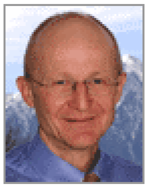
Viewpoint: Contrasting Payments Innovation in Europe and the U.S.



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Pay Before

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America has led Europe in payments innovation. Europe has led in payments regulation.

There are significant differences in payments innovation in Europe and the U.S., influenced by policymakers' views of their roles and the regulatory, tax and competitive climates. These differences affect the cost, quality and choice of payment products Europeans and Americans enjoy and, therefore, ought to be of profound interest to retailers and consumers. Payment providers, too, should be keenly interested in an environment conducive to competition and creating and enhancing services across the value chain.

Innovation at a Glance

Payments competition in the U.S. is greater than in Europe. Specifically, retail payment network competition in the U.S. is fierce and increasing. American Express, Discover, FIS's NYCE, Fiserv's Accel, First Data's STAR, JCB, MasterCard, PayPal, Visa and increasingly China UnionPay compete. In stark contrast, until 2009, Europe's third-largest card network, France's CartesBancaires, enjoyed a domestic monopoly. Until 2011, the Netherlands had a monopoly debit payment scheme.

Innovation Snapshot

Below is a short history of key developments in electronic payments. Notice that most innovations occurred in the U.S. market, many led by immigrant entrepreneurs seeking a friendlier regulatory and competitive environment.

General purpose credit cards were invented in the 1950s in New York City by Diners Club founder Frank McNamara. American Express introduced its charge card in 1958, first in paper, then in plastic the following year. The seeds of open payment networks, which we now know as Visa and MasterCard, were planted in 1958 when Bank of America launched its BankAmericard credit card in Fresno, Calif. Later BofA licensed the product to other banks and, at the urging of visionary Dee Hock, it ceded control to a bank association in 1965. The following year another band of banks formed the Interbank Card Association (later MasterCard). Decades later MasterCard and Visa outside Europe converted into public companies.

In 1966, the Bank of Delaware piloted the world's first debit card. In 1967, Barclays debuted an automated cash dispenser and, in 1969, New York's Chemical Bank installed the first modern ATM. In 1994, American video store Blockbuster invented gift cards, and in 1999 a former California radio disc jockey, Steve Streit, created the business now known as Green Dot and the GPR prepaid card.

Roaring out of Silicon Valley, PayPal—founded by entrepreneurs born in Germany, South Africa and Ukraine—first scaled the digital wallet.

In the early 2000s, Swiss and Chinese immigrants Daniel Chatelain and Will Graylin launched mobile-credit-card-acceptance ventures Bozca in Silicon Valley and Way Systems in Boston, respectively. They were too early. Global mobile operating platforms iOS and Android, however, changed the opportunity landscape. In 2009, Twitter co-founder Jack Dorsey started mobile-acceptance phenom Square. And, in 2010 Swedish iZettle and thereafter a host of European copycats followed.

Why the disparity? If you look at the snapshot (to the right), you can see details about payments innovations during the last 65 years. More often than not, these innovations were made in America. And that trend largely continues as new mobile wallet providers compete to shift consumer behavior. At the same time, bitcoin investments in the U.S. dwarf those in Europe, suggesting that emerging payments are more likely to thrive in the U.S. market. While there are many factors at play, the regulatory environment is a major force in shaping the two market realities.

Technology Neutrality Leads to Broader Regs

To understand the European regulatory environment and how it has and will continue to affect the payments industry, it's helpful to look at how European regulators view themselves. Often, it seems they believe that regulation should precede market solutions. For example, technology neutrality is one of the key principles of the European regulatory framework for electronic communications. The concept appears in the proposed EU Data Protection Regulation and the proposed EU Directive on Network and Information Security (the NIS Directive), both of which likely will be adopted in 2015 or 2016. In a nutshell, the same regulatory principles apply regardless of the technology used.

As Nobel Laureate James Buchanan says in his Public Choice Theory, regulators seek to maximize their power and utility. Technology neutrality is a banner under which European regulators inevitably will extend their authority to new markets and technologies, before or absent evidence of market failures meriting intervention. When has an EC regulator ever argued his enlightened direction wouldn't improve the market or produce more "European" results? In this sense, technology neutrality can encourage over-regulation of emerging markets. Consequent regulatory uncertainty and risk can cause businesses to defer or reduce investment, as the 2011 "OECD Council Recommendation on Principles for Internet Policy Making" explains. Although there is investment activity in payments in Europe, it would be much greater if the regulatory burden weren't so great.

Regulators 'Know Best'

European regulators' interest in new payment solutions remains keen. The European Central Bank's Euro Retail Payments Board, for example, is looking at person-to-person and proximity mobile payments. But private sector players have developed a range of P2P and proximity payment services. Some failed. Others are adapting and getting market traction. Are central bank-crafted solutions more likely to delight consumers?

Legal and regulatory differences notwithstanding, there is robust transatlantic traffic in payments ideas and competition.

Forged in the world's largest and most competitive payments market, American processors like First Data, Elavon, Global Payments, EVO and TSYS have had success in the Old World and generally have been more pan-European than their European peers. And while the Irish Collison brothers' San Francisco-based e-commerce specialist Stripe has debarked in Europe, Dutch e-commerce processors Adyen, Global Collect (Ingenico), British Worldpay and Wirecard also have ventured overseas.

With payment networks, however, the transatlantic traffic has been one-way: West to East. Visa, MasterCard, American Express, Discover/Diners Club and PayPal compete across Europe. While there's no regulatory barrier, Cartes Bancaires won't be establishing a New York beachhead.

On both sides of the Atlantic, faster ACH has attracted interest from regulators and merchants. Regulators view batch interbank ACH payment systems as out of step with the modern digital age. Merchants hope faster ACH systems will provide a means of reducing retail-payment costs.

Mobile Wallets in Europe

Despite Brussels' interchange caps crimping their economics, Apple Pay and, likely, Android Pay and Samsung Pay are poised to take off in Europe. Interchange fuels innovation on the spend (issuing) side of payment networks.

The European Commission's interchange caps cover card payment schemes whether account keys are managed from a piece of plastic, digital wallet or typed. One-stage digital wallets are containers, albeit with far more potential than their leather cousins. Two-stage digital wallets, such as PayPal, Alipay and Skrill—operating as open card-based payment schemes—would be covered in their own right. EC regulation applies to card-based payment transactions where the payer's and payee's payment service providers are in the EU, both in e-commerce, mobile commerce and at the physical POS.

European regulators have pressured the banking industry to implement faster interbank-payment processing. In the U.K., banks using their processor VocaLink implemented real-time ACH at the behest of regulators seeking to reduce float. Real-time interbank processing systems also have been implemented in Denmark, Poland and Sweden. Banks, MNOs and retailers are experimenting with consumer applications. Using VocaLink, British banks launched P2P and retail-payment scheme Paym. Later this year, U.K. banks' ACH-anchored retail-payment scheme Zapp, which is designed to compete principally with debit cards, debuts.

In January 2015, the U.S. Federal Reserve published a paper discussing the benefits of and need for faster interbank payments, advocating a role for itself shepherding the industry to faster ACH, but also acknowledging that the business case remains at best sketchy. The Fed however can't mandate faster ACH.

At its first meeting the ECB's Euro Retail Payments Board's instant-payments committee focused on payment scheme business requirements, discussing 24/7/365 customer availability, instant-payment-transaction-execution timing, availability of funds to payees and real-time access to payment status information. The European approach, not surprisingly, is centralized.

Debate versus Mandate

Regulation matters. In the U.S. while there are worrying trends with Operation Choke Point and the CFPB's highly prescriptive 870-page proposed prepaid rule, there's no consensus that more payments regulation would benefit anyone other than Washington regulators, while in Europe regulation is promoted as reducing card-acceptance fees, enhancing transparency and helping improve competition. Dissent is not brooked. Former EC Internal Markets Commissioner Michel Barnier blasted MasterCard's public criticism of proposed interchange caps as "unacceptable."

The contrast in the debate on either side of the Atlantic over legislation regulating interchange fees is telling. Over the last decade in the U.S., there's been a vigorous public debate on interchange. In 2005 Chairman Alan Greenspan said the Fed didn't have authority to regulate interchange. In 2006 Fed Vice Chairman Don Kohn said interchange disputes were best resolved by private parties in the market. Congress held three hearings on interchange in 2006 and 2007, which went nowhere. In 2008 and 2009 merchant-discount-fee legislation proposed by Sen. Richard Durbin (D-Ill.) and Reps. John Conyers (D-Mich.) and Peter Welch (D-Vt.) stalled.

In 2010 implacable payments industry critic Sen. Durbin, knowing a financial system regulatory bill was sure to pass, saw an opening. He sold debit interchange caps as good for consumers, merchants and small banks—a political trifecta. There were no hearings and little debate. Nonetheless, Durbin won only 64 votes in the U.S. Senate, attaching it to Dodd-Frank. A subsequent effort to defer his caps picked up 54 votes—a majority but shy of 60 needed to clear the Senate's filibuster hurdle.

In contrast, the EU Parliament rubberstamped—621 votes to 26, with 29 abstentions—the EC's proposal to cap credit and debit interchange. In the EU legislature there was only 4 percent dissent—a Supreme Soviet-style margin—testifying to no debate over fundamentals, notwithstanding that price controls suppress payments innovation, competition and cardholder value. Brussels views payment networks as public utilities.

The most significant U.S. payments intervention was the DOJ suing to eliminate MasterCard's and Visa's ban on banks using their products also participating in American Express and Discover. It was unambiguously pro-competition. Otherwise, Washington largely has let networks compete, consolidate and determine their own requirements.

Follow the Money

Capital and talent go where there's opportunity and they're well treated. Payments is no exception. While London has become Europe's fintech capital, there are still better prospects and more capital for payments entrepreneurs in the U.S. Through the second quarter 2015, the U.S. and Canada had 72 percent of global bitcoin venture capital investment, while Europe had 21 percent.

The gray economy and cash use are greater in every country in the EU than in the U.S. due to higher taxes to be sure, but also because of weaker payment system competition, innovation and cardholder value. In their seminal work "Shadow Economies All over the World," economists Friedrich Schneider, Andreas Buehn and Claudio Montenegor estimated the gray economies in France, Germany, Italy and Spain in 2007 were 14.7

percent, 15.3 percent, 26.8 percent and 22.2 percent, respectively. By contrast, they estimated the U.S. gray economy at 8.4 percent. While it's not the only factor, when most consumers have a wallet or purse chock full of payment cards with which they want to pay to earn rewards, gray market commerce has less appeal.

Light regulation and open competitive markets tend to create more robust competitors, innovation and consumer value.

Despite this, the 191-page Revised Payment Services Directive (PSD2) was passed by the European Parliament Plenary on Oct. 8—with 578 votes in favor, 29 against and 52 abstentions. The vote was postponed from September because the lawyers' linguists had to translate the agreed text from English to all member state languages.

In 2007 the first PSD provided the legal foundation for an EU-wide single payments market. In 2013 the EC proposed revising it, believing several important areas of the payments market, such as card, Internet and mobile payments still were fragmented along national borders and needed to be further addressed.

PSD2's scope is broader. PSD2 will create a new Third Party Payment Provider vehicle. Furthermore, PSD2's provisions on payments security and strong customer authentication will change e-commerce consumer authentication. This is yet another example of Brussels' central planners preferring to impose the right answer from on high as opposed to market experimentation and solutions. Left to work, the market continually and dynamically balances consumer and merchant security and convenience. Signatures, PINs, encryption, tokenization and most recently Apple Pay's use of fingerprint authentication were not developed by government masterminds.

Regulation matters. And Europe keeps leading in payments regulation, while America, thus far, has led in payments innovation. America must worry that more prescriptive European-style regulation will suppress innovation. For Europe the question is: "Will its digital payments agenda encourage or stifle innovation?" The agenda is referred to in the PSD2 recitals, but it may be lost in translation.

Based in Brussels for the past 13 years, ***Monica Monaco*** *created TrustEUAffairs in September 2013 to advise clients on relevant EU legislative initiatives**.** Monica focuses on payment systems and new payments solutions, such as mobile payments and contactless. She was senior manager for EU relations and regulatory affairs in the legal department of Visa Europe for more than 10 years. Monica can be reached at monacom@trusteuaffairs.com.*

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