MANOLE CAPITAL MANAGEMENT

Manole Capital: Zelle
October 2022

Zelle:

P2P (peer-to-peer) payments are a simple way to send or receive money, without going through a traditional bank. P2P payments have become so synonymous with simple payments that most people just say "Venmo me". Whether you're paying a babysitter or settling up a lost golf bet (something we know nothing about), P2P payments have become commonplace.

We have discussed the opportunity we see with PayPal's Venmo platform (click here). We stated that PayPal's ultimate goal was to gain physical PoS (point of sale) acceptance, with more and more consumers downloading and adopting its Venmo payment app. That is slowly occurring, but most brick & mortar merchants still don't accept PayPal and Venmo.

We haven't written about the equivalent payment platform for the banks – Zelle. It started in late 2017, as a payment project for big banks to compete with FINTECH start-ups like PayPal's Venmo. Now, Zelle reaches roughly 80% of US checking accounts and the network claims to have 10,000-member financial institutions in its network. Zelle is a bank-owned network, essentially run by its Early Warning Services (known as EWS) group. EWS is owned and operated by Bank of America, Truist, Capital One, JP Morgan Chase, PNC Bank, US Bank and Wells Fargo and it acts as Zelle's operator and payment network provider.

During its 5 years of existence, Zelle has processed over 5 billion transactions and nearly $1.5 trillion of dollar volume. On average, each transaction is about $275, which is much, much higher than the typical PayPal or Venmo P2P transaction size. Many small businesses are accepting payments through Zelle, as evidenced by their +162% dollar payment growth in 2021. Consumers and businesses sent 1.8 billion payments through Zelle, up an impressive +49% YoY. Last year, Zelle did $490 billion of transactions (up +59% YoY) which is more than 2x that was conducted on Venmo (statistics per American Banker).

The CEO of Zelle (and Early Warning Services) is Al Ko and he sees Zelle as competing with cash and check transactions, offering greater speed and immediacy of older payment methods. For Ko, he views Zelle as "digital cash" and he expects card-based payments to continue to "rule the roost." From its inception, a key concept for Zelle's success has been this concept of trust and knowing that your bank stands behind your transactions. The early marketing campaigns centered on the safety and security of Zelle, your traditional banks way of paying for things, as compared to the "wild west" of unknown and scary online payment platforms. In one of its earliest marketing campaigns, actor and rapper Daveed Diggs says, "You can send money safely, 'cause that's what it's for, and it's backed by the banks, so you know it's secure." This marketing angle was intentional and tried to piggyback on one of the keys to the massive growth and success of credit cards; consumers are protected from fraud. A key reason for the success of credit cards is that financial institutions act as backstops, protecting consumers from fraudulent transactions.

Recently, Bank of America was sued from fraud associated with its P2P platform and for it failing to refund consumers that were taken advantage of. It isn't just large financial institutions that are at risk, but smaller banks have also suffered from rising fraud levels. A recent study by PMNTS found that 71% of all financial institutions reported increased fraud rates and an average loss of 1.75 basis points per transaction. That same study found that 59% of financial institutions surveyed experienced an uptick in fraud, with fraud loss rates averaging 1.29 basis points per transaction. These types of losses might seem trivial, since they are reported in basis points, but one needs to understand it is happening on millions of transactions and billions of dollars of transactions.

Over the last few months, fraud on Zelle's platform has garnered some significant governmental questions. In 2021, Zelle stated that its consumer losses due to fraud were only $440 million and that the first half of 2021 it had just 192,878 cases of fraud loss. However, The New York Times has reported that 17 million Americans in 2020 were victims of fraud on their digital wallets or P2P apps. According to Insider Intelligence, US losses from fraudulent transactions will hit over $12 billion next year. Card-not-present payments (i.e., eCommerce and online transactions) are expected to equal $8.75 billion in the US, up over +11.3% from last year. Clearly, fraud is an issue that needs further examination.

Now, the CFPB (Consumer Financial Protection Bureau) is looking into this issue and has stated that it will shortly issue regulations and commentary on the matter. Specifically, the CFPB asked questions about "the rise of increasingly sophisticated scams on your (Zelle's) platform and the widely documented difficulties consumers have faced in seeking relief from banks…we seek to understand the extent to which Zelle allows fraud to flourish and the steps your company is taking to increase consumer protection and help users recover lost funds." Then, politicians from both parties lambasted Zelle for failing to protect their banking customers. At those DC hearing last month, Senator Warren (Democrat from Massachusetts) said that she worries Zelle fraud and theft "are rampant" and that it is failing to "root out disturbing reports of a rise in fraud." She then chastised Wells Fargo by saying that it has a "long and sordid history of misbehavior and mistreatment of its customers." Lastly, Senator Warren then threatened the big banks and said, "the big banks (who both own and partner with Zelle) have abdicated responsibility for fraudulent transactions, leaving consumers with no way to get back their funds." Ouch!

The American Bankers Association, Bank Policy Institute, Consumer Bankers Association, and The Clearing House issued a joint statement acknowledging that Zelle "is not free of fraud and scams" but claims the CFPB commentary and scrutiny "fail to acknowledge that 99.9% of the 5 billion transactions processed on the Zelle network (over the past five years) were sent without any report of fraud or scams."

How Banks View Fraud:

Zelle draws a sharp distinction between the two different types of P2P fraud. The first is unauthorized transactions, where a fraudster gets into your bank account and makes a transaction. This type of fraud has been fairly rare and uncommon, but it is covered under Regulation E of the EFTA (Electronic Fund Transfer Act). The EFTA provides liability protections for unauthorized transactions, but not for authorized transactions. This essentially means that a bank is required to repay customers when funds are illegally taken out of their account - without their specific authorization.

If a victim did <u>not</u> authorize a transaction, then the theft is fraud; the victim can usually be reimbursed. However, it is a different story if the victim acts on instructions from a scammer. On Zelle's website, it specifically states that "if you were tricked or persuaded into authorizing a payment for a good or service someone said they were going to provide, but they didn't fulfill it, this would be considered a scam." Zelle states that because you authorized that payment, you may not be able to get your money back.

The more common type of fraud are scams, cons, and deceptions. This is where the consumer authorizes a payment, but it turns out to have been a mistake or scam. The only way to protect against these fraudulent transactions is by education, information and somehow adding "smart friction points" to a transaction, that makes a user stop and think before pressing send. We receive weekly notifications from our banks about how we can avoid becoming a victim of P2P fraud, so we know this issue is painful.

We have spent decades in the payment space and find these new tricks by thieves to be devilishly ingenious and quite sophisticated. While AI (artificial intelligence) and machine learning technologies can help institutions track and combat fraud, the fraudsters always seem to be one step ahead. Want an example of this type of fraud? Well, let's say you receive a text on your iPhone from Bank of America or your traditional bank. It claims to be protecting you from fraud and it inquires if you authorized a $500 Zelle transaction. Since you didn't make this authorization, you want to protect yourself from fraud and notify your bank that it isn't legit. Next, you receive a phone call from the scammer, spoofed onto a Bank of America phone line, that walks you through the process of prohibiting this fraudulent transaction. The unsuspecting consumer receives a set of instructions that ultimately compromises their bank account information. The fraudsters have all the information they need to now withdraw funds from the individuals bank account.

Conclusion:

Politicians are looking to shields victims of fraudulent money transfers, even when they have been "induced" into transferring funds themselves. Banks believe they have no obligation to return money to their fleeced customers, as long as the users authenticated the transfers themselves. What happens if the liability protections are extended, and fraudsters can authorize valid transactions? How can a bank prevent its users from authorizing transfers? Is the goal to enact new and helpful legislation, or is to further regulate the big banks? If the CFPB institutes an expansion of bank liability, we imagine Zelle would scale back services, limit certain features and impose fees to cover their additional costs. These potential changes could result in service fees for users and/or the implementation of holds on certain sized P2P payments. So much for us being able to pay out our $20 lost golf bets on Venmo?!?

Warren Fisher, CFA
Founder and CEO
Manole Capital Management

DISCLAIMER:

Firm: Manole Capital Management LLC is a registered investment adviser. The firm is defined to include all accounts managed by Manole Capital Management LLC. **In general:** This disclaimer applies to this document and the verbal or written comments of any person representing it. The information presented is available for client or potential client use only. This summary, which has been furnished on a confidential basis to the recipient, does not constitute an offer of any securities or investment advisory services, which may be made only by means of a private placement memorandum or similar materials which contain a description of material terms and risks. This summary is intended exclusively for the use of the person it has been delivered to by Warren Fisher and it is not to be reproduced or redistributed to any other person without the prior consent of Warren Fisher. **Past Performance:** Past performance generally is not, and should not be construed as, an indication of future results. The information provided should not be relied upon as the basis for making any investment decisions or for selecting The Firm. Past portfolio characteristics are not necessarily indicative of future portfolio characteristics and can be changed. Past strategy allocations are not necessarily indicative of future allocations. Strategy allocations are based on the capital used for the strategy mentioned. This document may contain forward-looking statements and projections that are based on current beliefs and assumptions and on information currently available. **Risk of Loss:** An investment involves a high degree of risk, including the possibility of a total loss thereof. Any investment or strategy managed by The Firm is speculative in nature and there can be no assurance that the investment objective(s) will be achieved. Investors must be prepared to bear the risk of a total loss of their investment. **Distribution:** Manole Capital expressly prohibits any reproduction, in hard copy, electronic or any other form, or any re-distribution of this presentation to any third party without the prior written consent of Manole. This presentation is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use is contrary to local law or regulation. **Additional information:** Prospective investors are urged to carefully read the applicable memorandums in its entirety. All information is believed to be reasonable, but involve risks, uncertainties and assumptions and prospective investors may not put undue reliance on any of these statements. Information provided herein is presented as of the date in the header (unless otherwise noted) and is derived from sources Warren Fisher considers reliable, but it cannot guarantee its complete accuracy. Any information may be changed or updated without notice to the recipient. **Tax, legal or accounting advice:** This presentation is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations. Any statements of the US federal tax consequences contained in this presentation were not intended to be used and cannot be used to avoid penalties under the US Internal Revenue Code or to promote, market or recommend to another party any tax related matters addressed herein.