Pentti Hakkarainen: Banks and payment services in Finland

Speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the Nets Holding A/S Management, Helsinki, 19 September 2013.

*   *   *

Accompanying slides can be found on the Bank of Finland website.

I'm glad to have this opportunity to share with you some of my views about the main trends and challenges for banks and payment services. I will also talk about Finland, but mainly as an example. The trends and challenges present everywhere have been clearly visible in our small and open market.

Challenging environment of retail banking

Retail banking is originally about deposit taking, lending to households and companies, and providing payment services. Since 1990s the financial sector expanded. Retail banks got involved with new services such as wealth management, funds, brokerage and even corporate finance. There was convergence of insurance and banking products and financial conglomerates were born. Banks did not only expand their customer services but also became active players in the financial markets for their own account.

Basic banking services like payment services were automated, and brought to new channels. Some trends, however, were missed. As an example, many banks did not respond sufficiently to emerging needs of internet payments that would support online shopping, or mobile or real time payments. In the digital environment, payment innovation was left to new non-bank institutions to a large extent. After the recent financial crisis, we have seen a new interest in basic retail banking. The industry is also seeking cost efficiencies from all functions.

This reminds me of developments in the Finnish banking sector in 1990s. Finnish banks had invested heavily in information technology during 1970s and 80s, when the regulations of the time directed competition to service and quality enhancements. Only when a severe banking crisis hit the Finnish banking industry in early 1990s, banks had to make full use of their technological capabilities. Electronic payments were promoted heavily with customer education and price incentives. This has paid off, and Finns currently use electronic payments predominantly.

During the following 5 years, recovering from the crisis, banks more than halved their work force from 55,000 persons to about 25,000 when at the same time banking activities and volumes were expanding. Currently, Finnish banks have managed the turbulent times relatively well.

The European banking sector faces much the same challenges as the Finnish banks during 1990s. In order to recover and to comply with the forthcoming regulations, banks need to seek cost efficiency. Payment processing is traditionally seen as investment intense service, where heavy fixed costs allow economies of scale with relatively low marginal operating costs. Old legacy systems may not provide a viable platform for new requirements coming from the Single Euro Payments Area or new payment instruments.

During a period of low interest rates banks cannot cross-subsidise payment services from other revenue sources. At the same time, end-customers are not willing to pay for paying. The equation is quite difficult. Banks are obviously asking themselves the very relevant question whether it is worthwhile to invest and maintain this type of processing capabilities, or should they be outsourced or bought from companies which are specialized in processing. Should banks not concentrate in what they know best: customer relationship and risk management?

Drivers of change in payment services

Main characteristic of payment services is the two-sidedness: in order to provide payment services, both the payer and the payee must participate in the same network. Payment cards need to be issued and merchants need to accept the card in their payment terminal to enable card payments. This type of network requires co-operation between service providers. At the same time, we want to see competition in services provision. Competition gives incentives to streamline processing of payments and to service innovation. The competition takes place in the customer interface, whereas the efficient processing of payments needs co-operation for standards and security.

Other driving forces of payments development are changing demographics, changing customer demand and integration.

I mentioned earlier that banks have not met customer demand for internet or mobile payments or real-time payments. I know that cards are heavily used when paying in web shops, but that is not what cards were designed for. There are initiatives for improved security for card payments in the internet, but there is still room for improvement there. Mobile payments have been of high expectations but nothing much in reality. Some jurisdictions have created real-time payment systems, but mainly with support from the public authorities. European regulation aims to open the competitive market by allowing payment institutions to provide payment services. There is a lot of talk about big data, mining the payments data for better customer relationship management. Banks have a strong position keeping customers' accounts, but if they are not sensitive to the changing customer demand, they may well lose the momentum.

There is a Finnish study showing that 95% of people between ages 16–65 use internet regularly and 53% of people between 65 and 74 years do so as well. The majority of payments in shops are made with cards. Aging population does not mean that people suddenly lose their capabilities. In the future, we see more active and demanding aging population requiring services online as they have used to get them during working life. With experience these people may be more risk sensitive and they are able to demonstrate their needs, but they are no way hindering services development, rather the contrary. It goes without saying that the younger population considers the internet and mobile services as self-evident.

People today are used to being online all the time and they are used to travelling according to their wishes. In my youth, a trip from Helsinki to Stockholm was special, nowadays young people choose where they want to travel or study globally, and people have summer cottages in Thailand. In these circumstances it is very difficult to justify why payments need excessive bureaucracy or time. International payment card companies have succeeded to create a global acceptance network benefiting the card users, though authorities in several jurisdictions have pointed out problems in their fee structures. The Single Euro Payments Area, SEPA, harmonizes European payments: Payment Services Directive harmonises the rights and liabilities of payment service providers and their customers and SEPA standards harmonise the technical environment of payments. The migration to SEPA may be a burden, but in the long run, it is a source of efficiency and should be seen in that light.

Bank of Finland approach to payment services

Bank of Finland has a longstanding view that the role of central banks should remain rather limited in retail payment systems. Central banks as overseers and regulators should promote competition friendly environment for retail banking and payment services as well as ensure that the systems are safe, reliable and efficient to the society as a whole. Central banks can act as catalysts for change and improvements. However, retail payment related services should not be provided by central banks as this may distort the competitive environment.

We have pointed out and expressed five principles against which we evaluate the development of payment services.

Firstly, we wish to promote technical efficiency making payments cheaper, faster and more secure. Technology is not a goal itself but a tool. Often in adopting new technologies in network industries we face the chicken and egg problem: when is the market ripe for new technologies and when the technologies are ripe to benefit the industry and its customers. Sometimes here, the central bank's catalyst role may be needed.

The second principle for payment services is non-discrimination. There are people who may have limited capabilities to use internet or mobile services. Strive for efficiency must be done with responsibility. Prevailing agreements and promises of service with customers cannot be one-sidedly (unilaterally) broken. We cannot allow financial inclusion to deteriorate due to services development.

Thirdly, pricing of payment services should promote efficiency and be based on costs. Cross-subsidization may distort price signals. However, academic research shows that full cost coverage may lead to socially suboptimal use of payment instruments as well. Prices should give right incentives to payment services users. At the same time, strong players may not use their negotiating powers in a way that distorts the balance in the network industry. I believe the scrutiny by competition authorities and possible forthcoming regulation has its roots in the understanding that international card companies were not sufficiently sensitive to see merchants' benefit as well.

The fourth issue we want to emphasise is continuity and contingency of payment services. With this high number of electronic payments, internet banking and especially card payments, they have become completely critical to our society. This means very high requirements for their safety, continuity and contingency. This is an ongoing topic for discussion between overseers and payment industry, and very relevant when Nets is planning its future operations in Finland.

Our fifth principle promotes international compatibility by harmonization and standardization. I've already mentioned the harmonization of European retail payments by SEPA and the potential for efficiency it brings.

Standardisation is the key for efficient processing. Everyone who wishes to benefit from cost efficient processing should promote common, open standards, not only on European level but globally. We follow with great interest the Nordic banks' initiative to use SEPA standards also for non-euro currencies. They have really grasped the potential of common standards.

In SEPA standards, cards industry is lagging behind. Hopefully the knot stopping card payment standards can be opened by the industry itself. However, the regulators seem to be ready to take action if needed, as seen for SEPA credit transfers and direct debits.

Conclusion

The trend to harmonise and standardize services and to seek economies of scale is here to stay. Card payments, which work mostly efficiently and provide convenience and safety compared to cash, are an elementary part of this trend.