

Nonbanks in the Payments System: Innovation, Competition, and Risk

2007 Payments Conference

Federal Reserve Bank of Kansas City

May 2-4, 2007

Santa Fe, NM

Session 6: Central Bank Perspectives

General Discussion

Speakers: Thomas M. Hoenig, President and Chief Executive Officer, Federal Reserve
Bank of Kansas City

Philip Kloppe, Executive Director, De Nederlandsche Bank

Philip Lowe, Assistant Governor, Reserve Bank of Australia

Moderator: Mr. Hoenig

Mr. Hoenig:

Now we have some time for questions from the audience for either of the Philips or me, if you have any.

Yes, right here.

Mr. Gerard Hartsink, Chairman, European Payments Council:

One comment and one question. The access rules in Europe, the scheme management we created for SEPA credit transfers and SEPA direct debit includes also payment institutions. So, nonbanks can participate in the scheme. That is what is going on. It is also the market reality already in some of our markets.

The question I have is more about oversight. One of the key competencies of the oversight role of central banks is, of course, the 10 core principles of the BIS. If you analyze how the market evolves, we will have payment institutions in the future even more than today. We will have scheme management entities, sometimes with boards of

nonbankers. That will become the reality. The technology and the processing part of our customers, in particular merchants and corporations, are becoming more and more important for the total payment process. See *The Wall Street Journal* of today, the problems with credit cards. I like the thought of a functional approach for the topic, but my observation is the market is also evolving that our customers become more and more multicountry, multiregional, and even global—several of them are here in the room—and that is also true for the supply side at the banks and not only for the buy-and-the-sell side, but also for those who deliver technology.

Here comes my question. Would it make sense to create a consistent supervisory framework that we review—that you review maybe to kind of miss the market—the 10 core principles, are they still really actual for the supervisory board work? And, if you take the view that the functional approach is the better way to move forward for the future, which principles are applicable for which part of the functions? Because if you analyze the 10 principles—for instance, for a scheme management—you will soon find out that some of them are really not relevant for a scheme management entity.

What about including principles we included in OFAC, AML, BSA, Resilient, things like that? We are becoming more and more fragmented on the principles used by public authorities on in the end

delivering a payment from A to B. The key question is, What about upgrading the principles for the payment industry?

Mr. Hoenig:

Philip Lowe, since he started with functional, do you want to shoot at it and then the other Philip and I will throw in our two cents' worth?

Mr. Lowe:

My first observation is that we use the core principles as the foundation for much of our work, but we see them as just the starting point, particularly given that many of the issues we have been grappling with have to do with access. I am not sure that the core principles are that useful here.

The second observation is that the core principles deal with each system on a stand-alone basis. This means that you evaluate whether *each* system complies with the core principles. However, in some cases, the interaction between the systems is equally important, and this can be a limitation of just relying on these principles.

Obtaining international agreement to move beyond these existing principles seems to me to be a very big task. It has been hard work to get where we are, and I think it would be harder still to go significantly beyond this. It is probably beyond us in the short term. It is hard enough within one country to get agreement, let alone internationally!

Mr. Klopper:

I would agree with that. I want to add that, first of all, we should count our blessings. Given the dynamics of the payments market, it is an excellent starting position that we have these internationally agreed principles. Of course, we should continue to check whether they are up-to-date, and we should adapt them if necessary. They give us the flexibility to perform oversight in such a way that, in principle, it should not matter whether it is a bank doing a certain job in the payments chain or a nonbank. I would be very careful to maintain the structure of the international agreements, of course. And, yes, you need to assess from time to time whether they need updating.

Mr. Hoenig:

I think it is interesting we came together on the core principles about the time the dynamics of the payments system were really changing rapidly. 1) It is fortunate they are principles because that does allow us some flexibility in terms of working with those as guides and, in that sense, helpful. 2) Even without those, there needs to be increasing amounts of international cooperation because it is a global payments system. That attitude toward cooperation is more important than changing or trying to revamp the core principles. I will tell you candidly, I have some experience with changing the global capital

standards. I do not know that I want to try that again with 10 principles.

Other questions? Yes?

Mr. Wilko Bolt, Economist, De Nederlandsche Bank:

I would like to ask something about access to networks. Perhaps this is a question to Philip Lowe. I understand that in order for nonbanks to have a role or to put competitive pressure on banks, they need to have access to existing banking payments networks. On the other hand, I can also understand banks that have invested a lot over the last 10-15 years create and build up such electronic networks. They are somehow reluctant to open up all those networks because they took all the entrepreneurial risk in the past.

So, then you get into the problem of access pricing. And, we know from the telecommunications literature, it is a very complex problem. The danger of access charge or access pricing is, of course, that banks set those prices too high, so that nonbanks cannot really have a role in competition.

Then the question becomes, If those prices will be charged allowing access to networks, should there somehow be some regulatory body controlling those prices? My question to Philip is, Would the Australian Reserve Bank be willing to take up a role to regulate those prices if they would really be put by banks?

Mr. Lowe:

Maybe I can talk about the credit card system first, then the debit card system.

In the credit card system, if you are a bank, you can come in; join the Visa system, for example; and you pay whatever Visa charges to join. We would not see ourselves as getting involved at all in those charges. We have, however, said to both Visa and MasterCard that entry needs to be available to both banks and nonbanks.

In contrast, in the domestic PIN-based debit card system—which is based on bilateral linkages—a new entrant has to talk with each of the existing participants, and come to some agreement with them, before it can enter the market. What we were finding was that some of the nonbanks were saying, “We want to be a specialist acquirer, but we have to establish links with the major issuers to do so.” And the major issuers were saying, “Yes, we will establish those links, but we can’t do it for two years because we have a lot of IT issues on our plate, and we will have to charge you, and that charge will be X.” And X could be a very large number.

So, as part of the RBA reforms to promote access on fair and reasonable grounds, we have established an access regime for the EFTPOS system, and that access regime caps the price that can be charged to establish one of these links. We decided upon the level of

the cap after studying the actual costs of establishing a connection, and the charge is in line with the costs of an efficient provider of access.

Now, this was not something that we wanted to do. We would have preferred the industry to reach an agreement about an appropriate cap, but it could not. Many institutions wanted a number that was multiples of what we ended up with.

As we have said on many occasions, we are a reluctant regulator in these areas, but at some point you come to the conclusion that the solutions being proposed by the industry are just not conducive to competition. We felt like we had to address that. So, we have regulated access pricing in the PIN-based debit system.

Mr. Ken Posner, Managing Director, Morgan Stanley:

A question maybe for you, Tom. We have heard about access in Australia and I think yesterday we heard about an example of a French retailer that was able to set up a bank and get access to the payments system.

In the United States, it would appear to be more difficult for retailers to gain access to the payments system, if not impossible. Is that a difference in philosophy? Is that a difference in legal authority? Is it something U.S. regulators need to think more about?

Mr. Hoenig:

Well, it is a good question. It has obviously gotten some attention while we are here. In one sense, in this country, there is some legal precedent we have around the issue of banking in commerce. That is very deep in this country and it goes back from our foundations, as to how much you allow the nonbank into the banking industry.

But banking in the broad sense—banking in the sense of granting credit—what are the conflicts? That was what Glass-Steagall was about. Even before that, it was a tradition here. So, it goes deep, it goes back in time, and we have moved away from that, as illustrated by the fact there are important nonbank providers in payments and, as you have seen, even important in holding of value as transactors.

We have seen some of that move. In the United States, if it moves in that direction, it will move slowly because of the concerns not just for the risk, for the potential conflicts, and for concerns frankly about concentrated power around financial control in this country.

So, yes, it always deserves a review constantly, it has in this country received that, and it will going forward—with good reason—cautiously. If you think of how much consolidation has occurred around payments and you think of how much consolidation has occurred around banking and bank assets, I think it has served us well, but it has been very deliberate and that has also served us very well.

Mr. Klopper:

To add a comment from the European perspective, it is true that in Europe you have seen retailers moving into banking, payments, etc. What I have *not* seen is that being a great success. I have seen them move in, and I have seen them move out again. If you look at the current landscape, there is no large-scale presence of retail companies in payments or banking. I do know of retail companies that hold a banking license in a subsidiary for very specific functions. But I do not even know if that is very successful. I am not for it or against it, but I have my doubts about the business case.

Mr. Marc-André Lacombe, General Counsel and Corporate Secretary, Interac

Association:

I just have a comment about the issue of access. Back in 1996, Interac Association started the PIN-debit in Canada and was already on its way to being quite successful. The competition authorities, however, did not think this was appropriate. It was completely controlled by the banks. So, we had a consent order, which here is called a “consent decree,” which required Interac to open up to nonbanks, or what we call “nonfinancial institutions,” because the credit unions in Canada play a major role in our payments. They also required us to change the governance of the system and remove a lot of the barriers. So, we have now a governance system that includes credit unions, banks, retailers, payment processors, and acquirers.

Retailers are entitled to do their own acquiring system. One of them is actually on our board.

The consent order and the change in the government have been a very big success factor in PIN debit in Canada, to the point that as we are moving to chip in the next few years, so will the schemes (the credit card companies). They have started, Visa and MasterCard, to try to lure our banks to move to a debit card on their chip. But the largest retail advocate—the Retail Council of Canada—just wrote to them saying, “We have a system that we like in Canada. If you intend to bring in a new debit system, we will not lay down and let this happen without a fight.”

Letting the nonbanks into the system but making sure (and I think there was someone yesterday who also said that the importance) of changing the governance, you can have a payments system that is a successful one when you have a win on all sides. Thank you.

Mr. Hoenig:

Good point. Reactions? Other questions?

Ms. Margaret Weichert, Senior Vice President and Strategy, Innovation and

Payments Executive, Bank of America:

I have a question for Philip Lowe, following up on the comment you made to Wilko’s point. I am curious about the notion of cost that

you found unacceptable. When we look at IT investments with a fixed pool of IT resources, probably the most important cost aspect of any decision we make is opportunity cost of what we do not implement if we choose to do a particular project. So, I am curious whether you looked at opportunity cost when you did that.

Mr. Lowe:

The cap was established based on the results of a survey of all the major financial institutions as to their costs in establishing a new connection. That survey gave us a range of answers. Given our mandate to improve competition and efficiency in the payments system, we chose a number that reflected the costs of an efficient provider of access.

At the end of the day, it is not a large sum of money: \$78,000 per connection. Some institutions wanted two or three or four times that number. In the scheme of things, it is not a large fee, but when you are a new institution and you have to pay it 10 or 12 or 15 times, it can start to add up. The interesting issue is whether new institutions should be required to pay the high costs incurred by those institutions that find it costly to establish connections. Our conclusion was that such an approach was not consistent with entry on fair and reasonable grounds.

Mr. Hoenig:

Very good. Other questions?

Mr. Michael Schiffres, Senior Vice President and General Counsel, Citigroup:

I have a question for Philip Lowe. You spoke about merchants joining the credit systems of MasterCard and Visa. I was not clear what the current state of the rules is in Australia. Also, I would like you to discuss who does the underwriting because one of the functions in the credit card system is the acquiring bank underwrites the credit risk. If the RBA is going to mandate merchants have direct access, who does the underwriting and is going to bear the credit risk in the event of a merchant default?

Mr. Lowe:

To date, no merchant has joined the credit card system, although technically merchants are able to do so. Merchants are, however, doing their own acquiring in the PIN-based debit card system.

If a merchant is to join the credit card system and do its own acquiring, it would need to get a license as a specialist credit card institution. This means that it would be subject to APRA's prudential requirements to ensure it could meet any financial obligations that it incurred as part of the membership of the scheme.

Mr. Schiffres:

So, in other words, the credit regulator would decide and look at the deferred delivery, so they would have different standards for an airline than they would for a department store?

Mr. Lowe:

Potentially, yes. The regulator would say, "Well, what are the risks that you as an acquirer are running here?" And, the regulatory requirements would be designed to address those risks.

Mr. Schiffres:

In a sense, the regulatory would be taking on the role that is currently provided, at least in the United States, by private enterprise. The acquiring bank does that.

Mr. Lowe:

In effect, the regulator is setting minimum standards and saying, "There are risks from being in the acquiring business. You have to manage those risks and you have to hold appropriate capital and liquidity to deal with those risks. This is regardless of whether you are a bank or a nonbank." Again, the regulation is functional, not institutional.

Mr. Hoenig:

And, then, that is part of the issue for the central banks around the world—that is, does the market successfully self-regulate—and then when do you step in? I have to tell you, I very much appreciate Philip Lowe's coming here because he always helps us go through that because the Australia Bank has been put in the position of having to do it and, I think, pretty systematically.

Any other questions from the audience? All right then, why don't we bring this to a close? It is a good time to do that.

Let me just say a couple things. I am not going to try to summarize this conference because 1) I don't think I could, and 2) we don't have the time. But we will pull this together and make the proceedings available easily by Internet access, with all the right security behind it, and then hopefully, what I have learned at least, I hope you have also benefited from. For me, it has been a great conference. It has taken us a step forward.

I very much want to thank the staff of the Federal Reserve Bank of Kansas City—all of them: Barb Pacheco and Stu Weiner and our group here—because I can tell you how much stress and how difficult that is.

We also want to thank the participants who joined us on this podium to share the knowledge they have because that is what makes it successful. And, finally, I want to thank all the participants because

the questions from the audience have been absolutely superb and helped take the conference forward. For me, it has been a great experience, and I want to express my appreciation to all of you.

Thank you all.