

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

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Panelist Remarks

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Panelist: Gerard Hartsink, Chairman, European Payments Council

### **Mr. Hartsink: [remarks correspond with handout]**

I thank you for the opportunity to be a speaker in this conference.

My name is Gerard Hartsink. I am working for ABN AMRO, but I am a speaker here on behalf of the European Payments Council. Also, I have some experience within ABN AMRO, being the project manager of the merger of ABN and AMRO and also involved in the takeover of Michigan National Bank by LaSalle at the time. I really have a lot of experience that substantial cost savings are possible in the payment industry, the securities industry, and the card industry. I believe that is not only true for the banks but for all the layers in the payment industry—not only the bank layer, but also the payments scheme layer, which is different than the payment network layer, like the American way of thinking, and the processing layer. So I agree with Jean-Charles that only three arguments—basically scale, differential power, and the governance—that it adds value, it reduces the cost of the production, the manufacturing function of the payments industry.

However, there are two additional arguments, in particular for Europe, that are relevant on top of your three arguments. One is the political argument. Basically the decision of the European Community, the Ministers of Finance if you like, to create a more efficient financial sector in Europe, which is not only limited to payments, has to do with every function in the financial sector in Europe. That is a very strong political argument on top of the three arguments.

Another argument is the restructuring of the industry, which is more than mergers only. It is “industrial economics” to make it happen and, that is, in the whole chain of individual independent players a movement should start to change the industry. That is, however, very important from the point of view of the multicountry players. On the buy side, being our customers, the merchant, the Shells, but do not forget the SMEs. A lot of the SMEs in Europe do have a buy and/or sell side in more than one country or have companies in more than one country. That is not only Shell or Ikea. The market reality is that on the buy side of payments a lot of SMEs are also in this space.

But also on the supply side, a lot of the banks do operate in more than one country. If you analyze the numbers of the payment industry, although I believe there are still 6,000 bank licenses, if you add up the top 30 group, they do have at least 60 percent of the market. The

majority, if not all of them, are multicountry players. My company is working in more than 30 countries in Europe. That is the market reality.

If you like to have even more than the three arguments of Jean-Charles for getting more efficiency from a horizontal point of view, you need absolutely to take away other barriers, being legal barriers and barriers on standardization and business rules. That is what is happening at the moment in Europe. That is not only true for the payment industry, but also true for the securities industry.

The restructuring of these functions is done a bit differently in the securities industries than it is in the payment industry in Europe. Basically, in the securities industry, it is first merge and then consolidate and have a big debate on business rules and standards. That is what is happening with Euronext, with LCH Clearnet, with EuroClear, with Clearstream. In all those cases, first the merger and then we start to quarrel about business rules and standards, which ones are dominant and, in a lot of cases, propriety standards and not open standards.

What we did in the payments industry is basically unbundle the different functions and have the real debate on the business rules and standards and make them global, so that all market players should adapt these business rules and standards in their processing and in their product development.

That is basically the role of the European Payments Council in the industry. We are just a body of banks, it is only a decision-making body and not a made association of banks. We are not sitting around the table because we like each other. It is not always fun sitting at that table, I can tell you! There are nearly 70 banks and some associations, out of 30 countries, speaking 27 languages at the moment. Over there, we try to agree on the business rules and standards, in a world where all the business rules and the business models of those institutions are quite different in Europe. However, we achieved that.

The legal part was done by the Commission and the Ministers of Finance and the European Parliament. It is rubber-stamped, applicable for 27 markets. It is not only there for the euro area, it is there for all 15 currencies. It will change dramatically some of the business models in Europe, not only in the Euro zone, but also in the zloty and sterling zone, because certain pricing policies are not possible anymore.

The SEPA concept is focused on the euro—only the euro, applicable today as legal tender in 13 markets and moving up to 25 markets. Denmark and the UK are not obliged to move to the euro, based on the agreements. Also SEPA is relevant for countries like Switzerland, Iceland, Liechtenstein and Norway. So, it is the EEA and

EU-27 that has to do with euro payments—domestic for the EU-13 countries and cross-border for the other ones.

At the EPC, the focus is on SEPA. The focus is on creating rule books with business rules and standards or frameworks with principles. We do have a set of concrete deliverables. There is a supporting slide for that in your packet about credit transfer, direct debit, and a solution for cards. We are also moving forward for complementary deliverables for cash, for E-payments, for M-payments, but it all has to do with the cooperative space and not with the competitive space of banks.

The borderline between the cooperative space and competitive space is quite different in the different markets. That makes it even more complex, because the views of individual banks may differ even internally in large banks where the borderline is between the competitive and the cooperative space.

Debit and credit transfers. Maybe it is good that you look at page 12 of my slides, in particular for the Americans who do not understand Europe. We are thinking in three layers. The first layer is the value proposition of financial institutions or banks. They deliver core and value-added services that are part of the competitive space.

The second layer, and that is the work in particular for EPC, is the cooperative space, basically schemes, business rules, standards (not

European standards), global standards, ISO 20022 XML based on the best technology you can get today in town.

The third layer is again a mixture of competition and cooperation, principles of how we clear in Europe and how we settle in Europe. The central bank money for the euro the TARGET system is used. But there are different models of how we clear in different parts of Europe. In Germany, it is bilateral exchange. In other markets, like in France, there is one very thin platform in the middle. In the Netherlands, there is a very thick platform in the middle because at the time the banks outsourced a lot of their production functions to the common platform. So, the landscape is quite complex. But, if you do not understand these three principal layers, you do not understand what is going on in Europe.

The next picture is, in particular, relevant for the cards industry. For cards, we agreed at the time that it does not make sense to create the European card scheme because we have Visa, V-pay, MasterCard, and Maestro next to the domestic schemes, and some of the local markets do have Visa and MasterCard, as well as the local scheme.

At the time, we absolutely wanted that any card could be used in any POS terminal or ATM. If you do not create a new scheme, we thought the best is to create a framework with principles for the bank layer, so it makes one of the decisions is that any bank should issue cards from January 2008 with EMV and PIN and should take out those

cards which are not compliant at the end of 2010. A concrete principle for card schemes and for processors is that they should unbundle the governance of the scheme, so the business rules, the brand and the standards, and the processing part. And it has been done in several markets.

A lot of consolidation has taken place. It took us three years to get any compromise on the principles of the card framework. However, we are moving forward in Europe. What was said already today mainly is we are a debit card land and not a credit card environment. We thought, well, we have to take an additional step also again on standards, so we have an agreement of the EPC plenary, so all banks in Europe, that we are moving forward with standards. Those standards are also very important for the merchant. These are the standards for the card to terminal, the terminal to the host environment, the host environment from the acquiring side to the issuing side, and the whole certification process.

We will quarrel another one and a half years, but in the end, we will have open ISO-related standards, or EMV standards, or PCI standards—but in the end, global standards. Those global standards will have to be implemented, maybe two years, maybe three years, maybe five years, we will have to find out. But I am very optimistic that we can get that done. We already have an agreement on the

several business rules, such as how to move forward with fraud and how to move forward with clearing a settlement.

The only missing business rule basically is, What about interchange? That, in particular, has to do with two elements. First, we are not a scheme owner like we are for direct debit and credit transfers. So, that is not possible because we are not a scheme owner. And the second topic is the competition authorities do not give clarity as to how we should move forward with that topic, apart from the fact that all banks disagree on this point anyhow and there are different models in Europe.

So, if you analyze the requests of the European Central Bank in a report on November 18 to create a European scheme, not for 2008 but beyond, it was not easy to give an answer as the EPC because part of the Community said, "Over my dead body!" Others are very ambitious to realize it. Some senior bankers are now talking on the option that maybe we should create a scheme, despite the decision of three years ago, and the sentiment now is, "Well, probably we have to create such a scheme and it is feasible to do if you do have an agreement on the standards and that will happen within one and a half years."

If you do have an agreement on the business rule, the only thing that is really missing is, What about the brand? The key brand of any card is the brand of the bank and not the add-on of Visa or MasterCard



or PIN, whatever the brand may be. The best brand is your own brand, unless your own brand is a weak brand. I know that some key banks that will have a lot of cards in the market prefer to have the add-ons on the back or on the side of the card but definitely not anymore on the front. So, that is how we try to move forward with cards.

The impact of horizontal integration. First and foremost, what is the impact for customers? The multicountry corporations, SMEs, of course they will immediately have a lot of economic benefits and, in some cases, also better service levels. The argument of public administration is, What is in it for us? But in the end, the reality is that public administration—for instance, tax authorities—can only buy from a limited number of banks. Why? Because only the local banks have scale (volumes) based on the local standard. So Citibank or SoGen, or BBP Paribas or DeutscheBank, likes to deliver payments services to the Dutch tax authority, legally there is no objection, only they do not have scale and that is why they cannot have a proper pricing.

So if you now open the market by common business rules and standards, the competition environment will change also in the interest of public administration. Of course, there is a lot in it for society. I will not go into detail. If you are interested, it is on page 19.

The impact for suppliers is, of course, huge. You already mentioned a lot of investments have to take place. The business

models are changing. And all CEOs have to review their delivery side and the sourcing side of their payment services. On the sourcing side, does it make sense to continue to take care of the processing yourself at the sourcing side? It is golden times for banks that like to in-source or clearinghouses that like to do additional processing and/or for tech vendors.

The card schemes in Europe—it is a very sensitive issue—but some will die. It does not create any failure for the industry. I know that a lot of regulators fear that Europe ends into a duopoly. What happened already, some of you may not know, Visa and MasterCard decided to unbundle in Europe. So, you can have the Visa scheme, an Equens processing, First Data processing, or MasterCard processing. It is possible. In the end, banks are putting a lot of pressures that they want to pay only at the ultimate (not that much) for using only the scheme. In the end, the scheme is just a small part of the cost and part of an arrangement on a global level. But, the processing part is the major part of the cost base in American terms of a payments network. It is not the scheme layer, it is the processing layer.

So, card processors and clearinghouses, Ben told you the story, are also reviewing the strategy. If they do not change, they will die because it is a scale business. I was in a meeting with SWIFT three weeks ago, and 180 vendors were there. Well, for them, it is golden times and all the guys, like SAP, Oracle, IBM, have already

implemented the standards in their new releases of ERP systems and their technology for banks and for corporations.

To conclude, Mr. Chair, I believe that what is going on in Europe is we are restructuring the value chain for payment services. It has a huge impact for customers, in particular, corporations and public administrations, banks, schemes, and the service providers. And, they are all reviewing what to do for the next step.

The horizontal integration is taking place now. It will deliver value for individual institutions unless they do not change. Then they have a serious problem. In the end, it will also deliver value for society, for the customers.

Thank you.