EUROJÄRJESTELMÄ
EUROSYSTEMET

Deputy Governor Pentti Hakkarainen, Bank of Finland
Retail payments: Integration and innovation – Joint Conference of the European Central Bank and De Nederlandsche Bank in Frankfurt 25–26 May 2009

Background paper for the Panel Session on 25 May 2009
Views expressed are personal and do not necessarily represent the views of the Bank of Finland.

FUTURE OF RETAIL BANKING: MORE COMPETITION NEEDED

THE MAJOR CHALLENGES FOR RETAIL BANKING

Today almost all retail banks in the European region are universal banks which, in addition to making loans, taking deposits and processing payments, also provide wealth management services, brokerage and even corporate finance including not only debt and equity issues but also M&A consultancy.

Several underlying trends influence the business conditions in the retail banking market. These factors pushing development of the banking business have existed already quite some time.

- First is **new technology,** which has brought modern channels for delivering financial services; ATMs, internet, mobile phones and increasing use of telecommunication in general.

- Secondly the **borders between different businesses and different countries have become less clear** and less imperative. Insurance companies are providing long-term savings and investment products. Likewise, banks have entered into insurance business, mainly but not only in the life-insurance field. Traditionally, banking was regulated nationally and retail banking in particular was seen as a very local business, but in recent years several banks have entered into new markets outside their country of origin.

- Thirdly, **heavy fixed investments** make it more difficult to enter the banking industry. Starting a banking business has meant high fixed investment costs in technology, hardware and software, in brand creation etc, although once running, business causes **relatively low marginal operating costs**. Thus getting bigger, acquiring new clients and market share has been crucial for all retail banks. Also the optimal use of equity capital has pushed for increases in size and volumes. However, **the impact of size on costs is far from being a trivial and straightforward issue**. There is plenty of academic research on this topic, but this literature has failed to reach any consensus on the optimal size of a banking institution. Optimal size may depend on possibilities to outsource. Now there are more common IT-solutions and available at much lower costs to banks than before.

One challenge is the dependence of banks on **cross-subsidization,** especially of payment services. This practice may have made it more difficult for niche players to enter the market because obviously one cannot cross-subsidize between products unless one provides a large number of diverse services. Cross-subsidization has led to a situation where customers have got some services, such as payment services, entirely free or by paying just a modest fee, whereas transaction deposits are paid a very low rate of interest. Hence, customers pay for their payment services implicitly rather than explicitly, by accepting a deposit rate that is far below the risk-free return available elsewhere. One may wonder why this has come about. Without going too deeply into the matter I just want to refer to a dissertation thesis by Dr Juha Tarkka, Advisor to the Board in the Bank of Finland, according to which this cross subsidization may be a fully rational response to prevailing conditions for three different reasons; the taxation treatment of "free services", price discrimination between customers under imperfect competition, and customers' uncertainty of their service requirements. [i]

This cross-subsidization **may now become more difficult if interest rates remain low for a long period of time;** the difference between market rates and the rate paid to transaction accounts must be narrow if market rates are close to zero, implying that attracting deposits by offering free payment services would no longer be a profitable strategy. If this cross-subsidization is no longer possible, banks must adapt themselves to a new situation where they should find new ways to cover the costs of services given.

Thus, the old way of doing business – even in traditional retail banking – is changing. Increasing competition is crucial for improving efficiency. Today's main theme is therefore of utmost importance for increasing productivity in retail banking.

Productivity improvement in banking has been substantial. In my country, Finland, for instance, banks invested heavily in information technology in the 70's and 80's when the regulations of the time directed competition to service and quality competition. When a very severe banking crisis hit the Finnish banking industry in the 90s, banks had to make good use of their technological capabilities. They more than halved the work force from about 55,000 to about 25,000 over a five-year period, while increasing banking activities and volumes.

According to econometric estimations made at the Bank of Finland a couple of years ago by Dr Karlo Kauko and Dr Leena Mörttinen, productivity improvement in Finnish banking improved by 9 – 10% a year over the decade 1995-2004.[ii] Hence, each bank had to be able to compete against rivals that are improving their cost efficiency at a rate seldom seen in other industries.

When reducing costs instead of building up new operations, it is imperative to **outsource** all such activities where there are more efficient service providers available. Information technology and payment processing in particular is just such an example. It is here where the benefits of scale can be brought on. According to a Bank of Finland study of a few years ago, doubling the scale of payment processing activities brings down the average unit cost of transactions by almost 60 per cent.[iii]

Outsourcing has implications for competition and competitive strategy. The more common systems there are in use, the less important role these systems have in terms of mutual competition. We have seen how IT infrastructure and payment processing have become increasingly commoditised and outsourced and the importance of these scale-intensive activities for competitive strategies diminishes. Illustrative examples include the Dutch iDEAL online payment –solution, which is jointly used by several major banks in the Netherlands, and Crosskey Solutions, which has provided a retail banking solution to several rather small and recently established Nordic banks.

Banks can better refocus on other things: collecting and acquiring customer information and local conditions – especially on the credit side of the retail banking market.[iv] Recent problems with schematic credit scoring systems have certainly reminded the banks of the value of real customer information and better selection of customers.

Whenever one discusses the future, it has to be borne in mind that we live in a highly uncertain world; economic, political and technological factors may or may not develop the way we have been led to expect. However, there is one future development both banks and other institutions will certainly face in developed countries: **population ageing**.

According to the forecast by Statistics Finland, 10% of the Finnish population will be over 75 in 2020, and about 20% over 65. Other developed countries will face a similar situation. This change in the nature of the customer base will deeply affect the business environment of retail banks. Demographics will affect the structure of demand for different types of retail financial services; there will be less demand for housing and student loans, whereas the demand for, say, reverse mortgages will strengthen.

Ageing may also have an impact on which delivery technologies are successful. Home banking may be what old people prefer, but only if the technology is convenient and stable enough to be attractive to the elderly. Have banks prepared themselves for this highly predictable future development? In Finland 37% of people over the retirement age normally pay their bills by internet. Moreover, today’s young people are the elderly of tomorrow, bringing their skills with them.

The current **financial market turmoil** is, at least in the short and medium term, the most obvious challenge bring with it fundamental repercussions. The main issue is naturally a more difficult business environment due to the deleveraging process and a consolidating financial sector. Clearly there is overcapacity, which is melting away and banks’ position becomes thus tighter.

THE ROLE OF CENTRAL BANKS IN THE FIELD OF RETAIL BANKING AND PAYMENT SYSTEMS

The role of central banks is and should remain rather limited in retail payment systems. Central banks can promote a beneficial and competition-friendly environment for retail banking and payment services in particular as overseers and regulators. Their concerns are the integrity and reliability of the systems, not forgetting efficiency. Their role is important as a catalyst for both change and improvement. Nevertheless, they should not provide retail payment related services themselves. If that is done as a legacy from the past, it may be wise to wind such activity down. A public authority should not engage in competitive activities, and definitely not subsidize its own service production, which would crowd out private enterprise.

National differences in payment habits are significant, even within Europe still. This is why we have the **SEPA programme**, which aims at greater harmonization of basic banking services in the Euro area countries. The national systems vary in terms of efficiency as well. In cases of "not that efficient retail banking environment", there is an important role for a central bank. One of its responsibilities is to oversee the functioning of financial markets and an important part of that task is also to strive at an efficient and credible payments system. In this kind of environment a central bank plays an important role as a catalyst for improving and enhancing competition.

Central banks should monitor developments in the retail financial industry also for monetary policy reasons. Dr Jukka Vesala, head of department at the Finnish Financial Supervisory Authority, has noted in a study of his that **efficiency and competition in banking may be relevant to the conduct of monetary policy**.[v] The transmission of central banks' policy rates to deposit and lending rates is probably more efficient if competition is effective and banks have achieved a high level of cost efficiency. In such an environment, customer rates would be less dependent on banks' market power and cost structures. Consequently, the relative importance of market rates as a determinant of customer rates would increase.

SCOPE FOR A MORE INTEGRATED CONCEPT OF RETAIL BANKING

One has to emphasize once more the importance of effective competition in the field of retail banking and payment business. There are several reasons why competition, especially entry by foreign banks in retail banking markets, is hampered still today. National laws and rules still exist. Incumbent retail banks have enjoyed a protected competitive position and naturally they are reluctant to renounce that.

In order to open markets for proper competition, efficient **integration and standardisation of the payment infrastructure is to be implemented rapidly**. Always there are forces trying to maintain the current, established way of doing business. Banks have invested heavily in their processing systems and may be reluctant to renounce their legacy systems.

Further international integration and standardisation would naturally bring additional benefits. We already see global integration and service provision in the area of credit and payment cards – even though problems remain in the credit card industry, in particular their pricing. In today's banking markets however, more international integration and effective competition go hand in hand.

Customers use payment systems in the context of their real transactions. Nobody would enjoy initiating payments. Services must be suited for customers' shopping habits. In all shopping – whether just ordinary traditional or the increasingly popular online shopping – a quick and secure payment is of high value. Credit cards have been widely used, but they were not designed for internet, and fraud has become a widespread problem. Many people either have no cards, or they hesitate to use this means of payment online for reasons of security. Some arrangements are already in place, but there would be still **demand for pan-European or even global retail payment systems specifically designed for e-commerce.** A good system or standard could be used irrespective of the home country or house bank of the payer and the payee, and be both secure and reasonably priced for both parties. If an online shop operates with very narrow margins, it would obviously be reluctant to accept payments through a system that charges, say, 2% of the payment.

What is needed to make our retail banking and payments independent of time and place, in other words, mobile – and hopefully globally? We have already available e-services such as e-mails, e-maps and e-pictures. In the **field of retail banking and payments we still need global standards to guarantee appropriate security and user-friendly way of using services**. These two are critical criteria. The third important criterion is the cost of service usage. The two first criteria should be taken care of by authorities and retail banks, and their cooperation. The third is tackled by allowing – and perhaps enhancing – competition. It is obvious, that if retail banks and incumbent players are not capable of moving ahead, new entrants will gradually take over this business.

Thus, we can conclude that the potential demand for a truly integrated system and also the technological possibilities are there. The future retail market for payment services should be international, at least at the European level. The well known SEPA initiative of a Single Euro Payment Area is contributing to that goal. One challenge is naturally cultural differences in retail banking and in payment habits in particular. Until now, limited competition and nationally protected monopolies with several implicit entry barriers have dominated the market.

CULTURAL DIFFERENCES IN PAYMENT HABITS

One obstacle we face here is how to overcome the existing cultural differences in retail banking and in payment habits in particular. Even within the euro area we still today have very different ways of making payments. We can see that fundamental terms and conditions, to say nothing of the actual payment tools, vary a lot. In some countries the usage of electronic payments are overwhelmingly in use by the man in the street while in some other countries retail payments are still carried out in bank branches and with cash transfers.

Regarding cultural differences I experienced a nice paradox in Nice when I opened a bank account some years ago. I was offered cheques which would have been free of charge. I said that I didn't need cheques (I hadn't needed them since the 70's) but I would rather use online services, upon which the bank teller informed me that there is an additional fee charged for internet services. In Finland it is entirely opposite; internet services are free. The nice paradox is in the pricing of banking services: in Finland some people argue that when clients are doing all the work by self-service it shouldn't be charged for, and in France when asking how there is such a fee for doing work on behalf of bank tellers through using my internet, the answer was that "your account is in your use whenever you want and you are not limited to services in bank offices" i.e. the internet service brings additional value to you in the form of convenience of using your own bank account.

However it is likely that **when customers are offered the use of a user-friendly and secure means of handling their banking needs, change is rapid.** One could just ask, for example, how many customers would like to queue in a bank branch to get services which could be taken care of with one's mobile phone. The change in customer behaviour has been fast and fundamental in countries where banks have offered modern services to their clients.

FINANCIAL TURMOIL AND CHANGING SUPERVISION

The current financial market turmoil **will speed up developments in the long term**, by focusing banks on efficiency and cost control. In the short run the situation may be different. Many rescue packages offered to troubled institutions have been nationally rather than internationally coordinated, which has led to a re-fragmentation of markets. After some painful examples of losses incurred following expansion to foreign markets, banks are now concentrating more on their home market. Moreover, there may be some hindrances to investing in new ways of doing business, due to weakening profitability. However, in the medium to long run, banks in general are facing pressures to improve productivity, and it will become increasingly difficult for weak players to prevent entry from abroad. Banks have to squeeze costs to safeguard profitability on a sustainable basis.

There is also a danger that the financial turmoil gives rise to **regulatory nationalism**, in the sense that the priority of openness of the national banking market to international competition goes down. Less competition may be thought to reduce the risks of the national "safety nets" offered to banks. Let me just say that it would be a great setback if the financial crisis we have experienced would lead to a refragmentation of the international banking market in general and the postponement of the emerging international retail banking market in particular. It is a task for policy makers to ensure that the crisis management measures and revised regulations support the continued international integration of banking services, instead of reversing the process.

Part of the way forward is the work towards increased cooperation in financial supervision, which is on both the EU and the global agenda, now even more prominently than before the crisis. The authorities should, while focusing on cooperation in the field of better prudential regulation and supervision, not forget the parallel goal of a more unified, convenient and efficient international payment infrastructure.

FUTURE COMPETITION

Now, we **have three factors contributing to more competition among retail banks** when running their businesses and payment services in particular; the financial market turmoil and its impacts leading to tight profitability, the new ways of doing business with a threat of new potential entrants growing competition, and, finally, the new technologies which allow bank customers to bypass old payment methods.

Although it is the case that payment processing should standardise and become commoditised, and although transparency of pricing is important for customers, we should not expect retail banking as a whole to become an arms' length mass industry in the future. The **customer relationship is still the ultimate source of value for banks** – perhaps even increasingly so when factors such as distance and market fragmentation fade and cannot be used as engines of market power.

The value of relationship information became clear when some years ago some new **companies – entirely outside the financial sector,** such as telecommunications companies – thought about entering the banking business. The business looked very attractive. Telecommunications operators were presented with new possibilities through fast growing internet and mobile phone business. Client bases were exploding and new potential business undertakings proliferating. There were even ideas that telecom companies could take care of retail bank clients, if not establishing a bank of their own, then through the use of their web sites and online shops, which would house several service providers. These schemes did not carry the day. Relinquishing their client information to the hands of an outside company would have meant that the respective banks would have given away one of their main assets.

Through **multichannel client service**, including internet online services and mobile banking services, we enter a new world. There banks take more and more care of customers' management of finances and in much wider sense all housewifery. Already today quite many households have their financial accounting practically entirely in their house-bank. In its monthly bank statement one sees how much money and from where it has come, how one's wealth has been used, how savings are accumulated and how debts are paid. Several banks provide financial planners to their individual customers through online net service. Banks can easily widen their services further in this area. **Banks' electronic archives** can be given over to households' use for depositing wills and testaments, prenuptial contracts and deeds of estate inventory, deeds of distribution etc. It is obvious that with a credible bank, consumers are willing to use that service. In some countries this might be against national regulations, but in Finland, especially in certain rural areas, banks have traditionally offered some legal services.

Fast development of **mobile phones into more personal electronic devices** including identification information and appropriate systems for using it in a safe and secure way will give a great potential to further developing efficiency in banking and to combining different services in new and value-creating ways. Already today, mobile smart phones are like PCs when it comes to information handling capabilities. New potential ways of using your smart phone concern not only payments but also all areas of retail banking and wealth management. In your smart phone you will have all your personal financial information available and will be able to do business with your bank online without any limitations on information entered separately or on other intermediary company such as credit card companies.

---

[i] Tarkka, Juha: Approaches to Deposit Pricing, A Study in the Determination of Deposit Interest Rates and Bank Service Charges; Bank of Finland Studies E:2, Helsinki 1995

[ii] Kauko, Karlo: Pankkien kustannustehokkuus: havaintoja Suomesta (Bank cost efficiency; observations with Finnish Data, available in Finnish) Bank of Finland Financial Markets Department working paper 1/2006
Mörttinen, Leena: Rahoitusjärjestelmän vakaus ja tehokkuuden mittaaminen; (Financial stability and measuring of efficiency , available in Finnish) Bank of Finland Financial Markets Department working paper 1/2006

[iii] Khiaonarong, Tanai, Payment systems efficiency, policy approaches, and the role of the central bank. Bank of Finland Discussion Papers 1/2003.

[iv] The impact of bank organization on credit risk is analysed by e.g. Hyytinen, Ari: Essays on Bank Screening and Market Power in Loan Markets; Helsinki School of Economics and Business Administration A-182, Helsinki 2000

[v] Vesala, Jukka: Technological Transformation and Retail Banking Competition: Implications and Measurement; Bank of Finland Studies E:20, Helsinki 2000