Non Banks In The Payments System: Innovation, Competition and Risk

Thoughts/questions arising from the paper entitled: ‘Some Economics of Horizontal Integration in the Payment Industry’
Submitted by Mr Jean-Charles Rochet
How would this analysis work in a European SEPA environment?

- Europe is not the same as the US – comparisons difficult to draw
  - multiple cultures, languages, currencies, regulators
  - national payment industry dynamics, economics and profiles, ‘legacy’ constraints
  - payments value chain traditionally controlled by banks, directly or via jointly owned organisations
    - increasing role for non-banks in processing and networks
    - increasing role for non-banks in E-money/Prepaid, e.g. PayPal

- SEPA principles, enshrined in the Payment Services Directive, are likely to lead to consolidation, rationalisation and outsourcing of key aspects of the value chain – vertical and horizontal integration

- The challenge for SEPA and other EU initiatives is to achieve harmonisation across Europe in the creation of a single domestic market
  - politically rather than economically driven changes?
  - mission impossible in terms of implementation without regulatory intervention?
Do the principles of horizontal integration apply in the European payments industry?

Is it true that waves of mergers are triggered by deregulation or development of new technologies?

- In Europe the goal is self-regulation within a European regulatory environment to be broadly defined by the Payment Services Directive
  - is this deregulation or more a change in the regulator?
- For SEPA, cards technology will be Chip and PIN, but this is not new – it is just approved within SEPA principles

Are the reasons for mergers simply increasing economic surplus and benefitting shareholders/managers?

- Within SEPA, some mergers driven by survival strategies, the creation of entities that have scale, wider geographic coverage and merged skills
How applicable is the two-sided network argument in European payments?

Other factors may need consideration:

- Payments instruments operate in several value chain - business models vary across those value chains

- The economics of payments product provision in Europe are completely distorted by extensive cross-subsidisation of cash
  - not transparent to consumers, merchants or corporates
  - most banks, merchants do not know extent of cross-subsidy
  - removal of cross-subsidy – a political No-Go area?

- Could horizontal integration lead to commodity pricing of payments instruments to compete with the price/convenience of cash?

- Do European regulators fully appreciate the pricing structures in the payments industry two-sided market? Do they have the toolset to fully analyse impact of changes?
  - European regulators continually criticise fees around payments
  - for two-sided networks to operate efficiently, is there an argument for less rather than more regulation?
What are the potential consequences of SEPA?

**Infrastructure**
- Rationalisation – fewer processors, switches, vendors
- Scale economies
- Standards, Rules

**Commoditised, undifferentiated**

**Europe-wide Market**

**Platform for value-add solutions**

**Non-Bank Entry**
e.g. Prepaid Operators

**Competition**

**Product**

**Removal of payments system entry barriers**

**Horizontal Integration** likely at the infrastructure and product provision levels

Ultimately profitability derived from added value to core payments business
Horizontal integration and non-banks

- Barriers are being removed that prevented horizontal mergers in the past in European payments
  - breaking down of national payment schemes
  - significant merger activity also involving non-banks
    - Link/Voca, SSB/SIA

- Non-banks already exploiting opportunities to intermediate in payments industry under the European E-money regulation
  - interest in non-bank involvement in payments varies across Europe

- The difficulty in finding the balance between regulation and competition is clearly evident in Europe. Horizontal and vertical integration may generate barriers to non-banks
  - investment required to optimise scale economies?
  - less appetite for technology innovation/implementation?
  - ‘Europe-wide’ entry barrier replacing ‘national’ entry barriers

- What is really meant by the statement,

  “As far as competition policy is concerned, the only thing that matters is the governance structure of the different networks and their access criteria and pricing rules”? 
**Horizontal integration in the payments industry in Europe?**

Who will be the winners/losers?

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