

Porter's Five Forces Analysis on SEPA
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Introduction

This analysis of the Payments business - based on the “Porter’s Five Forces” method - is an input to a SEPA Programme.

This input is intended to be used in conjunction with the “Greenfield Approaches” and then to lead into the compilation of a Market Impact Analysis for each business unit.

The Porter method has been criticised as being applicable only to very static markets, which are not subject to the dynamic changes seen in IT and many other industries since 1990.

The selection of the Porter method as the basis done for two reasons:

1. Executives are familiar with it and it can still act as a good framework from which to start a programme, as long as one recognises its limitations, and that the analysis is not meant to be laying definitive conclusions – but rather to act as a stimulus
2. Payments people do tend to talk about the dynamic changes in the business, but these may be less obvious to the outsider. At SIBOS 2005 in Copenhagen Leo Apotheker – Board Member of SAP – likened the banks in the business to a chameleon: they change colour on the outside through the Euro, e-business, but not much changed fundamentally on the inside in the offering or the way in which it is delivered

Let’s start with some background observations about the Payments business and about SEPA.

Percentage of GDP that payments cost

It has been estimated that payments cost 3-4% of the EU’s GDP, whereas the equivalent figure in the USA is 1% (even though cheque usage in the USA is higher than the average usage in the EU).

If the EU figure fell to 1% after the realisation of SEPA, this would be a major revenue loss to the banking industry – and Tower Group estimate that the banking industry will have to pay EUR10 billion to establish SEPA.

Connection to the customer

It is very hard to exit the Payments business and still bank clients. At the Multinational end it may be possible – via FX, investment banking.. – but not in Retail and SME.

If the Payments business consists of the steps of **Acquiring** a payment from a customer, **Processing** it, and **Settling** it, there are – unlike in the Cards business – few examples of players who have positioned themselves just in Acquisition or just in Processing. There are some like FinForce or EBA who major on the back-end steps. There are no statistics that measure market share broken down by these three steps.

Statistics are misleading if they do not record that a payment can be acquired by one bank but settled by another. Statistics will also be prone to double-counting, inflating the total number of payments being made since the originator’s bank and the beneficiary’s bank will count it, as will each intermediary. An intermediary bank might count the incoming and outgoing payments!

Acquiring, Processing Settling

Most banks carry out all three steps, but they will not do all three steps on all payments: even the largest banks use correspondents and service providers.

There is also a direct correlation in the market environment now between the service quality that can be offered and the tightness of a bank’s connection to a clearing system: exiting the Settlement step can have a direct negative impact of service components such as time, information quality, price and reach, components which are likely to be most valued by the largest customers.

Even the largest payment banks have these issues regarding ACH instruments and cheques outside their home countries, when they are not carrying out the Settlement step.

In a more transparent market environment under SEPA it should not only be easier for a bank to connect to Settlement channels outside the home country (setting aside economic considerations) but also represent less of a service disadvantage if the bank does not. There is then a major conundrum about whether a bank should be a direct member of Settlement channels.

Economics

Falling prices, increasing demands for information and service from customers, commoditisation, low absolute interest rates reducing the value of lying balances, better cash management by customers, bigger demands from central banks for Settlement channel membership (IT, liquidity etc)...these are the drivers of revenue and cost in the Payments business now, even before SEPA.

Banks have followed the US trend of reorganising Payments – along with Corporate Trust, Securities Custody and Trade Services – into a Line of Business, called variously Treasury Services, Payment and Trade Services.

As a business the Payments business will have a lot of captive clients – the bank’s branches, its operational departments, its dealing rooms – for its Processing services, and it will have to support channels to Acquire the payments even from these clients.

Is Payments really a Business, or is it a Utility or a Service? How does SEPA change this? How does Basel II change this, when credit lines and capital are allocated to ever more Payments functions, such that this is no longer a Non-Credit Service?

Regulation

The compliance costs associated with being in a business that is tough to exit are indeed hard to swallow. These costs increase inexorably:

- ❖ Patriot Act/Financial Action Taskforce/Anti-Money Laundering/Know-Your-Customer
- ❖ Sarbanes-Oxley/8th EU Directive on Company Law for the bank itself, and in order to provide assurances to customers
- ❖ Basel II, in particular Operational Risk Capital

SEPA-specific:

- ❖ EU Regulation on cross-border payments in Euro
- ❖ Residual Central Bank Reporting
- ❖ Payment Services Directive

Clearing access

Access to the Settlement step of the business is tightly controlled by Central Banks in order to control systemic risk. The introduction of Real-Time Gross Settlement systems was aimed at reducing this risk. Only banks can be members of RTGS systems.

Opening hours of RTGS systems have extended.

Central Banks have formulated and tightened up policies regarding aspects of clearing membership:

- ❖ Posting of collateral in the form of cash or bonds
- ❖ IT&Ops set-up including fault-tolerance of computers, hot and warm stand-by sites, disaster recovery plans
- ❖ Sometimes specific minimum market share and/or overall value of payments

This all adds up to costs, and a requirement to operate on a large scale and almost without an end-of-day.

Premises behind SEPA

National payments markets characterised by local Payment Schemes, but operating efficiently due to standardisation of data and communications channels, and high local penetration.

But, however high the local penetration, this represents an inefficient model for the EU as a whole.

Cross-border payments in Euro and in the EU are slow, expensive, lacking transparency, predictability.

This inhibits cross-border trading between Retail/SME/Mid-Corporate in particular, and inhibits specifically the creation of the Single Internal Market and the benefits of the Euro.

The Euro High-Value infrastructure is in place via TARGET and EBA Euro1, and will be further enhanced by TARGET2 (Author's note: isn't that fragmented too?).

The Euro Low-Value infrastructure consists merely of redenominated Legacy Currency payment schemes at local level.

EBA STEP2 has attracted moderate volumes; the eligibility criteria have been drawn very restrictively by the banking industry and realised as MT103+. Even then the industry discovers an ability to apply differing STP definitions, charge for repairs, and leaving some endpoints inaccessible.

Summary

The current market environment presents many challenges and then SEPA will be layered on top of them, and interplay with them.

The Porter analysis has five aspects:

1. Bargaining power of suppliers
2. Bargaining power of customers
3. Threat from New Entrants
4. Threat from Substitutes
5. Competitive rivalry amongst existing players

Against each aspect we have an approach:

- List of symptoms of the factor (bargaining power/threat/rivalry) being high
- How it can be reduced
- So is it high under SEPA?
- How feasible would it be to use the reduction measures suggested above?

Now let's proceed into the Porter analysis

RJL/10.5.07

Bargaining Power of Suppliers

..is high when:

- market dominated by a few large suppliers rather than a fragmented source of supply
- No substitutes for the particular input
- The supplier's customers are fragmented, so their bargaining power is low
- High switching costs from one supplier to another are high
- Supplier can integrate forwards in order to obtain higher prices and margins (especially when the buying industry has a higher profitability than the supplying industry, and when forward integration provides economies of scale for the supplier)

Forward integration is attractive when the buying industry hinders the supplying industry in their development (e.g. reluctance to accept new releases of product from the supplying industry) and when the buying industry has low barriers to entry.

..can be reduced by:

- Partnering
- Supply chain management/training
- Increasing supplier's dependency
- Building knowledge of supplier costs and methods
- Taking over a supplier

So is it high after SEPA?

No it doesn't appear so. Consistent formats and a homogenised marketplace decrease supplier power, as does the overt legislation on pricing. The historical price structure between Hi/Lo value and Domestic/International will break down, with prices in the EU in Euro centering on the historical level for Lo-Value Domestic.

The customer's voice is being heard at the EU and at the European Central Bank via EACT, TWIST, RosettaNet.

IT/formats can no longer be a tie-in. Customers want to exclude banks' technology from their IT environment precisely to reduce supplier power and switching costs.

Suppliers have high fixed costs and cannot exit without high customer/revenue risk – but revenue will fall anyway and there will be a substantial compliance investment.

There are a lot of banks. Banks will continue to dominate the Settlement part of the business, but not necessarily the Acquisition part. The customers and their vendors are in effect entering the Acquisition part. A Supply Chain Management ASP could even be seen as entering the Processing part – because it debits/credits the buyer/seller accounts in its books, and issues a Settlement (to a card, to a bank, in its own pseudo-currency..)

Supplier's best defences may be:

- Customer inertia
- Poor communication of the possibilities offered by SEPA
- Legacy instruments continue in existence so the market remains fragmented
- Product-wise basic SEPA schemes to disguise low price of components

- Re-focus efforts on customer segments who do not want to understand banking methods and technology
- Acquire offerers of the technology that would enable the customers to reduce the suppliers’ power i.e. forward integration

Reduction measure	Viability under SEPA
Partnering	Is there any need for customers to do this to reduce supplier power?
Supply chain management/training	Yes, allied to working closely with ERP and middleware vendors, and with SCM ASPs
Increasing supplier’s dependency	By concentrating banking with fewer suppliers, or by hawking the business around relentlessly and on a rotational basis, along the lines used by Correspondent Banks for their USD clearing
Building knowledge of supplier costs and methods	Yes, by customers implementing an In-House Bank or Shared Service Centre, by using the same technology products as the banks (e.g. middleware), by hooking up to the interbank comms systems (SWIFT), by submitting payments directly to clearing systems (e.g. BACS model)
Taking over a supplier	Tried by Dow Chemical historically; central banks have resisted the acquisition of banks by corporates. Potential for a utility (MACUG Service Bureau) to reduce amount of work done in getting a payment done, and acting for the corporate.

Bargaining Power of Customers

..is high when:

- They buy large volumes
- There is a concentration of buyers
- The supplying industry comprises a large number of small operators
- The supplying industry operates with high fixed costs
- The product is undifferentiated and can be replaced by substitutes
- Switching to an alternative product is relatively simple and is not related to high costs
- Customers have low margins and are price-sensitive
- Customers could produce the product themselves
- The product is not of strategic importance for the customer
- The customer knows about the production costs of the product
- There is the possibility for the customer integrating backwards

..can be reduced by:

- Partnering
- Supply chain management
- Increasing loyalty/increasing incentives and value added
- Moving purchase decision away from price
- Cutting out powerful intermediaries (going directly to customer)

So is it high after SEPA?

Depends on market segment. Retail and SME may not have many such payments (depending on the country they are in) and/or may not be price-sensitive below a certain level (will they object to paying EUR0.75 instead of EUR0.35?). These customers have no interest in adopting banking techniques and integrating backwards – unlike major MNCs.

Customers with (a) large volumes (b) complex operating structures that currently involve many banks (c) counterparties who are happy to receive funds as international or domestic credits are liable to see potential in SEPA.

Customers who (a) have to comply with SOX and so need to demonstrate tight processes and controls (b) have implemented centralised ERP (c) conduct a significant proportion of trading on Internet or in e-space will see SEPA as an enabler of centralisation.

Correspondent bank customers outside the EU could see SEPA as the trigger to really consolidate their Euro business. Banks inside the EU might now be able to access a direct channel to all endpoints without the complications within Credeuro/ICP, and repair charges.

In general one can answer:

- Yes the supplying industry comprises a large number of small operators because even relatively large banks will go into SEPA with a small market share – and in some countries like Germany the domestic market was already quite fragmented
- Yes, the supplying industry operates with high fixed costs
- Yes, the product is undifferentiated, but the basic payment cannot easily be replaced by substitutes: it is more helpful to think of the potential for substituting who does the work in the steps Acquire/Process/Settle

- Switching to an alternative product may not be simple, but switching to a different supplier should be
- As long as customers are under pressure both from intra-EU competition and from China, India.. they will have low margins and be price-sensitive

A standardised eb interface with consistent data reduces switching costs and supplier power. Access to SWIFT for corporates is a form of backwards integration.

The impact of a payment – delivery of value to a counterparty and of information – can be replicated, if not with a service that is 100% different, then with one where the actions are performed in a different way e.g. by an ASP that acquires Invoice information from a supplier – which the buyer confirms – and causes a transfer of value to an internal account of the supplier; once a month the balance of the account is paid out to the supplier. One such payment could account for the balance of 1,000 invoices, so commercial payment volume dropped 99.9%.

A corporate that implements ERP and its own middleware, and obtains SWIFT access, gains transparency over the payments business, and can cut out powerful intermediaries like a bank supplying payments software that only links efficiently into that bank.

Reduction measure	Viability under SEPA
Partnering	Major corporates will be suspicious of this unless there is a clear added-value. Correspondent banks may be more willing to go this route (although it may really be an outsourcing). On the other hand, a partnering that involves supporting the customer’s invoicing and Accounts Receivable/Payable processes can be seen as valuable = forwards integration by the banks
Supply chain management	Corporates have become impatient with banks; RosettaNet can be seen as an example of corporates doing their own thing and backwards-integrating into the banks’ space – by dictating information and data standards.
Increasing loyalty/increasing incentives and value added	Basel II acts as a potential counter-weight to SEPA in banking relationships, making credit more scarce and expensive
Moving purchase decision away from price	Depends on ability to product-ise, and embed payments in a wider service; also dependent on customer segment
Cutting out powerful intermediaries (going directly to customer)	It has not proven easy to acquire numbers of banking customers for a general relationship without acquiring the brand they bank with. ING Direct is a specialised service with a simple but compelling proposition, not very like Payments. Banks have generally failed to acquire Retail, SME and Mid-Corporate franchises through direct calling/local branches. Which intermediaries are there (SWIFT, Clearing Houses??). Do they add value to suppliers or reduce it? Are they threatening to allow customers greater power and counteract their owners’ wishes? How could they be taken out of the loop?

Threat of New Entrants

..is high when:

- it is easy for other companies to enter this industry - new entrants can change major determinants of the market environment (e.g. market shares, prices, customer loyalty)
- there is a latent pressure for reaction and adjustment for existing players in this industry
- Absence of barriers to entry
- Liberalisation occurs to a formerly regulated environment
- A technology shift occurs

Typical entry barriers and do they exist in the Payments business:

Barrier	Existence in Payments market
Requirement for scale (minimum size requirements for profitable operations)	Yes, for settlements and processing. Given reduced prices in SEPA environment, does anyone know what the minimum scale of profitable operation is?
High initial investments and fixed costs	Yes, in the backend pieces
Cost advantages of existing players due to experience curve effects of operation with fully depreciated assets	One would think so, but when those systems have to be re-gearred for a new environment, do those “advantages” reduce, evaporate, or even become barriers?
Brand loyalty of customers	Corporates – loyalty is connected to credit Retail – loyalty is connected to the service bundle
Protected intellectual property like patents, licenses etc	No, we are moving towards an open standards environment, and away from proprietary techniques that can be patented
Scarcity of important resources, e.g. qualified expert staff	Qualifications for today may be superseded in new environment; resource constraint liable to be on IT staff
Access to raw materials is controlled by existing players	It is central banks who dictate that only well-capitalised banks can do the Settlement piece; entry criteria to other pieces are restricted by different Success Factors
Distribution channels are controlled by existing players	Yes at present, but MACUG or Service Bureaux options, aided by open data standards, create new distribution channels
Existing players have close customer relations, e.g. from long-term service contracts	No, at most on a 1-year rolling basis or annual review at the top end; otherwise service is used ad hoc
High switching costs for customers	Reducing due to open standards

Threat of New Entrants can be reduced by:

- Legislation and government action
- Increasing the minimum efficient scale of operations
- Creating a marketing / brand image (loyalty as a barrier)
- Patents, protection of intellectual property

- Bundling with linked products / services
- Tie-up with suppliers
- Tie-up with distributors
- Retaliation tactics

So is it high after SEPA?

It is lower, but one must distinguish between the three pieces – Acquisition, Processing and Settlement.

The entry barriers to Settlement are high, and so are the costs and commitment required to be in that space. SEPA should force a consolidation in this space, but it will only allow the remaining players to increase prices for that activity if the interbank Settlement channels consolidate as well, and if the remaining channels allow all endpoints to be accessed.

PSD has clauses about access to payment channels but they are not worded so as to be specific to settlement, and they certainly do not address the economics of membership, merely the objective of eliminating artificial and monopolistic entry barriers.

If a bank still needs to belong to many Settlement channels in order to provide a decent service, then all competitors who want to match that service towards the same customers will have to remain as Settlement channel members.

Otherwise the Settlement market will remain still overcrowded and fragmented, and banks will not reach the minimum scale to be profitable.

It is interesting that most regulatory pressure is on the price to the customer. If that price is regulated but the price that Settlement players charge to other participants in the business is not, then there is the prospect of intermediaries being forced out of the market because each payment they acquire can only net EUR1, and the Settlement players charge EUR0.95 per item, and their internal costs are EUR2.

New entrants might be of the type:

- To help Tier 2 banks reduce internal costs
- To help Payment Service Providers acquire and process payments without owning any infrastructure, and also enable banks to retire existing infrastructure
- A Payment Service Provider aiming simply to acquire payments by having a good brand in another activity (a “Payment Institution” as contemplated under PSD)

There is also the simple New Entrant which is a bank in a different EU state who, because the technical side of the payment service is now identical, can move into another EU state and acquire payments (through internet, through buying a brand), without building extra infrastructure.

Reduction measure	Viability under SEPA
Legislation and government action	No - legislation and government action are driving in the polar opposite direction, specifically permitting a “Payment Institution” under PSD as a type of new entrant
Increasing the minimum efficient scale of operations	Yes but no-one knows how big a survivor will have to be, and if other banks are willing to exit parts or all of the business to allow volume to be concentrated
Creating a marketing / brand image (loyalty as a barrier)	Yes, payments can be product-ised and bundled
Patents, protection of intellectual property	No, very difficult
Bundling with linked products / services	Yes, as above
Tie-up with suppliers	Many combination of companies with brand, IT vendors, telecoms companies etc are conceivable. The issues are acquiring scale and making money.
Tie-up with distributors	As above
Retaliation tactics	The banking industry has been very successful in the past at doing this, because entrants were often critically dependent upon some feature or function of the industry to help them undermine it. Or else the proposition of the new entrant was too narrowly based. However, how do you retaliate against an ING Direct? By paying even higher over the interbank rate?

Threat of Substitutes

..is high when:

- Alternative products are introduced with lower prices or better performance parameters for the same purpose – result is that market volume is spread across more products, reducing the potential sales volume for existing players
- Threat of substitutes is determined by factors like Brand loyalty of customers, close customer relationships, switching costs for customers

..can be reduced by:

- Legal action
- Increasing switching costs
- Alliances
- Customer surveys to learn about their preferences
- Entering the substitute market and influencing it from within
- Accentuating differences (real or perceived) between existing product and its substitutes

So is it high after SEPA?

In a sense the new SEPA Payment Schemes are substitutes for the existing national schemes. EPC’s stated aim is that the new schemes should enjoy “lower prices or better performance parameters for the same purpose”, but there are some issues with this:

- No mandatory retirement date for national schemes
- No SEPA scheme for cheque or Bill of Exchange

Thus SEPA could see the introduction of these substitutes which have a mix of advantages and disadvantages against the national schemes. Then a static number of payments – with fixed price to the customer – would be spread over an even wider number of Payment Schemes and settlement circuits. That would be a disaster on the costs side for the banks.

In another sense the new SEPA Payment Schemes are substitutes for one another, because they become homogenous across the Eurozone, because the schemes have many shared characteristics, and because the range of prices is much tighter. Thus there could be a radical shift (on a country-by-country basis) in the usage of the different available schemes compared to the pre-SEPA shares of the analogous national schemes. This could both strain capacity – if the usage of a scheme increases sharply – or squeeze the economics of a scheme if its usage falls.

These points should be of considerable interest to ACH systems thinking of becoming PEACH systems but only servicing one marketplace.

A genuine and complete substitute for a payment is difficult to envisage, but if one’s definition of a payment is a process to transfer value and information, then it becomes less difficult to envisage solutions that support the transfer of information completely, and transfer value to the satisfaction of payer and receiver (even if the transfer does not meet the Lamfalussy criteria of final settlement).

Such models might include:

- An ASP for Purchase Order/Invoice presentment, and agreement, where data is integrated with the buyer’s and seller’s accounting systems, and settlement is in a quasi-currency, to an account in the ASP that is underwritten with a credit insurance policy. If the participants concentrated enough of their trade within the ASP, they would not need much cash to come in and out
- Similar model for Purchase Order/Invoice presentment, and agreement, but a panel of banks buys the receivables from the seller as soon as the invoices are agreed. Buyer gets a credit in cash or quasi-currency; seller is debited on the future Due Date and then just has to clear their account balance by the end of that month

Reduction measure	Viability under SEPA
Legal action	No - legislation and government action are driving in the polar opposite direction. SEPA is aimed at causing increased competition between different payment schemes too e.g. causing the features of card, direct debit and credit transfer to converge so they can substitute one another
Increasing switching costs	No – it’s going the other way
Alliances	Banks could establish “Working Capital” models themselves, major on the supply of credit or insurance, not on payments
Customer surveys to learn about their preferences	Yes – also good for establishing in the customer’s mind that the survey sponsor “owns” the SEPA subject
Entering the substitute market and influencing it from within	Yes
Accentuating differences (real or perceived) between existing product and its substitutes	Could only be done to accentuate advantages of the SEPA schemes: emphasizing the advantages of the old schemes would not be politically possible for a bank. Would then need a commitment of effort to be an early adopter of the new schemes, and to build the sales message. Risk of internal conflict in the bank with those wanting to protect the status quo. Would need very strong management leadership to push this one along.

Competitive rivalry amongst existing players

..is high when:

- There are many players of about the same size
- Players have similar strategies
- There is not much differentiation between players and their products
- Low market growth rates (growth of a particular company is possible only at the expense of a competitor)
- Competition rotates around price
- Barriers for exit are high (e.g. expensive and highly specialized equipment)
- The result is pressure on prices, margins, and hence, on profitability for every single company in the industry.

..can be reduced by:

- Avoiding price competition
- Product differentiation
- Buying out competition
- Reducing industry over-capacity
- Focussing on different customer segments
- Communicating with competitors

So is it high after SEPA?

It has to be, if:

- The relevance of national markets and payment schemes reduces
- the product becomes homogenised and transparent, easier to buy – and easier to buy from someone else
- the size of the addressable market for each supplier multiplies by at least five

There will be many banks of about the same size, they have money, muscle and pride – and a strategy to be a leading player in the EU. The EU economies are not growing quickly, SEPA is unlikely to stimulate growth just by its creation.

There is overcapacity in the industry, and a high risk to banks of exiting Payments completely.

If there is any differentiation in what banks are offering, it will be reach (if PEACH systems do not guarantee this to all endpoints), customer service, integration with customer systems, detail of information supplied. But these are factors that are of interest at the top end of the market, not so much for Retail and SME.

Reduction measure	Viability under SEPA
Avoiding price competition	Unlikely, and inadmissible if there is any suspicion of interbank agreements
Product differentiation	Possible for Retail and SME customers; the top end will gain increased transparency into the banks
Buying out competition	Yes, as long as there is a clear target towards a player with the scale to make money. Thus a merger between banks from Portugal and Luxembourg would not make much sense. It is arguable that if the bank is not already German or French, it will be tough. Even then, the French market is already more concentrated than the German one
Reducing industry over-capacity	And who will volunteer to go first? The critical first step should be to reduce the number of current ACH systems to a maximum of 3 or 4 PEACH systems (even if one accepts that it is necessary to have more than one PEACH). There is a lot of “Turkeys voting for Christmas” around the gameplan that sees ACH systems voluntarily fold...and if they don’t AND they continue to process national instruments, capacity will have increased, not fallen
Focussing on different customer segments	Who is this exactly? Remittances not being sent through the banking system? The unbanked?
Communicating with competitors	Ok if via EPC or in deadly secret; not if discovered by the EU or the ECB

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