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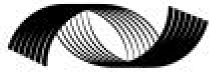
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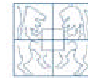
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‘Trans-European Retail Banking’

Challenges to new entrants and integration in European retail banking
An instructive case study of mobile banking

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EXECUTIVE SUMMARY

Policy makers are increasingly concerned by the relative lack of retail banking integration in Europe. For many, the long term success of the "Single Market" depends on bringing the benefits of economic liberalisation in a tangible form to consumers and the public at large. But there has been little if any development of cross border competition in retail banking. The emergence of pan-European retail banking is hindered not least by a lack of demand. The persistence of national structures is hence not surprising. But as a niche market, pan-European retail banking could be developed by innovative new entrants to the sector. Removing undue barriers that new entrants might face should be the first priority for European authorities, particularly if the pronounced preference for market led integration is to be respected.

Market led integration requires focus on removing barriers to new, innovative entrants. In highly concentrated markets such as retail banking, incumbents have little interest in initiating aggressive strategies to capture new market share. They may face decreasing returns as price competition lowers profits for all. Although there are no clear and simple recipes, integration is often triggered by competition from outsiders, especially new and innovative entrants with little or nothing to loose from an attempt to capture a share of a (for them) new market. Market integration is also often associated with an expansion of specialisation and variety, as competition encourages more targeted services and as markets grow in size, niche services may become viable. In other words, integration can often be stimulated not so much by an additional competitor, offering the same service, but by a new firm offering an imperfect substitute targeted at a portion of an existing market.

Market led integration also needs to focus on demand. Even if banks can supply cross border integration – pan European retail banking solutions – they will not be commercialised unless there is sufficient tangible demand from those consumers that actually place a value on a pan-European bank account service.

Mobile telephone operators will be important new and innovative entrants in retail banking. Particularly those with a wide European presence, such as Vodafone, mobile operators could, perhaps in partnership with a bank, be well placed to trigger cross border integration in retail banking. There are numerous advantages that Vodafone would have over

incumbents in the implementation of a trans-European bank account service: a multi-national presence, no vested interest in the status quo, a potential payment instrument in the pockets of millions of mobile European customers. But it is still possible that regulatory barriers and closed market structures, particularly in payments, will, to the detriment of European innovation and growth, either retard this development or help ensure that most of the gains are reaped by established banks.

As an illustration of what really matters to a new entrant, the core of this paper discusses the advantages and problems that a hypothetical 'Vodabank' would face, serving its own interests and, as a unintended servant of public policy, fostering retail banking integration. Beyond regulations, retail banks firstly face challenges achieving profitability while financing the large fixed investments often needed in order to establish a service and acquire clients. Although the internet has reduced the importance of having a local presence, branch networks continue to be important, and costly. Secondly, retail banks may be subject to important constraints on competition and innovation in the provision of payment services. A new entrant working through existing networks may be unable to diverge from established practices and pricing. But in seeking to introduce new payment instruments, they would face very significant challenges due to the strong network features of payment services and the market power of the existing collaborative payment organisations that dominate most European countries.

Authorities seeking to remove barriers to market led integration should be concerned with a number of initiatives.

> **Supervisory discretion** is an intangible but significant impediment to new entrants seeking to implement innovative business models, especially those that rely on an ability to operate and access clients across multiple countries. In such cases, supervisory discretion equals uncertainty and uncertainty equals risk, sometimes of a level sufficient to deter new entrants. More importantly, regulatory uncertainty weighs much less heavily on incumbents. This creates an uneven playing field of an anti-competitive nature. EU Supervisory convergence should strive to produce consistent and transparent policies towards innovative business models in retail banking. In the long run this will best be achieved through the establishment of an EU financial markets supervisor. In the short term this goal can be pursued through the Lamfalussy committees.

Outsourcing is one of the most important means of facilitating entry into markets traditionally characterised by high fixed investments. Supervisory authorities could go further in accepting cross-border outsourcing and relaxing the constraints on it along the value chain, helping to deepen and broaden the supply of wholesale transaction banking services. This implies not only trusting in the supervision of foreign operations but also facilitating new forms of outsourcing (e.g. distribution of financial services via non-banks) and coordinating banking authorities' application of national and EU legislation to cases of outsourcing.

The initiatives by the Committee of European Banking Supervisors (CEBS) to enhance coordination should be supported. Quite admirably, their approach is mostly 'principal based', rather than rule based. This has the advantage of avoiding overly prescriptive and rigid rules. But it also leaves significant scope for national discretion that can impede cross border operations. Ultimately, only a unified EU supervisor will be able to capture simultaneously the benefits of (1) flexible principle based regulation and (2) a coherent EU-wide interpretation and application.

Demand facilitation: Attempts to create pan-European retail banking services rely on an integrated market of consumers. Nothing will foster retail banking integration better than enhanced labour mobility. This is not in the field of the banking authorities to pursue. Nor is it self evident that European authorities should be in the business of demand stimulation. But if we are serious about fostering retail banking integration, authorities in other policy areas should be supported in their attempts to promote labour mobility and reminded of the interdependence between the labour market and the single market in services. Contractual arrangements for cross border workers, portability of pension rights and administrative and legal disincentives to paying salary to an account 'abroad' could all be useful areas for improvements.

Access to payment networks:

Access to payment networks, for cards, ATMs and inter-bank transfers is critical for any retail financial services provider. Without these means, no banking service is possible. The nature of such networks favours standardisation and a lack of variety. But in a cross border context, innovation is precisely what is needed. New entrants with innovations to offer must not be

unduly hindered from tapping into national payment systems where necessary. But conflicts of interest may arise between a new entrant and incumbents (i.e. competitors) that also play an important role in the governance of national payment systems.

Discriminatory membership rules and practices. The nature of payment systems, as networks of banks, lends itself to coordinated decision making processes. But where incumbents are faced with demands from competitors that may upset the balance, subtle, and sometime more overt measures, can be taken to make life hard for new entrants. Rules may be prohibitive, technology changes may be slow or unfavourable, membership conditions may place constraints on innovative business models.

It is impossible for competition authorities to prohibit (in advance) all potentially anti-competitive rules and behaviour. But there should be transparency of rules and decisions as well as means for confidential recourse by new entrants to public authorities in the event that anti-competitive behaviour is suspected.

Are prudential concerns warranted? Membership of payment and settlement networks if often restricted to fully licensed domestic banks. Commission proposals for a new status of payment service providers may relax restrictions, but ultimately leave payment providers dependent on partnerships with deposit taking institutions. With the rise of new entrants to banking, especially retail chains, and improvements in settlement systems and legal frameworks, the need for strict membership criteria, limited to banks, is becoming less justified. Regulators need to be sure that exclusion is warranted by the risks non-banks might pose to the stability of the payments system.

Vertical integration: although this is not necessarily a bad thing in itself, when combined with market power on the issuing and/or acquiring side, passive collusion between a few dominant banking groups can put barriers in the way of new entrants or payment instruments by constraining or denying access to ATM networks or from acquiring and issuing.

Mobile led retail banking will happen. The pace and path of change is difficult to predict, but integration of banking and mobile telephonic services will happen. It is already happening, in particular in Korea, Japan and Nordic countries where payment by mobile phones is integrated in the banking system, and in other countries where payment for specific low cost services (metro, parking, road fees, vending machines) can be initiated via a mobile phone .

Regulation and market structures that retard the development of integrated banking and mobile services will be to the detriment of companies and stakeholders, twice over: Firstly, banks, as participants in retail financial services, will suffer as competitors gain a head start in foreign markets; and countries in which innovators confront market based or regulatory induced barriers to this innovation will gradually become less attractive jurisdictions to use as home bases from which to operate international retail business. Secondly, once the pressure to adopt mobile distribution becomes stronger, the late adopters may find it twice as hard to catch up; there is likely to be a first (or second) mover advantage.

INTRODUCTION

Despite important advances in European financial market integration, visible[1] **retail** financial sector integration in Europe remains elusive. European Single Market policy aims, ideally via a market led process, to foster retail integration. In mature markets, particularly those dominated by a few firms, the best chance to foster integration often comes from a new, innovative entrant. European retail banking could benefit from new entrants that trigger cross-border competition. This paper uses the example of a 'Vodabank' – a hypothetical initiative in retail banking by a mobile telephone operator - to illustrate the barriers, beyond regulation, that new entrants may face and to highlight what policy makers should do to facilitate this type of innovation and promote retail integration at the same time through market led forces.

Within the context of European financial markets, there has admittedly been some progress: retail financial institutions are increasingly expanding across borders, establishing subsidiaries and branches abroad, acquiring foreign banks and pursuing mergers. But this has not as of yet led to the emergence of integration in the form of pan-European retail services that, as the Commission would like, can be used as "domestic" across the wider European market. The temptation to resort to regulation as a means to create at least the appearance of integration is rising. It is also dangerous and may risk 'denying' economic realities, creating distortions and perhaps only achieving superficial integration, the benefits of which accrue to incumbents and special interest groups.

Competition that is able to foster integration often originates with market outsiders[2] that introduce gains in variety, qualitatively different services or technologies that overcome market inertia and the advantages of incumbents. Their new services may be of interest only to a niche market and become commercially viable precisely because they can be marketed to a wider population, in an enlarged 'integrated market'. More than integration to produce lower prices through an extension of one-size-fits-all services to a larger population, it is through an expansion of variety proposed by outsiders that the benefits of integration may

[1] Behind the scenes, there already has been some integration at the production level, in particular for asset management and some form of outsourcing, such as for custody or IT systems administration.
[2] There is no lack of instructive case studies. Most spectacularly, mobile telephony has been the best remedy against monopolies in the fixed line business. MCI shook up the fixed line business itself by focusing just on long distance in the US once it gained access to the last mile via the AT&T network. Low cost airlines, starting with Freddy Laker, have been better than any regulations at diluting the power of duopoly power over passenger air traffic. Monopoly postal systems have been driven to reinvent themselves, not by regulation or privatisation, but by competition from the internet and from specialised parcel carriers such as FedEx and DHL.

manifest themselves most importantly. This ought to be the way in which European retail financial market integration is supported.

This paper outlines some of the hurdles, beyond regulation, to new entrants in retail financial services and discusses how Vodafone, as a pertinent example of an 'outsider', could be better placed than many banks to foster integration, in particular, if it were to lead the market in mobile banking. The chances of this happening are still slim, as the challenges to new entrants are significant. Established banks will be sure to try and manage the introduction of mobile banking services in their favour. Nevertheless, the "Vodabank" discussion herein should provide an instructive illustration of structural barriers that continue to restrain integration and competition in the retail banking sector – and provide reflections on how policy makers might best facilitate this.

The paper addresses specific challenges to establishing what will be referred to as a Trans-European Bank Account (TEBA[3]) and a corresponding market in retail banking services. A TEBA represents a particular vision of retail market integration. It would be a substitute for holding a set of separate domestic accounts in different European countries[4]. Of course there are challenges to achieving this vision of integration, especially through a market led process. Not least, there are doubts concerning the real level of demand for a cross border retail offer that spans domestic markets. Secondly there are a number of general challenges to new entrants in the retail banking market that stem from the high up-front investments and network effects in the industry. Some of these are gradually being overcome by innovations in niche retail financial services and service delivery, but their full impact is still unclear. And there are other, perhaps more important, barriers to a TEBA market that relate to payment services. These are not only widely used by financial services themselves, but are also primary components of, and gateways to other retail financial services.

The rest of this paper is structured as follows: The next section defines different forms of integration and the idea of a TEBA. Thereafter, the paper outlines some of the reasons for high entry costs and network effects that dampen competition. It discusses the extent to which the significance of these barriers is being eroded or why they may be less relevant for Vodafone. The third section discusses the relevance of payment services in a TEBA offer and

[3] No reference to the South African bank of this name is intended.
[4] Accounts with domestic banks are currently not good substitutes for accounts with banks in other countries.

hurdles to competition in this area. It similarly illustrates the extent to which a hypothetical Vodabank service could provide a source of competition in payment services that fosters uptake of a TEBA. The penultimate section discusses policy implications of the hypothetical Vodabank analysis, before concluding.

II. WHAT FORM OF INTEGRATION FOR EUROPEAN RETAIL BANKING?

In general, and in the context of European retail banking, competition and integration are not the same thing. Recent forms of integration – such as cross border expansion - have helped to increase competition in individual domestic markets. But this has not necessarily contributed to the kind of European competition and integration that many seek to foster in which a bank account and retail service may be operated as 'domestic' across the EU. There are three principle forms of retail banking integration discussed herein that each hold out the prospect of increased competition and gains in consumer welfare[5]. But the likelihood of these different forms of integration emerging – and the ease with which policy may facilitate their emergence – varies. In particular, the emergence of a TEBA, an account that can be used as domestic across Europe, may be the most difficult form of integration to achieve.

Mode 3 integration The first type of integration, which is currently advancing most in Europe, comes in the form of foreign direct investment (or mode 3 trade under WTO terminology). Cross border mergers and acquisitions have led to the geographical diversification of retail banking groups[6]. But their level of integration often stops at ownership, with operational structures and products remaining separated along national lines.

Extended mode 3 A further degree of integration can be achieved if fixed investments by banks - such as in risk management, technology, processing and infrastructure - can be utilised to support business across multiple domestic markets. This is now the challenge for many retail banks that have already expanded their geographical presence (within Europe).

[5] For a similar classification, applied to the financial sector more generally, see the European Commission's Financial Integration Monitor 2004. Therein, the Commission distinguishes between (1) competition within national markets only, (2) multi-domestic markets with ownership links and (3) open and fierce competition on a pan-EU basis.

[6] Recent examples include expansion by Santander (purchase of Abbey in the UK), Unicredit's acquisition of HVB, the expansion of Nordea across the Nordic region and the development of retail banking franchises in central and eastern Europe by foreign banks such as Societe Generale and Erste Bank.

This form of integration, if done well, should enable economies of scale to be exploited. Integration of this kind can be stimulated through advances in technology that make it easier to comply with various national market characteristics and greater flexibility in outsourcing components of service production. It may also be facilitated by harmonisation of, for example, rules, product standards and common infrastructure such as payment systems.

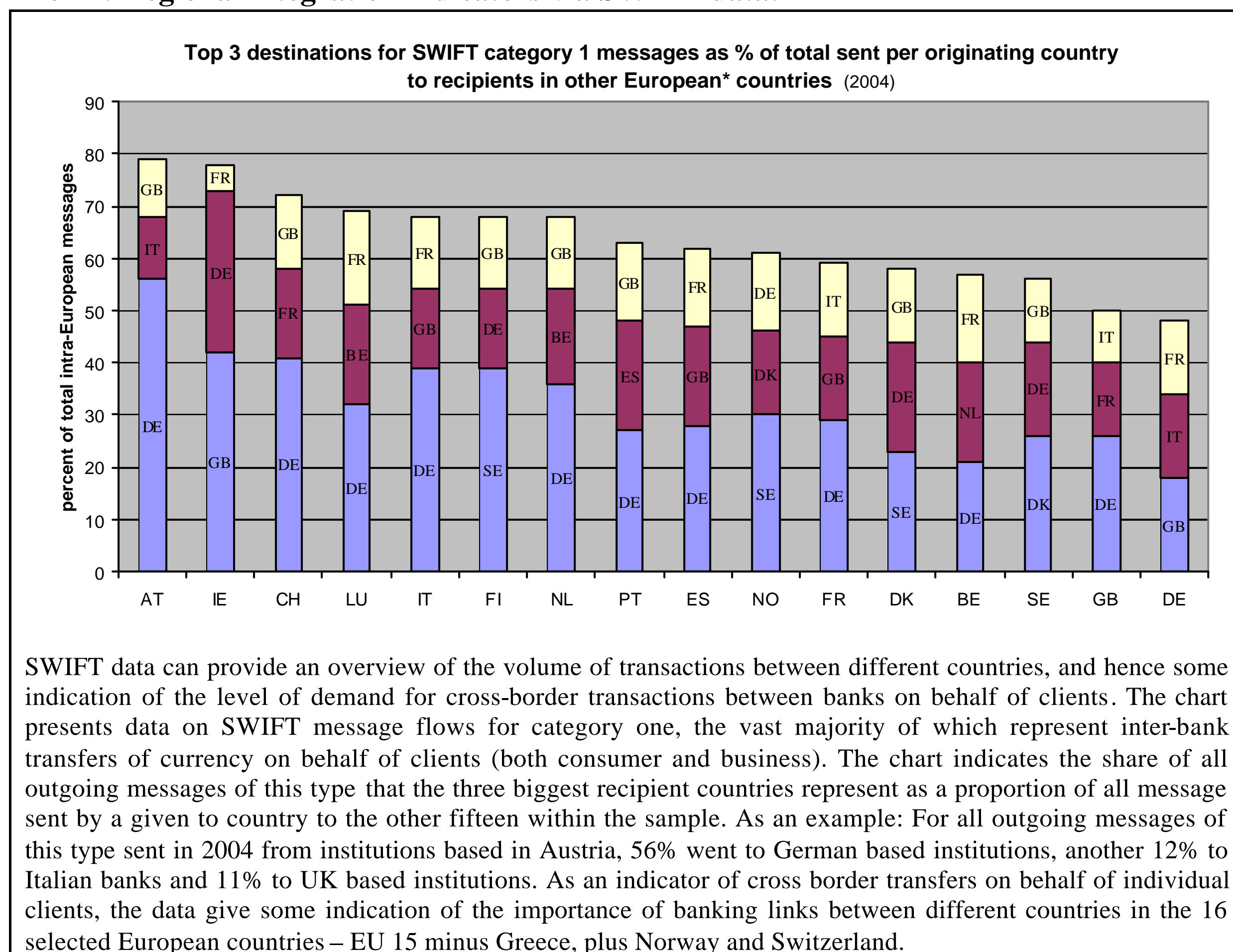
With sufficient competition, this form of integration could bring about important efficiency gains for the industry and welfare gains for consumers. It should at the very least enable suppliers to reduce the cost of providing efficient cross-border services. But integration of this type will not by itself stimulate cross border competition unless domestic banking accounts offered in one country become good substitutes for accounts held by banking clients in another country.

Demand integration Lastly, the most complete form of integration would see the emergence of a retail banking account (a TEBA) that can be used like a domestic account across multiple European countries, although not necessarily all. A prerequisite for achieving this form of integration is a significant level of corresponding consumer demand. This type of consumer demand would most likely come from individuals that have significant private and/or business interests across more than one country and that already hold separate accounts in these different countries in order to fulfil their needs[7]. Labour mobility is and will continue to play a crucial role in stimulating this form of demand. Only certain banks (with a complementary geographical presence) might be in a position to provide this TEBA service. They would compete with domestic banks in multiple countries for European clients and potentially trigger direct cross-border competition for retail banking services[8].

[7] A study conducted on behalf of the Commission (Qualitative Study among cross-border buyers of financial services in the European Union) in 2003 identified 8 types of consumers with cross border use of financial services. The typology is reproduced in box 1.

[8] Competition authorities would have to ensure that a TEBA provider was unable to use residency requirements as a means to prevent individuals from opening an account with their branches abroad in order to find the best price.

Box 1: Regional integration indicators via SWIFT data:



SWIFT data can provide an overview of the volume of transactions between different countries, and hence some indication of the level of demand for cross-border transactions between banks on behalf of clients. The chart presents data on SWIFT message flows for category one, the vast majority of which represent inter-bank transfers of currency on behalf of clients (both consumer and business). The chart indicates the share of all outgoing messages of this type that the three biggest recipient countries represent as a proportion of all message sent by a given to country to the other fifteen within the sample. As an example: For all outgoing messages of this type sent in 2004 from institutions based in Austria, 56% went to German based institutions, another 12% to Italian banks and 11% to UK based institutions. As an indicator of cross border transfers on behalf of individual clients, the data give some indication of the importance of banking links between different countries in the 16 selected European countries – EU 15 minus Greece, plus Norway and Switzerland.

Progress towards any of the above forms of integration should be welcomed, although under certain circumstances they may raise particular issues for competition policy[9]. This paper focuses on the hurdles that would have to be overcome for a new or existing bank to respond to (and help foster) the third form of integration – *demand integration* - by offering an economically viable TEBA.

[9] In the presence of a small number of very large international banks that have established cross-country operations there may be benefits from economies of scale; smaller local banks may under such circumstances succumb to competition leaving a high market concentration in domestic markets - and significant market power in the hands of a few international banks.

Box 2: Typology of Consumers of cross-border financial services

- **Historical Ownership**: owners of financial services in another European country than their present country of residence – yet these services were not bought cross-border at the time they were acquired, but merely kept there when they moved; they are consumers with strong ties with that other country (including nationals of that country).
- **Temporary Ownership**: profiles similar to "Historical Ownership", except that the stays made abroad by consumers of this type were short (and generally planned to be short from the start), and their ties with the other country much less strong.
- **Mandatory Ownership**: consumers whose cross-border purchase of finance services was imposed, or nearly imposed on them (most typically cross-border workers, people retired from employment in another country).
- **Cross-border hopping**: consumers who are often border region dwellers having sporadic or relatively frequent but limited transactions in another country.
- **Split lives**: typically, people owning a second home where they spend holidays in another European country, without having other strong connections with that country.
- **Dual bi-national lives**: members of bi-national families and people really living permanently between two countries and have strong ties with both (for business or other reasons).
- **Occasional opportunist behaviours**: consumers who "fell" one day upon an opportunity to acquire one or another financial service cross-border with interesting terms and conditions, rather than actively seeking the service of their own initiative.
- **Active border-free opportunist behaviour**: people actively searching for best opportunities cross-border as well as in their domestic market – including through the internet.
- **Mobile professionals: E**mployees of pan-European countries may travel frequently across borders, sometimes being seconded abroad for extended periods, yet retain a need for banking services in their home country. Meanwhile, companies may be requested to or require split salary payments, local reimbursement of expenses, etc.

Reproduced from Qualitative Study Among Cross-Border Buyers of Financial Services in the European Union, final report; OPTEM for the Directorate General of Health and Consumer Protection, European Commission; supplemented also with further own research

III. DEFINING THE SCOPE FOR A TEBA

III.A. How big is the population of potential TEBA clients?

This is perhaps the critical question for any bank wondering whether a TEBA could be commercially viable. Probably the most likely consumers of a TEBA are people that actually have a need for banking services in multiple countries. It is difficult to estimate, but figures suggest that there are several million Europeans living and/or working abroad within the EU

and hence more likely to be interested in a TEBA. Many more immigrants in European countries come from outside Europe or are economic migrants from within Europe, i.e. from less well off areas (such as Greece, Portugal, southern Italy). And figures suggest that as these countries' economies have grown, the number of their citizens working in northern Europe has declined.

OECD labour migration data provide an official view of residents abroad, which probably underestimates real numbers of cross-border workers and residents (see table 1 below), because potential TEBA clients may include individuals that spend significant amounts of time in other EU countries without officially changing their residence (or registering with a local consulate) as well as individuals that have previously lived abroad, but have since returned to their home country. For example, the French government estimates over one million French citizens resident abroad within western Europe (compared to about half that as official figures[10]). The official numbers of French citizens registered in the UK was (in 1998) about 68 thousand; but the government estimates that a further 127 thousand non-registered (French) citizens are also resident in the UK.

Table 1

Stock of foreign population by origin and resident countries (selected countries, in tsd)								
	Country of Origin							
Country of Residence	Belgium	France	Germany	Eire	Italy	Netherlands	Spain	UK
Belgium[2]	-	111	35		190	92	45	26
France[1]	86	-	129		379		316	86
Germany[3]	22	100	-	10	548	114	108	95
Eire[3]				-				74
Italy[2]		29	35		-			20
Netherlands[2]	26	14	56		19	-	17	44
Spain[2]		45	63		36	17	-	80
United Kingdom[3]		96	71	411	98			-
sources: OECD international migration data, German Statistical Agency, INSEE, ISTAT								
(1) 1999 FR: source INSEE, (2) 2001, Italy: ISTAT (3) 2004, Statistisches Bundesamt								

A more forward looking indicator of labour mobility can be drawn from statistics on academic exchange via the ERASMUS[11] programme. Student mobility has been steadily growing. In the academic year 2003/04, roughly 20 thousand students from Spain, Germany and France (each) studied abroad within Europe (7.5 thousand for the UK and nearly 17 tsd

[10] http://www.senat.fr/rap/r99-388/r99-3880.html

[11] The ERASMUS programme facilitates the pursuit of academic studies abroad within the European Union

from Italy). The total number of Erasmus students since 1988 has now reached over 1.2 million. Students also represent an important target market for domestic retail banks for two reasons. Firstly, as clients tend not to change bank accounts often, it is especially important to attract them to open their first account and capture the prospect of a long and potentially lucrative relationship[12]. Secondly, given European demographics, youth represent one of the major sources of new demand for banking accounts.

III.B. Key elements of a TEBA service

For the purposes of this exposition, a TEBA is a bank account service that provides account holders with a set of basic financial services, but does not exclude the possibility that these may be part of a wider service. The vision of a TEBA integrated European retail banking market is reflected in the idea that (retail) account holders with, for example, a Swedish institution should be able to use their account for daily needs in, say, Germany or Spain, just as easily and cost effectively as they do for day to day needs in Sweden. A TEBA would respond to many if not all of the profiles outlined in the typology of cross-border clients (see Box 1) and overcome the problems cited in the following section, allowing a single account to be used instead of opening different ones per country. The TEBA would include use of the most basic functions of a bank account including those listed below. It could also extend to secondary banking services such as sophisticated investment or financing products.

Box 3: Components of a basic TEBA service

- safe store of value, "current account"
- means to receive payments: salary, depositing of cheques or cash, funds transfers.
- means to make
  - person-to-person payments (e.g. via cash withdrawals, cheques, remote transfers)
  - recurring or remote person-to-business payments (e.g. credit transfers, direct debits)
  - retail point of sale (POS) electronic payments (e.g. credit,debit card or substitute).
- link to a credit card
- issuance of account statements, compliance with local tax regimes for savings and investments, issuance of relevant documents for fiscal or other authorities
- easy access to
  - a remunerated savings account
  - overdraft and other credit facilities
  - brokerage and safekeeping services for investments in securities or investment funds

[12] Most retail banks have introduced banking service packages marketed directly to potential clients in the age range from 18 to 25. Banks have also begun to focus on selling accounts to children (under 18s).

Some specific reasons why one might hold multiple accounts:

As a substitute for holding multiple domestic accounts, A TEBA would have to respond to some of the hurdles consumers currently face when trying to use a bank account in this context. In addition to differences in pricing and perhaps the availability of country specific payment instruments, there remain many practical difficulties that encourage "cross-border" consumers to open a local bank account. Some services simply do not work across borders; others are too expensive or slow. A sample of issues includes:

- **Direct Debits:** as the ECB report on progress towards SEPA notes, direct debits are not even available at a pan-European level, in part for legal reasons. The creation of a pan-European Direct Debit (PEDD) is a key objective within SEPA. Direct debits are widely used domestically for payment of recurring bills, such as for utilities.

- **Delays:** although credit transfers can be made cross-border (and now at lower cost than before the Payments Regulation), they often involve delays that surpass those for domestic fund transfers. This is in part due to the fragmented nature of clearing and settlement systems for retail payments which operate on batch processes and to which not all banks are connected. Again, remedying this situation is a SEPA aim.

- **Lack of ease of use:** Instructing a cross-border transfer of funds is often more difficult for consumers. Although now changing, banks often have separate transfer forms to be filled out for foreign transfers; these have rarely been available on-line or through automated tellers. And often consumers are required to provide the SWIFT IBAN code for the bank to which they want to send funds – but this piece of information is rarely familiar to clients nor available from local bank staff.

- **Paying salary to a foreign account:** Not all employers will pay salary or other forms of remuneration to a foreign bank account (even within the Eurozone). According to surveys, this is even the case for some government institutions. And for those that do pay abroad, there may still be charges and delays to be born by the employee. The reasons for this unwillingness are unclear, but it seems that delays in cross-border transfers may be important in the context of national legislation stipulating maximum delays in payments to employees. Accounts abroad may also raise legal issues and risks: transfer of personal data may require checks and approvals; proof of receipt of salary and attempts to reclaim pay may be complicated by cross border differences in legal systems.

- **Currency issues:** Although the introduction of the Euro has been a significant simplification for cross-border banking, banking with non-Eurozone countries still involves using multiple currencies and incurring exchange fees. Often payments and receipts are only accepted in one currency (sometimes by law). Hence different currency accounts may be a necessity for cross-border banking clients. Yet most retail banks do not offer multi-currency banking, or if so, accounts are not remunerated.

- **Local documentation needs:** Banks often provide documentation – such as account statements or tax forms - required by public authorities or companies. They may be requested as a proof of address/residence, as proof of income or evidence of sufficient funds if entering, for example, a rental contract or for tax declarations. Foreign banks are not generally willing or able to produce this sort of documentation, compliant with foreign requirements. They are even less likely to be able to produce them in different languages.

IV. NEW ENTRANTS TO RETAIL BANKING FACE NETWORK RELATED COSTS OF ENTRY

New entrants to retail banking confront significant challenges even in a purely domestic environment, in particular due to economies of scale and network effects that apply to the industry. New entrants seeking to develop in a multi-national European environment can face even more acute problems because some portion of their fixed investments usually need to be duplicated for each additional domestic market that they aim to serve. Large up-front investments hinder new entrants because they put them at a disadvantage compared to incumbents with a large existing client base. At low volumes and numbers of clients, new entrants suffer higher marginal and average costs. Recent developments in European retail banking display a number of aborted attempts to enter new markets – not for technical or regulatory reasons, but for simple business reasons: firms failed to recruit enough clients to cover their fixed costs[13].

Retail financial services require heavy information technology investments. IT systems represent significant fixed costs for retail banks. And the investments can be important even if a bank is serving just a small numbers of clients. IT systems have increasingly enabled banks and other financial services providers to automate processes for large volume standardised services, increasing the role of economies of scale. New entrants may need to acquire a large number of clients before they are able to break even while charging competitive market rates.

Establishing a branch network is important, but expensive. Branch networks are still important means of acquiring and serving clients, in particular for higher margin products for which clients still demand (or require) advice. And within a limited area, there may be increasing returns to branch network size – i.e. clients may be more inclined to choose a bank that has numerous branches in the areas in which they work and live.

[13] There have been several examples of failed 'de novo' banks in Europe over the last ten years. First-E, an internet bank focused on UK and German clients was closed after less than three years in operation. Zebank in France was sold to Egg of the UK, which also withdrew after a short period of time; and internet based stock brokers and consumer credit operators have entered new markets only to withdraw shortly after: e.g. Comdirect, Fimatex and Cetelem in the UK, Avanza in Germany, Self Trade in Italy.

Table 2: property costs as a percentage of operating expenses for selected banking groups and countries

	property costs as a percentage of total operating expenses							
	1994	1995	1996	1997	1998	1999	2000	2001
Austria, all banks	-	29%	30%	31%	32%	32%	32%	33%
France, large commercial banks	7%	7%	7%	7%	7%	6%	-	-
France, savings banks	7%	7%	7%	7%	7%	7%	-	-
France, cooperative banks	5%	5%	5%	5%	5%	5%	5%	5%
Netherlands, all banks	8%	8%	7%	7%	8%	7%	7%	6%
Spain, cooperative banks	40%	41%	41%	42%	42%	42%	42%	42%
UK, commercial banks	22%	22%	22%	22%	19%	21%	24%	25%

source: OECD Bank Profitability Financial Statements of Banks

The table above gives some indication of the costs of a branch network. Although the figures require careful interpretation due to the level of aggregation across activities beyond retail banking, it is worth noting that property costs can be a very significant proportion of total expenses. Also, these figures underestimate the costs of a branch network because they exclude expenses for branch staff.

Client acquisition can be slow and expensive. Acquiring clients is expensive, both in terms of time and money. Marketing costs can represent a significant portion of total costs during the early stages of development for a new financial services provider. The quicker a critical mass of clients can be acquired, the sooner a new operator can break even. Hence many foreign expansion strategies are based on a 'stepping-stone' model, building on existing networks or following other strategies associated with smaller up-front investments and lower risks; alternatively, expansion abroad is conducted through acquisition of an existing client base[14].

But innovations are eroding these hurdles. For many types of financial services, the importance of some of these hurdles to new entrants has diminished. Outsourcing, or a 'plug-and-play' strategy is increasingly enabling financial services providers to add products and services to their offer that they do not manufacture themselves, or inversely (for wholesale financial services providers) to market their services through distribution partners that maintain the final relationship with the end-client. Advances in information technology and use of the internet have played an important role in facilitating this type of business strategy. And of course the last decade has brought even pure internet based financial services providers. Finally, the relative cost of IT systems and services –- has continued to decline while at the same time their capacity to serve multiple markets has increased. And as there are

[14] A complicating factor for acquisition in banking is that individual client accounts cannot be transferred to a new bank without consent. Acquirers must take over a legal entity with which clients hold accounts. This is one reason why opening branches abroad is less attractive compared to subsidiaries: in the event that a foreign

difficulties and costs associated with modernising or replacing legacy systems, new entrants in particular can benefit from these trends of declining IT costs and expanding outsourcing opportunities[15].

V. VODAFONE AS A NEW ENTRANT: BUILDING ON AN EXISTING NETWORK

Vodafone has the means to minimise its fixed costs of entry. Building on an existing multi-national client base and distribution network, Vodafone would be in a better position than many retail banks to develop cross-border retail banking in Europe and a TEBA service[16]. It might also be in a better position than many banks to identify clients with a potential demand for a multi-national banking service. Although a lack of experience in this domain might favour the establishment of partnerships with banks, the illustration of how Vodafone alone could overcome some of the problems that also confront banks should be instructive.

An existing client base. Most importantly perhaps, Vodafone already has an established retail client base across some of the largest European markets. Just taking the five key markets of the UK, Germany, France, Spain and the Netherlands, Vodafone has a client base of about 75 million subscribers, over half of which are non-pre-paid clients[17]. Transforming just 5 % of these into banking customers could give Vodafone a client base of over 2 million account holders. As a comparison with two of the financial services providers most widely present across Europe, GE has about 20 million clients across the whole of their European area (including Eastern Europe and Turkey) where they are present in over 20 countries that together have a total population of about 750 million. This includes clients across a wide range of products including consumer loans, mortgages, retail banking and card services. Citibank, with a similarly wide geographical presence has between 2 and 3 million clients in the European area. Given the costs of client acquisition, Vodafone's existing client base, brand recognition and market experience represents a potential head start in reaching critical mass.

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venture does not succeed, a foreign subsidiary can be sold with client relationships intact, whereas a branch operation cannot be 'sold off' quite so easily while maintaining the value of existing client relationships.

[15] In so far as these two trends facilitate new bank entry and competition, liberalisation of trade in these services represents an important component of an overall strategy to facilitate competition and integration in the European financial sector. Reductions in trade barriers with India for these services may therefore be just as important (if not more so) as, say, legal harmonisation.

[16] Of course it is important to recognise the disadvantage of not having experience in retail banking.

[17] I assume that mobile phone pre-paid clients are less likely to be potential TEBA clients.

Table 3

Vodafone client numbers in thousands	existing telephone clients	thereof: non pre-paid	potential clients at 1%	potential clients at 5%
DE	27 720	75%	208	1040
UK	15 489	39%	60	302
ES	11 840	48%	57	284
FR (SFR)	16 200	55%	89	446
NL	3 860	44%	17	85
Total	**75 109**		**431**	**2 156**

source: Vodafone website and investor data

An existing branch network. In addition to an existing client base, Vodafone could also benefit from its established branch network of outlets for mobile telephone customers. This already exists in multiple European markets (unlike for most existing retail banks) and could probably be used to develop a network of banking branches more quickly and cost effectively than a new entrant, and perhaps with fewer complications than for a bank acquiring a foreign network. The costs for a new entrant of acquiring or establishing a similar network should not be underestimated. As noted above, property costs and the time spent finding and staffing locations can be a significant component of expenses for a retail bank and in particular for a new entrant.

Advantages in technology. New generations of core banking systems exist that are capable of dealing more efficiently with multiple domestic markets and their different requirements. But the costs and complications of installing such systems are perhaps higher for incumbents who need to migrate existing functionality and clients than for a new entrant that does not have the burden of dealing with so-called 'legacy systems'. This would apply to Vodafone. Additionally, Vodafone is likely to have its own core internal communication networks in place in the countries in which it operates and could perhaps expand upon them (more effectively than other potential entrants) to provide the back bone of an integrated multi-market technology platform.

Are these advantages enough? With return on investment as a first priority, Vodafone may have other opportunities that are more attractive than helping to stimulate cross-border competition in retail banking. On the other hand, it is very difficult to judge how large a market share they could capture and how much scope there is to operate more efficiently than

incumbents. The potential gains could be considerable, as many markets are dominated by just a handful of banks and competition is limited.

One might assume that the absence of a TEBA service from existing banks is a sign that it is unlikely to be profitable. But Incumbents have limited if any interest in developing a TEBA type service for other good reasons. Firstly it would risk 'cannibalising' existing business. And even it a TEBA offer disproportionately attracted competitors' clients, in most European countries, large banks may have little room to grow domestically without elevating market concentration to levels that attract unwanted attention from competition authorities. So offering a TEBA in order to capture domestic market share is probably not cost effective. It could even unleash intensified competition which, in an oligopolistic framework, could result in most of the big banks loosing revenue. Big banks are also unlikely to launch into foreign markets with a TEBA precisely for the reasons cited above, e.g. establishing or buying a branch network is expensive and risky.

The success of a Vodabank venture would also depend on being able to provide efficient and perhaps novel payment services as a basic component of retail banking services. This is discussed in the following section.

VI. PAYMENT SERVICES AND HURDLES TO EUROPEAN RETAIL BANKING INTEGRATION

One of the key reasons why clients hold bank accounts at all is to have access to payments services and infrastructure. A bank account is usually a prerequisite to gaining access to payment facilities as well as engaging in other financial services. Hence retail payments services are a key to understanding why potential TEBA clients might (in the absence of a real TEBA) hold separate bank accounts in different countries – and what a TEBA would have to offer to be a competitive, commercially viable substitute for a set of domestic accounts.

But as network based services, payment services and infrastructure display high levels of concentration and natural barriers to entry. Payments services offered by banks are largely based on common standards, infrastructure and suppliers, precisely to facilitate inter-bank settlement. In short, individual banks may have limited scope for price or service

differentiation in this area. That is in part why banks try to differentiate retail offers through other characteristics (e.g. special rates on mortgages, insurance policies, loyalty points, interest free periods, etc.) and why they often bundle services. A TEBA based on existing payment systems and services might therefore struggle to compete with domestic accounts in this domain both on quality and price. The payments related hurdles to a viable TEBA are considerable, and hence an area in which an innovator might be necessary to help drive market integration. Again, Vodafone might be in a more favourable position than other potential entrants to overcome these hurdles.

VI. A. Why are payment services so important?

Access to the payments network is a pre-requisite for purchasing almost any other core retail financial service today. It is virtually impossible to participate in today's economy reliant only on cash as a medium of exchange and store of value[18]. Without a "current account", somewhere, at some bank, often one cannot even receive salary or other regular income, pay utility bills, withdraw cash at an ATM, or pay in a shop with a debit or credit card. To operate a loan or make investments, you may also need to have an account from which to initiate transactions[19]. Use of the payments system is a prerequisite for other banking services, but the reverse is not true. In order to put money on a savings account or invest in a mutual fund, one needs a current account through which to channel funds. However, one does not need any particular savings or credit product in order to operate a basic giro or current account.

Evidence from surveys indicate that for most clients of cross-border financial services, a bank account is the most common product held and is often combined, perhaps as a prerequisite, with other products and services (such as a loan or credit card)[20]. The price and quality of payment services could be decisive features in competition for this small group of consumers with a demand for a multi-national European retail bank account.

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[18] Exceptions to this exist, such as driving across the border to Luxembourg with cash in hand to purchase physical certificates. Cash is also still important in the black economy and for economically very under-privileged groups; but there have recently been attempts in countries such as France and the UK to make basic banking services available to everyone as a universal service. It is for example difficult to even receive unemployment or pension benefits without a bank account

[19] The importance of having a bank account has been highlighted by recent policy discussion in many countries regarding "financial exclusion" and pressure by governments on banks to ensure that all citizens have access to a bank account, however basic its functionality. Pensions and social benefits often cannot be received without a bank account.

[20] See the Qualitative Study Among Cross-Border Buyers of Financial Services", European Commission

VI.B. A TEBA provider would need to accommodate diverse payment instruments

Clients holding accounts in different countries often do so because they need efficient access to local payment instruments – and foreign banks do not provide this; there may (in addition to other factors) be differences between domestic payment services and pricing.

In a European cross-border context, a TEBA provider would face demand for different types of payment instruments and diverging usage patterns across countries. Although it might not have to support all instruments (e.g. cheques), competition with domestic offers would force a TEBA provider to carefully consider which instruments, if any, not to support. Table 4 below provides an overview of different usage patterns in Germany, France and the UK.

Table 4

payment instrument usage (2003) selected EU countries
in millions of transactions

	France	Germany	UK
Cheque	3928	133	2251
% of total non-cash	*30%*	*1%*	*19%*
Debit Card	4342	1670	3364
% of total non-cash	*33%*	*13%*	*28%*
Credit Card	nav	583	1822
% of total non-cash	-	*4%*	*15%*
Direct Debit	2353	5252	2430
% of total non-cash	*18%*	*39%*	*20%*
Credit Transfer	2587	5692	2213
% of total non-cash	*20%*	*43%*	*18%*
Total (excluding electronic money)	13210	13330	12080
Cash in circulation (as percent of GDP)(a)	2,0%	3,3%	3,3%
ATM transactions (2003)	1245	3270	2373

a: F, DE:2001;UK:2003

Source : ECB Blue Book

The divergent patterns of use of payment instruments in these countries certainly have something to do with historical coincidence – i.e. it seems unlikely that they reflect fundamental differences in consumer preferences. But once established, these patterns of use are often hard to displace because of consumer habits as well as network effects. The benefits of using a particular payment instrument depend in part on how widely it is accepted.

VI. C. Payment Service Requirements and Challenges

There are three basic payments facilities that a new entrant would need to provide – and three corresponding industry structures with which a new entrant would either need to cooperate or coordinate. All of them are subject to strong network effects that favour market concentration and present important challenges to new entrants seeking to compete in domestic markets or propose a TEBA solution. The payment services that a new entrant would need to provide would require solutions for:

- Inter-bank transfers
- Electronic retail Point of Sale payments
- ATM cash withdrawals

Each of these areas is discussed in turn, highlighting current structures and barriers to entry. The following section then discusses advantages that Vodafone might have in overcoming some of these hurdles, as well as noting persistent challenges. A notable omission from this list is cheques. These are still used in several European countries. It is open to debate whether their absence from a TEBA would significantly dissuade consumers from opening a TEBA. But it is also possible that new mobile person-to-person (P2P) solutions could provide a good substitute for cheques in many cases where they are used today.

VI.C.1 Inter-bank payments

Any form of funds transfer between account holders at different banks requires direct or indirect links between banks for the purpose of settling claims. For a new entrant in the retail banking sector, solutions for inter-bank payments - both domestic and international - would be indispensable; and the options open to a new entrant would be largely constrained by existing market structures.

In a domestic context, banks settle claims between each other through clearing houses, either as direct participants themselves or via a correspondent relationship with a direct member. Settlement usually takes place via accounts held at central banks, through correspondent banks that themselves are direct members of clearing systems, or through banks that form the hub of independent clearing systems. Most countries have a very limited number of clearing arrangements, and each is usually specialised in particular kinds of payments (e.g. low value retail, or high value time sensitive transfers). For international transfers, banks may operate

through networks of correspondent banks[21] or, in Europe, settle via one of the emerging clearing houses run by the Euro Banking Association: Euro1, Step1, Step2[22]. The choices for a new entrant are limited, although a bank with operations in multiple countries may have scope to internalise cross-border fund transfers for account holders.

There are good reasons for this concentration. The benefits of working with a particular settlement network derive in large part from the number and scope of other banks (i.e. potential transaction partners) directly or indirectly in the network with which one can settle transactions. And there are economies of scale for these networks, so they have an interest in maximizing the volume of transactions processed through them. Maintaining accounts with multiple banks domestically or across Europe can be expensive and time consuming. It saps liquidity from banks, imposes counterparty risks and may require heterogeneous systems, standards and operations. Hence clearing houses which provide a secure, harmonised and centralised forum for exchange can be an efficient solution for most banks and their customers, even if it implies strong market concentration.

For new entrants that may want to propose new and innovative or less costly services, market concentration, i.e. limited competition and variety in these up-stream industry solutions, may impose constraints. In particular there may be minimum settlement periods set by clearing systems, minimum prices and limits in terms of technical and functional innovations. Governance and ownership structures as well as membership rules may also limit competition.

Governance and ownership structures may impede new entrants if there is a conflict of interest between existing members and new applicants. Members of payments systems cooperate with each other for clearing and settlement, but they may compete with each other in other related domains of retail banking, in particular if they operate in the same domestic market. A new entrant that risks posing a challenge to common practices and product standards may confront subtle or even more overt challenges to membership and resistance to

[21] Groups of commercial banks in Europe operate networks for international transfers. One such system groups savings and postal banks (Eurogiro), another is composed of mutual banks (TIPANET) and others are based on links between commercial banks, e.g. UniCash Alliance, IBOS Association.
[22] The European Banking Association is a member owned operator of clearing systems. Members comprise a wide number of European and international banks.

calls for changes to member owned clearing systems that would require investments by all participants, yet disproportionately provide benefits to the new entrant.

Entry and membership fees, rules and conditions related to clearing systems may all have an impact on the success of new entrants. Some conditions may be onerous, making it economically less attractive for new retail banking competitors to become direct members. But it is often very difficult to determine whether conditions are discriminatory or not. For example, are volume discounts on transaction fees discriminatory? must members be locally regulated and authorised banks? Is membership of a retail settlement system conditional on membership of a related wholesale system? Direct members may have to make significant investments in proprietary software and systems in order to be compliant with operations and risk management standards. Many such conditions can perhaps be justified on economic or prudential grounds. Whether their benefits on balance outweigh the impediments they may create for new entrants needs to be assessed on a case by case basis.

Similarly, new entrants seeking to introduce innovations to retail banking payment services may be unable to persuade other members to undertake collective investments. And even if they were to succeed in such lobbying, the process itself could force the new entrant to divulge sensitive business plans and other information to its future competitors. This might be a sufficient disincentive to lobby for changes at all.

Any limitations on payment functionality must be evaluated in relation to the scope that banks do have for differentiation; and direct costs must be seen in proportion to internal payments systems costs. But in general, the nature of collective clearing systems and scope for downstream innovation and service differentiation remain areas of concern to policy makers. The Office of Fair Trading (OFT) in the UK recently highlighted this latter concern in its report on UK payment systems (May 2003), noting that retail innovation and the flexibility it requires depends on the level of collective innovation by members of a clearing system.

VI.C.2 Electronic Point of Sale (POS) payments:

For consumers, solutions for electronic or non-cash retail payments are perhaps one of the most important components of a banking service[23]. They also represent important services to

[23] Credit and debit card services go beyond simple payments, including for example, fraud and theft insurance and interest free payment periods.

businesses in the retail trade (merchants). The market for non-cash retail payments is dominated by the two major international card networks (Visa and MasterCard), although important shares are also held by other card schemes (e.g. American Express), store cards, and cheques. Card payments services are subject to strong and complex network effects that make it difficult for a new entrant to retail banking to develop a competitive alternative. Membership of or compatibility with existing schemes might be a prerequisite for competing in retail banking. But this might reduce options for differentiation and innovation necessary for the success of a TEBA.

A TEBA based on existing card networks would leave limited scope for differentiation. To the extent that consumers choose between competing retail offers on the basis of retail payment services, scope for and competition from a new entrant and TEBA provider would be limited by the contractual and service arrangements from the two dominant card providers. Visa and MasterCard are – in spite of some differentiation – considered to be very close substitutes[24]. This is not to say that card issuers or merchant acquirers have no scope for service differentiation. But it does mean that banks may be inclined to seek differentiation in other areas and to market payment cards as part of an overall retail service. Hence it would seem unlikely that a new entrant to the market would be able to derive a competitive advantage from existing card services and use this as an argument to attract clients away from purely domestic offers. This is all the more so since variable costs to consumers for cross-border Eurozone card payments have been virtually eliminated.

Firstly, existing card arrangements set out rules and regulations that impose a basic pricing structure, based on interchange fees. Following a case brought to the European Commission, Visa now publishes its charges and in principle sets them on the basis of underlying costs. Even if this still leaves some scope for pricing variation, the framework set by card networks generally accounts for a very large percentage of total fees charged by banks to merchants.

Secondly, governance and ownership structures may also be restrictive. New developments (e.g. functionality, technology improvements) are likely to require agreement between members – who are both often users and owners. A new entrant dependent on innovations for its success would probably find it difficult to persuade other card members to invest in

[24] See the Report prepared by Retail Banking Research for the Commission

changes that yielded only limited if any benefits to them. Alternatively, if technological innovations benefited all members (a form of positive spill-over), the initiator might be reluctant to invest in the project unless a portion of the benefits to third parties could be secured.

Governance structures also, perhaps not surprisingly, forbid member banks from operating their own competing card systems, creating a conflict of interest[25]. Hence a new entrant would be unable to combine a proprietary payment network with a Visa or MasterCard service to enable transactions with parties outside its own network. Cross-border payments and withdrawals in Europe are well supported by the two dominant card networks. A TEBA provider focused on the cross-border market would risk direct competition with them.

Alternatively, there has certainly been speculation that mobile operators in general could cooperate with retail banks to provide payments services and additional access to banking facilities, standardised across the industry. This may still happen if one or more banks see it in their interest to lead the way. Alternatively, in highly concentrated banking markets, and perhaps where banking and the retail sector are intertwined, there may be less of a disincentive to innovation posed by positive spill-overs being captured by competitors. But for most retail banks, the introduction of mobile access is likely to be part of a defensive strategy, responding to competitors. Partnering with mobile operators would put retail banks at risk of weakening their relationship with clients. So retail banks with a secure domestic market are unlikely to have an incentive to be too helpful in facilitating the entry of a mobile competitor. Retail banks themselves may also see little financial advantage in providing mobile access, unless it is done as a defensive measure, as was the case often for internet banking access. It is most likely to be small and emerging banks that seek to capture retail market share by partnering with a mobile operator.

Although it may be tempting to see existing card networks as impediments to competition, policy makers have increasingly begun to recognise that many of their commercial and legal features (e.g. interchange fees, honour all cards rules) are not only a matter of good business. Imposing restrictions on them may not only fail to facilitate more competition but also result

[25] The new European Directive on payment services in the internal market may force open access even under these circumstances. Although there is room for varying interpretations of the clause, it states that "payment systems may not impose [ ] a ban on participation in other payment systems" (Article 23)

in less efficient outcomes for consumers[26]. The network features of payment solutions determine to a large extent the structure of the industry, and this may unfortunately imply that there are natural barriers to entry that policy makers find unattractive, but for which they may be unable to develop efficient improvements. It is worth noting in this context the ease with which travellers can now access funds and pay bills around the world using a credit card. This represents in itself a significant advance in consumer financial services trade and a benefit that authorities would be wise not to put at risk through inefficient regulation.

But a new, independent POS service would be hard for a TEBA provider to build. One way of getting around the dominance of existing card systems would be to create an independent alternative for electronic POS payments, allowing a new entrant greater scope to compete on quality, services and pricing. But the prospects for doing this are not great either. It is hard to compete with existing card payment organisations for a number of reasons.

Firstly, card schemes benefit from significant network effects, whereby the benefits of using a specific payment scheme increase disproportionately with the number and variety of subscribers. A new payment instrument may not be able to attract any significant number of customers at all if it cannot achieve a wide degree of acceptance by retailers early on in its development. But by definition, a new and developing service must start out with a relatively low degree of acceptance.

More precisely, card service network effects are of a special kind, an example of so-called two-sided markets, in which client acquisition is hindered by a kind of 'catch 22' situation. There are two types of users of the service – consumers and retailers – whose benefits from the service are dependent on each other[27]. In order to convince consumers to join, they need to be assured that the payment instrument will be widely accepted by merchants. But to convince merchants to accept the instrument, they need to be convinced that there are large numbers of consumers out in the market that will seek to pay with it. Both types of users need to be recruited to the service simultaneously for either to benefit from it. It is not sufficient for a new entrant to have an advantage in recruiting just consumers or just merchants; they must

[26] In a recent paper on Spanish regulation, Arrunada claims that price restrictions on MIF may reduce incentives for banks to a point where mutual acceptance of cards by different issuers and acquirers may break down, leading to a lower quality of service and perhaps more market power for incumbents.
[27] There is also arguably a third side to the market. Banks themselves are probably willing to subsidise core payment services in order to gain privileged access to clients in order to market other financial services to them.

have a successful strategy for acquiring both relationships. In practice this can be a big challenge

A consequence of these two features is that a new payment provider may be forced to cooperate with competitors in order to achieve widespread acceptance for their payment instruments. In particular, a new entrant would need to develop partnerships with merchant acquirers, most of whom today are also card issuers for other schemes, and hence retail banking competitors. They may be reluctant to 'acquire' for a payment instrument that they (1) cannot issue and earn revenue on and (2) helps a competitor to advance its own market position.

It is perhaps no coincidence therefore that the two major card networks are independent organisations, whose members are banks, but which are not owned and operated by any one particular bank. This sort of structure helps to circumvent conflicts of interest between banks. Existing card networks enforce mutual acceptance of cards (honour all cards rule) issued by all member banks, thus achieving a very wide scope of acceptance[28]. A new entrant seeking to ensure widespread acceptance of its own independent retail payment scheme would face a conflict of interest with other retail banks, especially those that issue cards from competing systems. Hence, a new entrant might find it particularly helpful to develop partnerships with non-issuing merchant acquirers[29]. Otherwise it might be difficult to advance a bank owned payment instrument in combination with a retail banking service.

A new POS service would in addition to these numerous challenges have to compete, for example, on price or quality. Given the interdependence between consumers and merchants, it is essential that new entrants exercise some degree of control over price and quality proposed to both sides of the market in order to ensure the commercial viability of the service as a whole. The following sections outline some of the ways a new entrant might compete for the custom of these two sides of the market.

[28] Sometimes the merchant acquirer bank is the same as the issuing bank for a given card presented to a retailer; in this case the transaction is referred to as 'on us'. Alternatively, the issuing and acquirer banks are different; this is an 'on them' transaction.
[29] Visa used to operate a "no issuing without acquiring rule", ensuring that all acquiring banks were also issuers of visa cards. This rule was removed by Visa in January 2005. This rule had been previously the subject of a Commission case concluded in 2001 (case no comp/29.373) which found that its impact on limiting competition was not significant.

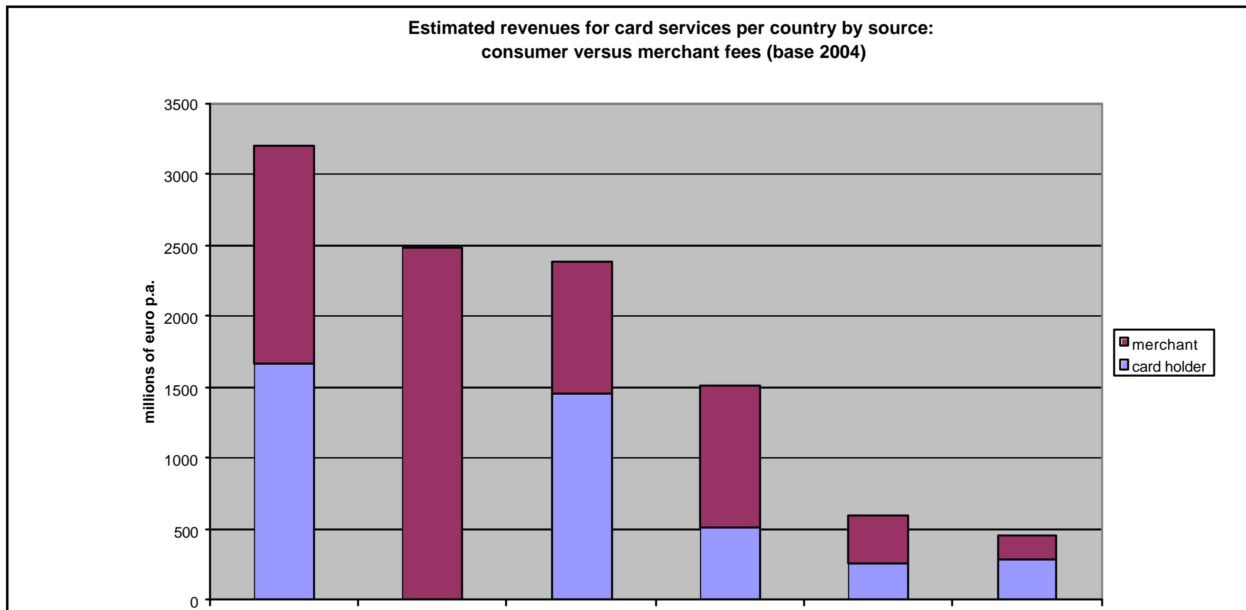
Competing for retail consumers

Room for price competition is limited. An efficient new entrant might try to induce potential clients to adopt their payment instrument by charging a lower price than existing competitors. Or as part of a comprehensive TEBA offer, other services might be combined with the payment instrument to create an overall attractive product. But price competition for card holders can be quite severe. In many European countries, payment cards are offered for free or even charged at negative rates through the use of loyalty points[30]. In other countries yearly or monthly fees generally remain low and fees per transaction are very rare, at least in a domestic setting[31]. And fees for using a card abroad (at least within the Eurozone) have declined to the level of domestic fees, probably under pressure from regulators.

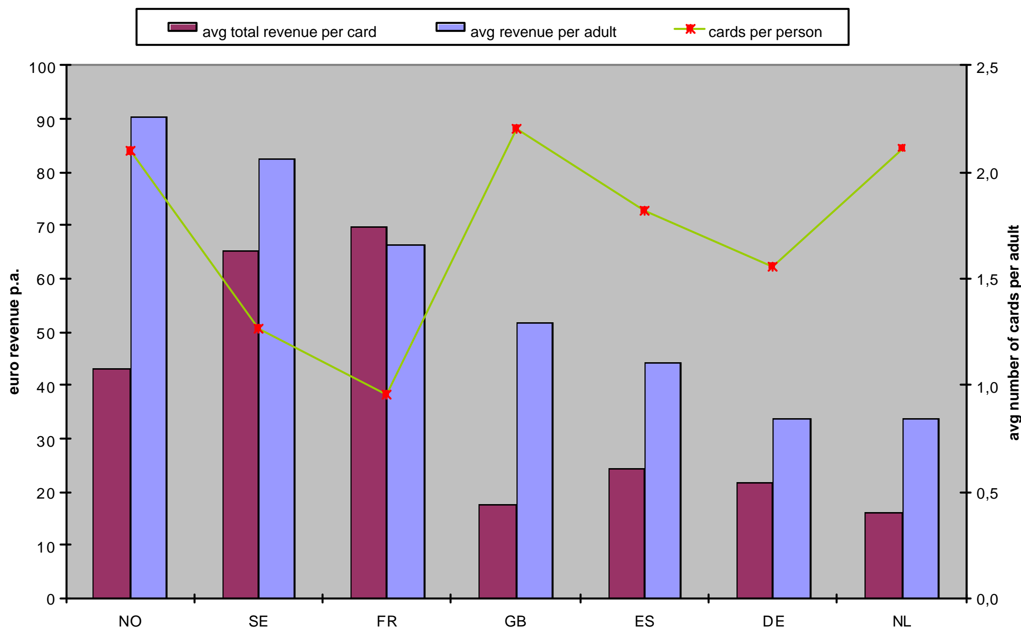
There is probably also significant scope in countries with higher fees for cards to engage in price competition (directly or through incentives)[32]. Some may even be willing to subsidise payment services in order to preserve the client relationship for the other sources of revenue that it provides. Banks that hold a client's main account have a privileged position to understand client needs and market other services.

[30] Indirectly, banks continue to collect revenue on interest rate spreads. Hence one may argue that account holders indirectly pay for card services even if nominal fees are zero or negative.
[31] Some commercial offers with a lower annual or monthly fee set an limit on the number of free transactions per period, above which a variable fee is incurred by users.
[32] Where consumers are able to negotiate rates below those published, this is an indication that banks maintain scope for price reductions..

Box4: Comparative card service revenues in selected European countries



As a two sided market, a completed overview of income from card networks must included information on pricing to card holders as well as merchants. Across Europe, although observed separately, pricing across Europe can vary, when income from both sides of the market are combined and compared on a per person basis, differences are much less pronounced. The two charts provide an overview of costs based on industry estimates* of card issuance and acquiring fees for adult populations in selected European countries.



* Pricing data herein, in particular on merchant fees, is a best estimate based on available data and is to be interpreted with caution. Data used herein has been derived from published sources at PSEL.co.uk as well as from testimony provided by Interpay to the UK Parliament. Card holder pricing has been taken from direct industry sources as well as reports completed for the European Commission. All data excludes store cards and does not account for interest earnings on overdrafts and other lending. Details provided by the author on request.

Competing for merchants

More scope here for lower priced services, but merchants are not very price sensitive. Most revenue for card payment services come from fees levied on merchants. A portion of this is kept by the merchant acquirer bank – the bank or other institution that provides card processing to the retailer. Some may go to a non-bank payments processor. The rest is allocated to the issuing bank (the bank having issued the card to the customer) in the form of "interchange fees" or to the card network operator itself[33]. A new entrant could try to gain a share of merchants through lower fees than competing card networks and acquiring banks, but merchants would be unlikely as a result to cease to accept payment by Visa or MasterCard. A competing POS payment instrument would have to operate as a complement to existing services.

On this side of the market it is also difficult for a new entrant to compete just on price. One of the odd consequences of this two-sided market is that competition between networks can potentially push prices up. Increased competition between card schemes may for example induce issuers to provide added incentives (such as loyalty points) to consumers to use their cards. The resulting increase in costs may be borne by merchants. Retailers may be relatively insensitive to price changes if they fear that refusal to accept widely held payment cards would result in a significant drop in sales[34]. To the extent that loyalty and other incentive schemes induce consumers to hold and use cards, merchants may be willing to accept higher charges. Hence the direct costs of added benefits to card holders may end up being borne by merchants (indirectly of course, these are likely to be passed back to consumers in the form of higher retail prices). Under such circumstances, a new entrant may find that price competition is not sufficient to persuade merchants to accept their new payment instrument or to capture demand from existing networks.

Once a POS instrument provider has achieved wide acceptance by merchants, revenues – and commercial viability - will depend on usage patterns by consumers. Choice of instrument by consumers can depend on various factors. Loyalty points and delayed payment periods can be important positive incentives for clients to use a card. Merchants on the other hand have

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[33] Estimates of inter-change fees in Europe range, for credit cards, from 2.5% in Greece to .7% in France and for debit transactions from 2.1% in Poland to .67% of the transaction value in Italy. See www.psel.co.uk for industry surveys. But they can also vary by industry, as research in Spain indicates. Arruñada cites data from the Bank of Spain that show a range of between 2.98% for "massages" to 0.7% for department stores.

[34] For retailers with significant local market power, this consideration may be less important.

traditionally had only very limited scope (if any) to influence consumers' decisions[35]. In many countries, a so-called no-surcharge rule prevents retailers from charging different prices to consumers according to the payment instrument by which they choose to pay[36]. And even where no-surcharge rules have been outlawed or are not imposed, surcharging has remained limited and merchants seem to have been hesitant to introduce differential pricing. Store cards do however propose 'loyalty points' that can act as an incentive for consumers to use the retailer's card instead of an independent credit card. New entrants may find that scope for price competition is relatively limited.

There are some areas though on which a new entrant might try to compete and differentiate its service from others. For merchants, technology, accounts management, fraud prevention and insurance and support for loyalty schemes may all be important factors in their choice of service provider. Consumers could be attracted as with other providers by loyalty points. Perhaps in the case of Vodafone, credits could be accumulated towards telephone calls.

VI.C.3 Automated Teller Machine (ATM) network access

A further requirement for a new entrant offering a TEBA would be to provide access to cash withdrawals at ATMs. A new retail bank could invest in its own network of ATMs, but it would be impossible to match the level of access provided by existing banks through their own and through associated ATM networks at home and abroad.

In seeking to ensure widespread access to ATMs, a new entrant would face challenges very similar to those discussed above regarding card payment solutions. This is because most international access to ATMs is arranged through agreements with the major card networks (e.g. Cirrus MasterCard, Visa Plus). In a purely domestic context, access to ATMs is arranged through other similar inter-bank relationships (e.g. LINK in the UK, Cashgroup in Germany). If a new entrant and TEBA provider wanted to ensure wide access to ATMs, it would probably need to enter into agreement with one or more of these existing networks. The alternative would be to develop partner relationships with one or more ATM operator per country. This could be attractive for a strategic partner in the banking industry. But some

[35] One common exception is the use of minimum amounts below which merchants refuse to be paid by card.
[36] MasterCard has reportedly removed its "no discrimination" rule, allowing merchants to surcharge.

banks might be reluctant, fearing this would facilitate competition from the new entrant for a similar client base.

New entrants are also constrained by the need to provide instruments (generally cards) that are compatible with existing ATM technology and standards. For a new technology, such as that based on mobile telephones, to be rendered compatible with ATMs, some form of investment would probably be required – not only by the new entrant but also by existing ATM network operators. Yet the benefits of these investments might accrue disproportionately to the new entrant. Incumbents may also fear that this would facilitate the growth of the new entrant, fostering unwanted competition. This conflict of interest is likely to retard any competing technology from achieving ATM compatibility. So a new entrant would probably be forced to use existing card technology and standards dominant in the industry.

The dominant use and compatibility of cards and ATMs sets a very high hurdle for the emergence of new technologies that could in theory be technologically more attractive instruments. But on the other hand, it must be remembered that card technology and ATM standardisation can also be seen as an advantage for new entrants. The fact that plastic cards can generally be used – technically – so widely internationally in ATMs across the world can be considered a major achievement in harmonisation of industry standards and trade facilitation. For new and existing retail banks, this level of compatibility facilitates life for clients, providing a single instrument that can be used at home and abroad for cash withdrawals at an ATM.

VII. VODAFONE AS A NEW ENTRANT: OVERCOMING HURDLES IN PAYMENT SERVICES

Given the network features of most payment services, a Vodabank service would be very hard pressed to develop a business model without some degree of reliance on or coordination with existing structures for inter-bank settlement, card networks and ATMs. Also, compared internationally, existing retail banking competition in Europe is still relatively strong and efficient, so the success of a new entrant such as a Vodabank would still require significant

effort[37]. But there are some advantages that Vodafone has that might facilitate their launch into pan-European retail banking – and more importantly from a policy perspective – trigger cross border competition.

Overcoming the catch 22

Firstly, Vodafone would have an advantage in overcoming part of the 'catch 22' that hampers development of a new retail payment instrument: in so far as mobile phones can be easily adapted to provide payment facilities, merchants can be confident that a Vodafone payment instrument would be widely held by consumers early on in its development phase. In most western European countries, mobile penetration is close to 100% percent, especially in the groups of people that a TEBA provider would target. This would at least solve half of the problem of client acquisition.

For the other half of the market – merchants – Vodafone would perhaps need to develop a partnership with merchant acquirers to ensure that retailers would accept payment via the new instrument. Merchants could be proposed attractive fee levels. And as a TEBA provider, there could be important scope for 'value added services' from merchant acquirers working with Vodafone for pan-European retailers. Insofar as the growth of outsourcing to specialist merchant acquirers continues, these kinds of partnerships are more likely to emerge[38].

Real time retail settlement

A second attraction for customers - both individuals and companies - could be the introduction of real time transfers for clients both holding Vodabank accounts. Technologically this is possible, especially if a bank is starting out with a new generation of banking systems. Risk management, particularly for in-house systems has improved. Real time settlement exists already in wholesale markets but has not been extended to retail clients, except in a few cases, such as an in Finland[39] and more widely for 'day traders'. The currently standard delays to accessing funds transferred between banks and accounts is probably one of the features of retail banking that consumers least appreciate. With mobile phones almost

[37] It is precisely because of the well developed payment structures in Europe that mobile based banking services have to date been most successful in developing markets where retail banks have less dominance over banking structures and clients habits and where there are still large numbers of 'unbanked' clients whose main alternative is cash.
[38] Recent outsourcing announcements include the agreement between HSBC and First Data as well as the sale by Citibank of its card processing to Eurconex, owned by a US banking group.
[39] See Milne and Tang

always accessible, clients could receive messages almost in real time confirming debits, credits and account balances without having to access the internet[40].

Constant remote access

Thirdly, access: A mobile based instrument providing direct access to accounts would expand ease of use for clients. They would have quick and easy access to make account transfers without having to log on to the internet, go to a bank or find an ATM. The 'ease of use' advantages could be significant. Past experiences with mobile telephone access to, for example, trading accounts suffered from slow connections and awkward screen navigation. But improvements are almost certain to come. Some mobile operators have already achieved success with very simple solutions. And the simpler transactions of credits and debits (compared to share trading) may be better adapted to telephone use.

Easier access is also important for person to person (P2P) transfers, especially remote ones. Holders of accounts with Vodabank could transfer funds between each other without the need for a cheque or more time consuming processing on-line or in a bank. Visa and Paypal have already demonstrated that there is some demand for more efficient cross border electronic P2P transfers. And mobiles have the advantage of allowing immediate notification of the recipient, which can facilitate a kind of Delivery versus Payment (DVP) without cash. It is also particularly of interest to providers of remittance services (see Box 4), as telephone based accounts can reach a much wider population in rural and developing regions than traditional bank branches allow. More generally, real time P2P transfers could be, in early stages, a novelty service that attracts clients.

Internal netting across borders

Although Vodafone would need to operate through existing clearing systems for settlement with other banks, costly international fees could perhaps be avoided by maximising scope for internal netting. This is not an advantage that would be unique to Vodafone. Banks with significant operations in multiple countries may engage in internal netting as well. But a Vodabank solution developed in parallel in several European countries might have a volume and balance of cross border activity that would warrant looking carefully at potential cost savings from netting opportunities.

[40] The Vodafone experimental service in Kenya (Mpesa) already in effect provides real time transfers.

Box 5: Commercial Developments in mobile phone based payment instruments

Although the recent past is littered with failed mobile payment initiatives, there are signs that some viable business models are beginning to emerge. Banks and mobile operators are beginning to experiment in Europe with solutions that go beyond alternatives just for low value payments and are integrated with full banking services. And real progress on this front may be achieved more quickly in developing markets with larger pools of un-banked clients. Several initiatives are advancing in Africa and Asia, in countries and populations where a relative lack of competition with alternative electronic payment forms (such as cards) potentially means there are lower barriers to new entrants.

PostFinance, Switzerland: The Swiss postal bank has been testing a mobile phone POS solution, developed with Unisys, called Yellow Account. The mobile phone is scanned by new POS technology that registers the user's telephone number. The customer uses a pin code typed into the telephone to allow their account balance and transaction limit to be checked. A text message containing an alphanumeric code is then scanned by the merchant to complete the transaction.

SMART Padala remittances, Philippines: Smart Communication in the Philippines has developed a solution for mobile based remittance services. It allows migrant workers in, for example Hong Kong, to deposit money with an agent and send funds using a text message to a recipient with a mobile account in the Philippines, on which the units are credited; the account holder and beneficiary of the transfer can cash in the mobile units at SMART retail outlets.

Mobipay, Spain: An initiative jointly owned by BBVA and Telefónica Móviles, enables consumers to pay for purchases by confirming a transaction message sent to their mobile telephone. Merchants are provided with a telephone number, alias or bar code and then send a message to the phone holder for confirmation using a PIN code typed into the key pad. The technology and model has been patented across a wide number of countries.

MTN and Standard Bank have together developed a cellular phone based bank account called a MobileMoney transactional account. The account enables a wider scope of the South African population to access a bank account using their mobile phone. Banking transactions and account statements via SMSs are free. All customer-initiated transactions (e.g. card and/or ATM transactions) are notified in real-time, irrespective of the day and time. MobileMoney also enables person-to-person payments and transfers to other bank accounts and credit cards and bill payments.

M-Pesa, Kenya: Vodafone has been testing a mobile banking solution in Kenya in cooperation with local microfinance institutions (MFI) that provide loans to clients who would otherwise have no banking relationship at all. Loans can be credited directly to the client's account with Vodafone using messaging via SMS. Clients can then use their mobile phone and pin code to withdraw money from retail outlets that sell pre-paid air-time for Vodafone. Clients can also deposit money with these agents. All transfers and balances can be confirmed directly through simple SMS based messaging and the use of a PIN code

VIII. POLICY CONSIDERATIONS

Retail banking integration in Europe continues to be an important objective for policy makers. This has given rise to a variety of legislative and other policy initiatives including attempts to harmonise the legal frameworks for retail products and efforts to foster investment in infrastructure for a new single European payments area (SEPA). In parallel, in Europe as well as the US and Australia, authorities have continued to be concerned by competition policy issues in payment services - especially credit cards.

This section assesses some of the current policy issues in these areas in light of the barriers that a Vodafone based TEBA scenario would face. It also discusses other areas in which public authorities could take steps or investigate potential to facilitate competition, new entrants and integration in retail banking.

VIII. A. The Single European Payments Area (SEPA)

Public pressure on the banking community to forge a single European payments area has been mounting. Under a broad definition, the SEPA project encompasses a number of initiatives including the cross border payment Directive, the proposal for a new legal framework for payments and payment services providers and cooperation with the banking community to foster the development of pan European Clearing Houses (PEaCH) and services. The underlying objective is to create a structure in which intra-European (or at least Eurozone) cross border payments can be made as easily, quickly and cheaply as within existing domestic frameworks.

To the extent that these initiatives may facilitate competition and entry, it is worth considering three specific aspects of this legislative and policy framework: price controls, minimum standards and legal harmonisation.

Price controls. The Directive on cross border payments and related pressure on banks and other payment service providers have forced through decreases in fees (to end consumers) for small retail payments (value under 12,500€) . At most banks, published prices for credit transfers have declined in line with legislation. Price restrictions applied to this part of the downstream market will have two main effects on the upstream market. (1) They will tend to

put downward pressure on supply (in-house or external). But all banks must continue to provide payment services, so unless they can cross-subsidise, inefficient banks will be forced to outsource these activities to more efficient wholesale providers of payment systems and services.

The ensuing consolidation in the upstream market may improve prospects for new entrants in the downstream retail markets. If wholesale providers are not also worried about protecting their own retail banking activities, they may actively seek to expand their client base and happily supply payment services and access to new entrants. On the other hand, if consolidation is largely along national lines, there still may be a very limited supply of pan-European payments processing services. If this situation arises, the benefits of consolidation may accrue primarily to those few banks that can efficiently serve several domestic markets.

(2) Price controls will also put pressure on margins. If SEPA succeeds in lowering real costs for intra-European transfers, declining prices and margins for cross-border payments may act as a disincentive to new entrants in particular those whose comparative advantage focuses on being able to provide lower cost cross border payment services. The reasoning is simple. If prices and margins decline for incumbents, any new entrant hoping to compete in this market will see its expected return on investment decline. At some point, margins may fall so much that a new entrant will be entirely discouraged from developing a competing offer.

Minimum standards. The new proposals also include a limit on settlement cycles, stipulating that credit transfers within the zone may (after 2010) take no longer than 48 hours (in practice less). This will have the effect of forcing participants to undertake investments, or side step obligations by outsourcing payments operations to specialists (who themselves will invest). Along with the beneficial effect of improving standards and delays, this too will have an effect on prices, supply and concentration of the industry.

Normally, banks and other operators forced to invest would seek to recoup their outlay through either higher fees or higher volumes of business (or both). But as fees will probably continue to be subject to direct or indirect controls, more pressure will be put on supply. Payments 'insourcers' will seek to capture more of the market in order to operate profitably. Signs of consolidation are already beginning to appear as banks begin to sell off or outsource payments operations to other banks or specialists.

The ensuing consolidation may indeed create gains in efficiency. But it will also be likely to concentrate market power in the hands of a few banking groups. New (and existing) retail banks may find it easier to enter new markets if they can transform previously fixed costs into external variable expenses. Like in the case of price controls, if consolidation among payments processors is largely national, a greater portion of efficiency gains may go to incumbents, with less passed on to retail institutions and their clients. Nationally focused consolidation would probably also fail to enhance competition between suppliers of cross-border payment services. This would not be favourable for the emergence of new entrants focused on developing a TEBA service.

Unfortunately, if past experience in Europe is anything to go by, consolidation will be most pronounced within domestic markets, concentrating payments in the hands of a few dominant processors per country instead of fostering cross-border consolidation. Minimum standards may help achieve consolidation, but they will also hinder the emergence of new cross border competition.

Harmonised legal and regulatory framework. To the extent that cross border operations suffer from differences in legal and regulatory regimes, the proposal to create a common legal framework for payments is a step in the right direction. In particular, countries which restrict payments to full credit institutions can benefit from being forced to relax entry criteria. And clarifying the legal environment for cross-border payments, to minimise operational and contractual risks should bring down transactions cost for all.

However, the proposed structures may still be too stringent. Payment providers will now have to seek a special license and go through the passporting procedure to operate in other countries (or set up a new subsidiary abroad and apply locally for authorisation). Although this may be the best one can hope for within the confines of the current EU regulatory framework, one cannot help feeling that the Commission has missed an opportunity here to introduce a simpler structure in which even the delays and uncertainties of passporting are avoided.

Moreover, there should be no illusions about the capacity for new legal divisions between different financial service activities to foster the emergence of a corresponding industry structure. The proposed divisions between (1) payments services providers, (2) credit institutions and (3) e-money institutions (and of course other financial firms defined in EU legislation) are unlikely to ever reflect clear industry boundaries; and these categories are likely to become outdated in the not too distant future.

By defining a new license category, the EU may have found a convenient way of forcing open markets that limit payments to credit institutions. But the real problem for new entrants relates to the uncertainty of how different authorities will view new business models (see related point VIII.D.). As the preceding discussion should have made clear, the interrelationship between retail banking and payment services are complex and very important to the success of new entrants in a pan-European market. It is also perhaps worthwhile recalling that funds transfer (and currency exchange) services were the origin of banking institutions that emerged in the middle ages. The way in which regulators define and interpret this boundary will have a potentially important impact on whether new entrants can test new models without getting bogged down in red tape and conflicting approaches across countries. The current proposal neglects this issue[41].

VIII.B. Surcharge fees

No surcharge rules have attracted increasing attention from regulators, with the suspicion that they are anti-competitive or at least hinder retailers from using price variations to send the 'right signals' to consumers about the relative costs of different payment instruments. But there are many other ways in which competition can be pursued in spite of no-surcharge rules. Banning surcharges may not even lead to lower prices for consumers. Although surcharging might facilitate new entrants, its other negative consequences probably outweigh any positive effects.

On the one hand, 'no-surcharge rules' do not prevent competition by other innovative means. Consumers already often face indirect price differences based on the payment instrument used by them. Retailers or card issuers may pay loyalty points to consumers. And the cost of interest free credit for limited periods of time is also a form of pricing.

[41] Another anomaly in the legislation is the continued carve out for post giro institutions, the history and impact of which requires further investigation.

Perhaps another way in which retailers adjust is by setting minimum amounts for card payments. In many countries merchants will not accept payment by card for low values. On balance, this may very well induce consumers to spend more than they would in the absence of minimum amounts.

On the other hand, if surcharges are allowed, there may be two particular effects. Experience to date suggests that merchants may find that differential pricing is not worth the effort. So even if they can impose different prices according to payment instrument, they may choose not to. This has been the experience for example in Australia for a large proportion of retailers. Modelling also suggests that for retailers with significant market power in their segment, the benefits of differential pricing will be disproportionately captured by them, with very little of the gains from price reductions going to consumers.

The other possible effect would be to reduce acceptance, which might have a gradual impact on issuing. Merchants with a strong franchise might develop competing card solutions valid only in their stores. This would lead to fragmentation and possibly an increase in market power of retailers.

Another area in which no-surcharge rules have applied is on ATM withdrawals. Here the experience in the UK suggests that allowing surcharging on cash withdrawals can actually provide an incentive for independent ATM networks to be developed. This can be advantageous for new entrants, providing them with greater choice among third party networks for arranging ATM access. Experience also shows that, many customers, especially those classified as 'cash rich, time poor' are willing to pay a surcharge to be able to withdraw cash at a convenient site (e.g. airport, train station, petrol station) instead of making a special (time-consuming) trip to another bank's ATM.

But studies have shown (Massoud, Saunders and Scholnick) that surcharging on ATM withdrawals favours client acquisition by big established banks. Clients that appreciate wide access to ATMs gravitate to those with the biggest networks through which withdrawals can be made free of charge. So even in this case, on balance new entrants may not benefit from a growth in surcharging on ATMs.

VIII.C. Facilitating stronger demand for a TEBA

Efforts to 'improve' supply of intra-European payment services can be wasted if demand for them remains weak. Of course it is more difficult to regulate consumer preferences than banks. But governments should be reviewing impediments and disincentives to using a cross-border account. A few issues stand out, some of which are partially addressed by current proposals.

Salary payments to 'foreign' accounts

There is some evidence from surveys that employers are still often very reluctant to pay salaries to an account abroad. As this is a primary use of a current account, it is particularly important that employees can if they so wish receive salary on an existing account held in another EU state. There seem to be a number of reasons why companies may refuse to do this.

- ***legal risks:*** payments made to accounts abroad may present greater risks to employers if a dispute arises on confirmation of payment amounts or dates or if the company needs to recoup undue payments. In such cases, the inconsistencies or simple differences between legal systems and conventions may present unnecessary complications that a firm would rather avoid. National law may for example differ on key definitions such as "proof of payment". Work on harmonisation of the legal framework in the EU for payments may help to alleviate some of these problems.
- ***costs and delays:*** Salary may have to be paid by or on specific dates – either by contract or by law. Foreign transfers which not only take longer but are also less reliable in terms of timing may present significant problems for corporations and employees. Similarly, as the cost of a cross border payment has, until recently, exceeded that for domestic payments, both companies and employees may have considered foreign payments to be undesirable. Of course, improvements in these areas are already the focus of legislation.
- ***Processing of tax forms and related documentation:*** Filing tax returns, managing pension rights and dealing with systems for social security (e.g. health, unemployment) may also require individuals to hold a domestic account. Salaries are often processed by external payroll companies that operate domestically, but may be unable to apply tax, social security or other rules to salary being paid abroad.

Administrative documentation requirements:

Many companies and public authorities rely on bank statements as proof of address, identity or available funds. Foreign bank statements and documentation may not be accepted for obvious reasons (language) or perhaps because formal guidelines and procedures do not recognise them as acceptable forms of documentation. Hence lack of a domestic bank account may create administrative complications for individuals, especially during the process of establishing residency, when this kind of documentation is frequently needed.

VIII.D. The costs of regulatory uncertainty weigh most heavily on new entrants

In spite of attempts to coordinate and harmonise regulatory policy across Europe, national authorities still hold considerable discretionary powers, especially where new business models do not fit clearly into existing and familiar frameworks. For a business whose strategy relies on simultaneously capturing a small part of several national markets, regulatory uncertainty can be an impediment to its development.

A TEBA provider might need to rely on gaining a number of clients in a number of countries in order to cover costs. But if regulators across Europe risk imposing different constraints and operational requirements on a new cross-border business model, the end result may be to discourage this kind of new entrant.

It is precisely for new entrants and new business models, particularly those that rely on cross border economies of scale (to be profitable), that EU supervisors must be able provide one unified and binding response to applications and view on operational and prudential standards. Established incumbents can often absorb the extra costs and risks of divergent regulation. For new entrants the problems are more significant. Hence in an environment where increased competition and in particular innovative pan-European providers are welcome, regulatory uncertainty is all the more disappointing.

VIII.E. Outsourcing: Regulators can do more to diminish the barriers posed by economies of scale. One of the more important developments in financial services over the last two decades has been the rise of outsourcing – both external and internal[42]. Outsourcing has enabled parts of the value chain of financial services, especially those that are subject to

[42] Internal 'outsourcing' refers to centralisation of activities and operations within the same institution, but serving multiple business and entities within a diversified group.

economies of scale, to be provided at lower marginal cost to both internal and external clients. This has reduced barriers to entry and facilitated competition from new entrants.

Outsourcing enables institutions to transform formerly fixed costs into variable costs. As the ratio of fixed to variable costs decline, new entrants are generally able to achieve break even at lower numbers of clients or a lower volume of business. This increases the chances of survival of new entrants and has a positive effect on competition, on pricing and service variety.

But regulatory authorities have only cautiously given way to outsourcing; and liberalisation in related services trade in the broader international setting is still warranted. The EU and national governments should as a first priority be reconsidering barriers to outsourcing, not only in familiar areas such as IT, custody and call centres, but also in terms of facilitating distribution of financial services via new channels (e.g. via other retail chains) and access to central infrastructure (such as payment systems) by non-banks such as corporates and retailers.

The principals on outsourcing supported by the Committee of European Banking Supervisors should be welcomed. But in practice, scope remains for divergent national interpretations. And anecdotal evidence suggests that the uneasy correspondence between rules and concrete banking practices can unintentionally impede outsourcing solutions or generate rents for outsourcing providers operating in a given national market. Ultimately, a single European supervisory framework will be the best way to ensure consistent, yet principals based, application of rules on outsourcing across multiple EU countries.

In the international context, governments should also be doing more to agree upon mutual recognition and equivalence of standards in order to widen the scope of potential suppliers to the financial industry and opportunities for new entrants to experiment with new business models. An accord with India for example could be mutually beneficial. While further improving access by IT companies to Europe, European banks could be provided with less restrictions on entry to the banking sector in India. This would also have an indirect advantage for European integration. It might increase the relative attraction of investment in Europe vis-à-vis emerging markets such as India. Restricted entry to the Indian market makes it more attractive to international banking groups that can pay the entry ticket and shoulder the risks

involved. Providing wider access would perhaps refocus some banking groups interest on improving returns in Europe.

VIII.F. Separation of merchant acquiring and card issuing

More separation between issuing and acquiring banks might facilitate the introduction of new payment instruments. Although this form of vertical integration is not anti-competitive in itself, if issuers or acquirers exercise market power, if there is tacit collusion, new entrants may be blocked. In particular, if merchant acquirers also operate as retail banks and card issuers, access to provide new payment instruments may suffer. Establishing a banking relationship with merchants across Europe could be a problem for Vodafone. It is in this context that a partnership with a merchant acquirer would be advantageous. And it is also in this context that market barriers exist.

In many countries across Europe, there is a high degree of vertical integration in retail payments, covering the card issuing, merchant acquisition and settlement components of the market. The recent interim findings on card systems by the European Competition Directorate at the Commission (April 12 2006) confirm this. If merchant acquirers have market power, i.e. individual companies can have an impact on prices, vertical integration may be profitable, and maybe even good from a social point of view[43]. But integration may on the other hand hinder new entrants that wish to propose new payment instruments and innovations that pose a competitive threat to incumbents. Where vertical integration is profitable, this may be a further impediment to cross border retail banking integration.

Luckily in some countries vertical integration is beginning to break down. Banks are increasingly outsourcing card processing and merchant acquisition responsibilities to third parties such as Euroconex, Atos, First Data and TSYS. But many still maintain these functions ‘in-house’. This trend may reduce the risk that conflicts of interests impede new entrants to retail banking.

Any mandatory separation of issuing and acquiring would be risky and unwarranted. In fact, as the market opens and once it becomes competitive, incentives for vertical integration ought to decrease, weakening the case for intervention. But authorities should ensure that vested

[43] See Rochet and Tirole (2000) where they briefly outline the implications of integration between acquiring and issuing service providers.

corporate or government interests do not unduly block acquisitions or developments by independent merchant acquirers, especially in markets in which these activities are dominated by a small number of vertically integrated banking groups.

VIII.G. EU Labour Mobility

Lastly, although is lies outside the realm of financial sector governance, it is worth emphasising inter-dependence with labour mobility and the impediments to it. These issues are well documented in other policy literature. Improvements to the portability of pensions, easier, less costly solutions for income tax on mobile individuals and aspects of employment law could all contribute to greater labour mobility within Europe. This would have a positive effect on demand for banking solutions serving a trans-European clientele.

CONCLUSIONS

Retail banking integration in Europe remains an elusive goal. As a step towards a market led process of creating a single retail market, policy makers should be hoping that a pan-European provider emerges, even if is seen as catering to a small population of relatively wealthy mobile Europeans. For a variety of reasons, mobile telephone operators with a broad geographical presence, such as Vodafone, would be in a better position than many existing retail banks to have both an incentive and good chance of exploiting this market niche. In any case, the integration of mobile telephony and banking services will happen. If the benefits of this innovation are not captured by incumbents, it could help foster European integration and the emergence of a pan-European retail banking service that targets this market – just the kind of people who value cross-border banking and are cognisant of the advantages of (and obstructions to) the single market. Policy makers should be trying to ensure that barriers to this sort of new entrant are minimised and that the fruits of innovation are duly passed on from banks to consumers.

The paper has discussed many of the natural or economic barriers to new entrants in retail banking and outlined areas in which Vodafone would be well positioned to overcome them. Foremost among them are those related to the provision of payment services. In the oligopolistic banking markets of most European countries, pronounced vertical integration in

this domain may limit opportunities for a new entrant to form partnerships. And innovations that might help propel the business model of a new entrant are hindered not only by the need for coordinated investment but also because the benefits of such innovations may be captured by incumbents in the retail banking community. These barriers are arguably more significant than legal and regulatory barriers that have been addressed by current European policies.

EU policy has to acknowledge its limited scope, beyond direct industrial policy[44], to influence the final outcome. Policy measures do admittedly seem to be encouraging market consolidation in the payments sector. This could turn out to the benefit of pan-European business plans. But there is also a danger that consolidation will be mostly national, concentrating any efficiency gains in the hands of banks and firms that may not be under pressure to pass them on to consumers and businesses.

Other areas in which authorities should concentrate efforts to enhance market openness include removal of regulations that unduly restrict innovations in outsourcing. Restrictions on access to participation in the payment system are being reconsidered, especially in the retail sector. And finally, demand for cross border services is still critically dependent on progress in other policy domains, in particular those that promote labour mobility.

[44] It is perhaps worth noting that, if Europe were a developing country, western agencies might well engage in a public private partnership to support integration. Indeed, this is the form in which the UK development agency, DFID, has supported Vodafone's MPesa project in Kenya.

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Appendix

Bi-lateral funds transfers: destinations as percentage of total messages sent (2004)

Type 100 messages received by selected countries as percent of total 'intra-European'* traffic by sender								
	sending country							
receiving country	BE	DE	ES	FR	GB	IE	IT	NL
Belgium (BE)		6%	5%	11%	6%	4%	5%	18%
Germany (DE)	21%		28%	29%	26%	31%	39%	36%
Spain (ES)	5%	7%		9%	8%	2%	6%	4%
France (FR)	17%	14%	15%		14%	5%	14%	9%
Great Britain (GB)	13%	18%	19%	16%		42%	15%	14%
Ireland (IE)	1%	2%	1%	1%	5%		1%	1%
Italy (IT)	8%	16%	13%	14%	10%	3%		6%
Netherlands (NL)	19%	9%	5%	6%	8%	5%	5%	
Total intra-European traffic by sender (tsd)	7 940	24 640	5 514	10 932	14 453	1 807	9 265	10 527
traffic for selected receiving countries (as % of total)	84%	73%	86%	86%	77%	93%	84%	86%
source: SWIFT 2004								
*intra-European is defined as traffic between the 15 'old' EU member states, minus Greece, plus Norway and Switzerland								

Some indicative price structures for basic retail payment instruments

France (prices as of 01.01.2006)

All prices in Euros	Card payments free in Euro zone	Minimum annual card fee at which withdrawals are free (carte premier) (immediate versus end of month debit)	Minimum annual card fee (for visa classic card) immediate /end of month debit	Number of free withdrawals (for basic card)	Price of subsequent withdrawals	Young person's tariff (national payment card)
CIC (Ile de France)	yes	121	34	4	1	
Banque Populaire	yes	95	31 / 40.8	4	1	
HSBC	yes	123	33	4	1	
Crédit Lyonnais	yes	123	34.50	4	1	
BNP Paribas	yes	128	36 / 45	6 or 8	1	18
SG	yes	112 / 122	32 / 42	8 or 4	1	-50%

*It should be noted that clients of French retail banks often report scope for negotiating reductions to the published fees, suggesting that banks maintain room for further price competition.
**Accounts are not remunerated unless indicated

Germany

All prices in Euros p.a.	**EC Card**	**Basic visa or MC**	**Gold Card**
Deutsche Bank	free / 5 (a)	20.45	60.47
HVB	free	20 (MC) 30 (Visa)	60
Commerzbank	free	13 ot 20 € (b)	46 to 66 € (b)

(a) free for certain account types and minimum average balances

(b) free for card holder spending over €5900 for std cards or €11900 per year for 'gold' cards