THE OUTLOOK FOR **NATIONAL PAYMENT SCHEMES** IN A **GLOBAL ECONOMY**

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ANTHEMIS VIEWPOINT

We sponsored the national payment scheme project because we believe that increased competition between payment schemes is good for the industry. Competition encourages Innovation which benefits users of payment services. Competition can be a catalyst for greater efficiency which is good for the overall economy. This can only happen if we have strong and vibrant national/domestic schemes in addition to the traditional international card schemes (ICS). We were delighted that 17 major national schemes globally participated in the project and feel that it shows a strong level of enthusiasm and commitment to the continued development of schemes centred in national economies.
We already knew from a number of existing and emerging schemes that we work with, that there is a renewed belief that national schemes have a positive future and the survey results are in line with our experience. From our viewpoint, the key success factors for national schemes that already exist or are in development are:

- The value for money proposition resulting from cost-efficient business models is critical for ongoing success. However, if this is at the expense of having development funding for new products and services then it is a self-defeating strategy. There are several alternative ways to access capital for development without compromising the overall low cost proposition although this requires the current scheme owners to accommodate this new reality and potentially accept different corporate structures.

- To build an international acceptance strategy that mixes co-branding with the ICS with co-branding with the smaller schemes such as UnionPay and Diners/Discover, and direct acceptance in key markets through reciprocity with other national schemes. It is not a paradox to state that in today's increasingly global world, every national scheme has to have an international strategy.

- The governance model of national schemes that allows significant local input is a strong point, however this needs to be balanced against the need to recognise that banks are not the only stakeholders that matter. There is a need for schemes, to take decisions more rapidly in the current business environment. And for long-established →

national schemes, a review of the governance model is probably essential.

- Embracing alternative payment methods is vital, as the dominance and control of the ICS is not currently repeated in this area. The most resilient national schemes are and will be those that support payment services not available from the industry giants and where legacy business models are not relevant.

- There are cooperation possibilities between some national schemes that could be very beneficial. Currently there is very little exchange of even basic information between national schemes and partly as a consequence each scheme generally builds 100% of its capabilities. There should be no requirement that every service offered by a national scheme is specified and developed internally and greater information flows between schemes should lead to raising the efficiency bar through best practice sharing and also to some schemes buying in certain services from other schemes.

Our other insight relates to regulatory bodies (including Central Banks) that have a major influence of the future prospects for national schemes. Most regulators globally support the objectives of greater choice of payment schemes and increased industry efficiency. However there are now many examples of regulatory action leading to greater, not less, industry concentration and hence reduced competition. Over-concentration by regulators on the question of interchange frequently leads to equally important competition issues being overlooked. For the regulators themselves, this is a question of acquiring a better understanding of the complexities of the card business that are much greater than the simpler automated clearing-house world. For the national schemes it is being prepared to explain this in more detail.

Our experience is that central banks and regulators should operate in an oversight role rather than provide infrastructure, should encourage standardisation and interoperability, should look at a much broader range of competition issues than just interchange including the contentious practice of upfront inducements by schemes to switch business and should seek to encourage a market in which multiple payment schemes can operate. ■

INTRODUCTION

In an increasingly global world with national barriers to commerce being fast eroded many industry insiders have questioned whether national card payment schemes[1] have any future. In Europe where there is the greatest concentration of national schemes, there has been a widely held view that their days are numbered. Over the past few years decisions have been taken to end three of the schemes[2], with the banks in those countries deciding instead to issue MasterCard and/or Visa cards. The Belgian scheme survived a near death experience to reappear Lazarus-like with a belief in their future. In other areas of the world, financial communities are considering the merit of national schemes. India, where the decision was taken to develop RuPay, is the highest profile example of the seemingly inexorable movement towards global schemes being questioned. But the subject is again actively being debated in a number of other markets.

Seventeen national payment schemes from Asia, Africa, Europe, North, Central and South America have participated in a major global project looking at the market today and prospects for the future. These national card schemes, collectively process in total more than 40bn card transactions annually, as well as significant volumes of non-card transactions. Although this is a very significant volume of transactions, no single scheme in the survey accounts for more than 20% of the total and therefore they have much less market power on their own. Input has also been

obtained from a number of financial institutions that have to evaluate national scheme solutions compared to MasterCard and Visa offerings. The research was carried out in markets where there is a choice for banks between the use of national or international payment schemes. ■

References

1 A national card payment scheme has all or a large majority of its cards issued within one country and has an ownership structure centred in that country. National schemes frequently have less than 100% market share due to competition with international schemes.

2 Ireland, Luxembourg, Netherlands

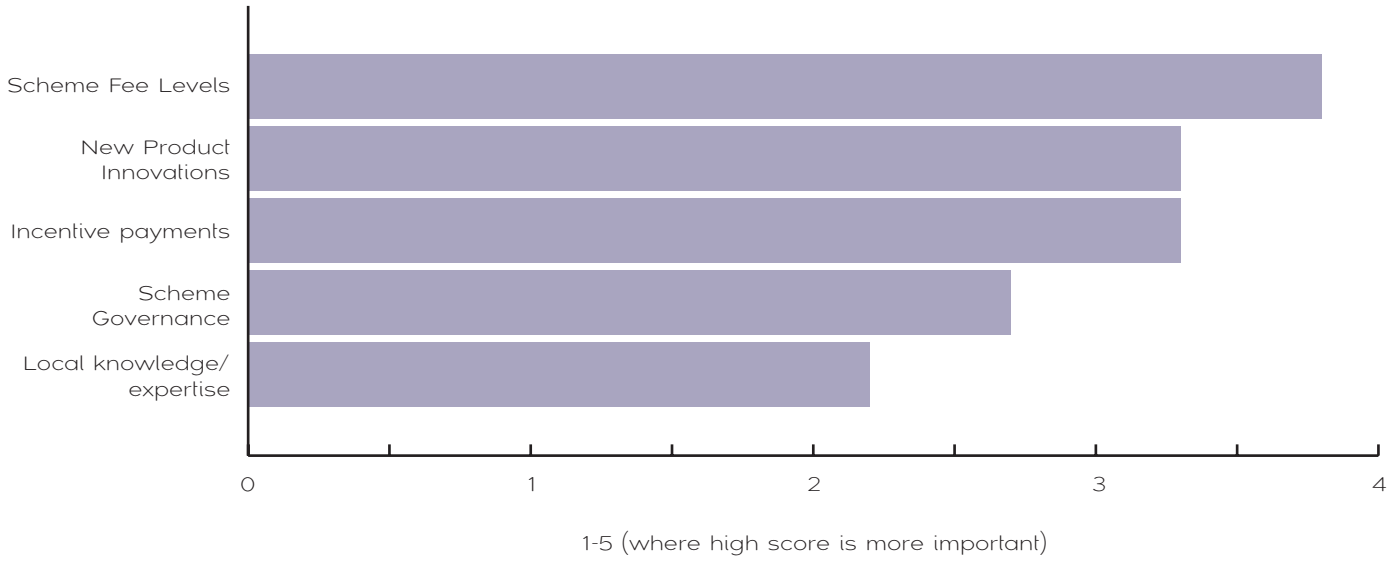
BANK DECISIONS ON PAYMENT SCHEMES

National schemes operate within the envelope of the global approach and financial resources of MasterCard and Visa. When questioned about some of the key factors faced by banks in making scheme decisions the most important factor seems to be the level of on going scheme fees (see table 1). The ability of a scheme to provide access for banks to new product innovations and up-front incentive payments rate as the next most important factors. Of lesser importance, somewhat strangely, is access to local market knowledge and on the ground expertise. This is however highly important for banks on an on going basis but seems to get somewhat overlooked at the decision time on new programmes.

> **"Access to new product innovations can tilt the balance in favour of the international schemes"**

When the national schemes evaluate their own

TABLE 1: FACTORS WHEN CHOOSING SCHEME



competences against the banks' requirements, they consider their three most important strengths to be:

1. Local market knowledge
2. Low costs resulting from an efficient business model
3. A governance model that encourages wide participation

Clearly there is a good match against bank requirements in the area of on going scheme fees. This is especially true for predominantly debit products in developing markets where is there is great emphasis on recurring scheme fees and the international schemes are viewed as high-cost providers. The recent trend of rising assessments from MasterCard and Visa creates an opportunity for national schemes to further emphasise their value for money proposition, although the complex and opaque tariffs of the international schemes can confuse the picture. In general, national schemes with their lean structures and low pricing cannot offer up-front incentives to banks which clearly motivate some banks' decisions despite the longer term financial position. →

"The international scheme choice is very much associated with incentive payments"

The latest annual reports from the international schemes show that incentive payments of US$2.2bn for MasterCard (22% of gross revenue) and US$1.9 for Visa Inc (17% of gross revenue) have been made, which underscores the scale of the issue faced by the national schemes. A number of years ago[3], the then President of Visa Europe took a principled stand against incentives by adopting a strategy of lower fees rather than paying upfront incentives. Despite the Board of bankers approving such an approach, the market quickly taught a harsh lesson by giving a greater share of new programmes to MasterCard. Competitive pressure then demanded a retreat on the strategy by Visa.

"Recent decisions between ICS and the local scheme has been hugely driven by short-term incentive payments"

Developing new products is seen as an area of relative weakness of national schemes due largely to the low cost models adopted, which often does not provide for sufficient budget to cover the costs of innovation. For the owners of national schemes to insist on absolutely minimum fees can endanger their long term survival.

An interesting development seen recently is that in some markets, such as Nigeria, additional capital is being injected by financial partners for product innovation and development without the national scheme moving away from a low cost model. Variants of this mixed ownership model to provide access to capital is also now being considered and being implemented in some other markets.

"The international schemes may have more money to innovate but it doesn't mean that they are always better at it"

Despite the imbalances in financial resources, the disadvantage that national schemes refer to most often is the difficulty of obtaining international acceptance for their products. In a world of increasing mobility this is clearly a significant issue although historically, especially in Europe, this was solved by a cobranding arrangement with one or other of the international schemes. However this kind of 'marriage of convenience' is no longer so popular with MasterCard and Visa, as it is seen to restrict the ability to participate in and levy fees on domestic transactions; that is central to both organisations' strategies.

Interestingly none of the national schemes highlighted interchange differentials as a major concern, suggesting that regulatory action may be making it harder for the international schemes to use this as a way to win business from Issuers. ■

References

3 1998

CHANGING BUSINESS MODEL OF THE INTERNATIONAL CARD SCHEMES

One of the most significant events ever, certainly in the last twenty years, in electronic payments has been the demutualisation of the MasterCard and Visa schemes (with the exception of Visa in Europe). Transformation of these organisations from member-owned co-operatives to Stock Market listed corporations was a fundamental change to their structures and mode of operation and many of the impacts are yet to be fully understood or experienced, by the schemes themselves and by users.

The national schemes that co-exist and compete with the international schemes were united in how they see demutualisation impacting the market.

One of the stated objectives of the demutualisation process was that the international schemes would be more able to develop new products and services more quickly. The plan was to short-circuit traditional lengthy decisions of a co-operative, where the decisions can easily get delayed by one of the major financial institutions blocking a particular initiative. The national schemes believe that on balance this objective has been achieved and that many more innovations are being brought to market.

There is also a very clear view that there has been a significant change with the interna- →

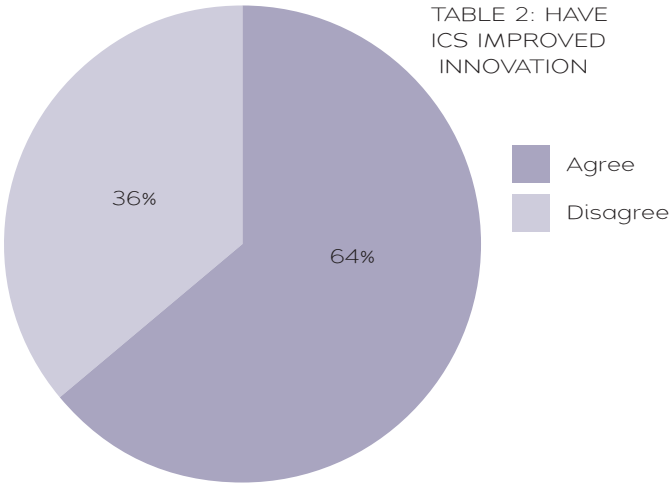


TABLE 2: HAVE ICS IMPROVED INNOVATION

tional schemes now far less focussed on meeting client bank needs and more interested in serving their own ends and the short term demands of the Stock Market. So it appears that demutualisation may not have been to the benefit of traditional scheme users, the banks.

Although Visa Europe was excluded from the Visa IPO, there is a clear view from the national schemes in Europe that there is little future for this split ownership model and that recombination of Visa Europe into Visa Inc is inevitable. Almost 80% of the respondents stated that recombination is inevitable, with no support for the view that an independent existence can continue in the long-run.

Just because the recombination is seen as inevitable (not only by the national schemes but also by many banks and other commentators that were interviewed), it does not mean that it is viewed as a positive move. But the message is that the days of Visa Europe as a bank-owned scheme are numbered; the question seems to be "when" rather than "if" they are absorbed back into Visa Inc.
Potentially this could increase the attractions of national schemes in Europe as banks become nervous about the impact of Visa Inc taking over their market although the uncertainty over timing and concerns over the future of the euro may well dilute any such impact. ■

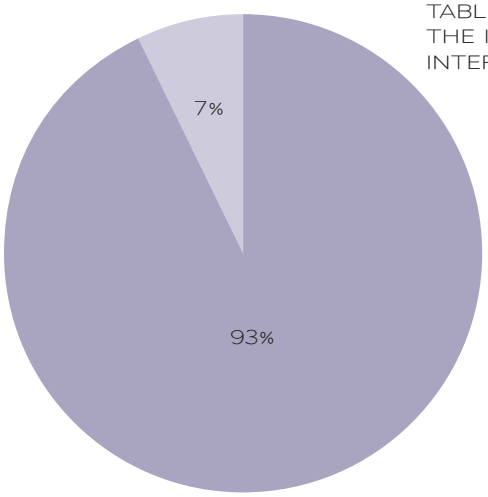


TABLE 3: SINCE IPO THE ICS SERVE OWN INTERESTS, NOT USERS

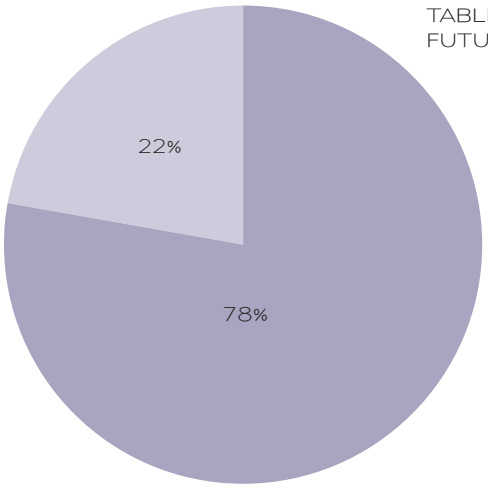


TABLE 4: VISA EUROPE FUTURE

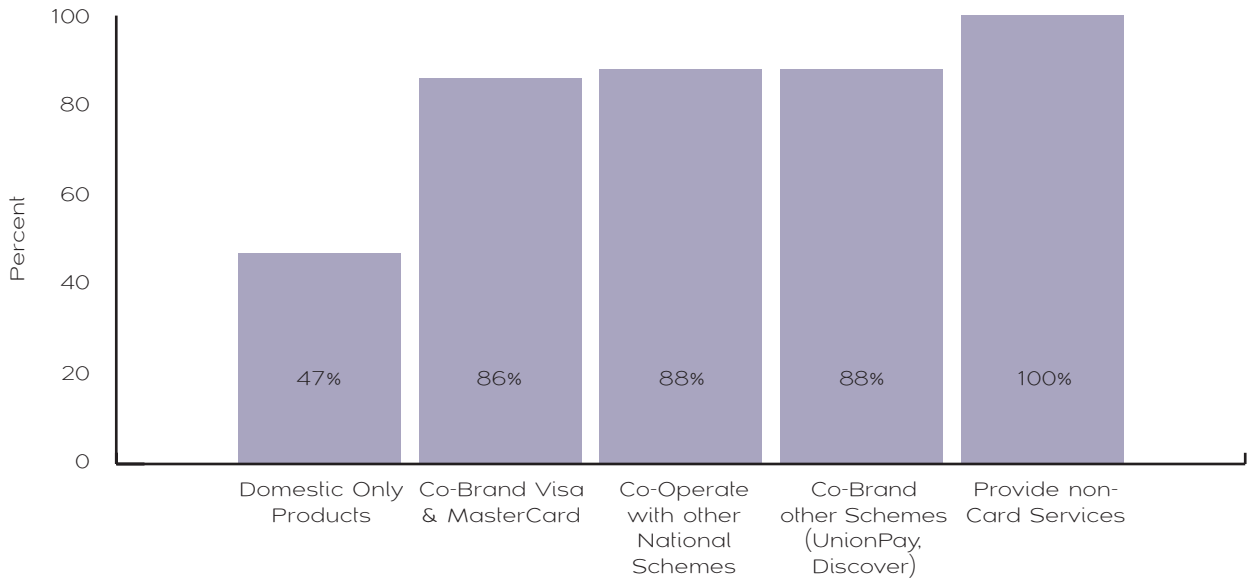
NATIONAL SCHEME STRATEGIES

Against the background of how banks choose which card scheme to align with as part of their customer issuing strategy and how MasterCard and Visa business models are changing after demutualisation, national schemes have a variety of strategies they can adopt.

The least popular approach is just to concentrate on the domestic card market although this is exactly what many schemes in Europe have done historically. The strategy attracts the least reaction from the major international schemes and does not require the owners of national schemes to take difficult decisions. It is, however, viewed as leading to the inevitable demise of many of them. Therefore many of the schemes consider that they will have to take some risks in future by moving away from total reliance on this approach if they are to avoid marginalisation and decline. →

> **"National schemes will have to experiment and take some risks"**

TABLE 5: DOMESTIC SCHEME STRATEGIES



Those currently co-branding with MasterCard and Visa see this as continuing for now but they see significant additional opportunity to

"Issuers are increasingly looking for value propositions that are not confined to a single geography"

also offer cobranding with the other International Card Schemes such as Diners/Discover, UnionPay and JCB. The recent selection of Diners/Discover as the international partner for RuPay is a landmark decision and with UnionPay now moving from an acceptance only strategy to one of encouraging foreign issuance there is a significant level of change happening in the market for co-branding.

This change has the potential to provide national schemes with at least two viable and potentially less predatory alternatives as international partners instead of Visa and MasterCard. There is also strong support for cooperation between national schemes for some form of reciprocal

"International acceptance via non Visa/MasterCard means is imperative"

acceptance. How this would operate will require some level of discussion between all parties and would probably require a neutral network infrastructure to be available and also for the national schemes to take a longer term strategic view rather than maximising short term revenue from the initial connection projects.

Provision of non-card payment services outside of the influence of the international schemes is seen as highly attractive and there is clearly a broad consensus (including from the banks) that

"Playing only in the legacy card space precludes capturing a significant share of emerging payments opportunities and runs the risk that national schemes are boxed into traditional categories"

the power of MasterCard and Visa in the card space should not be replicated in the alternative payment business areas that are developing in mobile and e-commerce. However, this is exactly the space that the international schemes are targeting for product innovation as they seek to minimise the risk to their payments pre-eminence.

In terms of their role and remit, national schemes believe that their active involvement in

national switching is vitally important from an economic perspective. Although charging models vary considerably from market to market, generally more than 50% of a national scheme's revenue comes from the provision of switching services to its members. This is vital revenue to make a scheme economically viable. Involvement of schemes in national switching is also seen as important for operational integrity. Schemes participating in the survey highlighted many real operational problems such as dispute resolution, rapid access to data for problem resolution and the ability to make required changes quickly that can occur if they are not directly involved in switching.

The current pressure from regulators to separate schemes from issuer and acquirer processing, as well as switching, that originated in Europe as part of the SEPA programme and has since been copied in some other countries is not considered on balance to be appropriate. There is recognition that there can be competition issues if a scheme can mandate only one issuer and acquirer processor and that therefore open scheme access for processors is desirable.

However those opposing the enforced separation are concerned that although national schemes can be forced to comply by the local regulator the international schemes consistently refuse such moves. So unless the international schemes can be forced into compliance, the national schemes believe that they should also be allowed to operate more of an integrated model. ■

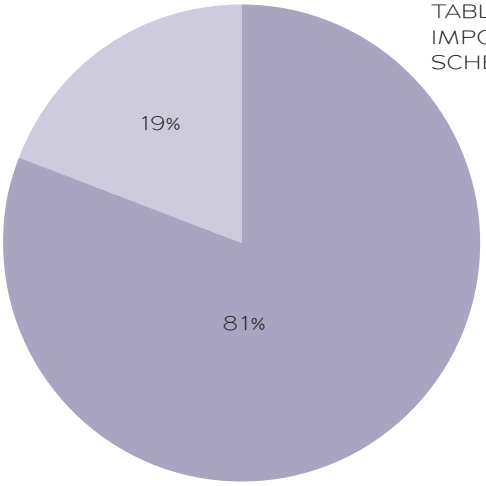


TABLE 6: SWITCHING IMPORTANT FOR SCHEME ECONOMICS

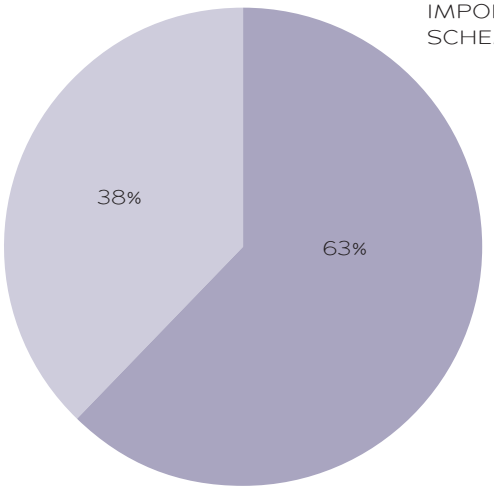


TABLE 7: SWITCHING IMPORTANT FOR SCHEME INTEGRITY

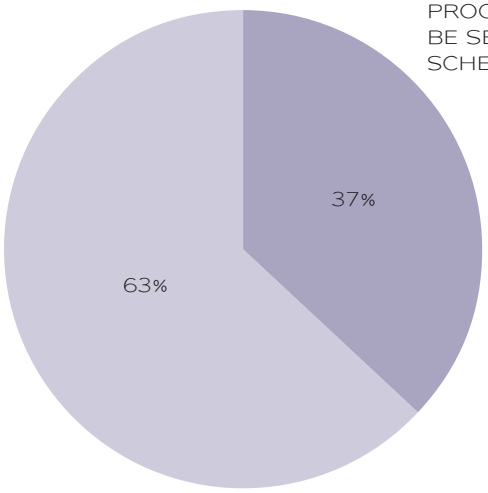


TABLE 8: SWITCHING/ PROCESSING SHOULD BE SEPARATE FROM SCHEMES

THE REGULATORY IMPACT ON NATIONAL SCHEMES

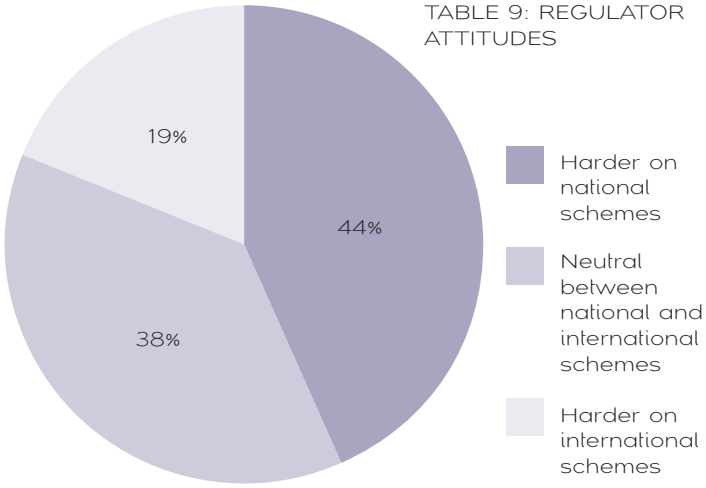
There is broadly an even split between national schemes that believe that payments regulators are even-handed between national and international schemes and those (generally from developing markets) that believe MasterCard and Visa get easier treatment because the regulators lack the expertise and resources to take on these highly powerful organisations. A much smaller number believe that the international schemes actually get harsher treatment.

In the area of incentive payments by MasterCard and Visa, regulatory inaction is a surprise to many in the industry including the national schemes. Payment schemes have such significant economies of scale that the use of upfront incentives in excess of US$4bn annually to grow their business by organisations that arguably already have a dominant market position is an area where the national schemes have expected regulators to show a greater concern.

An area where regulators appear to have been even handed is that of interchange. Unlike the USA market where MasterCard and Visa have until very recently been allowed to use interchange as a competitive tool to win Issuer business at the expense of Acquirers and Merchants without any regulatory reaction, regulators in other markets have tried to prevent this. In Canada, higher interchange was not allowed for the international schemes in competition with Interac. ■

"Our regulator favours a competitive market where providers are on an equal footing. However there has been strong concern about the market practices of the international schemes undermining healthy competition"

TABLE 9: REGULATOR ATTITUDES

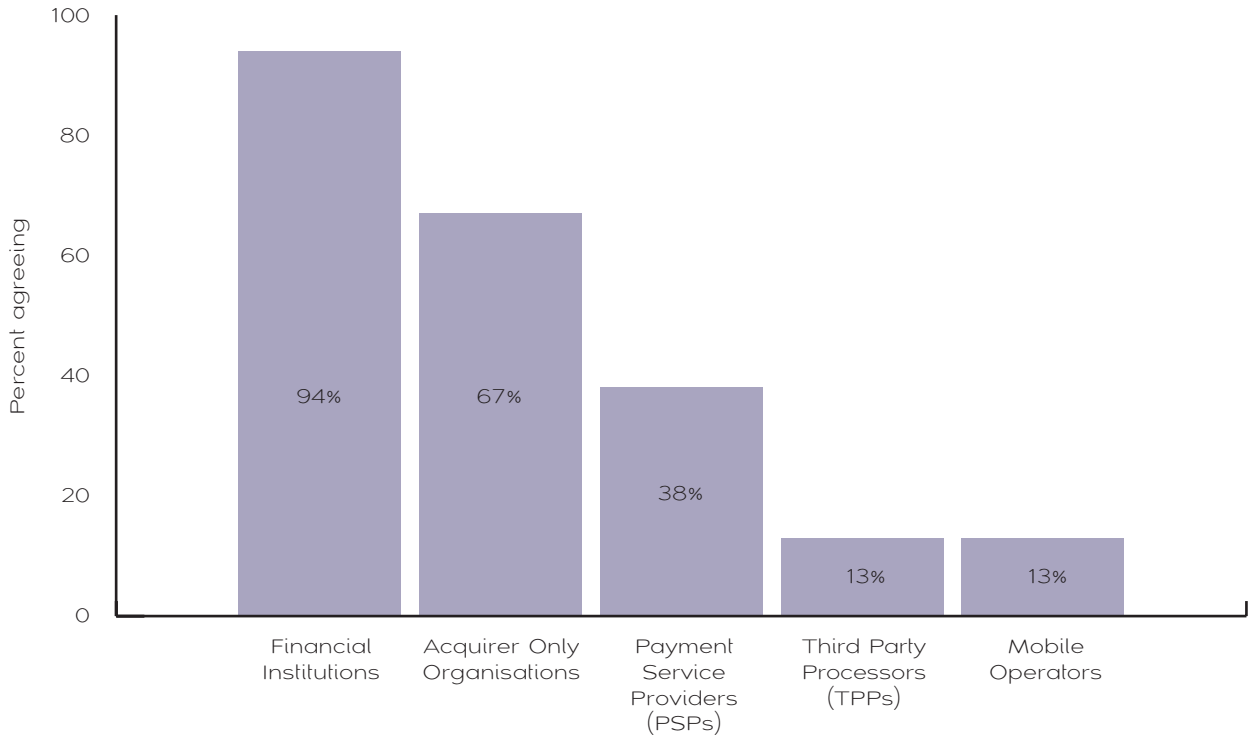


PAYMENT SCHEME GOVERNANCE

Scheme governance is an area where national organisations believe that they have a competitive advantage versus the international schemes especially following the demutualisation process.

In terms of which types of organisations should be involved in scheme governance, involvement of financial institutions is a given but there is a high level of support for specialist acquirers to have a seat at the table and reasonable support for payment service providers also to be involved. The industry does not yet seem ready to admit third party processors and MNO's to their governance structures although in relation to the mobile operators this is clearly under consideration given a high number of 'undecided'. ■

TABLE 10: SCHEME GOVERNANCE; WHO SHOULD BE INVOLVED

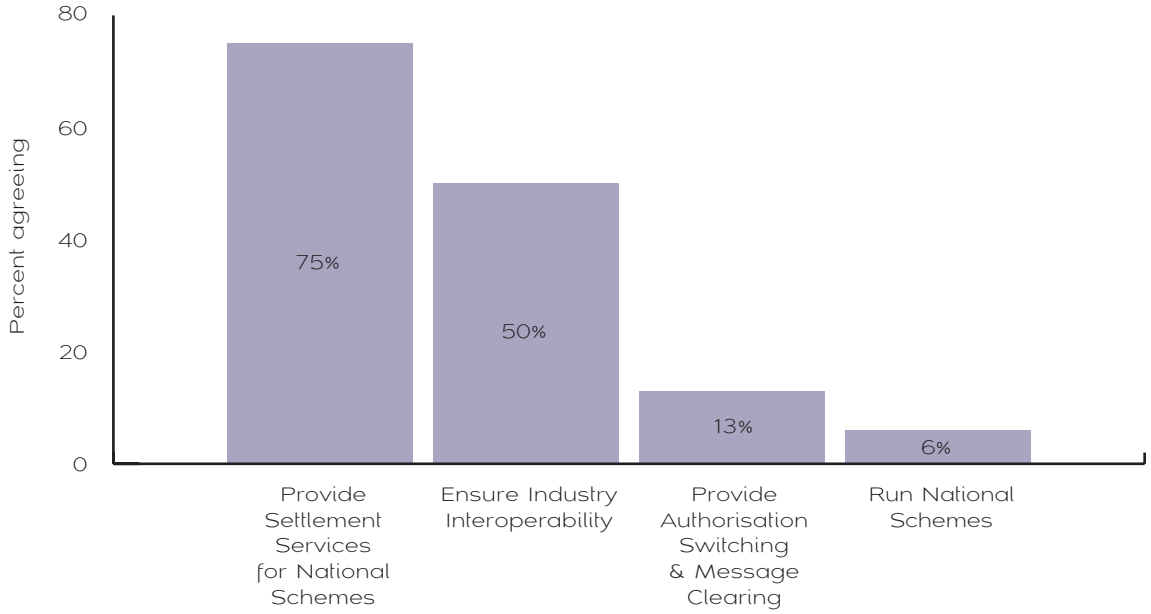


THE ROLE OF CENTRAL BANKS

In a number of developing markets, central banks have an ambition to become involved in running national payment schemes. The payment schemes supporting the survey that come from a broad range of developed and developing markets are united in the belief that this is not the role of a central bank or a central bank owned company. An oversight role is considered to be a legitimate role of a central bank but active involvement in operations is highly undesirable and viewed as outside the core competence of most central banks.

However, central banks do have a legitimate role to play in the payment scheme arena. Most national schemes believe that financial settlement (but not clearing) between the scheme participants should be through the central bank. Although many schemes felt that industry interoperability should be left to natural market forces to develop, there is strong support for the central bank becoming involved to ensure it if for some reason market forces do not operate and interoperability is prevented. ■

TABLE 11: ROLE OF CENTRAL BANKS



CONCLUSIONS

Inevitably national schemes are in competition with the MasterCard and Visa international schemes despite a historical coexistence in some markets. Despite there being a number of issues, such as cross-border acceptance, slow decision making or insufficient focus on innovation where national schemes need to improve but arguably they can influence their future, there is a clear consensus on the most significant threat which outweighs all other areas by an significant margin. That area is the payment of upfront incentives, which the national schemes cannot directly influence.

As a footnote, it is worth recording how outsiders such as the national schemes view the threats to the major international schemes. Out of five potential risks to the MasterCard and Visa duopoly, such as increased regulation of interchange and improved national scheme cooperation, there is again one that stands out above all others. That risk comes from the new payment providers such as PayPal, Amazon and Google and the direct to account e-commerce providers. That suggests that national payment schemes should be planning how to work with these providers and to develop new non-card e-commerce services. ■

ADDITIONAL SECTIONS FOR PARTICIPANT REPORT:

THREATS TO THE NATIONAL SCHEME MODEL

In terms of threats to the national schemes the picture is clear; it is the large upfront incentives from MasterCard and Visa that represent the biggest danger.

All of the other threats are to a substantial degree within the power of the national schemes to address although international acceptance is a major hurdle to overcome. EMV outside of the MasterCard and Visa constraints is now readily achievable but authentication for e-commerce remains a significant issue for national schemes. But it is the large upfront payments to often cash-starved banks that can turn decisions against national schemes even if in all other respects their offering is equal or superior to the ICS competition.

The national schemes consider MasterCard and Visa to be formidable competitors not least because the same banks that participate in the national scheme governance are often also recipients of substantial incentive funding. The largest threat to the international schemes is considered to be the emerging payments players such as Google, Facebook, PayPal and Amazon.

Regulatory action to reduce the upfront incentives would considerably reduce their attractiveness to issuers and could cause some significant rethink at MasterCard and Visa. ■

TABLE 12: THREATS TO NATIONAL SCHEMES

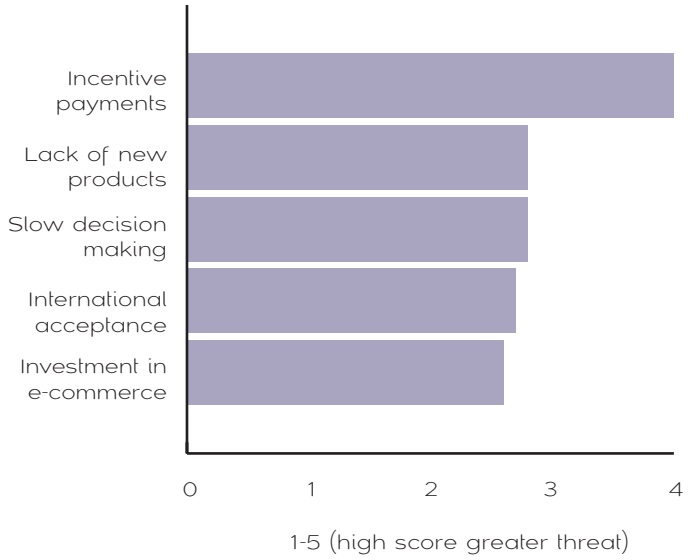
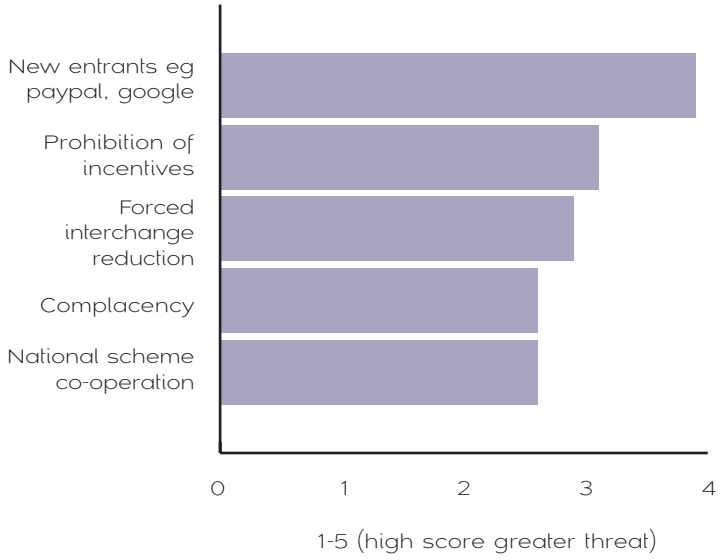


TABLE 13: THREATS TO INTERNATIONAL SCHEMES



COOPERATION BETWEEN NATIONAL SCHEMES

Lack of international knowledge has been recognised by the national schemes as an issue and a large majority would support the creation of an annual global forum for information exchange and for discussion of cooperation possibilities.

In terms of establishing a global interoperability framework and network, there was also a significant level of interest but many schemes were unsure about whether this is realistic given the number of difficult issues that would have to be solved.

Despite the issues that the EAPS scheme cooperation has run into in Europe, there was considerable interest in exploring further how such a concept could be delivered because the benefits could be considerable. ■

TABLE 14: VALUE IN AN INTERNATIONAL INDUSTRY DOMESTIC SCHEME FORUM

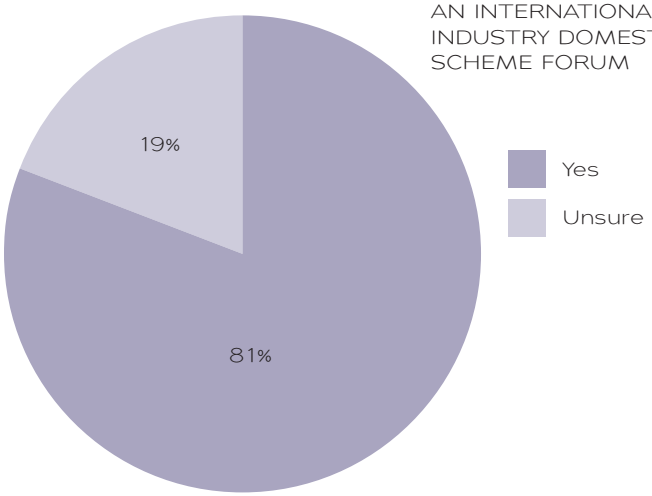
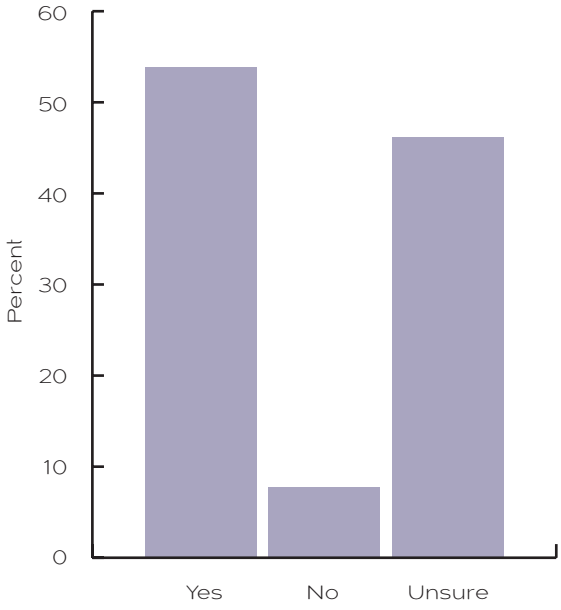


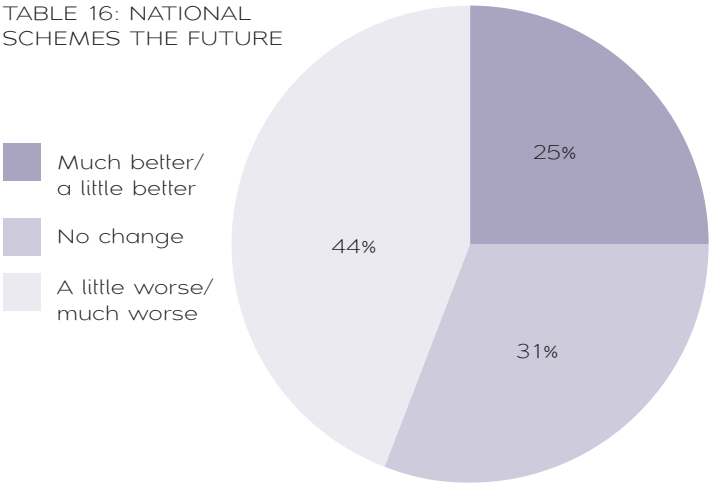
TABLE 15: GLOBAL ALLIANCE OF SCHEMES BENEFICIAL



OVERALL SENTIMENTS

The overall sentiment of the national schemes towards future prospects compared to 10 years earlier was slightly negative although 50% of the schemes thought that prospects were better or unchanged. Schemes based in Europe were more cautious about the future because 3 long-standing schemes are being wound up and it is national schemes that have suffered collateral damage from various regulatory initiatives. The failure to establish a new pan-European scheme is also considered to have emboldened MasterCard and Visa.

TABLE 16: NATIONAL SCHEMES THE FUTURE



> **"We can never beat the international schemes by copying their strategies. We have to fully understand how they work but then do it our way"**

However there are also some more positive views of the future especially given that the more financially aggressive approach of the international schemes after demutualisation is beginning to negatively impact the views and loyalty of their traditional bank partners.

The schemes that have this more optimistic view of the future prospects believe that if some their current business practices are improved, that if the regulators can be encouraged to take a more even-handed approach and that some risks are taken to gain overseas acceptance, then they can not only survive but in fact prosper. ■

ABOUT ANTHEMIS GROUP

ANTHEMIS GROUP is the new face of finance and is best seen as a "fractal" startup; a company that deliberately seeks to connect and grow an ecosystem of complementary and vibrant new financial services businesses by marrying long-term growth capital with expert operational and strategic advice. People, networks and ecosystems are the foundations upon which anthemis group is built. We work with a diversified group of customers, ranging from startups, venture capitalists, private equity firms to larger, more established organisations representing both financials institutions and retailers. Anthemis Edge is a specialist advisory arm of the anthemis group deploying its significant operational and leadership experience in financial services and technology to provide strategic advisory services to the payments sector

Anthemis (Án-the-mis) is a genus of about 100 species of aromatic herbs in the Asteraceae... Nicknamed "the plants' physician", it seems to improve the health of other plants grown near it. (source: Wikipedia) ■

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