

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

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Moderator Remarks

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

Mr. Howes: [remarks correspond with handout]

Thank you very much, Jean-Charles, for your discussion. I am sure there are going to be lots of questions around some of that, particularly, and also from some of the comments we are going to hear from the panel.

I now have the opportunity to say some things myself. So, I will draw some observations, if you like, that I have taken from Mr. Rochet's paper and its applicability perhaps in the European payments environment, but also move on a little bit to some of the developments that are going on in Europe, in particular with relation to horizontal integration and the role of nonbanks.

First of all, I know it is obvious, but it is easy to forget that when you are talking about the payments environment in the United States, it is *not* the same as in Europe. Sometimes, comparisons are difficult to draw. We have multiple everything in Europe: multiple cultures, multiple languages, multiple currencies, multiple regulators. For many aspects of payments, the industry has developed on a national basis—on a country basis—different dynamics, different economics, different

profiles, leading to a lot of legacy issues, a lot of legacy constraints, a lot of legacy business models from country to country.

For example, credit cards—with the notable exception of the UK—are not dominant in most of the rest of Europe. It is very much a debit card or a direct debiting culture and cash still is very prominent in a number of countries. You can travel 300 miles in Europe, across the national boundaries, and you will have completely different payments environments for banks, merchants, and customers in each of those countries.

The payments value chain, however, in Europe has been traditionally controlled by banks, either directly or through jointly owned organizations. But we have seen the role of nonbanks increasing significantly in recent years, particularly that is in the back-office side of the business, such as processing and network provision. Nonbank activity, however, is also now beginning to emerge in the provision of payments instruments and payments products. It is going to be interesting to see the development of organizations like PayPal and Google intermediating potentially in the payments value chain in Europe.

Now, in the United States, Mr. Rochet's paper suggested a couple of the key drivers of structural change in the payments industry have been financial deregulation and migration to electronic payments. Well, certainly the latter is a very key issue also in Europe. The

challenge for SEPA and other EU initiatives to achieve harmonization across Europe in the creation of a single domestic market is—and I might say controversially—a politically driven as well as an economically driven challenge. Therefore, one has to recognize that maybe economic drivers may not always work in the best way in terms of the end result of what might be SEPA and harmonization in Europe.

What is certainly true is the level of impact that SEPA and other initiatives are generating will mean significant changes in the European payments landscape. One of the consequences of that is potentially the emergence of more new firms, more new organizations, including nonbanks.

Another is the significant investment level, and I have not heard that mentioned today; a significant investment level is needed to implement some of the changes that are taking place. And not just the level, but also the prioritization impacts are critical. Those who want to be SEPA-compliant, therefore, are having to decide on investments and prioritization that impact some other developments.

Now, in terms of horizontal integration, the paper cites the waves of mergers are triggered by aspects, such as deregulation or development of new technologies. In Europe, we have seen, as has been mentioned before, the desire to achieve some self-regulation. Within a European regulatory environment, which is now broadly defined by the long-awaited Payments Services Directive, there is not

so much deregulation, but perhaps a change in the regulatory environment.

Now the focus has to be on two other key areas, in my view: first of all, strategies to reduce cash usage (I will come to that later.); also, the updating, if you like, or relook at the e-money regulations that are around in Europe in the light of the Payments Services Directive.

Another principle worth mentioning is the fact that, in Europe, in the cards business, of course, technology is changing. It was already the cards schemes' decision to move to chip technology—that is a principle of SEPA. Maybe SEPA is encouraging laggards in the industry to make that necessary investment.

In terms of reasons for mergers, and the benefiting of shareholders and managers in particular, I am still not clear where the survival instinct fits into this context. In Europe, some of the projected mergers are to create entities that have sufficient scale, geographic coverage, merged skills to help survive in a marketplace, where some national entry barriers actually have been removed. The real drivers could be shareholders or executives looking to continue, if you like, with the same form of business, but looking for merger partners to do so.

I would argue, however, that even in a non-SEPA environment, the drivers of horizontal integration were always going to apply in Europe, at least in the manufacturing part of the business. The prevailing views are that the SEPA principles, reflected in the Payments Services

Directive, are likely to lead to more consolidation, rationalization, and outsourcing of key aspects of the payments value chain.

Another interesting point is the level of expectation about rationalization within the payments industry as a result of SEPA. Particularly relevant is the processing environment where the number of processors across Europe is expected to reduce significantly because of scale economies. At the interbank level, where electronic interbank transactions have been traditionally processed by national ACHs, we are also beginning to see interesting cross-border mergers, such as the creation of Equens.

Recently, Edgar Dunn did some work for a processor in one of the countries in southern Europe. Now, the shareholders of this organization were concerned they would lose cost and other advantages in the future, owing to what they saw as a big transformation of the European processing industry. We were asked to look at all the options from sales to outsourcing and value those options. I know that without those major changes taking place, the shareholders of this organization would not have considered any other scenario but the status quo. So, they are being forced to look at this. In a sense, rationalization in the processing environment due to SEPA is, to some extent, self-fulfilling.

Let us remember the payments instruments we are talking about often have a multipurpose aspect. In my view, they operate in more

than one value chain, often at the same time. Clearly, they operate in point of sale in the buy-sell value chain. But, increasingly, they are operating in other value chains. With credit cards, they operate in the provision of credit value chain; with money remittances and transfers, they are operating in another value chain; and sometimes the same instrument can be applied into all of those value chains, sometimes at the same time. I believe that the relationships with other value chains actually provide real opportunities for nonbanks to provide value-added services to the commodity core payments instruments to make them more attractive to consumers.

One example could be payments fulfillment services. Another example would be load networks for prepaid top up. Controversially, I wonder whether the European regulators do fully appreciate the complexity of the pricing structures for payments instruments and the potential impact on the competitive environment of some of the changes.

I am concerned about the absence in a lot of the discussion—and deliberately so—about the profit motive and the inevitable commoditization of payments that might lead to less competition; less investment in payments; and actually even the withdrawal, for example, of the traditional banks involved in payments or at least in relooking at their continued role. So, it might be paradoxical that

measures that actually encourage nonbank participation in payments might encourage banks to reconsider their role in payments.

Let me expand also on another couple of points. The economics of payments in Europe are absolutely distorted by the extensive cross-subsidization of cash. This is not generally transparent to consumers or to merchants. In fact, work that we have done with extensive studies for clients have shown that many, many banks in Europe do not know the cost of cash, and many merchants in Europe do not know the cost of cash. Hardly surprising, then, that it is not transparent to the consumer, who, in many countries in Europe, see cash as a free commodity.

Now, the EU would like to see migration, I think, from cash to electronic payments, but to address the cross-subsidization of cash might be a political no-go area. I don't know how we can discuss integration, nonbank involvement, etc., without looking at the total picture of payments—including cash, which is a huge element.

A key question might be whether horizontal integration and rationalization of the payments manufacturing base will lead to the commodity pricing of payments instruments to the extent they become more competitive with the price and convenience of cash.

Our panelists today will be able to talk a lot about the impact of SEPA on their particular businesses; obviously the harmonization of standards, the evolution of SEPA rules, facilitating the opportunity for

some pan-European scale economies. I believe to some extent the commoditization of payments becomes a feature of this.

We have already heard that, in many countries in Europe, payments are not necessarily a big revenue stream for the banks. However, there is a big cost of provision of payments facilities. So, commoditization will have an impact. Banks will need to look closely at whether they want to continue to try to generate the cost efficiencies that outsourced players can provide.

The climate for nonbanks' involvement in the product delivery side of the payments business, I believe, has never been better in Europe. We are seeing a plethora of new types of organizations, products, and programs emerging in Europe.

No better example of that is in the prepaid area. Now, prepaid is much more prevalent in the United States at the moment than it is in Europe. But, for example, there is a surge in new prepaid programs, many of them driven by nonbank processors and some from just pure program managers. In the last two weeks, in the UK, a new prepaid card has been launched. The distribution network is media and magazines. The processor is a nonbank. The payment scheme is MasterCard. KYC—Know Your Customer—is undertaken by a nonbank third party. The bank BIN sponsor is Newcastle Building Society—not exactly one of the largest financial institutions in the UK. Yet, the company that has delivered this card, very successfully and

very effectively, has no track record in payments and has launched a product with five staff. This is an example of nonbanks entering and intermediating into the payments business. They are not doing everything and they are using a bank as a BIN sponsor, but they are heavily involved and they are providing added value in this respect.

The payments schemes themselves now estimate there are more than 300 prepaid programs about to be launched or launched across Europe. It is inconceivable that all of these will succeed. Therefore, we are likely to see another wave of integration as some of those programs find it difficult to succeed in a competitive environment for prepaid.

I am not sure I have heard one particular issue today; that is that this development could create huge areas of reputational risk around payments, which obviously has a major consumer impact going forward.

So, there are some key reasons why nonbank involvement in payments in Europe will grow. First, the barriers are being removed that prevented horizontal mergers in the past in European payments, and some of those mergers are actually involving nonbanks, albeit that a lot are ultimately owned by banks. For example, Lynk and Voca in the UK, SSB in Italy, SIA, and so on.

Second, the regulatory environment enabling nonbanks to exploit opportunities to intermediate in payments will lead to another wave of

integration in the next few years. Many of these organizations will be too small to survive and they will look to integrate.

Banks, for their part, will be evaluating where they need to participate in the commodity end of the payments business. For back-office functions that do not actually lend themselves to scale economies, there may even be roles for smaller boutique nonbanks to provide outsource facilities. Let me give you a couple of examples here. Dispute resolution services—you can image an organization just specializing in that. And also processing account applications is another one.

In conclusion, these trends raise some important questions for our discussion. Is the regulatory framework, established in Europe under SEPA principles and the Payments Services Directive, really creating a new type of entry barrier, replacing national entry barriers with a European entry barrier, because the standards are now applying to a bigger domestic market but, at the same time, providing and encouraging scale entry barriers to certain parts of the payments value chain?

Second, does the commoditization in the payments value chain ensure less appetite for technology innovation and implementation rather than more? To what extent will horizontal integration occur between European and non-European players? What will be the impact of that?

Finally, who will be the winners and losers in this? Or maybe we shouldn't be talking in that context. Are the consumers really going to be the winners in this? Are the cost efficiencies that are going to be derived something that will pass back to the consumers?

In conclusion, where we have seen, for example, in Australia issues around surcharging and merchant service charges, there is no clear evidence that we are seeing those benefits going back to the consumer in lower prices for product. That is an interesting question in terms of all the regulatory intervention that is going on.

Thank you. And now over to Ben. Now you are going to hear something really interesting.