Competitive Forces Shaping the Payments Environment: What's Next?

Retailers' Entry into Banking and Payments: Much Ado about Nothing?

Friday, May 11, 2007

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Panel Questions

- What factors contribute to the success or failure of retail banking venture?
- What are the advantages and disadvantages of a retail firm offering payment products to its customers?
- Are alternative providers filling new niches or competing directly with banks for retail banking customers?

Reasons Retailers Want Entry to Banking

- Process store payments made by their customers
  - Reduce costs of accepting payments
- Offer customers additional products & services
  - Credit cards
  - Home mortgages and home equity lines of credit
  - Investment products
  - Transaction accounts

Reasons Banks Do Not Want Retailers in Banking

- Reduces their revenues from payments processing
  - Merchant processing fees
- Challenges the bank franchise (charter)
  - Its value lies in its exclusive right (ability) of final settlement of payment
  - Yet, is currently being encroached by third party payment providers
- Large retailers (especially those with market power) pose additional threat to both

Reasonable Motivation By Both Parties?

- Banks offer a comparative advantage in payments in many respects
  - Access to Federal Reserve operated payment systems
  - Trusted third-party guarantee
  - Expertise in financial risk taking
  - Soft-information collection (know your customer) and hard-information collection (know income and spending patterns)

Reasonable Motivation By Both Parties?

- But banks also "outsource" or "offshore" a number of functions
  - Customer service (call centers)
  - Account servicing (lockbox, account reconcilement)
  - Loan production (mortgage processing)
  - Information technology (networks, software)
  - Credit history (credit scoring)
  - Currency (armored car carriers)
  - Check Processing (adjustments and exceptions)

Bob Olson, from Carretek discussed "How Payments Offshoring Is Helping US Banks Execute Their Payments Strategies" at the Chicago Fed, November 16, 2006.

Retailers in the US

- In the U.S., retailers have had to find creative alternatives to outright owning a commercial bank
  - Due to separation of banking and commerce activities, which has existed since 1787
- Solutions:
  - Cooperate with a payments provider
    - Open a bank branch in a retail outlet
    - Offer niche or limited payment services
  - Establish an Industrial Loan Corporation (ILC) or a Credit Card Bank (CCB)

U.S. Solutions:

Industrial Loan Corp (ILC)

- Only a small number of retailers own ILCs
  - Target
- Or are awaiting approval
  - Home Depot
- Wal-mart's application brought issue to forefront
  - Current moratorium on ILC applications

For more information see: Wilmarth. 2007. "Wal-Mart and the Separation of Banking and Commerce," Conn Law Review 39 (April); Kaufman and Johnson. 2007. "A Bank by Any Other Name." draft.

U.S. Solutions:

Industrial Loan Corp (ILC)

- Significant size differences between ILCs and Commercial Banks (CBs)
  - $213B in assets in ILCs
  - $8.9T in CBs ($11T in all banks)
  - Largest Commercial Banks: Bank of America ($1,084B), JP Morgan Chase ($653B), Citibank ($538B)
  - Largest ILCs: Merrill Lynch ($67B), UBS ($22B), American Express ($21B)
  - 52% of ILC assets in top 3, all financial firms
  - All ILCs account for < 2% of banking industry assets

U.S. Solutions:

Credit Card Bank (CCB)

- Retailers with CCBs: Sears, Circuit City, Harley-Davidson, Nordstrom, May Department Stores
- Potential benefits to owning CCB:
  – Increase revenue with private-label cards (interest income)
  – Improve targeted sales efforts (direct mail campaigns)
  – Reduce cost of financing CC receivables (move to CCB)
- No evidence of improved performance of retailers with CCBs, some negative results (longer collection periods, more receivables)

Source: Nam, Gup, Kim, 2007. "The Financial Performance of Retailers Owning Credit Cards Banks," International Journal of Revenue Management 1 (2). 18 CCBs studied.

Retailer solutions in the US

- Retailers could have competitive advantage in:
  - Distributing goods (services) to a wide customer base (both demographically and geographically)
  - Providing new products
  - Offering competitive prices
  - But it is not obvious that these advantages would make retailers skilled at banking

Much ado about nothing?

- Debate regarding retailers entry into payments
- Would it result in:
  - Competition?
    - by competing in the same payments space, but without the potential regulatory oversight and without the experience and foundation in payments/banking activities
  - Cooperation?
    - by bringing new business/customers to banks, driving innovation and/or creating efficiencies by passing on their knowledge and advantages (i.e., running electronic networks, creating expansive distribution networks, branding and advertising)
- Let's ask our panelists…

Panelists

- ***Steve Worthington***
  - Professor of Marketing, Monash University, Faculty of Business and Economics
  - Retailer experience in the UK
- ***Dave Martin***
  - Executive Vice President and Chief Training Consultant, NCBS
  - In-Store branching
- ***Hamed Shahbazi***
  - Chairman & CEO, TIO Networks Corp.
  - Offering payment solutions to niche market