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Promoting Integration of European Retail Payment Systems: Role of Competition, Cooperation and Regulation

Ms Sinikka Salo's presentation at the SUERF Seminar in Malta 4th May 2006: "The Adoption of the Euro in New Member States: Challenges and Vulnerabilities on the Last Stretch" jointly organized with the Central Bank of Malta

First of all, I would like to thank the organisers for this opportunity to present the paper by my colleague Kari Kemppainen and myself on "Promoting Integration of European Retail Payment Systems – Role of Competition, Cooperation and Regulation"¹. The topic is very important, and very topical taking into account the initiative of building the Single Euro Payments Area (SEPA) that is high on the Commission's and ECB's agenda, and continues to call for political support. The forthcoming Finnish EU Presidency hopefully highlights this topic also on its agenda. It should be reminded that the Single Market in goods and services inevitably needs payment systems that also operate smoothly and efficiently in the whole context of the market.

In the area of large value payments, systems such as TARGET and Euro1 are already offering EU-wide services. In the area of retail payments, however, the situation is very different and the fragmentation of the payment landscape is clearly visible. We still have 25 heterogeneous retail payment areas!

The aim of our paper is to contribute to this discussion through reference to network economics theory, to shed light to questions like: What are the reasons for this segmentation? How to promote integration of European retail payment systems? What are the policy conclusions?

We believe that the policy debate on the development of the European retail payment systems can be understood better by reviewing some lessons from the network economics. This is justified by the fact that the payment system industry inherently has many characteristics in common with network industries. In particular, the theory of network industries provides useful concepts and tools to analyse the interaction in *the competition-cooperation nexus* and regulation in retail payment systems.

¹ The paper will be published in SUERF Studies

Useful concepts

In the paper, our purpose is, indeed, to highlight the usefulness of the network economics theory through some key concepts that characterize also retail payment networks. In this oral presentation, I only take on board two of them – path dependence and “chicken-and-egg”- problem.

In network markets *history matters*: network market equilibria cannot be explained without reference to the pattern of technology adoption in the earlier periods. In payment systems, *path dependence* can be seen in the development of national payment systems and, especially, in the slow change of national payment habits. For example, the division of giro- and cheque countries in the European Union is still prevailing, and probably mostly due to historical reasons.

Critical mass or installed base of network facilities plays a crucial role in the start up and growth of a network. The start up problem is often referred to as the *chicken-and-egg* problem: many consumers are not interested in purchasing the good because the installed base is too small, and the installed base is too small because an insufficiently small number of consumers have purchased the good. Accordingly, the potential problem for the payment system development is that a new, more efficient payment system may not attract enough customers to validate its existence.

These are observable phenomena in the European payment systems. The payment systems in EU15 countries and New EU countries are illustrated in the following slides, where numbers of various types of retail payments per inhabitant are shown in 2000 and in 2004. Some observations:

First observation:

In the slides, the fragmented structure of retail payment methods in the EU countries can be clearly seen. This is true in particular with regard to the “old countries”. The figures also illustrate the fact that payment habits are slow to change – 2000 vs. 2004. In some countries, like France, the cheque continues to be an important payment method even though its relative share has been declining in recent years. In other countries, like Finland, credit transfers are dominating and cheques have

virtually disappeared. Naturally the differences in payment methods used in different countries are reflected in the structure and organisation of payment systems in these countries.

In the *new Member States (2000-2004)*, the fragmentation of cashless payment methods is also present but in many cases the high use of credit transfers and card payments is noticeable.

2nd observation:

Generally speaking, the development of payment system infrastructures in different countries is likely to have been influenced by some sort of *path dependence* ("history matters"). This phenomenon seems to be stronger for “old countries”, whereas in “new countries” it is weaker, because these countries started to create their payment systems later and were thus in a better position to adopt the most modern payment technologies.

Key ingredients of path dependence are the structure of service providing sector, national payment traditions and legislative environment. Consequently, each national payment system has its own membership criteria, standards and practices that have evolved over time. Another factor affecting the development of national payment systems is the observation that *payment habits are slow to change*. Only minor changes from 2000 to 2004, in particular for “old countries”.

3rd observation indirectly seen in the slides relate to “chicken-and-egg-problem - for example in the very slow adoption of the e-money or another new payment methods that would also facilitate cross border retail payments.

A factor affecting the slow development of cross-border retail payment systems in the EU is the current low volume of cross-border retail payments. These payments account currently for 2-3% of all retail payments in the EU. Whether this figure will increase in the future naturally depends on customers' needs, but also on the existence of efficient cross-border retail payments systems to execute payments reliably and cheaply. The establishment of such an infrastructure will require cooperative efforts by the service providing sector and of course, commonly adopted standards.

I believe, that there, indeed, is a “chicken-and-egg” phenomenon in the European retail markets concerning cross-border retail payments as also demonstrated by the slow development of STEP2 (a pan-European automated clearing house). There is however some examples of new successful initiatives like PAYPAL in the internet.

What should be done to promote the Single Euro Payments Area (SEPA)?

In the European retail payment landscape and especially in the development of cross-border retail payment systems, the *competition-cooperation nexus* has been observable. The following quotation from the ECB from 2001 nicely reveals the challenges that the competition-cooperation nexus brings along:

"The lack of competition among banks explains the lack of progress with regard the price level of cross-border credit transfers, whereas the lack of co-operation on standards and infrastructures explains the lack of progress in reducing the cost of processing cross-border transfers."

On the one hand, cooperation among service providers is needed on establishing standards and infrastructures in order to have a large enough customer base for their services ("*network effect*"). On the other hand, agreement on common standards (compatibility) increases competition and may thus reduce service providers' incentives for the increased compatibility ("*competition effect*"). Accordingly, the crucial question for policy-makers and regulators is to find measures that maximise social welfare in this type of environment.

The competition-cooperation nexus is directly connected to the stylised market structure in retail payment markets where the vertical structure of industry is common. Accordingly, the basic framework of retail payment industry can be generalised as follows:

Payment service providers compete directly in the provision of retail payments instruments and services to end-users but, at the same time, they also cooperate in shared payment networks.

In other words, it can also be said that there is "*upstream cooperation combined with downstream competition*". This poses several challenges to public authorities. On the one hand, viewed from the efficiency standpoint, it is desirable to facilitate the utilisation of economies of scale by means of allowing cooperation between market players. On the other hand, there is also a risk that such cooperative arrangements may be anti-competitive. From a competition policy point of view, it is possible that cooperation at one level may lead to collusive behaviour at another level. For payment system regulators, these are crucial concerns in assessing the trade-off between competition and cooperation.

In general, it has been argued that market competition is the way to promote efficiency in many traditional industries. In retail payment markets, a particular characteristic is, however, that competition among market participants needs to coexist with the mutual cooperation in payment system infrastructure arrangements. In this context, a key issue is whether the service providers are able to achieve an adequate balance between competition and cooperation to benefit market users. Therefore, public authorities should consider whether the market structure supports innovation and new market entrants, and whether existing access restrictions serve to promote or impede competition and contestability.

In retail payment systems, cooperation is required among market participants in the context of their participation in payment system infrastructure arrangements. The main issue for regulators is then whether this cooperation supports market efficiency. The BIS report from 2003 argues that established payment networks are a typical context in which this issue will arise. They have the potential to provide a stepping stone for innovation but they are also in a position to create entry barriers that impede competition and innovation. In protecting their own interests, members of established payment networks can create entry barriers either by imposing access restrictions or by more indirect means, for example by a choice of standards and rules that are inappropriate, difficult or costly for other payment initiatives to adopt.

A related question is whether competition between different systems or competition in one system is better for overall market efficiency. If excluded entrants to a particular system decided to establish their own system that was more efficient and they are also able to attract enough customers for the new

system to survive, market efficiency could be fostered. However, the uncertainty in reaching the critical mass of users may make the establishment of the new system difficult.

Roles of different stakeholders in developing Single Payment Market

In our paper we discuss the roles of key parties that are involved in the development process of retail payment systems. They can be grouped into three groups: (i) *End-users*, (ii) *Payment service providers*, and (iii) *Regulators*. I just take on board the role of Regulators:

In the EU/Euro Area, the main regulators in the payment service field are the European Commission and the European Central Bank (ECB)/ the European System of Central Banks (ESCB) along with the relevant competition authorities.

The European Commission

When fulfilling its role in promoting the development of the Single Market, the European Commission has been active in facilitating financial market integration. Since the beginning of the 1990s, the Commission has been arguing that high costs for cross-border money transfers are inhibiting the Single Market development and financial market integration. In this context, the Commission has formulated the following objectives for the single payment area:

- to make the Internal Market the domestic market
- to promote efficient and secure payment means and systems
- to enhance customer protection and strengthen consumer confidence relating to all payment means
- to ensure competition on equal terms in a level playing field.

In pursuing these goals, the Commission has assumed a more active role in recent years. The fact that the charges for cross-border retail credit transfers had remained high over the years prompted the European Parliament and the Council to adopt Regulation (EC) No 2560/2001 on Cross-border Payments in Euro in December 2001. The Regulation aims at facilitating the expansion of the "*Single Market*" concept to cover the money transfers and payment systems markets as well. The adoption of the Regulation was seen as the ultimate tool to foster the development of the market where, according to the Commission, "no substantial development efforts by market participants" were observed before

that. In December 2005, the Commission adopted a proposal for a Directive on Payment Services in the Internal Market, earlier known as “New Legal Framework (NLF)”. The NLF should establish a modern and comprehensive set of rules for all payment services in the European Union and form a comprehensive legal basis for SEPA developments. Parallel to the NLF directive proposal, the Commission has also issued the so-called “SEPA Incentives Paper” – nowadays also called as “Next Steps” – that analyses the current situation and identifies a number of areas and issues where supplementary action may be required to achieve the full economic potential of SEPA. Very recently, the Commission also launched a public consultation on the *Interim Report on Payment Cards and Payment Systems*. According to the Commissioner Kroes, the inquiries are an important first step in allowing the Commission to identify ways to improve competition in EU financial markets.

European Central Bank and the European System of Central Banks

The central banks' interest in the efficiency of payment systems is based on the Article 105(2) of the Treaty and the Article 22 of the Statute. According to these, *the European System of Central Banks shall promote the smooth operation of payment systems*. This also includes facilitating and ensuring the efficiency of payment systems. In addition to general efficiency, the central banks have also defined financial integration as one of their main objectives. In the beginning of 2005, the ECB and the national central banks agreed on a document of “strategic intents of the Eurosystem”. This document gives a high priority to unification of financial systems, and, by implication, the payment systems as well. The relevant phrase in the document is as follows: *“The Eurosystem shall aim to safeguard financial stability and promote European financial integration in cooperation with the established institutional structures.”* As such, this document did not mark any change in the ECB policy. But it confirmed that for the ECB and the Eurosystem as a whole, promoting financial integration is not only a means to an end, it is also a goal in itself.

In the area of retail payment systems, the Eurosystem has focused on the importance of providing efficiency and safety standards for retail payment instruments and euro retail payment systems with the aim of fostering the achievement of a single euro payment area. In principle, both the safety and efficiency targets are important, and in many cases, as in the large-value payment systems where potential for systemic risk is bigger than in retail payments, the safety requirement is the first one to be achieved. However, in retail payment systems as well, the same safety requirement is important as the

central banks should also ensure that the public confidence in payment media is not put in danger in any circumstances.

The ECB/ESCB has acted as a catalyst for development by publishing various reports and studies as well as by organising seminars and meetings with all stakeholders including end-users.

Ladies and gentlemen!

A successfully conducted integration process will lead to a situation where no "national payment borders" exist anymore and the most efficient and reliable payment methods and systems are adopted EU-wide. Integrated and efficient retail payment market will contribute to the realisation of the Community's Lisbon programme.

The Single Euro Payments Area project aims to contribute to the Lisbon programme on its own part. Ideally, the SEPA-project is a market-driven process where the authorities ensure a level playing field for different service providers. Currently, there is a strong political commitment to SEPA-project but some practical difficulties have arisen due to the differences in national payment habits and systems, as I pointed earlier. The evident path dependence in developing payment systems and other vested interests of payment service providers may make the process challenging, but the commitment of all the stakeholders to achieve the final goal will help to overcome the potential obstacles.

Concerning policy conclusions on the appropriate role of payment system regulators, the following ideas can be highlighted:

The general characteristics of retail payment markets supported by findings from network economics theory, suggest that an optimal degree of efficiency and integration are not going to be achieved by markets themselves without some intervention by the authorities. The appropriate nature and scope of this intervention is a much more difficult question, however. In principle, the authorities have several options available for regulating the retail payments market. They can leave development to the market and aim simply to foster a competitive environment and provide investment incentives in the field, e.g. by assuming a tolerant attitude towards payment system joint ventures and other types of cooperation. They can also act as a catalyst or facilitator for development, e.g. by participating in the development

of payment standards – standards by the way are crucial, as we all know -and supporting the work of cooperative groups formed within the industry. As a stronger measure, they can resort to specific regulation to influence market development, e.g. enforcement of standards. Finally, as the ultimate measure, the authorities can become ‘operationally active’ by establishing their own systems for providing payment services. This option should only be used when the authorities judge that reliable and efficient payment systems cannot be provided by the market.

To sum up, we should note that the practical challenges for authorities and private operators alike should not be underestimated. The banks and other operators must prepare themselves for the technical and marketing tasks required by the unification of the European payment system. The authorities, for their part, must develop new competencies. They must learn how to assess the developments in the market for payment services, and prepare to deal not only with difficult technical issues, but even tougher questions of fair vs. unfair market practices etc. On the other hand, many of these challenges have already been with us for a long time at the national level. In the future we must deal with them at the European level, where stakes are bigger, and transparency and peer pressure are more and more important considerations.

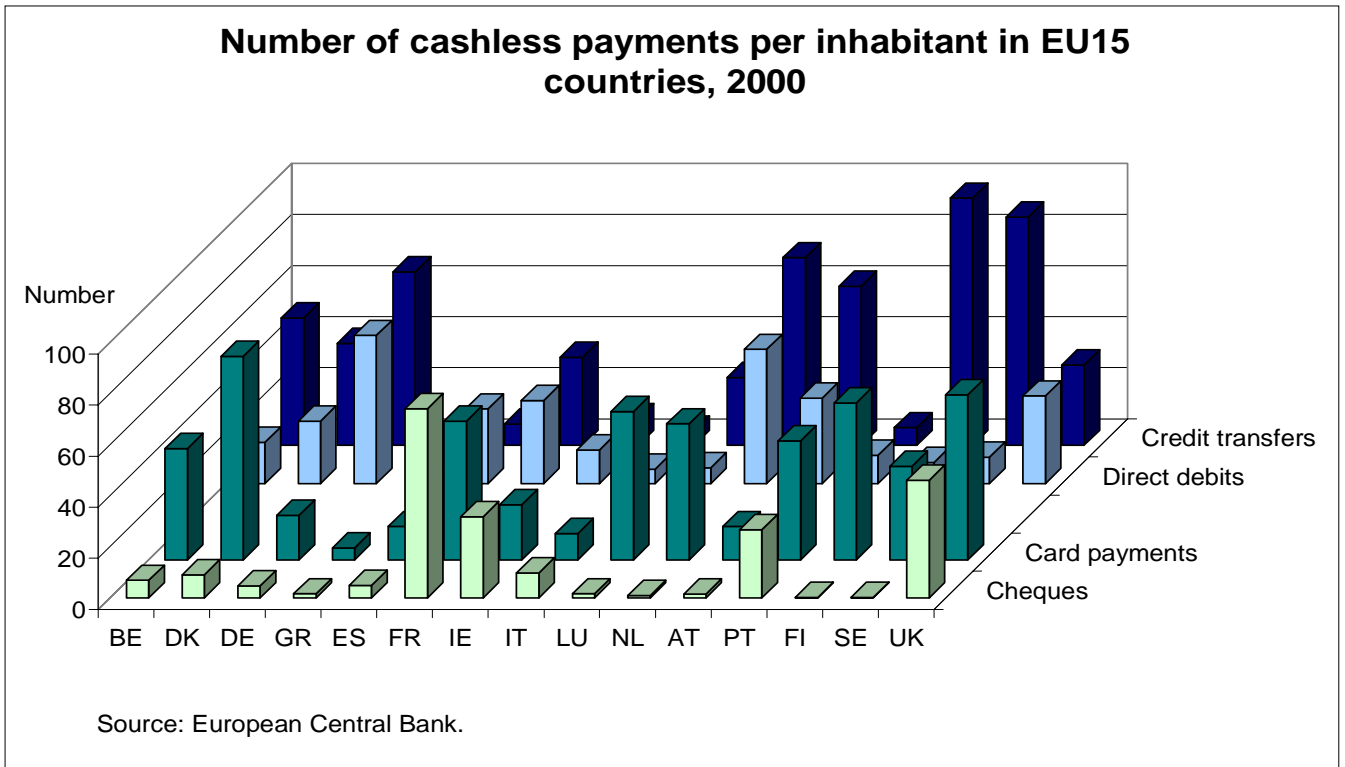


Figure 1 “Strong” path dependence (1): EU15 Countries

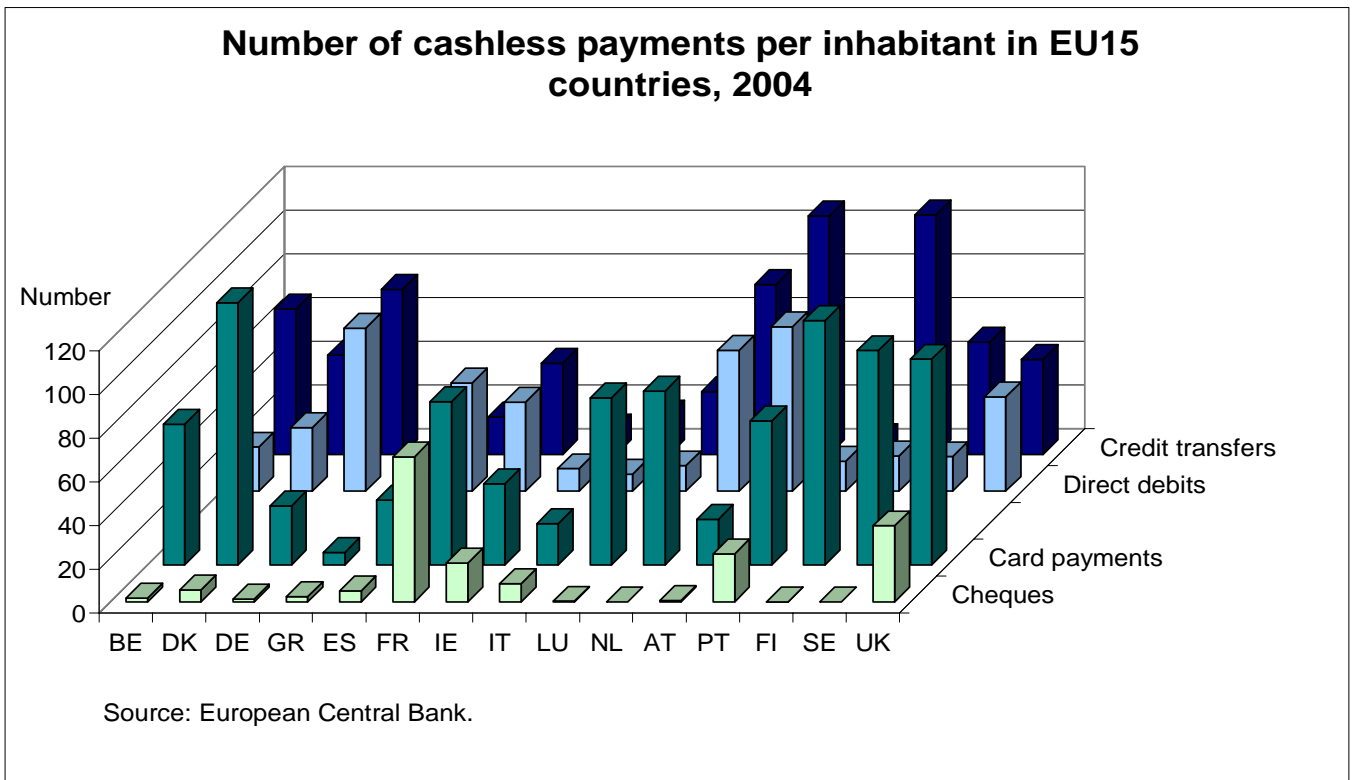


Figure 2 “Strong” path dependence (2): EU15 Countries

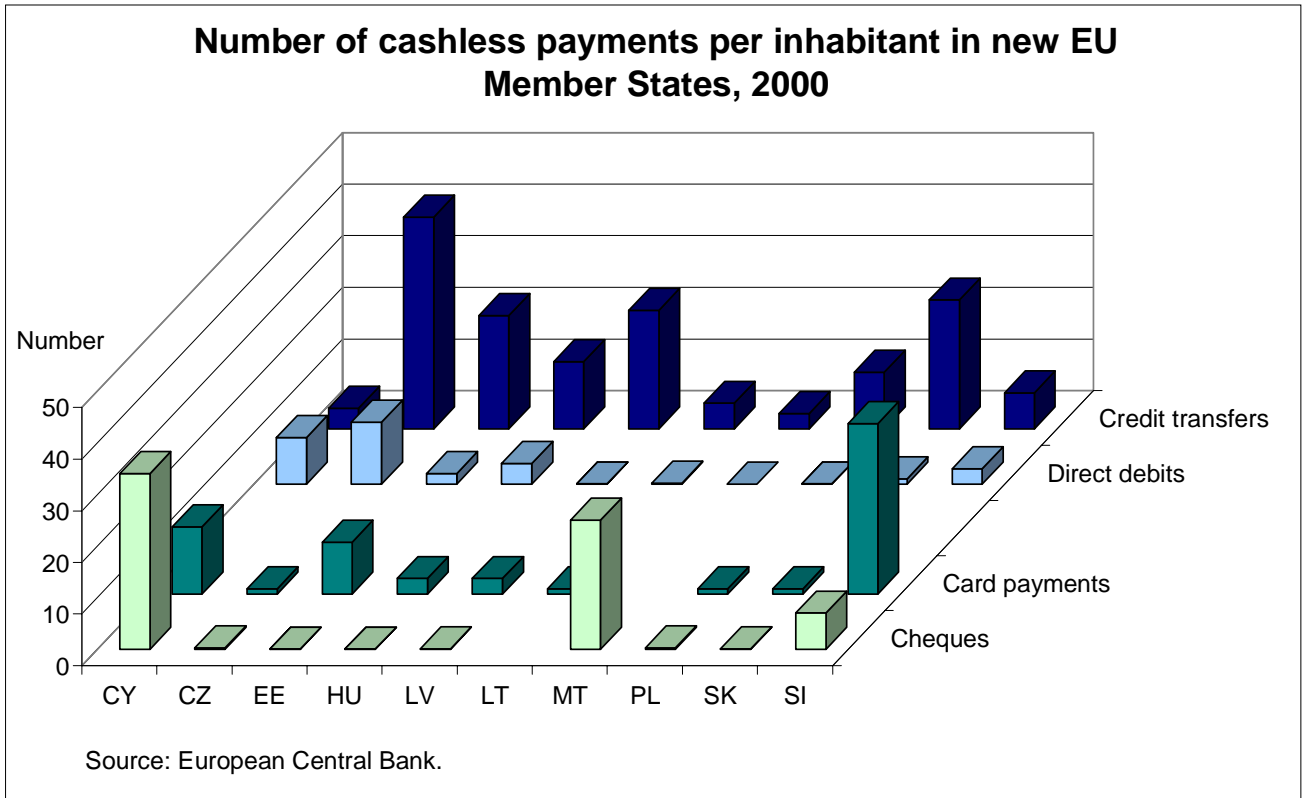


Figure 3 “Weak” path dependence (1): New EU Member States

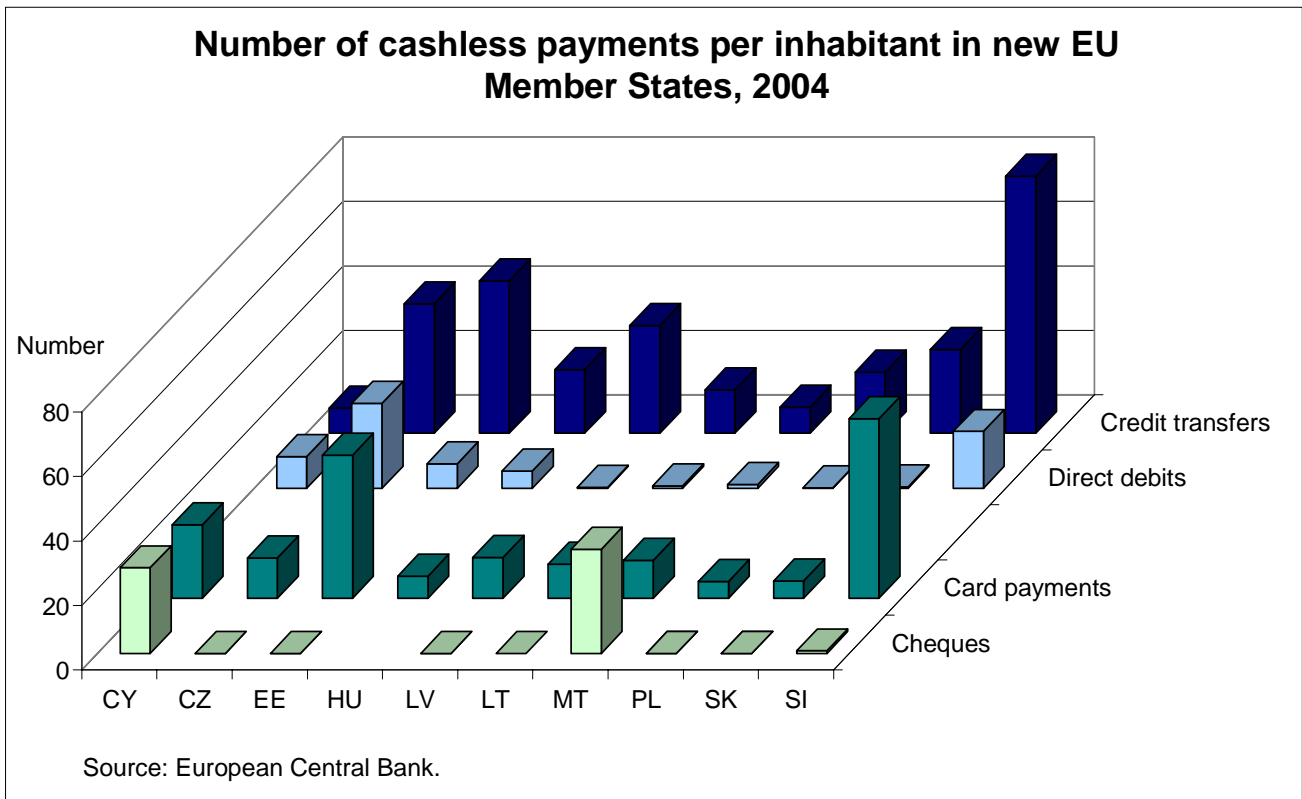


Figure 4 “Weak” path dependence (2): New EU Member States