-bank players
- Explosive pace of innovation and change
- More rapid technology turns
- Intensive competition from old and new sources
- Increased government regulatory intervention
- Declining or stable volume in traditional payments and depressed economic conditions
- More outspoken customers and changing demographics
- Rapid globalization of payments

At the Core of the New Paradigm

Changing Payment Volumes

- Impressive declines in check payments
- After years of double digit growth, ACH volume tables in 2009/2010
- Credit usage levels off after steady growth
- Explosive growth in debit usage continues unabated

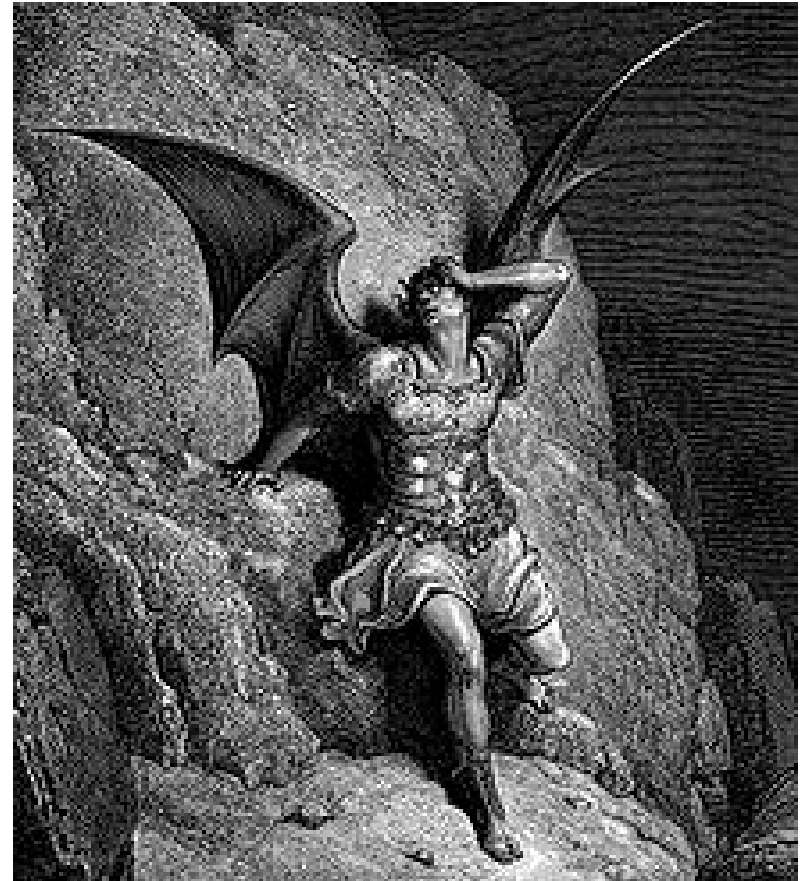


Federal Reserve Payments Studies (2000-2009)

And Many Candidates for Satan

Depending on Your View

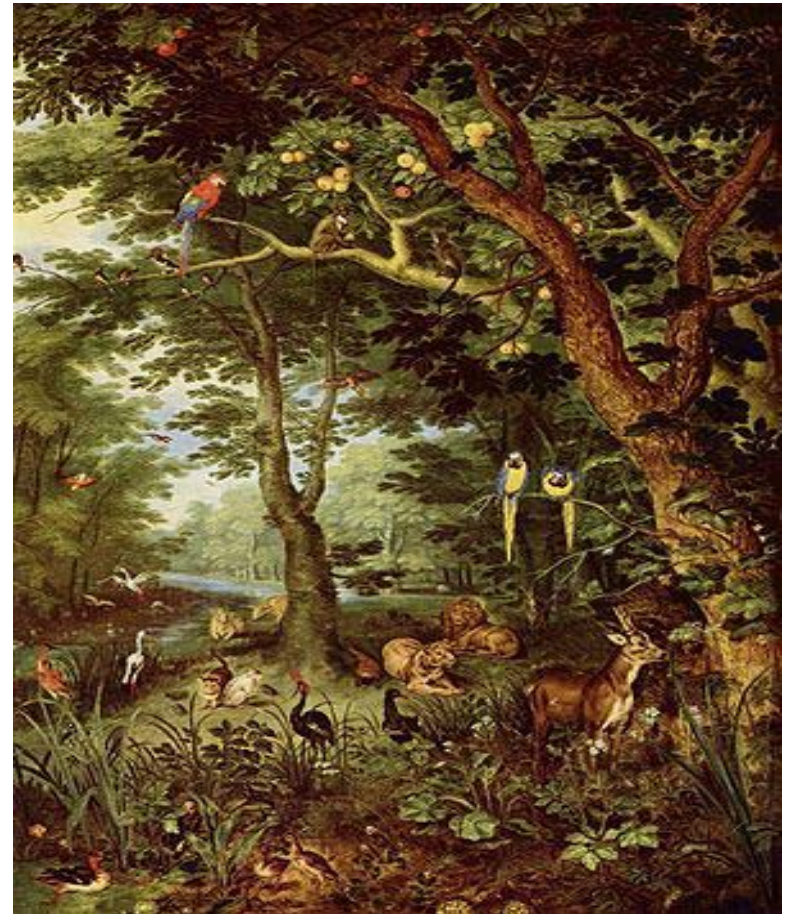
The Durbin Amendment



Gustav Dore, 1866

The Paradigms of Payments Paradise

- Provide the customer new products they should like and minimize education
- Minimize disruption, foster incremental change
- Compete largely on price/service level
- Rely on your own world view and resources
- Engage in long planning and execution cycles
- Buy more for the future
- Focus domestically

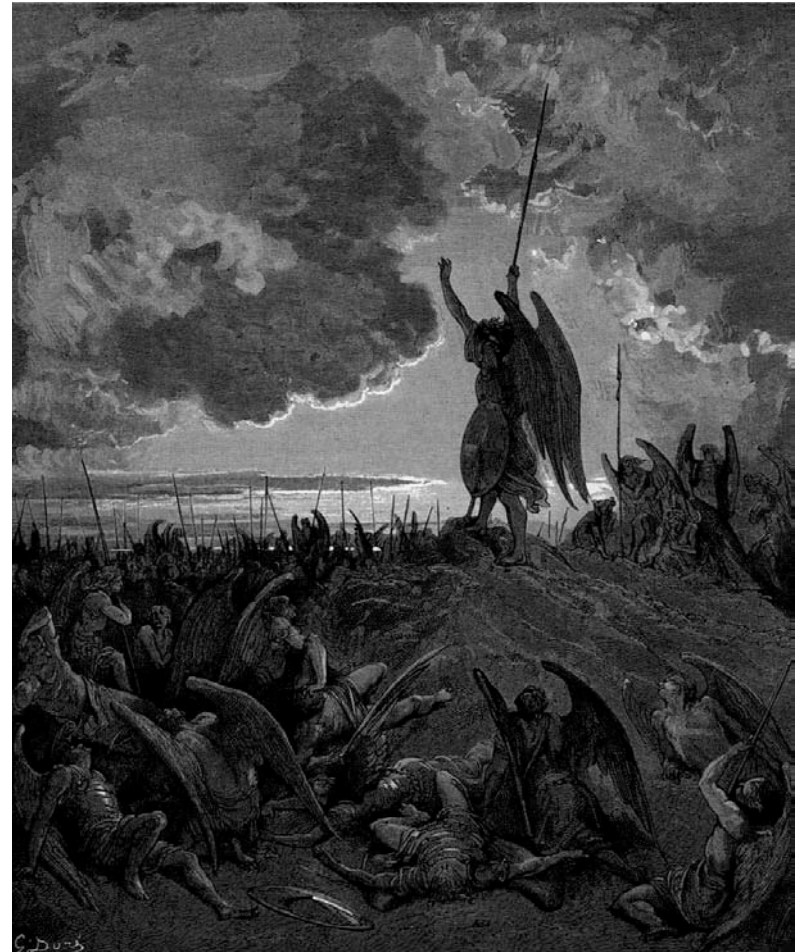


Jan Brueghel, 1620

New Paradigms Of Payments

Pandemonium

- Stay very, very close to the customer and inform them
- Sponsor innovation and disruptive change
- Compete on technology and new ideas
- Explore collaborative opportunities
- Develop flexible strategic plans with modest windows
- Buy only when needed; depreciate rapidly
- Compete globally



Gustav Doré, 1866

On The (Long?) Horns Of The Dilemma

Managing Payments Technology Today



Duration of Technology Turns



Time to Implement New Technology

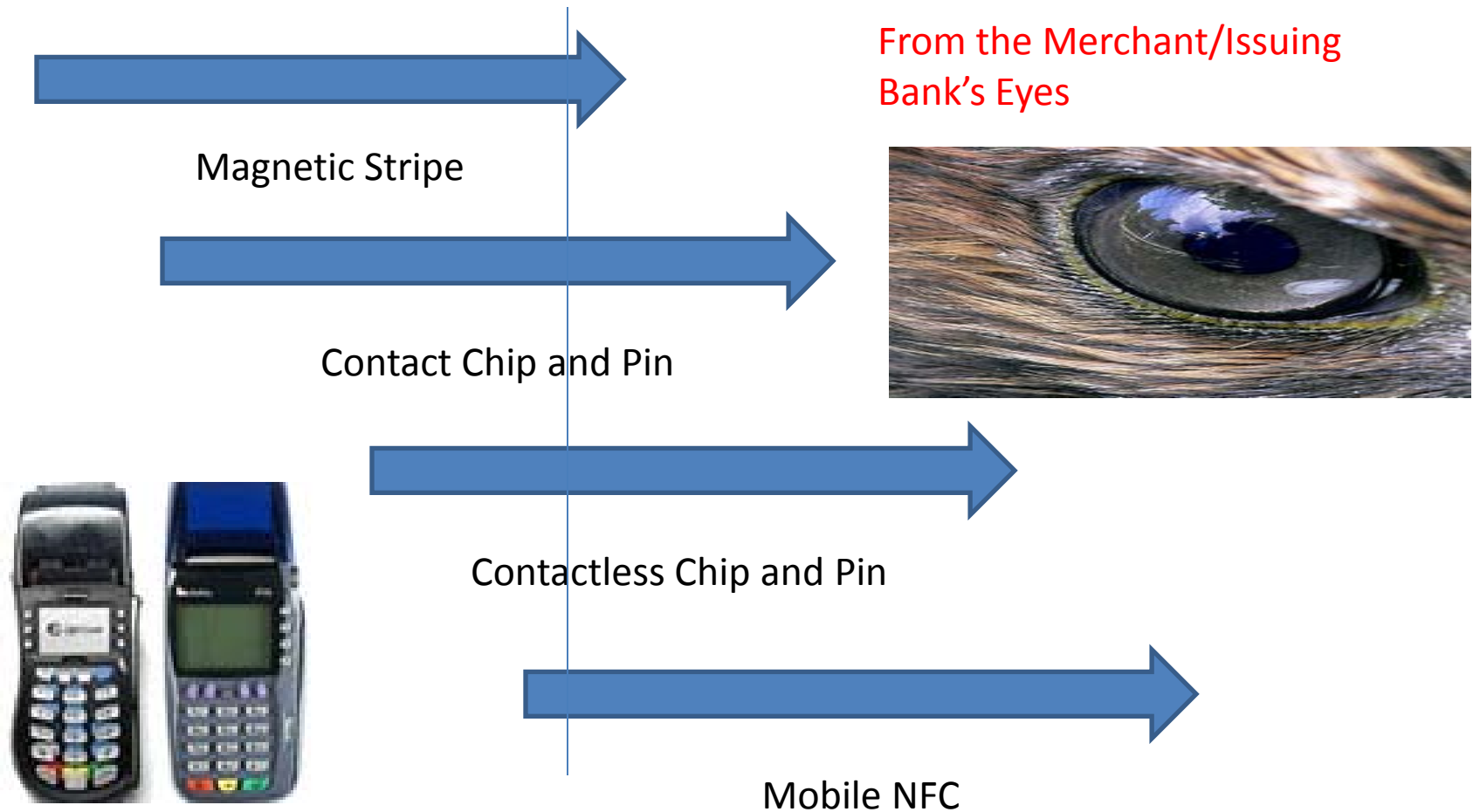


Time to Depreciate Investments



A Case in Point?

Managing Point of Sale Technology



Finding the Way Forward

New Rules for a New World

- Rule 1: **The old rules don't work**
- Rule 2: **Get much closer to the marketplace**
- Rule 3: **Strategic planning is a must...every year!**
- Rule 4: **Innovation is a necessary ingredient**
- Rule 5: **Aggressively manage the bottom line**
- Rule 6: **Explore partnerships to accelerate progress**

Rule 1: The Old Rules Don't Work

- New factors like the Internet, mobility, globility, and demography have changed the game
- In combination with tough economic times
- And new regulatory landscapes
- And complete transparency in an interconnected world



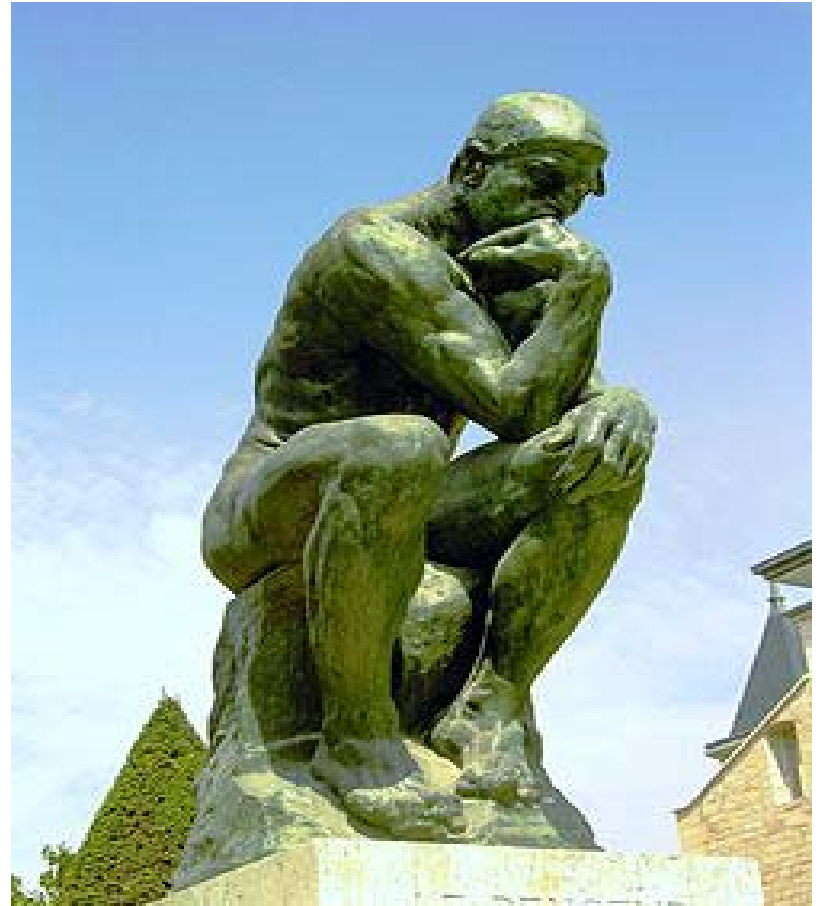
Rule 2: Get Much Closer to the Customer and the Marketplace

- Don't take anything for granted
- Overconfidence has serious repercussions
- Market intelligence is at a premium
- Survey work can shape products and services- emphasize value added services
- Competition is virile in a worldwide market



Rule 3: Strategic Planning is a Must...Every Year!

- Try a five year vision
- With a three year plan
- And an annual review
- And serious, honest scenario planning
- Involving more of your leadership team
- Remember: “Some planning is better than no planning all the time”



Auguste Rodin, 1902

Rule 4: Innovation is a Necessary Ingredient

- Innovation is a must to survive!
- May involve a difficult **culture** change
- But must be done thoughtfully
- And rewarded when successful
- And may involve partnerships and strange bedfellows

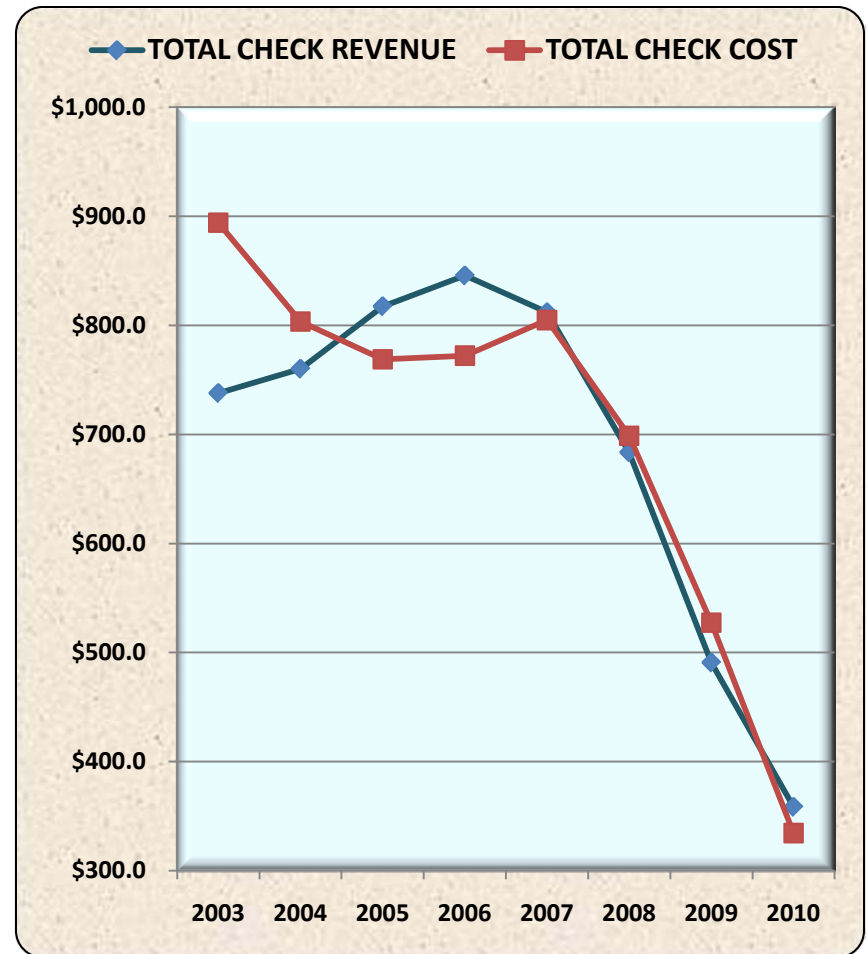


Innovation and Culture Change



Rule 5: *Aggressively* Manage the Bottom Line

- Tried and true and tough
- Avoid compounding debt
- Eliminate silos wherever possible
- Do better business case analysis
- Invest in incentives to meet or exceed targets
- Outsourcing is a potential answer



Federal Reserve Check Costs and Revenues (2003-2010)

Rule 6: Explore Partnerships to Accelerate Progress

- Skill specialization and lean budgets hamper independent efforts
- Successful products must satisfy users across multiple dimensions
- Shared resources improve economies of scale
- Speed to market is enhanced
- But... must balance against later flexibility



A Case in Point?

The Mobile Payment Evolution

- Growing widespread appreciation for the market potential of the smart phone, but penetration still modest (Rule 2)
- Innovation flowing from virtually all ecosystem players in the form of feature announcements and pilots (Rule 4)
- With lots of concern about the cost and revenue aspects of the bottom line absent ubiquity (Rule 5)
- But, no real roadmap and no effective venue for collaboration and agreement on key issues, in essence misuse of the term “ecosystem” (Rule 3, Rule 6)
- An effort to gain momentum through the Fed sponsored Mobile Payments Industry Workgroup. See white paper at <http://www.frbatlanta.org/rprf/> or <http://www.bostonfed.org/economic/cprc/index.htm>

Foundation Elements of a Successful U.S. Mobile Framework

- An *open mobile “wallet”* that supports *multiple payment credentials* in a *secure container*
- Implemented using *contactless NFC technology* and *enabling phone apps*
- Clearing and settlement over *existing rails* (credit, debit, prepaid, ACH) with openness to any future new channel
- Use of *dynamic data authorization* for integrity and security
- Based on evolving *global standards* and an industry supported *certification process*

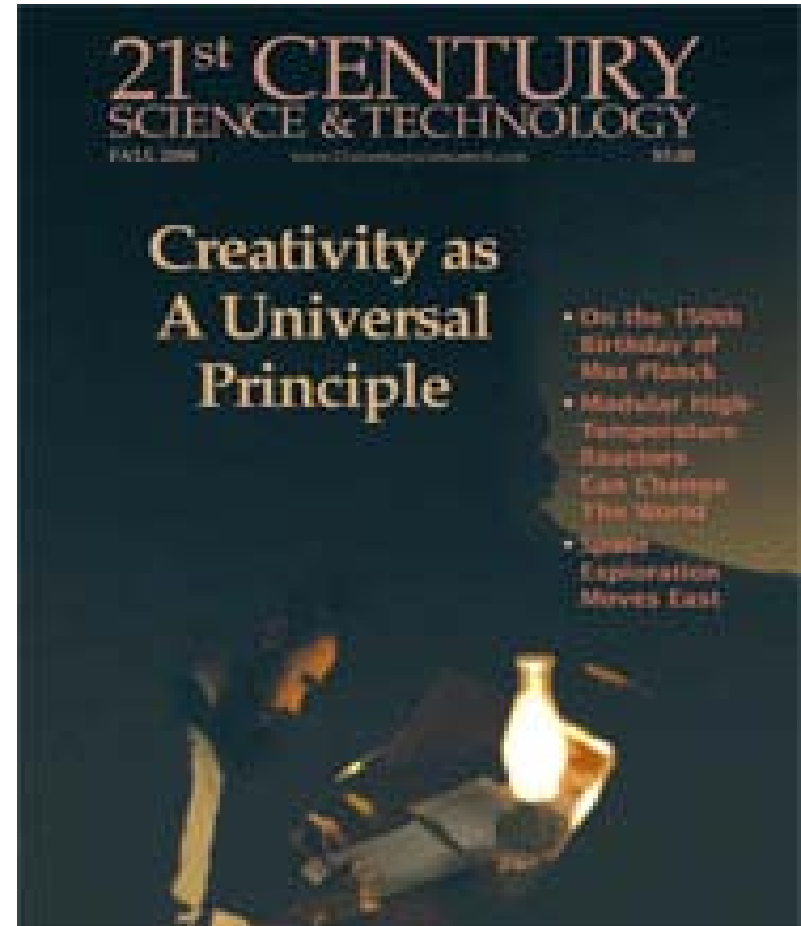
Foundation Elements of a Successful U.S. Mobile Framework

- Clear delineation of ongoing *regulatory oversight* responsibilities
- Presence of *Trusted Service Managers (TSMs)* to provision the secure elements in the phone
- Potential future need for a *collaborative, neutral industry forum* to address issues of common concern and importance (standards, business rules, security challenges, etc.)
- MPIW did not concur with a short term effort to construct and *industry roadmap* for going forward

Paradigms Found

The Rationalization of Payments

- **Stay** very, very **close** to the customer and **inform** them
- Sponsor **innovation** and **disruptive change**
- Compete on **technology** and **new ideas**
- Explore **collaborative** opportunities
- Develop **flexible strategic plans** with modest windows
- Buy only when needed; **depreciate rapidly**
- Compete **globally**



Concluding Thoughts

“He who will not apply new remedies must expect new evils; for time is the greatest innovator”

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“Chaos is a friend of mine.”

-Bob Dylan, 1985

