



# The Political Economy of Payments Improvement: An Outsider's View

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- Topics
- Payments improvement in the long run
- Complications in retail payments improvement in the short run
- Example: Faster payments in the US



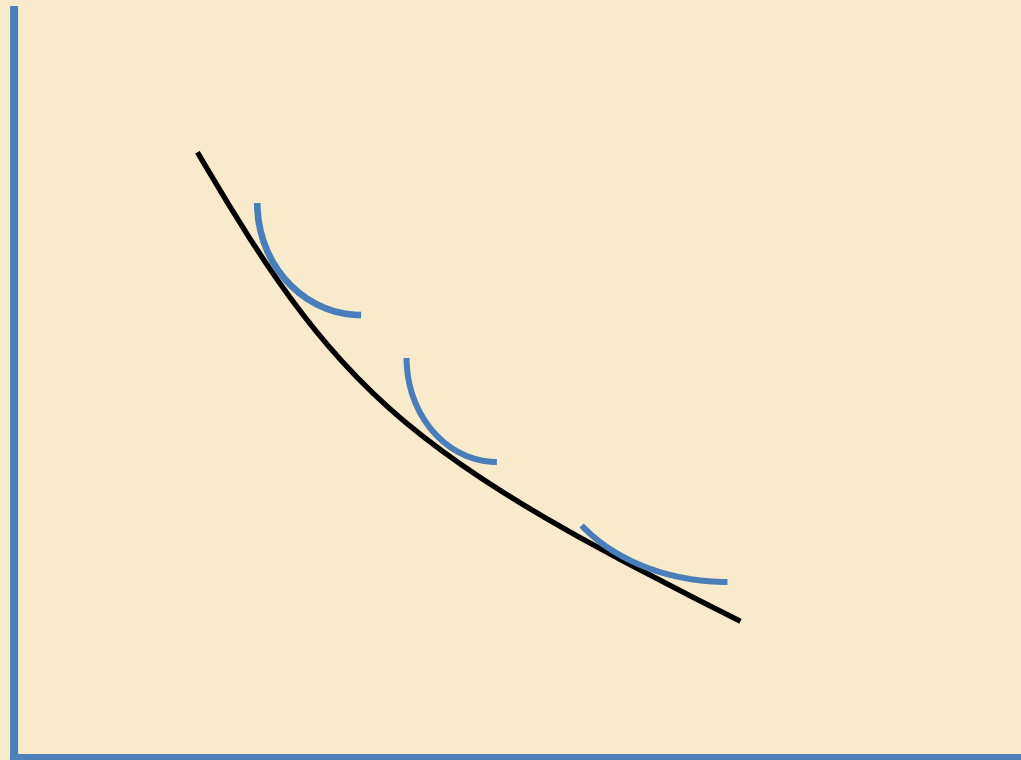
- Sources
- Kahn, Quinn and Roberds (2015)
- Kahn and Park (2015?)



- **Payment system cost frontier**

(Adapted from Berger, Hancock and Marquardt 1996)

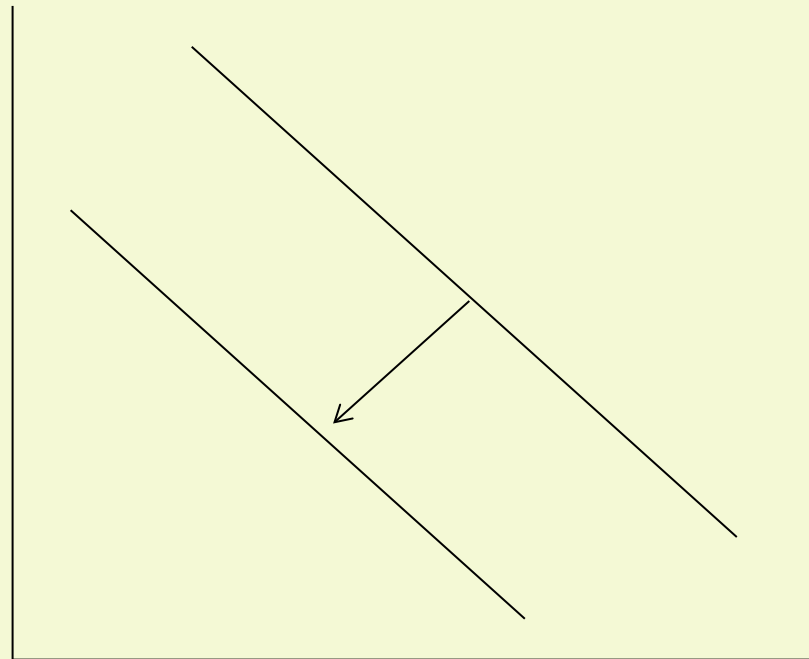
Liquidity  
Risk



Collateral  
Requirements

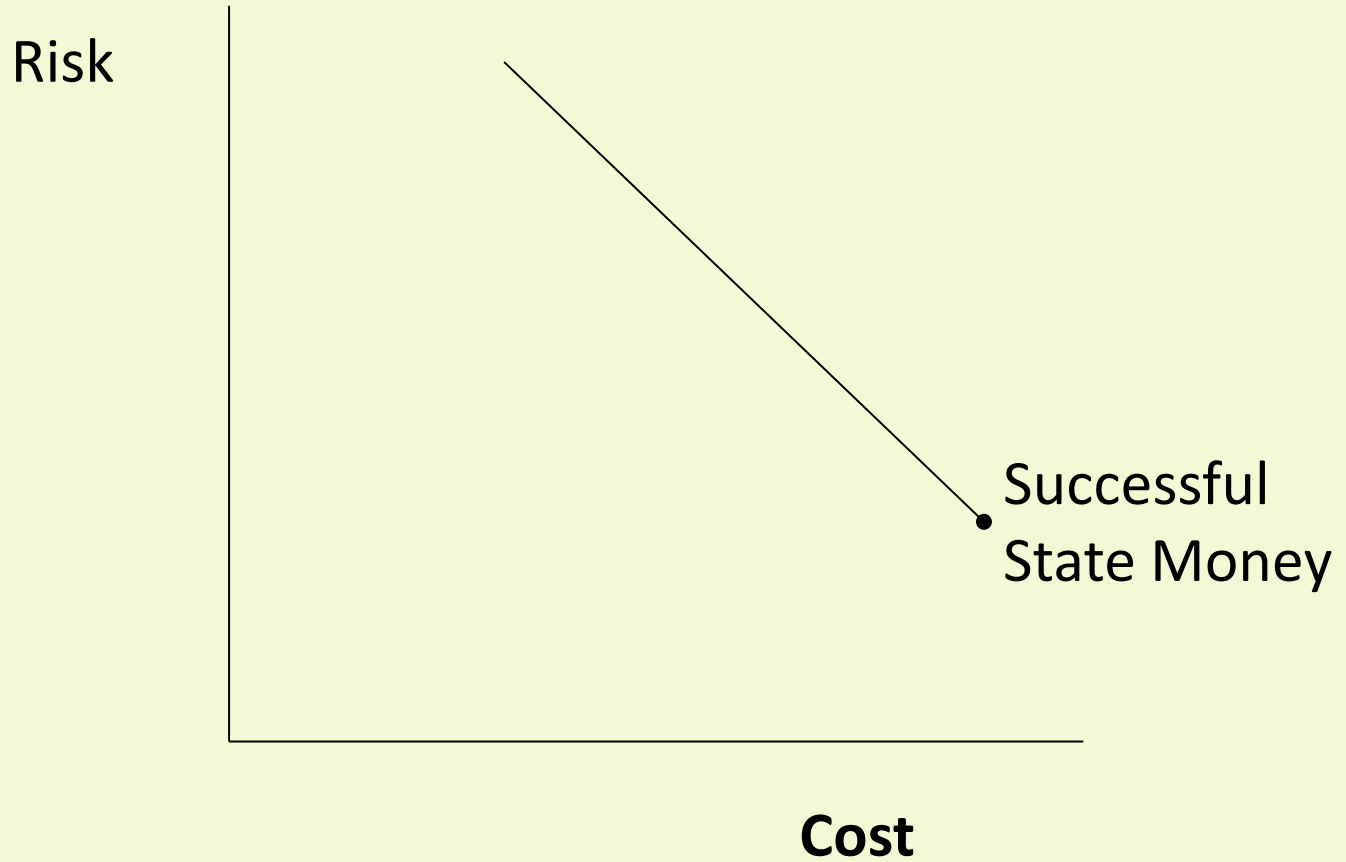
# Evolution

Liquidity  
Risk



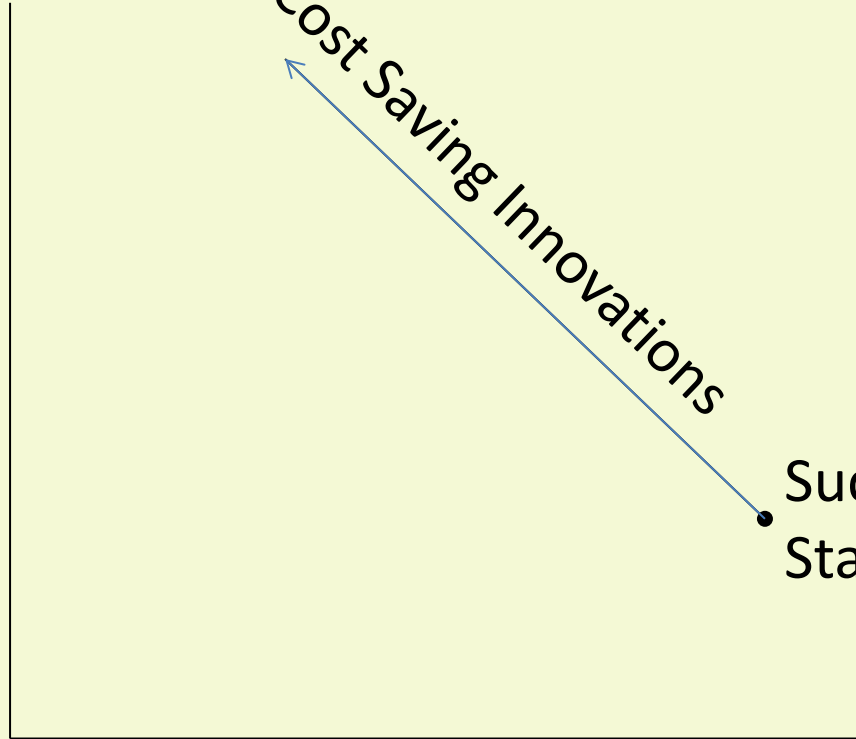
Collateral  
Requirements

# Anchor



# Anchor

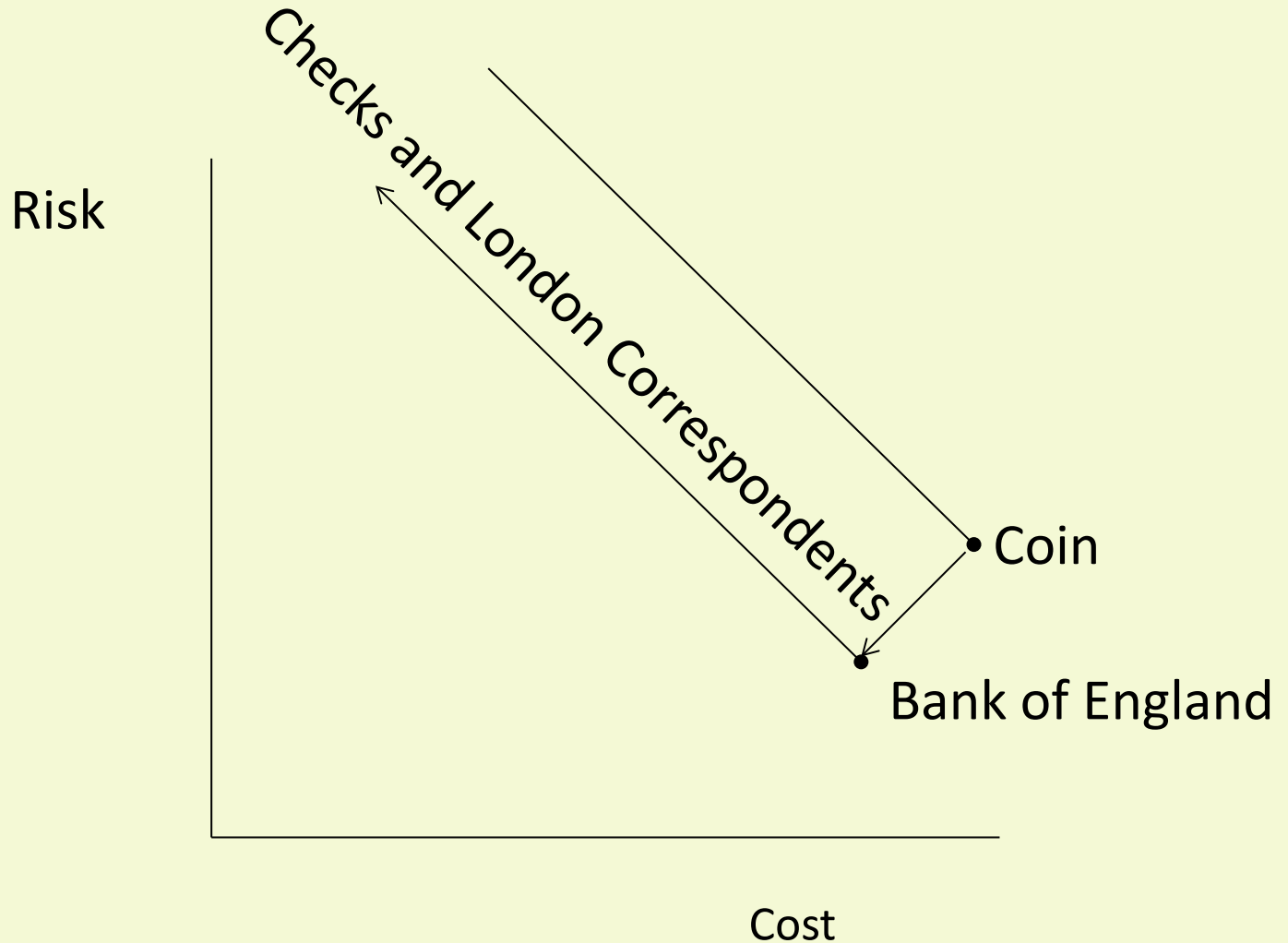
Risk



Successful  
State Money

Cost

# Example: Bank of England (early 1800's)





- Modifications for case of retail:
- Convenience and safety, rather than assurance of settlement
- Otherwise similar story: Retail systems built on government-provided backbones



# Complications in the short run:

## Who pays?

- Bilateral interactions: regular or casual?
- Setup costs vs transaction cost
- Who has bargaining power within the transaction?



# Complications in the short run:

Who pays?

- Network Externalities
- Two-Sided Pricing



- Consequences
- Focus on platform activity
- Small numbers of players interacting
- Capturing regulators



# Result

- Payments improvement by centralized mandate
- Or by dominant incumbents internalizing benefits
- Or by stealth



# “Strategies for Improving the US Payment System”

Current attempt sponsored by the Federal Reserve to bring  
Faster Payments to the United States

Looks carefully at costs and benefits of faster payments

But ignores game theory/political economy



Under-attention to the rivalry between two types of providers:

- Entrenched bank-associated payments arrangements
- Entrant non-bank payment arrangements



# Major Disconnect

- Apparently small demand for faster payments
- Apparently major concern among payments providers about the Fed's discussion





Faster payments is not pressing issue for entrenched providers

- “Users are likely to discover new benefits”
  - valid argument but only long-term effect.
- Many of the gaps imply only occasional use:
  - Emergencies not frequent enough to get customers’ attention
- P to P is the realm of start-ups
  - until one start-up gets traction, not worth worrying about for entrenched providers



# Real issue: not new services but existing rents

- For merchants, existing systems adequate
- Key feature: immediate authorization, not settlement
  - (want the funds sequestered, don't care about two-days' interest on them)
- Their complaint is about pricing



# Real issue

- Are charges to merchants for debit card payments in line with actual cost of authorization?
- And if so, only alternatives are
  - Regulation of pricing
  - Provision of alternative services



- Ancillary Service: Directory
- Classic example of network externality
  - The more people in the directory the more useful the directory is
- Relatively easy for the central bank to establish



## But well-known payment providers reap little benefit from directory

- Can send e-mail directly requesting information from payee.
  - If well known, payee response high
  - (If not well-known, looks like Nigerian money scam)
- Thus established providers will resist joining without coercion



- Note contrast with UK
- If large proportion of the transactions are “on-us,” faster payment can serve as competitive edge for a bank.
- In the US unlikely: and stickiness of demand deposits remove competitive pressures



- But, all is not lost...
- Stealth competition is real
- Incumbents find ways to internalize benefits



- Stealth competition:
- Paypal (and in earlier decades credit cards)
- Develop network externalities in a niche
- Expand from that niche





## In the US:

- Can wait for mobile phones to invade the payments space, adopting systems not dependent on bank accounts.
- Of course, this brings its own headaches: safety, cross-subsidy, regulatory hurdles, systemic concerns...



- Incumbents adopting systems when they can internalize
- Example: clearXchange (CXC)—a system that provides P2P directory for participating banks:
- Payment ID through e-mail or mobile number
- For the six banks in the system (including JPMorgan Chase, Bank of America, Wells Fargo) fully interactive
- But not fast (three to five days)



- Prediction for US faster payments
  1. In the US, uniform system for faster payments will be successfully resisted by entrenched payments providers
  2. Large incumbents will support directory services among themselves, but will resist participating in uniform system
  3. Will only come when the threat from non-financial providers becomes overwhelming



- More generally
- In the long run, costs and safety determine the choice of payments systems
- In the short run, superior technologies can be delayed by entrenchment
- A role for central systems as coordinators, but in their absence benefits only through stealth or internalization





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