

PayPal, the “new Microsoft” in the payment industry?

eBay reinforced

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Abstract:

A few weeks ago, eBay acquired PayPal, including the (internet) payment system of the same denominator with the apparent focus on Person to Person (P2P) payments, for ca. USD 1.4 milliard. The reason for this deal isn't only the ideal complement of the business areas (most eBay auctions in the USA are paid with PayPal). Analysing PayPal's philosophy recalls the first years of Microsoft. Wholeheartedly Peter Thiel (PayPal's founder) announces to demand the leadership in the world. Bill Gates could have said the same. Then, like now, the competitors' reactions to such statements are different. There are more similarities: The speed of PayPal's getting new customers and the fact that both PayPal and Microsoft built up their success using the infrastructure of their direct competitors.

This document describes backgrounds and results of an expansion of the PayPal system*. Both the business point of view for the direct competitors and the economic aspects like monetary policy and liquidity changes are considered.

* A detailed description of the PayPal system including all functions which are provided to the customers is part of the document “PayPal – The new world currency?” See: www.novosec.com/downloads

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Introduction

The announcement that eBay International acquires PayPal has provoked furore and astonishment within the financial industry.

For ca. USD 1.4 milliard, the biggest online market place takes over a company which offers digital payment transactions. Despite the fact that PayPal has more than 17 million customers, the reason for this acquisition is another one. Most of PayPal's customers are already using eBay which has more than 46 million customers. The reason is in fact the ideal complement of the business areas: eBay needs a mass market P2P (Person-to-Person) payment system in connection with its auctions. Online auctions over eBay are one of the core businesses of PayPal now. It stands to reason that eBay assures another opportunity of revenue within its own generated value chain.

The fact that the financial industry loses the control over payment transactions within a well-defined and new generated market segment, probably is only a small side blow due to the relative small part of the total market. Transferring the business policy from eBay to PayPal however, a punch to be reckoned with can be accrued. eBay's current successful strategy to expand the customer segments successively (starting from private persons (P2P) to SB2C - Small Business to Customer, B2C - Business to Customer and finally B2B - Business to Business) can and will be continued with PayPal in the same manner.

The competitors' starting position couldn't be more different. Whereas banks and credit card companies extend their offers by transferring and adopting their existing services to the new technological opportunities (internet, mobile networks), PayPal started as pure internet company and attacks the financial industry's business areas.

It remains to be seen who will win this apparently disparate fight between David and Goliath. Will PayPal surprise?

Status Quo

As an internet start-up, PayPal used the sales policy of the internet industry for its concerns from the beginning. As first provider within the financial industry PayPal took a chance to address customers over the new medium and subsidised the registration of new customers. Customers who recruited new customers received USD 10. Due to the fast spread the bonus was reduced to USD 5 since the short term liquidity outflow endangered the whole company. Today, PayPal registers, according to its statement, round about 28.000 new customers per day. The principle of "viral marketing" is one core success factor. The acquisition by eBay enables the direct addressing of new customers of the main target and will boost the amount of PayPal customers. The vision to assimilate all internet users into the existing system is more and more getting reality - also due to the continuously increasing complexity of functions and services.

Functions and Services

The opportunity to transfer money between private customers within seconds using emails is the core function of the PayPal system. Immediate after the launch, PayPal payments were used almost exclusively for online auctions as so called auction payment. By and by PayPal customers increasingly use the system for private payments independent from online auctions as well. The easiest way to describe this transaction is a conventional **money transfer/bank transfer**. In case the PayPal customers are located in different countries it is an **international money transfer**.

PayPal also offers a physical **PayPal debit card**. This is a PayPal branded MasterCard/-VISA card which can also be used for payments at **physical POS** and withdrawals at ATMs using the MasterCard/VISA network.

At the same time PayPal strengthens the Business Accounts by arranging rules which allow offering **virtual POS transactions** with extensive payment guarantee to corporate customers.

Electronic Bills can be sent as money request via PayPal. Money on PayPal accounts can be invested (Money Market Fund). From a banking point of view this is very close to a **yield of a payment transaction account (bank giro account)**.

Following eBay's and PayPal's philosophy additional functions will certainly be added.

PayPal, the new world currency?

PayPal's slogan („The new world currency“) underlines the claim and the aggressiveness the newcomer is acting with.



The fact, that PayPal isn't a currency¹ nor seriously has the aim to create an own currency, doesn't matter. The company's intention is to establish a **world wide payment system**. In the second step it can focus on other banks' services. "Yield of bank giro account" demonstrates this attitude and can be expanded to asset management.

Remembering Bill Gates' statement: "The world needs banking but it doesn't necessarily need bankers" it seems that PayPal just took this idea and started with its realisation. PayPal, the "new Microsoft" in the payment industry?

The initial point couldn't be better. The internet offers the opportunity to act world wide competitively. Whereas after several flops the "old economy" only hesitantly invests in the new media, companies like Amazon, eBay and PayPal profit now. In

case PayPal succeeds with its intention it won't only result in a new order of the financial industry but also have consequences for the whole economy.

Starting point for payment transactions

Due to the internet expansion from a medium for information publishing to a global transaction platform, payment transaction methods are needed. Banks and credit card companies tried to fulfil this requirement by expanding existing systems or by developing new methods. There are several reasons why there is no similar success story like PayPal up-to-now.

Competing payment systems:

First of all, banks tried to gain the market with competing payment systems. For example, there was a competition in Germany between Deutsche Bank's eCash™ and CyberCash™ of other banks (Commerzbank, Dresdner Bank). Since payment transactions can only be successful when they are widely deployed², none of the systems could prevail.

Lack of ease-of-use and high system complexity:

In particular the application (registration process) for eCash™, CyberCash™ and also SET™ often took several weeks. As a result of this, only a small part of the interested customers passed through the whole Registration process. A trade-off between the partly contrary requirements security³ and ease-of-use is needed. Security is not an end in itself and can hardly be sold to customers in case the ease-of-use is affected. Since security cannot be quantified by the majority of customers the system which is easy to use

¹ All payments are currently denominated in USD.

² „Payment is commodity“ and the essential distinguishing feature of a standard service is the quality of this service.

³ The security of the total system essentially depends on the registration process.

and fulfils the subjective security requirements at the same time will always prevail.

In fact, the direct competition between the banks is history, but no system is supported by the whole financial industry up-to-now. Reason for this is the complex bank infrastructure in Germany (private and corporate customer banks) with partly contrary interests, in particular with regard to the fees policy.

The internet offers the opportunity to get access to central systems all over the world. Especially for payment transactions a coordination and standardisation between companies is needed. This requires a lot of time. The strength of the banks and credit card companies, which is the networking of local systems, becomes less important due to the globalisation. By using the existing infrastructure it is possible to offer comparable services faster and cheaper than ever before.

Beside an opportunity to reduce costs for banks it also means a "cannibalisation" of their own existing services and sources of revenue.

PayPal takes the opportunity

In a time when banks are forced to safe expenses because of a strained revenue and stock market situation PayPal grasps an opportunity to establish its payment system. For this purpose, PayPal uses (at least momentarily) the infrastructure of the banks and credit card companies. This seems most brazen and deserves the necessary respect. Basis of a PayPal Account is a credit card or an existing bank account. The enormous spread of credit cards⁴ and their world wide established networks are the fundament of the total system. Every customer can register fastly for PayPal with a few mouse clicks.

⁴ More than 1.6 milliard credit cards are circulating world-wide.

Due to the fact that mainly in the United States payment transactions between private customers were underdeveloped, PayPal could gain ground in the money/bank transfer market quickly. Based on the function "request money" it is also possible to integrate the PayPal system into an **EBPP** (Electronic Bill Presentment and Payment) system. Similar to eBay, PayPal is expanding its business to corporate customers. Small merchants, who haven't received an acceptance contract for credit cards up to now, can indirectly receive one without talking to credit card companies or acquirers by opening a PayPal account. Regarding the payment transaction PayPal acts as a master merchant who owns acceptance contracts for credit cards (of VISA, MasterCard, Discover and American Express) in order to accept payments for the benefit of third parties. Strictly speaking it represents a kind of "sub-acquiring" which is normally prohibited by the credit card companies in reference to their rules. Why is PayPal allowed to do something which is forbidden for other companies? The only reason for this might be that the credit card companies look at PayPal not as a competitor but as a complement. Neither the credit card companies nor the banks possess an online auction payment. PayPal filled this gap and provided additional transactions and revenues to the credit card companies.

This increase could be a boomerang in the long run.

PayPal vs. financial industry

PayPal's possible global success could result in extensive interferences within the financial industry. Those are described here in detail.

Credit card companies:

For a long time, all credit card companies have been determining rules in order to expand their business for the internet. The possibilities to pay at a POS as well as to withdraw at an ATM shall be completed

with card to card transactions (as P2P payments). In the USA, money transfers following an internet auction – a special case of P2P payments – are controlled by PayPal already today. Therefore, it will be very difficult for credit card companies to intrude this business area. PayPal's takeover by eBay should consolidate this situation.

Considering the credit card companies' business model (fees are shared between credit card company, issuer and acquirer), it won't be possible to keep predominance in a price-competition.

(Credit) card issuer:

These are normally banks or big companies who issue credit cards to their customers. As long as the main part of PayPal transactions are processed via credit cards – which can be assumed for the future – using PayPal increases the number of credit card transactions and therefore the issuers' revenues. There is the risk that PayPal acts as credit card issuer and thus as direct competitor. PayPal issues both a MasterCard and a VISA card already today.



The fees are extremely advantageous for customers. Thus a serious competitor probably arises.

Credit card acquirer:

PayPal doesn't only occupy a new business area but also attacks the existing credit card companies' business. Just 60% of all PayPal transactions are online auction processing. The other 40% are mostly conducted via small shops. A company which opens a PayPal Business Account indirectly gets the opportunity to accept credit card payments of VISA, MasterCard, Amex and Discover by signing only one contract. This complies with a global acceptance contract over all credit card companies and is also shown in the acceptance logo.



Due to the high transaction volume PayPal might have better conditions than small corporate customers. Because of this and the fact that PayPal is passing them to the Business Accounts, it is more favourable for small merchants accepting credit cards via PayPal than conducting acceptance contracts directly from the credit card companies. In a way, PayPal offers the credit card companies' service cheaper than the industry itself using their infrastructure.

In case a customer is paying a PayPal merchant with a PayPal card the fees are even more profitable. Then a merchant receives 1.5 % of the standard PayPal merchant fee as cash back. For many small merchants it is nearly impossible to obtain an acceptance contract for internet transactions from the acquirer. Because of risk and liability considerations, acquirers are not willing to place a contract and even cancel existing contracts. A realistic scenario would be the displacement of acquirers by PayPal.

Banks:

PayPal's product innovations increase the pressure on the banks. In the USA – which in respect of payment systems is less developed compared to Europe – PayPal could also benefit from another circumstance.

Dominated by checks and credit card payments the United States don't offer neither bank transfer nor debit payments. Cashless payments between private customers in the USA are more and more done via PayPal. In comparison with checks, the handling is vitally easier and faster. In fact, this gap doesn't exist in Europe but a crowding out can nevertheless start.

Germany is a country of giro accounts, but the move to establish a payment system – on basis of the internet banking (online money/bank transfer) or a debit system – all over the country wasn't made. According to banks' statements, reasons for this are the already described structural issues and the problems in respect of creation a common business model.

Time can be short.

Another threat occurs with regard to international payments. In particular for international payment transactions PayPal offers a cheap alternative to the existing bank products.

Transferring USD 150.— from Germany to USA		
	Bank (USD check by house bank)	PayPal (including transfer on Account)
Payer fee:	EUR 10.00 equivalent to USD 9.95*	charge credit card international fee 1% = 1.50 USD
Payee fee	USD 20.00	2.9 % + 30 Cent ** USD 4.65
Total fees	USD 29.95	USD 6.15
Extra costs: USD 23.80 or 387 %		
* Exchange rate: 0.9945 ** Standard rate (equivalent to max. fee)		

With this **international money transfer** PayPal addresses in particular corporate customers who mostly process cross-border payments. In order to process a bank-initiated cross-border payment a Swift-Code is needed normally, high fees have to be paid and several days pass by before the payee receives the money. PayPal's slogan: Easy, fast and cheap. These arguments convince.

So far, only insiders are using those functions but the comparative low costs could quickly cause a substitution of an existing bank service. Some banks consider outsourcing or hiving off payment transactions which apparently produce costs and gain only small revenues. This could be indeed short-sighted.

The typical banks' service - which customers are utilising most frequently- is payment transaction. If this service is taken over by a third party other business areas can be lost quickly. In addition to this, PayPal could use the Money Market Fund as the first step to overtake the deposit business. The argument that PayPal cannot act in Germany and Europe as in USA because a bank licence is needed could be another fatal misinterpretation.

European Central Bank:

PayPal doesn't necessarily need to open a branch in Europe to do their business. Already today every German citizen and every German company is allowed to open a PayPal account without any problems. The low spread in Germany mainly results out of the fact that neither PayPal offers German web pages nor eBay Germany promotes PayPal.

If PayPal keeps on with its strategy to exclusively run the system via the USA this would mean the de facto export of the payment service. This would have a negative impact on the volume of money in circulation and ECBs minimum reserve policy and therefore shift liquidity at the expense of Europe and in favour of the USA. This especially applies if all the money within the PayPal system will be invested in the US American financial market and will therefore mainly support the US economy.

National economy:

The situation would be even more dramatically if PayPal succeeds in the market and still denominates in USD only. In an extreme case this could mean that products and services offered via the internet would only – or at least in addition – be priced in USD. The USD as internet currency could not be of interest for either the European central bank or the European economy.

The effect of globalisation based on different national legislation with respect to topics like money laundering, taxes and fight against fraud would raise fundamentally new questions: PayPal transactions do not show up in any bank documents⁵.

⁵ Peter Thiel: "Let's say you're in the middle class in Moscow, with a ruble-based bank account and a credit card. Use the card to make payments to a PayPal account and you've effectively opened an offshore account."

Source: http://www.wired.com/wired/archive/9.09/paypal_pr.html

PayPal's Strengths and Weaknesses

First of all the strength of PayPal is the high grade of service orientation. An email question from our side was answered within less than 30 minutes! With this reply behaviour PayPal may have beaten the average reaction time of its competitors by far. Everyone who registers at PayPal can experience that PayPal has completely internalized the credo of the new economy: speed. As a matter of course PayPal directly settles transactions. In case of international payments the advantage is easily comprehensible.

PayPal has not reached its goal yet and even the impressive number of 17 million customers with about 28,000 new customers daily and more than 200,000 transactions per day does not already guarantee a breakthrough. On the other hand, as a Gartner Group study⁶ shows, PayPal is settled at least within the USA if it achieves the critical mass of more than 25 million customers.

The contracts with the credit card companies could turn out to be an Achilles' heel. If the credit card companies cancel the master merchant contracts PayPal's only possibility would be to engage in this part as well. This would result in a new, direct competitor for the credit card companies which could, on the other hand, cancel the issuing of credit and debit cards of the existing companies with negative influence on their business. Based on its centralized system PayPal could probably establish an own, less expensive credit and debit card system. This may explain the current, almost indifferent position of the card industry.

A further obstacle could be the regulation authorities. If PayPal will be regarded as a bank several regulations would take effect. Especially the requirements regarding customer registration (mandatory check of a

legitimation document) could abruptly stop the rapid spread.

Banks, credit card companies and public authorities do not perform any visible steps against the further spread of PayPal. The probably feared cannibalization of the own flow of income could also be done by PayPal. To wait does not give any advantage. It's currently not realistic that banks acquire an interest in PayPal and are able to "share the income" similar to credit card companies. As a matter of fact PayPal would more likely have to increase its fees when integrating other companies, and therefore lose one of its most important advantages. PayPal does not seem to depend on any cooperation with the financial industry – in April PayPal achieved profitability.

Whether or not PayPal can be stopped is still an open question. Its success in Europe will be mainly determined by eBay's strategy. It will seem more or less improbable that eBay supports PayPal in the USA only. The number of customers will increase even faster if eBay establishes PayPal as globally preferred internet payment for auctions.

You can't stop the moving mass. In the beginning almost nobody dared eBay's success as well. Founded in 1995, eBay is the largest online marketplace worldwide today. Competitors like Yahoo, Hood, etc. are meanwhile almost irrelevant. ricardo, revealed only a few years ago, could not even affront eBay through the acquisition of QXL.

Conclusion

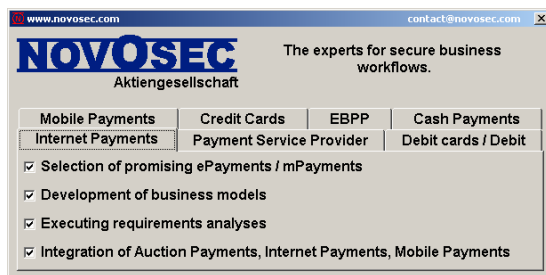
PayPal is certainly still far away from its own ultimate goal to "achieve world domination". In the area of internet payment transactions PayPal is already a market power today. The spread of business is prepared and in full swing. Therefore the further success more than ever depends on the position of the banks, credit card companies and public authorities.

⁶ See also Gartner study „Online Person-to-Person Payments Move Into the Mainstream“

One fact is clear: PayPal sets the benchmark regarding comfort and cost; this will influence the whole business independent from the further existence of the company PayPal itself.

Are you interested in these topics? Do not hesitate to contact us:

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