

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

2007 Payments Conference

Federal Reserve Bank of Kansas City

May 2-4, 2007

Santa Fe, NM

Session 3: Competition: Vertical Integration

Panelist Remarks

Moderator: Kenneth Posner, Managing Director, Morgan Stanley

Panelist: Michael Cook, Vice President and Assistant Treasurer, Wal-Mart Stores, Inc.

Mr. Cook: [remarks correspond with handout]

I just want to touch on one of your last slides there [see Posner handout]. I want to point out that something we are already seeing is that integration is taking place where MasterCard is doing the authorizations or wanting to do global authorizations and Visa is doing the authorization piece for certain types of transactions. They already have integrated in some of the processing pieces as well. If you ask First Data, that is probably on their radar as well that they will be moving into that realm.

Hopefully, you know who Wal-Mart is. If you don't, you can read through the material. Many of you probably would wonder what happened with our industrial loan bank application that we applied for in 2005. We did withdraw that earlier this year. There were a number of reasons. The two primary ones were that the FDIC had extended for the second time the moratorium on granting industrial loan bank charters. And the second was what we would call the "manufactured controversy" that was created by the unions and the banking lobbyists

around what we were going to do with the institution. Based on those two major issues, we withdrew our application earlier this year.

Some of you may not realize that we applied for a thrift institution in 1999 in Oklahoma. It was a full-service thrift that was going to have full banking rights and so forth. At that time, Wal-Mart was significantly smaller, but we were still a large retailer. But you may not realize that the Gramm-Leach-Bliley date of enactment was made retroactive to less than 30 days to the filing of our application. It did not go into effect the day Bill Clinton signed it. It did not go into effect the day that it came out of Congress. It went into effect less than 30 days prior to the date of our application being filed in 1999.

Then in 2003, we applied for an industrial loan bank in California. Once again, legislation was passed that went into effect retroactive to our filing date that prevented us from getting an industrial loan bank in California.

I find it strange that somebody would say they don't feel as though there is a level playing field. I don't know as yet any retailer that is opposing a banking institution getting into retailing, and I would welcome them to get into retailing because they would find it very difficult. But yet there is a massive, extensive lobbying effort to prevent retailers from getting into banking. I would think about those types of issues and whether there really is a level playing field in the United States on those issues.

One last thing I would add is that we have recently been granted a charter in Mexico, within the last six months. Part of that was at the encouragement of the Mexican government because of the power of the banking industry, because of the banking industry and what they have done in Mexico, and they are hoping for more competition in that market. That is where we stand on the industrial loan bank and where we stand with entering into the banking industry.

If you go on to the next page, about payment preferences and how they are changing, if you look at this slide, it will show where PIN debit and checks have basically flipped in their penetration over the last four years. We only expect that to continue to grow. In fact, we believe it will grow at an even faster rate than it has over the last four years because at the last week of April, we finished implementing electronic check conversion in 100 percent of our Wal-Mart stores nationwide. If you can imagine that a customer comes in, hands us a check, we frank it “void,” and hand it back to the consumer, you will quickly have a scenario where the consumer says, “Why don’t I just pull out my debit card and use it instead?”

We will see that checks will continue to decline at a faster rate than they historically have. PIN debit will increase at a faster rate than it has historically as well. Before I leave this slide and go on to the next one, our biggest challenge here is to control these electronic payment types. I might mention that “other” category down below. Where that

growth is coming from is through electronic benefit payments—the EBT cards that state agencies are issuing—the flexible spending accounts and the HSA cards that are being issued into the market. Some of it is coming obviously from gift cards, but the majority of it is coming from EBT, HSA, FSA-type cards into the market.

If you consider that last year Wal-Mart's net income was approximately \$12 billion, you might say that is an awful lot, \$12 billion of net income. But consider that we paid in excess of \$1 billion in credit and debit card fees globally on a net income of \$12 billion. It is hard to fathom that is reasonable that we would pay more than \$1 billion in credit and debit card fees.

Go on to the next page and look at the concentration of the payment processing. One of the things I failed to demonstrate here on this slide was that if you think about it, Visa and MasterCard, in our view, are the same institution. They are the same entity. There is no difference between the two. If you think of them as one institution that is controlled by the same governing body, the same financial institutions, Visa's share on credit is 41 percent of our volume in our stores. If you add MasterCard on to that, it goes to 65 percent of the credit volume in our stores. PIN debit, for example, is at 40 percent market share for just Visa. MasterCard has not had too much luck there with their PIN debit program, and it would only add 6 percent to that, so that would jump to 46 percent if you combine the two entities.

But if you look at the final pie chart, on signature debit, if you add MasterCard in, it is 100 percent of signature debit. So, you would say, “Well, Visa has 81 percent market share.”

At what market share would someone decide that they should be regulated? Is it 100 percent? Is it anywhere less than 100 percent? (Or does it need to be more than 100 percent?) Hard to fathom. If you look at the graph below and what I have tried to demonstrate there, you almost have to look at the previous slide as well, which showed how PIN debit is increasing year over year at a phenomenal rate. But yet, if you look at the chart down below in the last slide, think in your mind that PIN debit is increasing at as fast a rate as it is. And then imagine that Visa as a percent of PIN debit is increasing at 38 percent compounded average growth rate on a product that is growing at a rapid rate.

If you walk down the street and ask 10 people if they know who Interlink is, 10 out of 10 would probably say no. Visa does not advertise that brand, do they? Yet, if I told you that the penetration of Interlink in our stores is greater than Visa Credit, could you believe that? And it is. Interlink is almost twice the volume of Visa Credit, but yet no one would know who they are.

If you look at the vertical integration, to add onto the whole discussion here, what I probably should have been more focused on is that if Wal-Mart is AA credit, why would it be that we would even

need an industrial loan bank to do our acquiring business? We have talked to both associations about not needing an acquiring institution. It is not like the airline industry, where you are paying for a product or a service that is going to be delivered at a future date. In our model, you are taking the merchandise out at the time of the transaction. We do not need an acquiring institution in our model. We do not have an acquiring institution between us and American Express or between us and Discover. Why do I need it with a Visa and MasterCard situation?

I do believe there are many times when vertical integration in our business is not necessarily beneficial because people ask me, “Why don’t you get into the payment mix? Why don’t you develop your own payment network?”

Why don’t we vertically integrate in product production? If the market operates as it should, there would be no need for us to vertically integrate into product production, whereas in the payment network, it does not operate on a level playing field.

If there truly was a level playing field today, then merchants would be able to collectively negotiate against the associations, just as the banks have historically been able to negotiate collectively against the merchants. We have approached many of the large institutions about direct acceptance of their brand. Until November of last year, Sam’s Club did not accept any credit except for Discover. We approached

several large financial institutions and said, for example, “What if we accepted *only* your bank’s cards in our Sam’s Clubs?”

And we branded or marketed it that way. You would think they would be interested. You are opening up the seventh-largest retailer in the world, opening it up for acceptance. Why would they not be interested? Is it because they wouldn’t be able to collectively benefit from the pricing set by the associations? Would it kill the goose that lays the golden egg?

I would venture to say that I do not think that vertical integration has necessarily worked extremely well for American Express and Discover. However, it has worked to a certain degree for them.

Mr. Posner:

Thank you, Mike. I think Mike has made his point well enough. I don’t think I need to ask any questions at this time. Let’s save time for the audience.

Let’s move on to Trey Jinks, chief of TSYs Corporate Strategy and Planning group.