When pocket-size can become a pain – in the pocket!

A brief overview of payment service providers and their challenges to the banks

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CreDec

Taking Credit Where It's Due

CreDec

The explosion of online payment services makes it difficult to truly gauge the costs and benefits of these solutions - what does it really cost?

We have to call it something, so we've settled on "payment tech-funk". PayPal, Google Wallet, Bitcoin, the list is a long one. Whizzy internet and smartphone payment apps and the like. Yes, we know. It sounds horribly retro and a bit like Mum and Dad trying to keep up with their savvier kids, but somehow it fits. It describes the phenomenon that as payment solutions become entirely electronic and internet hosted, there has been an explosion of providers offering, well, payment solutions. This raises a key question: why has this space become so busy? Do these payment solutions all fulfil a market need that is not met elsewhere? How are business users best to make sense of these competing players and apply some simple metrics to what they do and where they sit in, what the banks insist on calling, 'money services'.

Moving money

Cost is at the heart of it. The speed with which great chunks of economic activity have migrated on-line - 12.7% of all UK retail activity in 2012, a 50% increase in the 4 years since 2008 - and online transactions' requirement for a real time guaranteed payment mechanism which – at the outset –only a credit card could answer, is the single largest cause of the number of new entrants in online payment services. The global Visa/MasterCard duopoly that dominated at the beginning of the age of 'online' and the resulting search for lower cost alternatives explains a great deal. After all, in retailing goods and services for resale margin is everything, and a one percentage point reduction in the costs of achieving secure payment on a 10% net margin, delivers a 10% increase in net margin. Not bad, and certainly worth the effort. It explains why PayPal went in 12 years from a total payment value of more or less zero to some $145 billion US Dollars in 2012.

Hidden costs?

It's worth noting that PayPal for example, has achieved this success without a banking licence. It remains registered in the US as a payment service provider (although registered as a bank in the EU). You cannot open a PayPal account without a funding bank account and this raises a number of questions about which is the primary banking institution serving a business, selling online for example, PayPal or its bank? And what are the actual costs of the payment services options provided by PayPal and others?

This is where the true cost of payment services becomes much harder to identify, when multiple suppliers are involved. What CreDec refers to as the Total Cost of Ownership or TCO. If a business sources payment services from more than one organisation to ensure the most efficient means of securing payment for its goods, then the headline costs of a provider like PayPal may not give the full story. Just to continue with PayPal as an example, its UK marketing material explicitly states "One solution, one provider - you don't have to deal with any payments provider except PayPal". But as we've noted, the cost of the business's underlying bank account becomes part of the cost of operating a PayPal merchant account. Does this matter? Well the answer is perhaps not, especially if the headline cost saving is significant. But it's worth asking the question, especially as 'Total Cost of Ownership' cost models are useful because they capture hidden costs, costs which don't result in direct charges but are

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concealed elsewhere in a business's overhead. And as payment costs operate at the margin, it's a cost that ultimately needs to be measured – precisely.

Multiple relationships?

So, where to look for these hidden costs? Well, there are the possible impacts of a reduced, perhaps diminished relationship with the primary underlying banking institution – including lower credit scoring and potentially higher credit costs – whose account facilitates third party payment services, the additional costs for audit and accounting of managing money flows across what for accounting purposes is two bank accounts, and the indirect costs to the business of managing a dual set of relationships. There is also the danger of suddenly falling victim to the ever increasing stringency of Money Laundering Regulations as a result of reliance on a payment services provider which may not have the long standing knowledge of a business's operations and ownership that is familiar to its bankers. It does happen: businesses using providers such as PayPal suddenly finding access to their cash has been frozen pending further, often onerous compliance requirements of their provider, which of course may be reasonable in themselves but the timing of which can often be, to say the least, very unwelcome.

But it's not solely a matter of cost. Convenience and ease of access to their services are also considerations heavily relied on in the marketing of such services by payment providers. Smartphone apps which give access on the go help to create an illusion of payment services accessible from your pocket, when the reality is much less straightforward. Most of us like technology. It's fun stuff and frequently delivers a 'solution' quickly at low cost. Let's face it, which of us doesn't like fiddling with our new smartphone and feeling a little charge of excitement as we affect to be completely unmoved by our possession of the latest model. After all, as psychologists delight in telling us, we like low risk rewards like this.

On its way to becoming a historical curiosity?

But there's a reason why technology marketers go to such lengths to make their products sleek and attractive, and that's because, if it doesn't succeed in blinding us to the defects completely, it makes us more tolerant of the disadvantages of their product solutions when we encounter them. For example, the fact that what appears to be at first a stand-alone third party payment solution doesn't alter the requirement for a bank account, and so another mobile banking app or a PIN reader to log-in to your bank account on-line to fund a transaction. It's not one handy device you have to jam into your pocket but two. The sleek slim lines of your mobile

The provision of payment services to end users relies on a complex chain of suppliers and enabling networks with the commercial banks at the top of the food chain

device are let down by the need to carry not one but two devices.

Complexity and simplicity both have an associated cost, which a business has to measure in order to judge where the correct balance of advantage between the two lies. It may be helpful to think in terms of a simple hierarchy of all the banking and payment capabilities required by a business to operate when assessing the most efficient combination of its financial service suppliers.

CreDec's financial hierarchy model has 3 levels:

Enabling Networks (e.g. BACS)
Primary Suppliers (Licenced Commercial Banks)
Value Added Suppliers (e.g. PayPal)

The key point about this model is that it is strictly hierarchical, with enabling networks like SWIFT, BACS and LINK the ATM network, providing the underlying transactional capabilities on which all suppliers' services depend. The banks – not just by virtue of owning much of the network infrastructure on which banking services rely – are the primary suppliers, at the top of the food chain, the big beasts. This is because – as we now all know to our cost – the power created for an institution by a banking licence is not equalled by any other economic sector or player, outside of government. Other entities, such as PayPal, comprise the value-add suppliers who are reliant on both enabling networks and primary suppliers to feed themselves.

There are similarities between payment services and telecommunications. Telecom network operators all talk about the 'last mile' which is the ability to terminate call traffic on the handsets of users who subscribe to a different network. In telecoms, as in banking, there is no universal network, and it is the cost of terminating calls (or payments) to a third party institution that creates cost, essentially because the incumbents take advantage of their partial monopoly to charge higher fees.

This is a helpful comparison, because the banks do take advantage of their ability to provide a single supplier solution to business. They remain the dominant providers of payment services to business. Why don't they lower their costs to compete directly with upstart competitors? Again the arithmetic is clear; it's not economic for the banks to lower their higher charges across the board in order to recover only that small fraction of the payment services market they have lost to new entrants. The big beasts continue to enjoy the lion's share.

And where do we sit in our own model? Well CreDec is both an enabling network provider – by virtue of its direct access to the BACS network – and a value added supplier, working in close cooperation with its UK sponsoring banks. So does that mean you can eat with the big beasts? Yes, it does.

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