

Nonbanks More of a Market Force

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Nonbanks have always been a key component in the nation's payment system, enhancing the efficiency, breadth and competitiveness of the industry. In recent years, they have become even more prominent, whether in back-office processing or front-end consumer interaction.

"Nonbanks in the Payments System," a paper from our Payments System Research Department, addresses some important questions raised by nonbanks' increased presence in the marketplace: In which payments activities are nonbanks engaged? What roles do nonbanks play in specific payments types? What types of risk are potentially associated with nonbank participation?

Nonbank activities, roles

Three different examples illustrate the importance of nonbank participation in some key payments activities. Three firms — Fiserv, Metavante and Alltel — reportedly have an 80 percent share of the core data processing market. Two other firms, Concord and First Data/NYCE, have a 63 percent share of the regional ATM/debit card network market, and PayPal has an 80 percent share of the online person-to-person (P2P) market.

In addition, the role of nonbanks extends to almost every transaction type. For example, in traditional point-of-sale transactions in which a check is used, nonbanks often provide check authorization for merchants and check outsourcing and data processing for financial institutions (FIs). In a card transaction, nonbanks can be processors and handle transactions via their own networks. They can also be at the forefront of a transaction, as is the case with emerging payments such as electronic bill presentment and payment (EBPP) and P2P services, in which a consumer may initiate payment on a nonbank's Web site.

Though data are not available to determine whether nonbank participation in the payments system is rising, there is reason to suspect growth. Reports indicate that FIs are increasingly outsourcing payments activities to third parties, and the U.S. payments system is steadily shifting from paper-based to electronic transactions.

Risk considerations

Nonbanks are conceptually susceptible to all types of payments system risk. But in practice, settlement risk — and any associated systemic risk — does not appear to present a major concern because nonbanks are rarely direct participants in settlement arrangements. Instead, they have relationships with FIs that undertake final settlement on their behalf, typically through Fedwire®, the automated clearing house (ACH) network or the Federal Reserve's National Settlement Service.

However, for both nonbanks and FIs, operational risk exposure is a concern because payments system participants are heavily involved in the transfer of critical payments-related information. Operational risk can arise both internally and externally. Internally, an entity can experience an operations disruption that does not spread beyond it. However, if a



Our Payments System Research staff is committed to researching emerging payments issues and providing you with regular updates. The staff is composed of (from left) Richard Sullivan, economist; Stuart Weiner, vice president and economist; Terri Bradford, consulting analyst; and Fumiko Hayashi, economist.



nonbank, for example, is doing processing work for an FI, an operations disruption in the nonbank could affect the FI's operations as well. This is a bilateral risk that both FIs and nonbanks assume whenever they choose to outsource, and there is growing awareness among payments participants that such risks must be carefully monitored.

Legal risk has also become an increasingly important payments system factor due to the uncertainty of liability issues as interdependence between financial service providers and technology providers grows.

Full study

Greater detail about nonbank activities, figures depicting where nonbanks enter in specific transaction processes and a broader discussion of risk considerations can be found in the "Nonbanks in the Payments System" working paper. You can view the full study on our Web site at www.kc.frb.org by clicking on "Working Papers" under Payments System Research. ■



Payments System Research Papers

Our Payments System Research (PSR) Department produces a series of papers presenting results of the department's research. These papers cover a range of topics, including types of payments methods, developments in payments networks, and various participants' roles in the payments system. A second paper from the department, "A Guide to the ATM and Debit Card Industry," is now available on our Web site, in addition to a working paper by PSR's Fumiko Hayashi and Elizabeth Klee of the Board of Governors called "Technology Adoption and Consumer Payments: Evidence from Survey Data."

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