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

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Session 3: Competition: Vertical Integration
Panelist Remarks
Moderator: Kenneth Posner, Managing Director, Morgan Stanley
Panelist: Pamela Joseph, Vice Chair, U.S. Bancorp

Ms. Joseph: [remarks correspond with handout]

Let me just make a couple of quick comments and give you a little bit of background. I really want to focus my commentary on the real world and talk about vertical integration in the past, the present, and where we see it going in the future.

First of all, just for those of you who may not be familiar with U.S. Bank, I am in charge of all card issuing at the bank. We have the eighth largest in the United States. I am in charge of merchant acquiring. We serve about a million merchants in 18 countries and are the third largest. And I am in charge of our ATM business. We currently provide services for about 40,000 ATMs in the United States and abroad. We also have a very robust corporate card business. In that business, we are going to talk a little bit about some of the integration strategies we see there specifically.

Finally, one last comment I would make. We look within our bank like a nonbank because my businesses serve more than 2,000 banks, so we look like an FDR or a Total Systems inside of a very large bank.

Again, we provide a lot of outsourcing services to banks. We will touch on that as we go through the presentation. Because we are one of the most cost-efficient banks, I did not create my own slides. I actually used Ken's slides and marked them up a little bit. But it will help illustrate the points.

First of all, the first slide shows you who we are and how we sit in the payments spectrum. We are on both sides of the equation. We do serve merchants. We do issue cards. And I added a few more boxes because we are very big in the corporate card space. In addition, we do not outsource anything. So, everything we do, we do internally and on our own platforms. And I think you will see why that is important as we move through this stack.

If you move to the next slide, we are going to talk about the old days. By the old days, I mean probably more than 20 years ago. Really, back then—or even if you go back even further, private label, general store credit—vertical integration was the way payments were for a long time, before national bank cards came to be.

If you look at online debit, which is when I actually entered banking out on the West Coast, I was involved with one of the West Coast banks building Interlink, back when it was a bank-owned service and product. It really came to be because a lot of supermarkets that were only cash and check accepters started to tie ACH in with their loyalty card programs. So, we had stores back then that do not exist anymore, like Vaughn's and I think Safeway Stores ran Ralphs. They created ACH products tied to their loyalty cards. That was the first foray into what I would consider a very good application of vertical integration of payments. They were on both sides of equation. It was a very cheap payment, but it did not work very well, and there were a lot of issues around it. It was the impetus to get the banks to move and create and build the online debit infrastructure.

I am sure the banks would tell you that they were thinking about it long before then, but it really is sometimes to our advantage, and we embraced merchants doing things in payments because it is a driver sometimes to get banks to move in a direction and to start taking those ideas and turning them into products that more merchants can use. Again, if you look at online debit, it came as a result of that original ACH loyalty product.

In addition, you can see the same thing in gift cards. If you think of the original paper gift certificates, those were vertical integration of payments. They were tied only to those merchants, and those products have now evolved into card products. Luckily for Wal-Mart, Visa and MasterCard stepped in and created a whole new infrastructure that I am sure cost them a lot more money because now there are Visa gift cards and MasterCard gift cards, which have a lot more use than just at one particular merchant outlet.

If you look at the next page, this is where we get more into the corporate space. In the old days again, if you looked at Shell, Chevron, and some of the old oil and petroleum companies, they created fleet card programs. Those programs were created and driven so that large corporations with company-owned vehicles and fleets of cars could provide cards to their employees to buy only petroleum or gas or maintain their autos that were company-owned vehicles. Back then, when you went to a gas station, they could change your tires, change your oil, and it was not a grocery store with a gas pump outside. These fleet card products evolved through the oil companies, again a very good example of vertical integration of payments.

Over time, those companies and products migrated out of the fuel card industry and back into the banks and into processors. Right now, if you look at that particular industry, Ceridian owns Comdata. You see Wright Express, and then we own a company in Houston called Voyager, a very good product. It does not go out to the card associations. It does run on a proprietary network, which we run on behalf of our customers, and it is a very nice closed-loop environment. A very good product.

What you see over time—and we saw it with ACH with the supermarkets that did it, we see it with fleet—many, many companies get into the payments spectrum, sometimes because they think it will be cheaper or sometimes, in these cases, because they needed a solution or an application. But at the end of the day and as time goes on, they realize the capital and the infrastructure required. It comes back down to do you want to invest $1 into a payment infrastructure or do you want to invest it into other things for your particular business?

We find over time that, while these may be developed in merchant environments or by corporations, they ultimately end up being owned, run, and operated usually by payment processors or banks or people in this industry. It is a natural evolution, which is why again, as a bank and as a nonbank processor all in one, we very much embrace the idea of vertical integration of payments because we know, over time, if you stay in the space long enough, all of these products and services will eventually evolve into something we can provide out to the rest of our customer base.

Finally, if we talk about the future and where we are headed from again a vertical integration space, you can see, for example, that we are very big right now into health care. For those of you from the United States, as you know, health care is moving to consumer-directed health care. We are seeing a lot in terms of very high deductibles, HSA accounts, FSA accounts. But we are working very closely with our hospitals.

In the past, our hospitals have been recipients of various degrees of payments, whether it was credit cards or debit cards or checks. We have now added the functionality of being able to underwrite them for recourse and receivables, and they can issue a patient finance card to their customers. That card can either cover a very high deductible for the patient, or it can be used to pay for a procedure that they may not be insured for.

In essence, it is private label, but for the medical community. By doing this, we do everything through a closed-loop environment. They own the receivables and the recourse, but we drive everything through our proprietary credit card billing system. We drive everything through the collection process. By doing that, we have found that we have a great opportunity to raise the receivables for any particular hospital or provider out there.

If any of you are in banking at all and have ever looked at the balance sheet of a hospital, you know the accounts receivables are usually off the chart. As a matter of fact, many times when we talk to hospitals, they would maintain that they are not for profit, but mainly it is because their collectibility is usually very poor.

We see this as a fantastic opportunity. We already have a product out in the marketplace. We have a lot of hospitals in our queue to go live and have brought up quite a number. In addition, we have integrated into that product online eligibility, which actually goes out to check to see if the customer and their insurance provider are eligible for certain care and certain kinds of treatments.

Finally, but very far out—probably 10 years from now—we would assume this can eventually move into adjudication, although I would say we are at least 10 years away from that happening.

Again, it was my goal to try to bring to you a variety of different ways that vertical payment integration does actually work and in situations where we have been able to use it much to our advantage and to help differentiate our bank as we work our way through the payments phase.