



Network industry implications for the competition-cooperation nexus in retail payments

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Evolving Landscape of Payment Systems

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15.10.2014



EUROJÄRJESTELMÄ
EUROSYSTEMET

Agenda

- Competition-cooperation nexus in retail payments
 - Network good characteristics and market features
 - Compatibility and competition modes: competition *in* the market & competition *for* the market
- Case: The Single Euro Payments Area (SEPA)
 - Market integration perspective
- Policy conclusions:
 - Adequate upstream cooperation to facilitate effective downstream competition
- Practical considerations for developing future retail payments

* The views expressed are those of the author and do not necessarily reflect the views of the Bank of Finland

Competition-cooperation nexus in retail payments

- **Competition** between service providers normally seen as the key contributor to market efficiency
- but, because of inherent characteristics of payment industry, a certain degree of **cooperation** in setting standards and ensuring interoperability between infrastructures is also needed.

Policy question:

- How should this **competition-cooperation nexus** be dealt with in defining appropriate policy stances?
- => Implications from **network features of retail payment industry** can provide some guidance

Basic network good characteristics and market features

Network good or service has two characteristics:

1. the value a person gets from the product/service increases as more people consume it
2. the technique a firm chooses to produce the product depends on the technique chosen by the others firms

General network market features:

- consumption externalities (positive demand side network effects)
- economies of scale on supply side

The key role of compatibility through standardisation

Typical features in network industries

Presence of network effects tends to lead to

- **concentrated market structure**
- **“tipping”**: often one system gets dominant
- **“path dependence”**: history matters
- **“excess inertia”**: markets **locked-in** to old standards
- **“critical mass”** and **“chicken-and-egg”** problem
- **potential underproduction**

=> *also observed in retail payment industry*

Key network issues for retail payments: Compatibility and standardisation

- **Compatibility:** common standards
 - Set by standardisation organisations
 - Set by industry (in cooperative manner)
- **Incompatibility:** proprietary standards
 - Set by individual firms

=> Compatibility/incompatibility decisions define **the mode of competition**

Compatibility and competition modes

- Compatibility: Competition *in* the market
- Incompatibility: Competition *for* the market

PSPs have counteracting incentives for compatibility:

- (i) “**Network effect**”: larger potential customer base
 - (ii) “**Competition effect**”: increased potential competition
- =>(i) enhances compatibility, (ii) discourages it

Practical implication for retail payment markets:

PSPs may not strive for compatibility, if not in their business interests (may use competition policy requirements as an “excuse” to protect their own business)

Competition *in* the market

Competition in services in a single network or compatible networks, compatibility through common standards

- Facilitate exploitation of positive network effects
- May involve a loss of variety in the products
- Innovation incentives may suffer, free-riding problem
- Regulatory policy important: should ensure fair access to networks and standards

“Good for static efficiency, some problems for dynamic efficiency”

Competition *for* the market

Incompatible systems/products compete for the market, proprietary standards

- Innovation incentives supported
- May involve unnecessary duplication of infrastructures
- Potential underutilisation of economies of scale
- Difficult to reach critical mass => “chicken & egg problem”
- Regulators can rely more on direct competition

“Problems for static efficiency, good for dynamic efficiency”

Case: Single Euro Payments Area (SEPA)

Competition in the market and competition for the market have both pros and cons

- For integration of European retail payment markets, ***competition in the market* is more appealing**
 - Better exploitation of positive network effects (both demand & supply side)
 - Critical mass & chicken-egg problems easier to be solved
- **“SEPA-ideology”**: same rules and standards to achieve integrated markets
 - “SEPA-history” shows the difficulty of achieving integrated markets under the *competition for market* –mode

Market integration & competition perspectives in SEPA

- In the SEPA-context, **competition-cooperation nexus** may be viewed in a different way by *central banks* and *competition authorities*
- “**Market integration**” **perspective** (central banks’ catalyst role) emphasises interoperability through commonly agreed standards
- “**Competition**” **perspective** is more sceptical on cooperation because of potential anti-competitive effects

Market integration perspective (1)

“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 cooperation on standards and infrastructures explains the lack of progress in reducing the cost of processing cross-border transfers”

(“Towards an integrated infrastructure for credit transfers in Euro”, ECB, November 2001)

This 13-years old quotation describes “**Market integration**” view on competition-cooperation nexus:

- 1. Lack of competition in downstream markets serving end-users**
- 2. Lack of cooperation in upstream markets (standard-setting, building interoperable infrastructures)**

Market integration perspective (2)

Based on the network features of retail payments, market integration perspective could be read as:

To facilitate further development of integrated European retail payment markets, there must be adequate upstream cooperation to ensure effective downstream competition!

- Reasoning: without any upstream cooperation (in standards & infrastructures), it is extremely difficult to have effective pan-European downstream competition at the end-user level.

Market integration perspective on competition-cooperation nexus

Foundation for market integration perspective:
upstream cooperation and downstream competition can and should coexist

- Two levels:
 - “Upstream level”: standard-setting, inter-PSP -level
 - “Downstream level”: end-user level / customer level

Questions:

- Is the nature of these levels different?
- If so, what are the implications for the appropriate public policies?

Downstream competition

“Competitive space”

- Competition in serving final customers
- For market efficiency and social welfare, competition in the downstream market is the key
 - => *ensuring effective competition at this level should be the main focus of competition authorities!*
- Naturally, downstream competition is dependent on upstream market
 - If innovation incentives and access of potential entrants to upstream market are limited, no downward pressure on prices and costs in downstream market
 - But if upstream standards/systems are not adequate/non-existent, downstream competition is very limited!

Upstream cooperation

“Cooperative space”

- Nature of payment systems (*multiple customers and PSPs*) requires a certain degree of cooperation
- Cooperation at the standard-setting/system level:
 - agreement on technical standards
 - establishment of jointly-owned systems

Upstream cooperation in defining standards:

- Make it easier to achieve a critical mass of users (exploiting *positive demand side network effects*)
- Facilitate the utilisation of the potential economies of scale in production (*positive supply side network effects*)

Policy conclusions for SEPA

To facilitate further development of integrated European retail payment markets, there must be adequate upstream cooperation to ensure effective downstream competition!

- Adequate upstream cooperation should be tolerated by competition authorities; focus on ensuring downstream competition
- To facilitate adequate upstream cooperation, central banks should be active (“honest brokers”)
=> Establishment of **multi-stakeholder cooperative bodies**: e.g. the Euro Retail Payments Board (ERPB) & national payment councils

General policy recommendations

1. Policy-makers should **tolerate and facilitate sufficient upstream cooperation by payment service providers to exploit positive network effects**
2. At the same time, they should also **ensure fair and open access to upstream standard-setting and systems**

In addition, central banks could support the establishment multi-stakeholder cooperation bodies where both payment service users and providers are represented.

Practical considerations for developing future retail payments

Future challenges:

- Broad view needed in the development of future retail payments (“Iceberg picture”)
=> inclusion of all relevant stakeholders also outside the traditional “payment business”
- Further elaboration of the concept “***socially efficient retail payments***”, ingredients:
 - the safety and reliability of payments
 - the availability and usability of payment services
 - the (cost) efficiency of payment solutions

Big picture: Payments represent the top of the iceberg in the real economy

"10%" Paying/payments
(consumers, corporations,
authorities)

"90%" Financial administration systems,
Cash register systems, etc.



Thank you!

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