

## **Nonbanks in the Payments System: Innovation, Competition, and Risk**

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Panelist remarks

Moderator: Lee Manfred, Partner, First Annapolis

Panelist: René Pelegero, Senior Director of Industry Relations, Strategy and Compliance,  
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### **Mr. Pelegero: [Remarks correspond with handout]**

This is a session about innovation, and probably one of the biggest innovations we are seeing in our lifetime has been the Internet. Many years ago when I was a programmer (at the time, we were called “programmers” not “engineers”), I used to work for NASA as a consultant. I remember developing an application that allowed engineers from all the NASA centers across the United States to find bits of software that somebody else had written. It was like a mini search engine.

I was using a 360/67 mainframe, and these were talking to each other through something called the ARPANET. And I thought, “Computers talking to each other. This is really cool.”

Never in my wildest dreams did I imagine when CompuServe and services like that came along that things were going to get as wild and crazy as they are today. The Internet is permeating everything we do today. It changes how we communicate. It changes how we entertain ourselves. It changes how we look for information and inform

ourselves. It has also changed how we shop. As has been indicated, the growth of e-commerce on the Internet is significant. Although it is still small as a percentage of total commerce, it is growing at a fantastic pace.

To give you a sense, some of the numbers that come out from eBay indicate that, for example, a diamond ring sells on eBay every three minutes. A dress sells every 30 seconds. A digital camera sells on eBay every 30 seconds. A car, once a minute! Right now, eBay is the largest used-car dealer in the country. Who would have thought?

But the thing that the Internet probably makes more appealing, as Ben also indicated, is the fact that buyers and sellers can actually connect with each other. The Internet is a connectivity tool to a large extent, so I am echoing some of what Ben Ling was saying early on as well. It is now possible for people to trade with other entities about which they do not know anything. That is probably one of the biggest changes that the Internet is causing.

That capability of trading with other entities you do not know anything about creates a demand for a whole new level of trust. Do I trust that particular entity with my financial information? Do I send goods without having received payment? This is where PayPal comes into the equation. I agree with Ben Ling that our innovations and our contributions to the development of e-commerce have not been

tremendously revolutionary. They have been more of an additive. I will go through some of those points in a few minutes.

Some of you may recall back in the late 1970s or early 1980s, there was a television show on public television called “Connections.” How many of you may have seen that? It was a great show, and one of the points made was that sometimes people look for something and they discover something else. For example, the person who discovered plastics, as such, was actually looking for a remedy for malaria. It was the competition for more complex and sophisticated patterns in textiles that gave the rights to numerically controlled machines that became computers.

In our case, PayPal initially began its business as a mechanism to try to convey money from PDA to PDA, from BlackBerry to BlackBerry. The Web addition was a kind of additive; it is one of those, “Let’s just put it on the Web as well.” That is the one thing that took off and grew like crazy.

We just reported our Q1 numbers, and they are still continuing the up-and-to-the-right-side trend in our bar charts. We closed the quarter with 143 million customers, of which about 35 million are active customers—these are people who have done more than one transaction in the last quarter. We processed nearly \$11.5 billion in payment volume. Last year, we processed \$38 billion in payment volume, and we process around 2 million transactions per day. So, the growth

pattern still is there. That means we are actually doing something that consumers appreciate. We are in 103 markets, with 53 countries, where people can take money out to a bank account. In 14 countries, we are fully localized and we support 17 different currencies.

Our footprint provides, again, the benefit and the value proposition that consumers are looking for. Consumers like us primarily because our system is easy and secure. One of the predominant messages PayPal brings to consumers is that we never share the bank or card information with the merchant. Meanwhile, the merchants also like us because we provide sales lift for them, as well as provide our services at very competitive pricing.

It is a sad fact that war sometimes brings about a lot of new innovation. I bring that topic up because everyone who is in this space is in a war. Meg Whitman, who is our CEO, spoke recently at a conference on the security of the payments systems. She has stated that we are in a state of war with bad guys and criminals who go to work every day as we do, they go to buildings like we do, they sit in front of computers like we do, but their job is to try to hack and steal information and to commit fraud.

So, we are very much committed to trying to address a lot of those issues. Our innovations—I do not know whether I would call them innovations—are things that we are doing in the area of phishing, and these are some relatively new things we are now introducing or trying

to lead the industry in that space. We believe the best way to address phishing is not to let the consumer see the phishing e-mail to begin with. We are digitally signing every e-mail that we send, and we are working with all of the large ISPs—the AOLs, the Yahoos, the Googles—and requesting them not to deliver an e-mail that appears to come from PayPal but is not digitally signed by PayPal. That would be one way of addressing that.

In the area of spoofing, we are one of the first companies that is supporting Extended Validation certificates. That means that every time you type [www.paypal.com](http://www.paypal.com) on the URL with one of the newer browsers—Internet Explorer 7, for example—you will see a green glow, indicating that you are really talking to the right site. We are also providing customers with two-factor authentication tokens, if they choose, so they can customize their own security experience. All of these are things we are beginning to develop in this war as we try to address some of the problems we may encounter as an industry going forward.

But, while we are on that topic, let's talk a little bit about some of the issues related to not only fraud and security but also some of the regulatory aspects of this business. We are certainly not a bank; we are a nonbank. But we are under supervision, and we have to comply with many of the banking regulations.

Just to give you a small smattering of the alphabet soup of the things with which we have to comply, they include OFAC; anti-money laundering (AML); and the applicable portions of the Bank Secrecy Act, the U.S. Patriot Act, and GLB. We are in compliance with PCI Security Standards at the highest level. We are an MSB, as well as an IPSP and an ISO. All of these are just a whole mess of alphabet soup of regulations with which we must comply, and we do. We also have money transmitter licenses here in United States in every state where it is required, as well as an ELMI license in the UK. As such, we are then subject to regulation by FSA in the UK.

In summary, what is it that PayPal has brought to the industry in terms of innovation?

***Trust.*** As I indicated before, consumers and sellers do not know each other, but they want to transact. The current payment mechanisms do require one party or the other to share banking information. PayPal and some of the other nonbank providers are actually allowing the capability to do the transfer without sharing that bank account information.

***Speed.*** The Internet is all about immediate gratification. We all want to have it now. However, some of the mechanisms for payments, such as checks or money orders, take time to be delivered as well as cleared. PayPal offers a solution such that funds are made available to

sellers much faster, and with our debit card, they can get cash almost on an immediate basis.

*Ease.* Again, consumers feel the Internet is all about convenience. In some of the current mechanisms, to apply for a merchant account to accept payments is slow and cumbersome. It is a very, very easy process to set up a PayPal account, and we make the checkout process easy as well. For example, you do not have to reenter bank account information every time you buy from any given merchant. We are also making our services available to digital telephones as well as to debit cards, so that consumers—buyers and sellers—have easier access to their funds.

*Security.* Anyone could move money from point A to point B, but to do it in a secure, safe fashion is something that we bring core competency to the space. We have developed in-depth expertise to manage fraud and to address the whole issue of risk. Sometimes, I think we are more of a risk management company than a payments company.

With that, I want to state PayPal's commitment to continue doing the business of satisfying the customer's needs, while at the same time managing the risk associated with processing all of these payments. I extend an invitation to the entire industry, so that we continue working together to address issues related to risk associated with these processes.

Thank you.

**Mr. Manfred:**

Just a couple of questions, René. Can you talk a little bit about the mobile P2P product and debit cards, how they work, and your strategy for those?

**Mr. Pelegero:**

Sure. The mobile telephone approach is nothing more than a vehicle to access a PayPal account. It comes in two flavors. The first one uses SMS messages. So, if you are walking down the street and see a display that says to give \$25 or give whatever money to this particular charity, it is easy to dial the appropriate number and to enter the SMS code that is provided on the display, and funds are immediately taken out of your PayPal account and sent over to that particular charity.

For some of the more sophisticated mobile products like PDAs, like your BlackJacks, your Trios, or BlackBerries, we also have a Web checkout interface. You can go to a merchant that has a Web screen or a Web interface and you can buy things using PayPal through those particular devices.

The debit card is a product that we have made available to customers who tend to hold balances in a PayPal account because they



are receiving funds from multiple sales. A debit card allows them to go to an ATM and withdraw cash—as I said, on an immediate basis—or go to any other place where that particular card is accepted (and it is a MasterCard), basically use those funds, and give more fungibility to the PayPal account. So, that is the general positioning of those two products.

**Mr. Manfred:**

Does being a nonbank—whatever definition of that we are using at the moment—give PayPal an advantage over other entities in the system in introducing innovation?

**Mr. Pelegro:**

Not necessarily. As a matter of fact, I just went through the whole laundry list of regulations with which we have to comply. We recognize the sensitivity of the business we are in. What PayPal has done is created additive innovations. We sit atop the existing payments networks. We could not exist if the banking networks were not in place. We could not exist if the ACH and bank-transfer networks were not in place. What we have done is address a specific consumer need. Here again, I will echo what Ben was saying earlier on, consumers are asking for ease and convenience. We saw the opportunity to provide that service—just like a number of other

companies have been able to do—and to try to improve the efficiency of the system. Any bank could have done that.

**Mr. Manfred:**

That is great. Margaret, you are up.