# End bank control and let the competition begin

**Mark Falcon** *believes the payment system needs radical reform and wants regulators to end bank control, saying this would stimulate competition and innovation*

Financial services is a critical infrastructure, together with other sectors such as communications, energy and transport. We all depend on these and are greatly harmed if they fail. Regulators define several types of industry failure. There is company failure, when a single business performs badly; systemic failure, when a poorly performing company also causes others to fail; and market failure, when a whole market performs badly because of a lack of effective competition.

The job of regulators is to protect against these. Financial services, and especially banks, are at high risk of all of them. This is inherent in the conventional bank model, combining deposit-taking, lending and payments. The biggest challenge for financial services regulators is that the core activities of a bank are more risky together than if they were separate. This reflects both how banks operate and the network characteristics of payments.

Unlike deposits and lending, payments is intrinsically a network business, connecting banks, non-banks and customers. Like other network industries, payments are both competitive and utility-like. This dual nature has not always been recognised or understood and regulators appear undecided whether payments are competitive or monopolistic. This has led to market failures continuing unchallenged. Bank control of payment systems, in particular, remains entrenched, choking competition and innovation, and misplaced price regulation has had the opposite of its intended effect.

There are straightforward solutions. Other competitive network industries, such as communications, provide a template. What has happened in telecoms shows that regulators should champion competition above all else, alongside targeted wholesale price regulation.

Financial services generally is becoming much more competitive, especially with unbundling away from the conventional bank model to dedicated payment service providers (PSPs), non-bank lenders, infrastructure providers and other new FinTech operators. But more needs to be done to make competition work in payment systems. In particular, regulators should mandate full separation of payment systems from banks. This would mean all payment systems becoming for-profit commercial operators, funded by outside investment and paid for by competitive and/or regulated wholesale pricing. There is already a big precedent for this with the card payment systems.

This change would bring huge benefits to competition and innovation in payments markets. It would also contribute to reducing the risk of systemic failure more widely.

The problem of payment systems competition has long been recognised. In 1998, the UK government commissioned what became one of the most important banking regulatory reports of the past 25 years, the Cruickshank review. The review highlighted that payment systems tend to a natural monopoly and that bank control greatly compounds this problem. The review found that payment system governance was poor and outdated, leading to many problems, including: lack of effective competition between payment systems; lack of innovation; anticompetitive access restrictions; anticompetitive wholesale pricing; and slow and inflexible service to end users.

> “ *Regulators have so far focused only on the symptoms of the problem, not the underlying issue*

Recent changes in payments regulation have sought to address some of these problems. But, 17 years after the Cruickshank review, the central problem of bank control of payment systems remains. The only exception is the card payment schemes, MasterCard and Visa, which are now public companies rather than bank-owned.

Regulators have so far focused only on the symptoms of the problem, such as lack of innovation or access restrictions. Requiring banks to accommodate third-party payment initiation service providers (PISPs), as the EU's PSD2 and the UK's open banking standards do, or exhorting the industry to innovate more,  is not a substitute for addressing the underlying structural problem in payment systems.

### Grasping the bank control nettle

The modern knowledge economy is also called the platform or network economy. Networks/platforms are now the dominant business model. The world's eight largest companies by brand value are all platform businesses: Amazon, AT&T, Apple, Facebook, Google, Microsoft, Verizon and Visa.

Platforms bring together different user groups. Online marketplaces connect buyers and sellers, and media platforms and operating systems link content, advertisers and consumers. Payment platforms are a network for anyone wanting to send or receive money, while communication and social media platforms mediate anyone wanting to connect.

The success of platforms is driven by network effects: their value increases with the square of the number of users. This creates large-scale economies, and profits.

This does not necessarily mean a monopoly position. Only a few platforms have no rivals. Most platforms compete vigorously with others, eg the Google Android operating system v. Apple iOS, Visa v. MasterCard, or Uber v. Lyft. Competition in all those spaces is fierce. But it can vary substantially for the different user groups that platforms serve. When there is a choice of platform, typically one group chooses which platform to use and the other group must go along with this, or not interact. This means that platforms usually always compete for one group of customers, but not the other.

That also applies to payments, which is a paradigm competitive platform business. Payments is the oldest platform, long pre-existing the knowledge economy. But competition in payments is frequently misunderstood. For example, the UK Payments Strategy Forum (PSF), the industry body tasked with promoting payment systems innovation, describes card payment systems as "competitive" and inter-bank payment systems as "non-competitive". Neither is right.

In payments, it is the "payer" who chooses which payment platform to use. The "payee" must then accept the payer's choice, or lose the transaction. For example, a utility customer can typically pay by any method — ie cash, cheque, credit card, debit card or direct debit. A utility company that did not accept most payment methods would lose customers to the competition. Similarly, most consumers have either a MasterCard or Visa card for retail purchases. Almost all retailers, therefore, accept both MasterCard and Visa.

All platform markets are like this. One group chooses between alternative platforms. They are known (in economics) as "single-homing". The other group must, therefore, accept all platforms. They are known as "multi-homing". The single-homing side of the market is competitive but the multi-homing side is not. It would be wrong to describe a platform business as "competitive" or "non-competitive" without specifying the relevant side of the market.

Alternative payment systems, in general, compete for payers, but not for payees. This has profound effects on how payment systems should be regulated. They should be regulated like communication networks.

This is where it might be argued that PSD2 fixes the problem: it opens up competition for payers. (See box.) After all, once consumers can chose between a range of payment service providers and see all their data in one place, the payments as a whole should become cheaper and better. However, this will make little difference to competition for payees, nor the underlying competition and innovation at the payment network level.

This argument has direct parallels with the de-regulation and competition in telecommunications networks. It was only when there was competition at the network level, for example between BT and Virgin, or between mobile network operators., that consumers began to get substantially better pricing and service. This is why telecoms regulators prioritise network competition above all else – eg through licence awards, merger policy or mandated separation. Indeed, regulators have actively blocked several recent mergers and are seeking greater separation of BT. However, (as in routing payments), a phone caller cannot choose the recipient's network.  So, despite strong network competition, wholesale network-interconnection charges remain regulated.

The most effective way to promote competition in any industry is to ensure independent ownership and control. This would mean the banks divesting their interest and control of all the payment systems operators (PSOs), eg by floatation or private sale. The PSOs would then become funded by external investment and paid for by commercial and/or regulated wholesale transaction pricing to their PSP customers.

The Payments Strategy Forum (PSF) recommended in July 2016 that that Bacs, the Faster Payment Service, and the Cheque and Credit Clearing Company be consolidated in one simplified structure. The PSF argued that this would "act as the springboard for the new payments architecture". The Bank of England is separately calling for the independent governance of the PSOs.  This only meaningfully be delivered by them becoming independent commercial companies.

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Full independence will address the conflicts of interest inherent in bank control of the PSOs. It would also make direct interventions to promote innovation, access or better service largely redundant. Competition is always the best way to deliver these outcomes. Collaborative innovation should be the role of international standards bodies, in order to maximise inter-operability and scale economies.

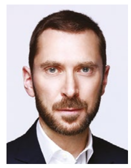
Demutualisation of the MasterCard and Visa international card payment systems is powerful evidence of the benefits of ending bank control of payment systems. Before 2006, all UK payment systems were owned and controlled by the same main banks. In 2006, MasterCard became a public company, followed in 2008 by Visa Inc (except in Europe). In 2016, Visa Europe also became part of Visa Inc. This has been the biggest event in payments in the past 25 years, leading to a transformation in competition, innovation and investment. It has also left the remaining bank-owned payment systems a long way behind.

Over the same period, regulators have also sought to regulate credit and debit card interchange fees. These are the wholesale fees paid by retailers' PSPs (merchant acquirers) to cardholders' PSPs (card issuers). This regulation limits the "net issuer compensation", namely the net wholesale fees payable to card issuers. Such regulation was intended to protect retailers and consumers from excessive pricing, but it has had the opposite effect.

Regulated interchange has been replaced by new fees, leaving card pricing to retailers largely unchanged, or even higher than previously.

This is a big regulatory failure. It has happened because interchange regulation was conceived when MasterCard and Visa were bank-owned, but was not adapted following the card schemes' change of ownership model. This dramatically changed their commercial objectives. By stopping the card schemes from competing, interchange regulation has created a much bigger market failure than the one it was intended to solve.

This failure, now acknowledged by regulators in the US, can be resolved. Instead of limiting the net issuer compensation, the regulation should limit net charges payable by acquirers. It should also ensure open acquirer access to relevant payment schemes. Together, such regulatory actions could greatly enhance the efficiency and reliability of the UK's critical financial services infrastructure. ■



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## PSD2 – what is does

The aim of PSD2 is to update the legal ground rules for payments across the European Economic Area (the EU plus Norway, Iceland and Liechtenstein) so that they keep pace with technological developments and further boost competition, while protecting the consumer. In the UK, the Financial Conduct Authority (FCA) is responsible for watching over PSD2. PSD2 is a "maximum harmonisation" directive, which means that member states have to stick closely to the original directive. At the time of going to press, the FCA had not responded to questions on whether regulations could include "gold-plating", or whether Brexit might affect the transposition of the regulations into UK law.

PSD2 allows customers to give authorised third parties access to their online payment accounts data. It is intended to make it easier for customers to manage their online payment accounts and to compare deals. In principle, mobile and internet payments should become simpler and additional services should become possible. The Payments Systems Regulator hopes, for example, that new entrants might help the financially excluded.

The EU directive ushers in two new regulated entities: "payment initiation service providers" (PISPs) and "account information service providers" (AISPs). What this means in practice is that consumers will not have to go directly to a bank or card company to make a payment. They can ask a PISP to fetch money from an online account and they can use an AISP to aggregate all their online payment account information in one place. The account-servicing payment service providers (AS PSPs) – generally banks – will have to respond to requests for payment initiation and account information from third parties but the account holder has to give their consent to the data being taken. Banks will still be running the underlying payment rails but the customer-facing role could be taken on by other providers.

PSD2 came into force in January 2016. It grew out of a review of the Payment Services Directive of 2009 and all EU members have to bring its rules into national law by 13 January, 2018.

The Payments Services Directive of 2009 laid the legal ground rules for payments across Europe and also introduced the concept of a payment service provider (PSP). Until then, payment providers had either been deposit-taking institutions or issuers of electronic money. The directive opened up payments to non-banks and it also laid out what PSPs are expected to provide in terms of execution time, refunds and liabilities.

# When push comes to shove

**Tim Green** *looks at a new way of moving money in which people can make push payments to retailers without the need for account details, identification or card networks*

In the course of researching this article, I received a payment request from Paul Rippon, the deputy chief executive of "challenger bank" Monzo. He wanted £1.01 ahead of a phone interview. This was not a fee for talking. It was so that I could see for myself how Monzo has "re-booted" payments to reflect the mobile-first world of 2017.

I received a link via email to a "Monzo Me" web page. This contained a personalised message (filled with emojis) and a form