

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

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General Discussion

Author: Jean-Charles Rochet, Professor, University of Toulouse

Moderator: Ken Howes, Director, Edgar, Dunn & Company

### **Mr. Kenneth Posner, Managing Director, Morgan Stanley:**

I want to clarify how this separation of processing and scheme would work. If the customer walks into a store with a certain card, they have made the choice. Who then determines where the processing goes? Would the merchant do that or would the bank do that?

### **Mr. Gerard Hartsink, Chairman, European Payments Council:**

It could be the bank. It could be the merchant. The merchant can knock on the door of several processors. That is possible. They use the scheme, so in your first slide, what you presented, the top player you said the payments system, you should unbundle that in two parts. It is a network and it is the scheme owner. So the scheme owner gives rules to the game for those who adhere to the scheme. Those could be banks. Those could be payment institutions. So it is not exclusive for banks. That is who fits in the scheme rules. Processors could fulfill

any role in this game and they could support merchants, banks, or banks and merchants.

**Mr. Posner:**

This is a follow-up. Suppose I walked into a grocery store with a Visa card and the grocer wanted Visa to process it and the issuing bank wanted MasterCard to process it?

**Mr. David Yates, President, Europe, Middle East and Africa, First Data**

**International:**

Could I maybe pick this up? I think the example you are giving is not really the example for which the ECB is trying to regulate. The concern that exists is that there is a scheme like Visa or like MasterCard, possibly other schemes that will emerge over time that will define the governance and the rules associated with payments.

What the ECB would like to see, as I understand it—if I am wrong, there are a couple of members here who will correct me—is that any individual bank or merchant acquirer should have the opportunity to take the processing of that business, even if it carries a Visa logo on the card, to whichever processor they want to have and there should be no—under any circumstances—cross-subsidy from a scheme to that processing business. That is my understanding.

**Mr. Howes:**

There is one there and then one there.

**Mr. Nicholas Economides, Professor, New York University:**

I guess this is kind of technical question, but it is for Jean-Charles. I heard you say that the horizontal merger is, in general, desirable with network effects. That is probably not what you wanted to say because even though we have network effects, they must be relatively very strong and relatively special circumstances to make it desirable to have a horizontal merger, which would increase consumers' welfare.

**Mr. Rochet:**

What I meant exactly was that, in the case where these economies of scale are really important, like in the payments industry, then it is likely the mergers are good for consumers. However, there is an additional aspect that maybe I should have emphasized, which is that you do not necessarily want to have small members of networks because you may just encourage coordination or interconnection of different networks, if there is another way to achieve these economies of scale in particular on the demand side. This is related to the notion of reachability that was introduced here.

You may want to maintain several networks, but if those networks are interconnected, then consumers do not lose anything from that and

they benefit from competition. I believe this aspect is also very important.

**Ms. Bronwyn Hall, Professor, University of California, Berkeley and Maastrich:**

I wanted to ask the people involved with SEPA, I wanted to understand the transition process from the perspective of an SME, multicountry or not multicountry, just because in a sense that is a way to understand how difficult this process is. I did not quite understand. I think about it from an U.S. SME perspective. This is fundamentally not a problem if something like this happened here because his bank does the transition for him.

How do I make my payments? I write checks or I charge things. How do I receive payments? I receive Visa payments or I receive checks from customers that I deposit in my bank. So, it is my bank which does the transition. From my perspective, the whole thing is transparent, as long as they accept the same payments. How does it work in Europe? Is this also true in Europe or would this SME have to do something?

**Mr. Hartsink:**

We have a model, which is similar to the model for the introduction of the euro. So, basically the design is at the European level, the business rules, that is. The implementation is done country

by country. We have a common future, but the history and the reality are different. But, if you take the case from a consumer perspective, from January 2008, any consumer can go to his banks, like from now on, move forward with SEPA credit transfer—and only SEPA credit transfers. That is possible.

What does it mean? All consumers in Europe do have already an IBAN number, mostly also on their statement. They are not always aware of it. From a consumer perspective, they receive all salary, or pensions, or social benefits, it will be in the end on their account.

The outgoing side is basically using debit card in the majority of cases for getting money out of an ATM and/or in a POS terminal or through a direct debit. So, the number of payments done by a credit transfer where you should know the IBAN number of your counterparty is very limited in Europe from a consumer perspective. So, IBAN conversion has taken place already in some countries, like Luxembourg and some of the East European countries, which some of them are not yet on the euro.

Your question on an SME. The model is that any SME can start asking for these types of services from January 2008. Probably some of them are interested because do not forget the number of SMEs will buy or sell in more than one market and do have more than one bank account or have special arrangements to get it done. So their bank, of course, has to support them moving forward. And, in their accounting

systems, their EIP system—it is not an ESP system, not SAP, or an Oracle-type of system—will have to be upgraded. This market of those who are in technology to give support for the account payables and account receivables of SMEs, that market is moving very fast at the moment.

**Ms. Hall:**

I have just a couple of comments on that. First, there is already a substantial incentive to use IBAN numbers in cross-border transfers. So people are already learning how to do that because you do not have to pay fees if you use an IBAN number. That should help a little. It does not make it easy; it just helps a little.

For doing a transfer, it sounds like the real problem for an SME—I am thinking about a small SME, meaning not one that has Oracle. This is one that does its accounting in QuickBooks, the little firms, because that is where your lag is going to be, right? Your larger firms, in a sense, have the resources and they have the incentives to get the savings from this, where the lags are going to come from is from the many, many small firms. So, I was trying to understand—it seems to me most of them will face a lowering of costs. Their main problem is that they may need to get IBAN numbers from their customers. It sounds like it. That is the key thing here from their perspective.

**Mr. Howes:**

I think everyone is piling on this one. Ben, do you want to go ahead.

**Mr. B. J. Haasdijk, Chairman, Equens:**

To answer that, as I said earlier, in billing up our service portfolio, we are also reckoning with the fact these products, as they are described in rule books, may differ from what people, small SMEs, are accustomed to. We do not know, and neither do the banks at this point in time, what is going to happen. One should be careful in trying to address that change or at least take care of the fact that it is indeed totally transparent for the ultimate user of the banking services. Otherwise, those people, those companies, will be confronted with making, albeit small but relatively high, investments to accommodate for new products they do not need, in their perspective.

**Mr. Yates:**

A couple of observations on SMEs. I think the discussion around IBAN is very straightforward. A bank-to-bank transfer, everybody in Europe now has a number that can be used internationally. From the end user's perspective, that is very simple. From the bank's perspective, it is rather expensive to process, but that is something that will get sorted out afterwards.

When you talk about individual money transfers that go cross-border, the actual volume is less than 1 percent of total payments in Europe right now that go cross-border. So, we are not talking about a huge amount at the person-to-person level, but when you get to the SMEs, that number increases and probably will increase even more. So, then you get into the discussion about merchant acquiring cross-border and e-commerce cross-border. When you start to get into those levels, actually receiving a card and accepting it is easy enough for a merchant taking a foreign card on any point-of-sale device in Europe.

The issue becomes one of the fees that get assessed on that, on whether the acceptance of a MasterCard in your domestic currency equals the pricing for the same card coming from a foreign country. That is not simple to sort out in the short term, but it will get straightened out within the next couple years. That is what a lot of the consultation work that Gerard and his team is working on is about, to harmonize those things.

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

Ken, at the end of your presentation, you made a comment—maybe I misunderstood you—about whether the real benefits of implementing surcharging in Australia had gone back to the consumer. What struck me strange about that was clearly, in my view, if I do not use the higher payment type, I am buying the item at a lower price



than if I am using a higher payment type. So, I was trying to understand why that pricing transparency that exists there was not a good thing, or maybe I misunderstood your question in general.

**Mr. Howes:**

I am not sure when I last went into Australia. I was being priced—I was being surcharged—effectively everywhere I went. Every time I asked I was told, “Well, this is not our problem. This is actually the problem of the card scheme and so on.”

The amount I was being charged I know was much more than the amount of the merchant discount fee. So, effectively, and this is anecdotally from what was happening to me, I saw an excuse being made for surcharging on certain types of products in certain types of stores, when in fact I did not see the rationale for a surcharge because I knew what the merchant service charge was.

I am not sure whether ultimately the consumer is benefiting specifically on that. I know when I last heard Woolworth speak, they were arguing that there were consumer benefits that had been reflected. A colleague from Australia may know much more about that. I certainly anecdotally did not get that impression. Because of the work we do with banks, I knew what the merchant service charge was likely to be, and I was being charged more than that as a surcharge blamed upon the banks.

**Ms. Hall:**

Of course, cash customers may be paying less now. They can price-discriminate against visitors.

**Mr. Howes:**

That may be it

**Ms. Joanne Robinson, Managing Director, VRL KnowledgeBank:**

I have a question for the panel. As the payments industry in Europe continues to consolidate, the cost-revenue model also continues to evolve. I wanted to hear your views on the evolution of the models and, more interestingly, if you would take your crystal ball and give us a feel of where each of you thinks they will be going over the next few years.

**Mr. Haasdijk:**

One of the reasons underlying our merger is the synergies that are obvious. Our business model is not one of having to achieve a yield on equity that is good for our shareholders because that is not why they are our shareholders. What we need to have to achieve is a return that makes our life sustainable. Apart from that, any benefit we will

have will be passed on in terms of reduction of the prices for our services.

On the basis of having everything on one platform, because that is the underlying supposition, we think prices will go down at least 30 to 40 percent in today's money.

**Mr. Hartsink:**

The EPC does not have any position on pricing, but, as an industry expert in working for a company, I am prepared to say something about it. What my observations are, the reality is that in all markets in Europe cash is not priced properly. And, cash is still king also in Europe, at least six out of seven payments on average are done in cash, more in Italy and less in Finland.

If you analyze the revenue models, and you compare them with the U.S. revenue models, the U.S. revenue models are on average better. Why? Because it is more fee-related. In Europe, the revenue models are mainly interest-related. So, it is the float; it is the balances on credit balances and debit balances in the current account. What will happen is that the Payments Service Directive will reduce the interest-related revenues of banks, not only for the euro, but also for the zloty and sterling because it is applicable for 15 currencies. That is a serious issue for banks to reconsider their marketing-pricing model in relation to their value proposition.

What is also the reality in Europe is that every market today is an ecosystem and, in some markets, on balance, it is more the consumers paying the bill. In other markets, on balance, it is more the corporations paying the bill. So, it will be a challenge if we open technically old markets what the new balance will be. A lot of CEOs talk about 20 percent of the revenue base and fear that we are moving into a direction that may become unmanageable because our colleagues—the large merchants—will, of course, if you give them one cent, start to quarrel on another cent. But, in the end, who is paying card payments? Is it the smaller merchant? Is it the consumer? Or is it the large merchant? Who is paying the bill for card payments? If it has to do with direct debit, who is paying the direct debit in the end? Is it the consumer? Or is it those who collect the money—public administrations, large corporations, etc.—so that debate has to take place and will take place in coming years.

**Mr. Yates:**

A couple of observations on the cost-revenue model. I think from the bank's perspective, the revenues they can generate out of the retail payments business are going to come under serious pressure. There are attacks coming from many different directions. Clearly, the retailers are not happy. We heard some of that a little bit earlier on. But also the regulators are taking a hard look at interchange. The

consumer protection bodies are looking at annual fees and late-payment fees and all kinds of fees. So, from every direction, there is pressure on those models.

The second thing that is going to happen is, when you start to look at the harmonization of—now I was talking about the cards business in Europe—what you tend to find is that the economic models for these things are completely incompatible from country to country. If I take a couple of extreme examples, let me take Greece as one example, where terminals are so free that merchants typically have five or six of the things, but get hammered with high interchange and high merchant discount fees versus Belgium, where effectively debit acquiring was free for the merchants, but they get hammered with expensive terminals.

You can see this incompatibility that exists, so there is no market that really looks coherent. As these things coalesce, there is going to be a lot of money being taken out of the system there as well. We are going to be looking for ways of generating new profit. I think the banks will turn toward credit as a tool for generating additional profit. They are going to need processing environments capable of delivering that. But also processing environments of themselves respond to this cost pressure and take cost out on behalf of their bank customers and their merchant customers.

**Mr. Howes:**

I have a couple of observations on it. There are some regulators intervening—particularly national regulators—in a way which is prejudicial in my view to a normal business model in economic terms. One example would be those regulators that intervene in consumer pricing, setting limits or not even allowing consumer pricing. That might be a consequence of some of the other developments taking place. I am not sure that it is appropriate for a national regulator to do that in a bigger domestic European environment or indeed a European regulator. There is also a classic one, and I am sure my European colleagues will groan. Effectively you have an example of taxation on card functionality when there is a cross-subsidization of cash existing in the same economy.

The other thing is, on nonbanks, the business models can look very different. In terms of nonbank entry, some of the traditional revenue streams that banks look for are not necessary for the nonbank environment because they are effectively cross-subsidizing for other aspects of their value proposition. I think business models of nonbanks will become very interesting going forward because they enrich more the overall value proposition of the product.

**Mr. Wilko Bolt, Economist, De Nederlandsche Bank:**

I heard the panel saying a few times—Ben said it and also David—that the optimal number of payment processors in Europe could be between three and five. That does not sound like an awful lot of players in a large geographic area. I understand that because of scale effects the number of players is reduced, but scale effects also imply probably that the market is not very contestable. Who makes sure in the end that the large cost reductions—because of scale economies—are passed on to the end users in that market?

**Mr. Haasdijk:**

I will try to explain three to five by finding the optimum between a number of suppliers allowing for competition, on the one hand, and, on the other hand, avoiding a too-high degree of complexity, for instance, in the context of reachability throughout Europe. You can imagine if that number would be 10, it would be horrible to achieve that.

If you look at the clearing and settlement side, where I was talking about, most of the institutions that are there currently are bank-owned. What you see happening is either mergers—like the one we did—or you see central banks or groups of banks finding other suppliers for their processing activities.

One of the reasons is, if you go back to the SEPA core product I was referring to, that is basic to everybody. I am quite sure the price of those transactions at that level will be a first determining factor in

finding a processor. You have to bear in mind, even to the extent there are only three or four processors, banks have the possibility to shop around and we have every certainty they will indeed do that. By virtue of the standardization, that will help.

**Mr. Hartsink:**

The reality of the market is that not all markets in Europe do have clearinghouses and processors. If there is such an animal, it is max 15 percent of the cost base of processing. So, 85 percent of the cost base is in banks themselves. If you compare these animals, like Equens and Voca and the others, they have a clearing function, but some of them are also in-sourcing processing. More and more, they become processor instead of clearinghouse. If you compare it with the United States, the Clearing House Payments Company and EPN today are part of the New York clearinghouse, which also acquired the Chicago clearinghouse. There was a concern in Chicago, in particular for the smaller players, that the big boys would dominate the whole game and they should pay higher fees. It was sorted out.

So, if you then compare Europe and the United States in particular on the clearinghouse level, there is a lot to gain in Europe. I believe there is even maybe a lot because you need reachability to all bank accounts. That is not happening. There is only one so far, EBA



Clearing Company, apart from the TARGET system. Others do not have reachability to all bank accounts.

**Mr. Howes:**

David, I think you may have the last comment because we are running out of time.

**Mr. Yates:**

There will probably end up being more niche players than just three to five. But in terms of scale players, three to five is probably about as much as the market can really afford. And that for a couple of reasons: One is because the banks and merchants are going to have to demand very, very efficient processors because competition is going to be pretty cutthroat. If you look at the United States and see what has happened in the United States on the ACH side, I think there are two in reality, so why wouldn't Europe come down to three to five? Beyond that, we had a big conversation earlier on about systemic risk and making sure that processors—nonbanks—involved in the payments system are regulated to the same levels and standards as banks themselves. You cannot afford to do that unless you are up to a certain scale. The demands and regulated supervision of these organizations would get to a point where it forces the small players out of business.

**Mr. Howes:**

Are we out of time? Just one left.

**Mr. Ron Congemi, Senior Vice President, First Data Corporation:**

Ken, you referenced several times, as did Gerard, the cost of cash. I believe, Gerard, you even suggested the lack of knowledge—I will use that term—of the true cost of cash can sometimes act as a barrier to electronification of payments. In other words, until we realize the cost of what appears to be 80 percent of the payments in the EU, this is going to be a considerable challenge.

I know I cannot ask a question like, What do you believe the cost of cash to be in Belgium? Or the cost of cash to be in France? But is there a range that has been established either from a banker's perspective, like Gerard or yourself as a consultant, because I know your organization works on interchange rates worldwide.

**Mr. Howes:**

There have been a number of cost-of-cash studies done. In certain countries, in particular, for example, the Netherlands, there has been a cost-of-cash study done. I do not think from where we have gone into individual banks to work out their cost of cash or indeed where we have done some merchant studies—we have done some in Germany,

for example, to look at their cost of cash—it has been easy to average it out.

On the merchant side, cost of cash really differs significantly between the type of merchant. The interesting thing is the lack of knowledge, even for people running their own business, in terms of working out or having some sort of idea of the cost of cash to them. If you think that is strange, we do cost-of-payment studies worldwide and this is what we see.

It is absolutely astonishing how the handle on understanding costs is not really there in many financial institutions and certainly also not in many merchants. It is very difficult to average that out. Certainly, we did at one time say, for a transaction above a certain amount of euro, it is more cost-effective to go into a card or a direct-debit transaction and so on. One or two other consulting firms have done that as well. That might be a rule of thumb, but it is changing as well. Because of other, more cost-efficient means of electronic payment the cost of cash does become comparatively a disadvantage.

That is probably not an answer to your question. It is very difficult. But you have to look at each country or each particular bank. What we do know is the cost of cash is higher, and it is cross-subsidized and not transparent.

**Mr. Hartsink:**

The EPC started to review how to reduce the cost of cash in all elements. We started first with the back-office part. There is a card-cash framework, SECA (Single Euro Cash Area), and that is focused on the euro. That was also the trigger for the governing council of the ECB to have a decision how to move forward with the cash convergence story—not yet published but soon it will be published—to have more harmonization from a central bank perspective in Europe in the euro zone. Some central banks do not do anything on cash, monitoring and basically issuing of cash legally. But the processing is done outside the central bank. However, there are also central banks that are still printing bank notes, so that is another part of the extreme.

The EPC will come in June with a document. It is about cash usage in Europe. It is not only focused on the euro zone, but it also includes the lessons learned in those markets. Think about Norway, where there are very strong cooperation models of banks, merchants, and the public authorities—not only the central bank, but also the Ministry of Finance—how to drill down the cost of cash. The best examples you can find in Europe Economic Area countries are Iceland and Norway. So, if you would like to know more, it is a very good example. They could drill down the cost substantially.

**Mr. Howes:**

In fact, there is a paper published by Norway which is available.  
We are there. We would like to thank the panelists for their great  
contributions.