The Regulatory Effect in Faster Payments

by Eric Grover

Banking Strategies

July 8, 2016

Handing someone a $100 bill is an instant payment. Likewise, proprietary systems such as PayPal and open, un-permissioned Bitcoin offer near real-time value transfer. For most consumers and businesses however, a leather or cryptocurrency wallet, cash under the mattress or PayPal isn't their anchor liquidity instrument; it's their demand deposit account (DDA). Every country has at least one Automated Clearing House (ACH)-type system that reliably and cheaply delivers non-spontaneous payments between DDAs. Historically they were next-day, which was good enough.

Increasingly however, global financial regulators – taking cues from each other – have been talking up the opportunity to enable better and new services and improve economic productivity by speeding up interbank-payment processing. Banks noticeably haven't been chomping at the bit, as, while faster payments are better, it's challenging to get consumers and businesses to pay for them.

Eighteen countries now have real-time, interbank, retail account-to-account systems, in various stages of adoption. Zengin in Japan developed by NTT Data and launched in 1973 was the first interbank faster-payments system. The near real-time SPEI system operated by Mexico's central bank has been live since 2004. In Europe, Icelandic banks' data center was the trailblazer, initiating real-time interbank payments on a limited scale in 1985.

While interbank-payment-processing infrastructure is vital, it's near invisible and, in most countries, neither competitive nor innovative. Absent competition and often with a sole bank-cooperative provider, there's been little impetus for change. But now, EU, UK and U.S. regulators are taking an interest, albeit with different approaches to spurring improvement. EU regulators, for example, see payment networks and infrastructure providers as public utilities. In contrast, British regulators view payments infrastructure as a market that's underperforming. And the paramount U.S. financial regulator, the Federal Reserve Bank, understands the ecosystem is complicated and works for banks, businesses and consumers, but is nudging the industry toward faster interbank payments.

In my view, regulators at minimum should police the rules of the road. Additionally, where markets aren't competitive and self-correcting, they should pursue structural changes to boost competition and, therewith, value. Unfortunately, for regulators there's a worrisome temptation to centrally plan, i.e., to set prices, allocate resources and specify product features. With interbank payment-processing infrastructure, the temptation to stipulate a single, correct solution is particularly strong.

Prescriptive and Political

The **European Central Bank (ECB) charged the European Payments Council (ECP) – a liaison between regulators and the banking industry – with developing** an instant interbank euro-payments scheme. **The EPC aims to have it defined by November, 2016** and implemented by November, 2017. Its approach is prescriptive. Part of what drives the ECB is political: stitching together the EU patchwork. Then there's the conceit that enlightened regulators can better direct resources than the messy market coordinated only by prices and actors pursuing their self-interest.

To deliver an instant-payment system, EBA Clearing, which is owned by 58 banks, selected Italian processor SIA, whose largest shareholders are the Italian ministry for the economy and finance and Italy's central bank. Such an ECB-blessed approach with a single government-and-bank-owned provider constitutes euro-corporatism and while it may be well-designed at launch, all but guarantees a sclerotic, utility-like solution.

A payment scheme with the ECB's imprimatur out of the gate will enjoy a reputational edge with banks it regulates, and hopefully, it won't preclude or discourage the development of competing payment schemes and processors across the EU. And, while the ECB is focused on euros and the EU, new, faster interbank-payment systems should be bifocal, in other words, delivering commercially viable solutions in euro markets while aiming to serve a broader and ultimately global market, whether directly or through a web of reciprocal processing relationships.

With forbearance – better yet with encouragement – from the ECB, multiple players including British banks' Vocalink, French processor Worldline

Equens, French banks' cooperative processor STET, Scandinavian processor Nets, SIA, and perhaps payment-software gorilla ACI Worldwide and card networks like MasterCard and Visa, could offer real-time interbank debit and credit payments in the EU and beyond.

The UK regulatory climate, meanwhile, is decidedly more market-oriented. While pushing for improvements, UK regulators are focused on economic rather than political objectives and pushing structural changes to increase competition, innovation and access; they have avoided being prescriptive.

Under pressure from the Office of Fair Trading (OFT) and the UK Treasury, bank-owned Vocalink implemented near real-time ACH processing in 2008. Harnessing it, banks launched a mobile phone-aliased money-transfer service known as Paym and will soon debut a retail-payment system, Zapp, to compete with MasterCard and Visa. Zapp will be an interesting test case, as most new retail-payment networks fail, unable to find a path to critical mass with consumers and merchants and therefore to relevance.

UK Payment Systems Regulator (PSR) Hannah Nixon is concentrating on changing ownership and governance of core suppliers and focusing on more open procurement in order to enhance competition for core-payments infrastructure and, thereby, increase productivity and value. The idea seems to be to introduce a degree of dynamism where there's been little. Hallelujah!

The PSR rightly worries that a core interbank payments infrastructure with a single provider for each service, each owned by banks, isn't competitive and inhibits innovation. PSR Nixon wants banks to spin off Vocalink, with the laudable goal of spurring payments-infrastructure competition. Banks that weren't shareholders would be more likely to seek services from other providers. Ideally, multiple interbank faster payment providers would enter the market and consign regulators to playing the role of night watchmen.

Collaborative Approach

In the U.S., high-profile regulators fired shots across the payments industry's bow in 2014, when New York's top financial regulator, Benjamin Lawsky, **lambasted the ACH system** as "ossified," and in "desperate need of repair and improvement." He also threatened that, "if banks do not make significant progress soon, regulators should consider actively pushing for, or even perhaps mandating improvements." At the Clearing House's annual conference, Consumer Financial Protection Bureau director Richard Cordray **all but ordered** banks and their processor to build a real-time payment system.

The Fed itself has taken a collaborative approach to encouraging faster interbank payments. While it lacks statutory authority to mandate, it's using its bully pulpit to good effect. **A committee** including regulators, banks, networks, processors and retailers is developing nonbinding faster-ACH requirements. One has to worry, however, that with the Fed's imprimatur, these requirements won't have to be binding to be binding.

Interested parties are moving. Bank-owned processor Clearing House engaged Vocalink to support faster ACH, while the Atlanta Federal Reserve Bank hired IBM to enhance its ACH platform. Bank processors FIS and Fiserv are leveraging their debit networks to deliver instant interbank payments. And, in March, bank cooperative ClearXchange launched real-time P2P payments with Bank of America and U.S. Bank.

The U.S. interbank-payments market seems primed to have multiple providers with different and evolving offers vying for validation and share in the market. It remains to be seen, however, if financial institutions can harness faster interbank payments to deliver commercially compelling services to consumers and businesses.

The payments infrastructure is not sui generis. The model of regulators encouraging competition by addressing market structure and governance impediments represent a better path to greater value creation than treating payments as a public utility. The dynamic interplay between multiple interbank-payment systems, banks, businesses and consumers, collectively determining winners and losers and guiding innovation, will produce superior results in both national markets and globally.

*Mr. Grover is principal with Minden, Nev.-based **Intrepid Ventures**. He can be reached at**Eric.Grover@IntrepidVentures.com**.*