The Role of Competition in a Cooperative Market

A Look at the Credit Union Industry’s Shared Services Framework for Payments

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This paper, a study commissioned by DC Payments, represents the independent, third-party view of the market and competitive environment of Edgar, Dunn & Company, a management consultancy that focuses exclusively on financial services and payments. This paper, and the conclusions herein, was developed based upon research conducted independently in the market by Edgar, Dunn & Company, consisting of interviews with numerous industry participants, including credit unions and service providers, and desk research using publicly-available information.

This paper draws upon Edgar, Dunn & Company’s expertise in payments, built up over more than 35 years of experience in the payments industry, and its global footprint of payments experts that is able to bring lessons learned and best practices from Canada and payment markets around the world. The conclusions and analysis herein are those of the authors and Edgar, Dunn & Company.
Abstract

Canadian financial institutions are facing increasing competition for customers and to successfully compete they must innovate, rolling out new products and services quickly at the lowest practical cost. Credit unions are competing for the same set of customers as bigger banks and thus are facing the same set of competitive dynamics. However, while they compete with each other, they also cooperate on certain elements of their business, including back-end shared services such as clearing systems and switching. While this allows credit unions to gain economies of scale and be more competitive against the country’s largest banks, it must be done in a manner that enables individual credit unions to differentiate themselves in the market.

Periodically, credit unions, both individually and collectively, have an opportunity to evaluate their shared service environment, and specifically the option of whether they, as a group, rely on a single provider for a specific service or a competitive market for the service.

As the market determines how it will approach transaction switching, it is helpful to evaluate the options using a framework that highlights key determinants of success for a shared service in the financial services industry. Based upon experiences with monopolies and competitive environments in Canada and other markets, one such framework includes the following five perspectives:

1) Economies of Scale;
2) Ability of Service to Capture the Entire Market;
3) Governance;
4) Innovation; and
5) Pricing.

With regards to transaction switching services, the potential for economies of scale means that it is possible that a monopoly provider would provide near-term cost advantages in the market. However, they may not be as significant as anticipated because today’s infrastructure already supports multiple services, thereby keeping costs down, and the fact that the monopoly provider is unlikely to capture the entire market. Furthermore, maintaining competition is more likely to create balanced governance and support innovation in the market, as well as maintain market-supported, reasonable price levels over a longer period of time. Taken together, this suggests that there are significant risks to achieving the potential benefits of a single provider model. Analysis of all the factors suggests that credit unions are more likely to receive a higher level of service and a superior choice in products at a reasonable price in a competitive environment than they are in a monopoly environment.
The Role of Competition in a Competitive Market

The financial services industry in Canada is in the midst of a period of rapid change. Mirroring a trend that is occurring throughout the world, Canadian financial institutions are facing increasing competition for customers, ranging from chequing accounts to credit cards to investment products. To remain relevant to current customers and attract new ones in the future, financial institutions have to innovate and roll out new products and services. It is no longer acceptable to only offer online banking – credit unions must have a mobile banking offering and be prepared for what consumers will demand next, such as mobile payments, remote deposit capture and new ways of paying that will undoubtedly emerge in the coming years. Such innovation will be critical to remaining relevant to their customers. A 2012 study by Aimia, a loyalty marketing company, showed that over half of Canadian millennials expressed interest in using mobile technology to access financial services, such as using mobile banking, using a phone to pay at checkout, or using a phone as a credit or debit card.¹

Although smaller and currently more regionally focused than the national banks, Canadian credit unions nonetheless have to compete for the same set of customers as traditional financial institutions. More uniquely, credit unions operate in a world of ‘co-opetition’ – cooperation among credit unions is key to their success, but at the same time they must compete against each other and the larger banks in order to win new customers and retain existing ones. One important area of cooperation is shared services – the back-end services such as clearing systems, transaction processing, switching, and online banking platforms that are critical to operations but sit behind the scenes. Credit unions can and do share these services, which allow them to gain economies of scale and be more competitive against the country’s largest banks. However, these shared services must also provide an individual credit union with the capability to differentiate itself from the others.

Periodically, credit unions, both individually and collectively, have an opportunity to evaluate their shared service environment, and specifically the option of whether they, as a group, rely on a single provider for a specific service or whether they instead rely upon a competitive market for the service. While it may be clear that simplification of the overall payments ecosystem is in order, it is critical to determine in advance just how simplified the end state should be. In particular, for each of the shared services, it is important to consider if ending up with a single solution provider is in the long-term best interest of credit unions, or if some degree of competition in the market is critical.

Each credit union must evaluate the market in light of the competitive environment for its own products as well as within the context of its own go-to-market strategy. Based upon experiences with monopolies and competitive environments in Canada and other markets, it may be helpful to look at the decision from five perspectives:

- **Economies of Scale** – Is a monopoly provider able to gain sufficient economies of scale over two or more providers? Can a competitive market provide economically efficient services with duplicate infrastructure? Are there benefits to additional infrastructure?

- **Ability of Provider to Capture the Entire Market** – Would a monopoly provider be able to capture the entire market, thus realizing the economies of scale for the entire market?

- **Governance** – Are all participants in a monopoly provider able to participate in a representative manner for decision making? Would a competitive market provide greater ability for a credit union to influence decision making?

- **Innovation** – Would a monopoly provider be able to deliver upon the innovation required in the marketplace? Would a competitive environment provide a higher level of innovation?

- **Pricing** – Would there be an overall reduction in costs achieved by using a monopoly provider? How would pricing differ in the long run between a monopoly provider and a competitive environment?

As credit unions evaluate their options for shared services, it is helpful to keep this market framework in mind. Looking at the future structure in light of the framework and the set of questions described above, while also looking at other experiences in Canada and select international markets, suggests that credit unions are more likely to receive a higher level of service and a superior choice in products for a sustainable price in a competitive environment, in which the service providers themselves are competing for customers, than they are in a monopoly environment.

### Shared Services Market Structures

When looking at the market for shared services across the financial services industry, two primary models exist – a monopoly model consisting of a single provider and a competitive environment consisting of two or more providers. Periodically the question arises within the Canadian credit union system of whether the system would be better off...
with a single provider model for some or all of its shared services. It is no surprise that the question has come up again now – changes in the industry due to the new federal credit union option are beginning to occur, and increased competition from traditional and non-traditional players and the technological revolution continue to pose a significant disruptive threat to the industry. Due to these factors, as well as other industry trends such as a low interest rate environment, credit unions are facing margin compression and are consequently struggling to fund investment in new products and services. As credit unions move to operate and organize across provincial boundaries and determine how to leverage technological advancements with limited resources, there is naturally a question of how to better compete with the traditional banks – and with other credit unions.

With a monopoly provider, customers are theoretically able to experience lower cost through greater economies of scale; by consolidating all volume or purchasing power on a single provider, the system may be able to secure services at a low cost. While the value of competition is a basic tenet of economics, economic theory also suggests that monopolies may be justifiable in a few specific situations. For instance, a monopoly can provide higher value when the minimum economic scale to operate is too large given the size of the market. Additionally, monopolies may make sense if the cost of infrastructure, such as the last mile of utility services to customers’ houses, makes it prohibitively expensive for a competitive market. Monopolies typically succeed when it involves a true commodity product (e.g. utility wiring to a consumer’s house or cable television within specified geographic boundaries).

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However, managing this monopoly market also typically requires significant external intervention and work. Regulators and other government bodies, such as local utility commissions, usually provide oversight, and often intervene, in order to ensure balance in the market is maintained. This oversight can come in many guises, from regulating prices and product offerings to requiring that other companies can access the underlying product, often at wholesale rates, in order to provide services, some of which may compete with the monopoly’s own products and services. In essence, the intervention serves to ensure that the monopoly does not abuse the pricing power it has from being the sole provider.

In a competitive environment, the providers compete in order to secure customers. A provider can try to win market share from its competitors by providing a different value proposition, which might include different service levels, price levels, and innovative products. As a result, customers are provided a choice in the market and thus can select a provider that best aligns with its business objectives and customer needs.
Prices in a competitive environment may not be as low as situations in which there is a monopoly provider who has a single, often lower cost, infrastructure and who passes those savings on in the form of lower prices. However, pricing under a monopoly may be higher if the monopoly provider exercises its pricing power or if new functionality or services are needed while the contract is in effect but were not included in the original contract. In this situation, customers may be more exposed to unfettered pricing than if there was an actively competitive market.

With more than one provider, prices are theoretically kept in check by the natural competition between providers who must compete for customers based on both price and service and thus have a natural incentive to keep costs low. For example, prior to 2008, credit union prices for switching services were in excess of $0.07 per transaction. As a result of the competitive bidding process and the entrance of a new provider, however, prices fell significantly in a few short years.

While the existence of a competitive environment is not a guarantee that the government or other market participants will not have to intervene in the market, the need for intervention is usually lower since market dynamics achieve many of the results that regulators and others are forced to mandate in a monopolistic environment. As one example, it is far easier to determine the appropriate market price in markets where there is competition; in a monopoly environment, regulators or the monopolies themselves spend a lot of management time to determine an appropriate ‘market price’.

Analytical Framework for Market Structure

Many markets face periodic decisions as to whether a monopoly provider is best positioned to provide a particular product or service, or whether a competitive environment is the best structure to ensure valuable products and services. Sometimes this evolution occurs naturally; for instance, when a provider becomes the only supplier through organic growth, acquisition, or some combination of the two. Other times, there is a conscious choice by the market to select a monopoly provider or ensure a competitive environment through their vendor selection. Either way, for the customers, it is imperative that they enter into these strategic supplier decisions with a careful consideration of the options and a thorough understanding of the implications of their choice.

The trade-offs between these two models can be evaluated from five essential perspectives:

- Economies of scale
- Ability to capture a market
- Governance
- Innovation
- Pricing
Each of these perspectives presents potential benefits or risks to a particular market structure. When evaluating the market for transaction switching in light of a potential decision on providers, it is helpful to consider each of these perspectives individually.

**Economies of Scale**

A primary argument for monopolies is the ability to capture economies of scale that are otherwise unattainable with multiple providers with duplicate infrastructures. For a service that some see as a utility, the argument for a single provider is that consolidation of volume would lower the cost of service by improving the economies of scale. Thus, it is important to understand whether a monopoly provider would be able to achieve greater economies of scale than is currently present in the market and also to understand exactly what additional costs would be removed from the market by consolidating volume.

For shared services in payments, the argument goes that some services, such as payment transaction switching, have a high and largely fixed-cost structure, and thus it is likely that lower costs could be achieved if the surviving entity could capture additional volume. Assuming that a single provider does not abuse its monopoly pricing power by raising prices once it has eliminated the competition, a lower operational cost is definitely desirable in the marketplace. As credit unions increasingly compete head-to-head with some of the nation’s largest financial institutions, both in the current provincial structure as well as in the future in the new federal structure, having a low operating cost will be critical to ensuring success.

However, in the current market environment, it should be recognized that
costs associated with running the switch infrastructure are not allocated solely to support credit union services. While there currently is duplicative infrastructure in switching, some of the infrastructure also supports other non-related volumes, which has resulted in a lower per transaction cost than a standalone system would have due to the additional volumes on the platform. Thus, a counterpart to understanding whether market participants would benefit from greater economies of scale in a monopoly is also asking the question whether providers in a competitive environment are each able to reach sufficient economies of scale in order to provide an economically-efficient service. It is important to recognize that this question is even more relevant when the majority of the costs associated with the development of the infrastructure has already been incurred and should now be considered a sunk cost.

As a final consideration, there is a cost for those institutions that must switch in order to use a monopoly provider - a cost in terms of money, resources, and management time, all of which need to be incorporated into any calculation of total cost and netted out from expected savings. Taken together, it seems unlikely that anticipated cost reductions from consolidation to a single supplier would be fully realized.

While there are also duplicate management costs in the credit union system that come from managing multiple suppliers, many of these costs, such as market research, vendor negotiation, and monitoring service level agreements, are costs that are associated with being an ‘educated consumer’. Thus, they are likely to be incurred in some form even in a monopoly market as part of a customer’s process to ensure they are getting the service and pricing they need, meaning that a move to a single supplier is unlikely to result in a complete removal of these costs.

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### Ability to Capture the Market

A second analytical lens is understanding whether a monopoly provider can capture the entire market or at least enough new volume to realize the additional economies of scale desired by the market, since neither is guaranteed in a free market. If the single provider is not attractive to a subset of players, it is unlikely that those institutions would agree to migrate to that provider or remain with the surviving processor if the market moved to consolidate down to a single provider. Instead, as history has shown, they are likely to seek alternative solutions, including in-house processing or alternate third-party providers, both of which could ultimately result in increased fragmentation of the system, rather than a reduction.
If too many customers, particularly large players, choose this route, the expected efficiency from volume gains would not be achieved, thus limiting the actual economies of scale from a single provider and ensuring that the resulting pricing benefits would only be partially realized. As customers withdraw from a monopoly provider, the remaining customers bear an increasing burden of the costs, since there are fewer customers to cover fixed costs, meaning either prices increase or less money is able to be dedicated to capital investment.

When looking at the decision from this perspective, it is worth noting that the history of credit union shared services for transaction processing suggests that it is unlikely that the system would be successful in agreeing to a sole provider model. Originally, when there was a single provider of services, a group of credit unions formed a competing service provider and attempted to consolidate all volumes across the system to that solution. However, instead of converting to the new provider, another group of credit unions decided to continue with the original provider. As a result, the market fragmented with both companies providing services to individual segments of the industry.

Later, the two service providers joined through acquisition, forming a single provider. Shortly afterward, a dissenting group of credit unions forced a bidding process for shared services, and a third service provider was selected. Once again, only a portion of the credit unions elected to go with the selected provider, leaving a competitive situation in the market. It seems hard-pressed to project different behavior given the market composition today, a view echoed by some conversations in the marketplace, with one credit union participant flatly saying, “I do not want to be captive.” Thus, it appears unlikely that the entire market would agree upon a single provider of switching services.

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This is not unique to Canadian credit unions. Other markets have experienced similar dynamics. The U.S. ACH system provides an informative example, wherein market and competitive pressures resulted in the introduction of a second ACH network that created a duopoly within the US ACH market.
The ACH system in the United States has its roots in the regional cheque clearing houses that were formed around the Federal Reserve districts to clear cheques between member banks. As the paper-intensive processes migrated toward electronic transfers of payment data, two national networks evolved: The Clearing House, a private-sector entity, and the Federal Reserve, an arm of the government’s central bank.

Two networks were not required for technical reasons – although the ACH system grew via an amalgamation of multiple regional ACH systems, it has long been unified at the technology level as there are few vendors of the technology and their systems are to a great degree interoperable. Nor is the reason that there are two operators of the ACH a matter of geography. Payrolls and other transactions move seamlessly from any point in the country to any other under the auspices of either operator. Nor, as many assume, is the presence of two separate operators the apex of some period of slow agglomeration as many formerly regional ACH systems (which themselves had emerged from banks and credit unions joining their previously separate systems together) merged until only two remained. Nor is it the case that two separate operators were set up from a desire to ensure fail-over capacity or back-up in case of an outage at one or the other (although that is one of the side benefits of having two operators, each capable of running the entire system if necessary). And finally, it is not a matter of cost economics. On a theoretical basis it would seem that a single system would be more cost efficient. Whether this would be theoretically the case or not, the reality is that the two operators actually achieve very low operating costs as a result of needing to remain price competitive with each other, which means they focus on delivering their services in a cost-effective manner.

The history of the development of the ACH in the U.S. reveals the underlying reason that two operators are maintained. The original private organization was set up to clear and settle transactions within a group of mostly New York City-based banks. These banks were, for the most part, the larger financial institutions. As the ACH began to grow into a nationwide network, mid-sized and smaller banks and credit unions were hesitant to join an organization in whose governance they felt they would have little effective voice. To assuage these concerns, the Federal Reserve set up the second ACH operator, Fed ACH, whose primary purpose is to ensure that there is always a nation-spanning electronic clearing system that will be offered at a cost that non-large FI’s can afford. And the presence of a second operator serves to contain what would otherwise threaten to possibly hold, in economic terms, a monopolistic pricing power.

Over the years the many benefits of this dual operator model have become
It is instructive to understand this historical context, as well as examples from other markets, when looking at the choice from the perspective of whether the monopoly provider could capture enough of the market to reach the promised economies of scale.

### Governance

Achieving a balanced governance model is critical to the success and sustainability of the provider, and thus it is a critical lens with which to analyze the decision about service providers. In today’s market environment, with a heightened need for responsive suppliers and product development, it is important to understand which model offers a better path for an individual credit union to have a voice in product development and service levels. Under a monopoly provider, particularly one that is formed from or owned by the market, having a voice in corporate governance also becomes a question that should be addressed.

If there are classes of customers, such as owners and non-owners, one class is unlikely to feel adequately represented – in this case, the non-owners – and is more likely to opt out. In addition, winning over the non-owners may require the owners to make concessions to the non-owners and effectively subsidize their business, for example by offering attractive pricing for the initial term. Conversely, owners may make decisions that are in their own self-interest and that may not be aligned with the interests of other customers.

While these are conscious decisions made by the ownership, they do not necessarily set up a sustainable structure for the business moving forward, nor do they create confidence that the business would be able to adequately invest in future development, given any disparities in service offering, including price, between different types of customers. Many in the industry recognize this dilemma; in the words of one credit union participant, “Owning our own supplier is very complicated. The industry should go into it with its eyes wide open.”
Similarly, if the ownership structure is imbalanced between large players and smaller players, one or both groups may be less than satisfied. A classic example of the struggle around governance can be had looking at MasterCard and Visa – as associations, they struggled with this issue. Their smaller financial institution members felt that they were under represented and that they had no voice. Meanwhile the larger institutions frequently argued that because all product development was made available to the entire market, they were, in effect, subsidizing product development for smaller, less efficient competitors.

It is also important to understand the sustainability of such structures, given any disparities in governance and influence among customers. When MasterCard and Visa were associations, their member financial institutions had minimal market power to achieve better service or better products since there were huge barriers to moving their business to another association. However, now that they are public companies, financial institutions are moving business among the networks in order to secure better deals and take advantage of different products and services, which ultimately gives them greater flexibility for their business.

“Owning our own supplier is very complicated. The industry should go into it with its eyes wide open.”

It must be noted that the struggle for leverage and influence among different customers does not go away in a competitive environment, since businesses will have to weigh the needs of different types of customers. However, the key differentiator in a competitive environment is that the problem remains a strictly business and economic problem, not a governance problem. Thus, as credit unions decide the type of supplier environment, it is critical to understand the type of influence it is likely that they would have under each scenario and make a decision as to what is best for their business.

**Innovation**

The role of market structure in innovation has been a subject of much debate among economists. Many economists support theories that posit that innovation is maximized in a competitive environment, citing empirical evidence that indicates that innovation occurs more frequently within competitive markets and decreases at either end of the market share spectrum (monopolies and highly competitive markets). Where innovation occurs in markets with dominant market leaders or monopolies, they find that it tends to be markets where there are low barriers to entry and the incumbent is required to innovate to stay ahead of potential new entrants.

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Today’s credit unions are in a similar environment: technology is lowering the barriers to entry and enabling new participants. The opportunity to digitize financial transactions has captured the interest of the technology innovators, inside and outside traditional financial institutions, and as a result the pace of change and number of new entrants is accelerating. New entrants are developing solutions that challenge traditional banking methods, providing streamlined services and enhanced user experiences.

Financial institutions with large, complex, and often outdated technology infrastructure are having problems being nimble in responding to market challenges. As a result, newer entrants, with newer technology, are popping up throughout financial services, from insurance to consumer bank account management to wealth management to installment lending, and just about everywhere in between. Credit unions, along with larger mainstream financial institutions, must keep pace with innovation to remain relevant, and they must be prepared for innovation throughout their business, even in areas that seem commoditized today. This issue is well understood among credit unions – in the stark words of one representative of a credit union, “Huge transformation is occurring in the financial world – are we as credit unions going to be relevant if we do not capture some of that technology innovation?”

A shared service model that relies upon a monopoly provider that offers the lowest cost solution could severely limit a credit union’s ability to innovate and thus successfully compete with larger financial institutions. Ultimately, with one player in the market, there would be limited incentive to invest in alternative solutions or services, whether they are value-added services or entirely new systems that could change the business. Being the lowest-cost provider usually requires significant standardization and/or simplification in order to capture the highest share of volume. This drive to the lowest common denominator is necessary in order to appeal to all constituents and achieve the lowest price point, but it may come at the cost of supporting future innovation. This is not the goal of most credit unions, as one participant clearly asserted: “Credit Unions should not be a movement that enables the least common denominator”.

Although the core switching service is viewed by many to be a commodity service, the service providers do in fact create a suite of services which directly impact the ability of credit unions to compete effectively, manage their cost structures, differentiate themselves from their competitors, and innovate. For example, in winning its initial contract, one vendor committed to a certain level of investment in its platform, which resulted in enhanced fraud capabilities and an Active Active network as well as a number of enhanced services that the system had been seeking for quite some time – thereby leading to an improved product offering for its customers. These enhancements subsequently drove further development by the second vendor, resulting in improved products and service levels to their customers, and a current reputation for being innovative. Thus, the competitive bidding process drove product and service innovation that continues to have a lasting effect today, resulting in
improved product offerings for the market. Going forward, there is no reason to think why competition would not continue to spur innovation in the market.

As another example, in Card Production, one company built up the capability internally, including a chip card order facility, and card and PIN management. The other provider similarly chose to build up some capabilities internally but also outsourced elements, such as PIN validation. These different strategic approaches are just one element that credit unions take into consideration when deciding with whom to contract for services. Each has their risk. Building internally can lead to growing pains and a slower speed to market as new technology is implemented, while in this case relying on outsource partners meant a more stable solution that was in market earlier, but it has subsequently resulted in the unexpected market dynamics of providing revenue to competitors – due to the sale of the outsourcing partner. The existence of choice ensures that credit unions can consciously decide on the options that best align with each institution’s own business goals, market strategy, and appetite for risk.

Looking at other markets, Germany provides an example of a market where competition between providers spurred product improvements that may not have been introduced in the absence of competition. In Germany, competition among the network service providers for merchants led to the creation of an online direct debit payment option— in an effort to differentiate their service, the NSPs developed innovative, value-added services around the core, basic value proposition. Not only did this provide additional benefits to the marketplace, but it did so at a lower cost than the alternative, the more expensive EC Giro System. Thus, when factoring low cost into a decision, it is also helpful to ensure the full impact is considered – a lower cost option for one particular service offering may require the need for other, more expensive services elsewhere in the value chain.

The competitive bidding process drove product and service innovation that continues to have a lasting effect today, resulting in improved product offerings for the market.
German Electronic Direct Debit (Elektronisches Lastschriftverfahren, or ELV) is a type of payment transaction that was developed in Germany in the mid-1980s by merchants and some network service providers (NSPs). NSPs are a unique type of German payment service provider that creates the link between the merchant’s bank, the German interbank clearing systems and the cardholder bank. They normally operate the merchant’s POS and switch the payment transactions for a low fixed transaction fee. Funds are then cleared and settled directly into the merchant’s bank account. In this manner, NSPs are in direct competition with local acquirers and have become so strong in the German payment market that many of them have decided to extend their service offerings up the value chain to include acquiring services as well.

With ELV, payments are approved by the cardholder by signature, but instead of traveling over a card scheme’s network, the account data is used to create an ACH-type direct debit transaction. While a popular and inexpensive method for retailers, it is also risky because similar to cheques, payments can be returned unpaid without any merchant recourse for a period of 28 days. ELV online, also known as OLV, was introduced by competing NSPs as an alternative to ELV and as a way to compete more effectively with the bank-owned, PIN-based, “EC Giro System” that provided a bank guarantee for the transaction. OLV’s value proposition was to be more appealing to merchants by providing a ‘guaranteed’ ELV at a lower cost than the bank-guaranteed EC Giro System. The general procedure is similar to ELV, but with OLV, every transaction runs through a series of risk checks, including a credit rating score, a nationwide blacklist, and social-geographic databases, thereby reducing risk but increasing cost a bit. This risk check provides the merchant with greater assurance about the presence of supporting funds than is possible with traditional ELV. Very often, transactions identified as high risk are not processed as an ELV/OLV but rather are switched to become EC Giro transactions, which then would generate a bank guarantee but at a higher cost to the merchant.

While ELV could arguably have operated more efficiently if all merchant acquirers were in full support of the process, competition in the space gave rise to OLV as another value proposition and choice for merchants. Ultimately, consumers stand to benefit because merchants are able to rely on a greater understanding of the risk of a particular transaction and can thereby provide better service and faster delivery times, since they do not have to worry as much about the risk of returned ELVs.
Having the proper conditions in place for innovation is a critical element in any market dynamic, even for a product or service that some think has been commoditized. The rapid pace of technological change, combined with the extension of payment providers into adjacent services to provide value-added services, means that the opportunity for innovation may exist in unexpected markets soon or in the near future. Furthermore, innovation itself has multiple elements, including speed to market as well as a variety and choice. As participants look out over a particular market, ensuring the proper incentives for innovation is critical – they may not be immediately needed, but when they are, having providers that can respond, preferably with a variety of solutions and approaches to market that allows a buyer to choose the best solution for its business, will be important.

Pricing

The final lens through which to evaluate the marketplace is pricing, which is an important element in any service agreement but, as we have discussed above, is not the only one. Monopoly providers, in theory, can provide a low cost service, if they truly operate efficiently and do pass their cost efficiencies on in the form of lower prices. However, a market with proper competition should naturally end up with low costs as well due to the nature of competition. Thus, when analyzing a decision about the market environment for service providers, it is critical to understand how those dynamics may play out over time, both with and without competition.

For credit unions to realize the benefits of a low cost provider in a scenario with a monopoly provider, they must be assured that the scale economies are passed on to the credit union in the form of the price they pay for the service, both in the short term as well as in the long term. History does not provide reassurances that this would be the case. The industry was moved to call for an RFP process when the then monopoly provider announced fee increases associated with the conversion to EMV, including a large upfront fee to cover the conversion, as well as pricing increases that almost doubled the per-transaction costs. However, once the competitive RFP process occurred, neither competitor raised prices anywhere near the pre-RFP levels. As one credit union participant said: “History proves the point – a single supplier is going to charge way over the market rate.”

It is also worth noting that in situations where there is a low cost provider that is operating in a manner that recovers costs but does not support investment in product development on an ongoing basis, the monopoly provider would require capital infusions in order to support research and development. This creates two notable dynamics: 1) a masking of
the true cost of the service versus a competitive market, as operating costs may be lower day-to-day but larger capital expenditures could occur that drive up the overall cost; and 2) investment decisions would be subject to the collective approval of individual market participants who need to approve the infusion, thus layering this decision with the governance issues described above.

“History proves the point – a single supplier is going to charge way over the market rate.”

Conclusion

When considering the question of whether the market should consolidate its procurement of switching services from a single provider, the analytical framework laid out above yields the following insights:

- **Scale and ability to capture the market:** It may be difficult to achieve the scale required to yield material savings through consolidation to a single provider, since history has shown that the market is unlikely to fully agree to a single solution and the fact that the scale achieved by suppliers from outside the Credit Union market, which is currently helping to drive down costs, would be significantly reduced.

- **Governance:** A competitive environment is more likely to yield balanced governance in the marketplace, since it lets competitive pressures drive the marketplace as opposed to a monopoly structure that is more likely to favor specific credit unions.

- **Innovation:** A competitive environment is more conducive to innovation – which will be critical to the credit union industry going forward.

- **Pricing:** Supporting a competitive environment has been helpful in reducing pricing levels and maintaining pricing at market-supported levels.
Shared services play an important role in credit unions’ strategy and ability to create the scale needed to provide competitive services. As the industry evaluates the role of competition within shared services, it is important to look at the multiple elements of the framework described in this paper.

While there may be short-term cost advantages from consolidating system volume in switching services, they are unlikely to be as significant as anticipated and also must be considered in light of the critical trade-offs outlined above, including innovation, product development, and pricing over time. Coupled with the uncertainty created by the challenges of realizing the ideal of a single provider, including the challenge of an acceptable governance model and questions as to whether the market would actually fully consolidate, there is significant risk to achieving the hypothetical benefits of a single provider model.

Analysis of all the factors suggests that credit unions are more likely to receive a higher level of service and a superior choice in products at a reasonable price in a competitive environment than they are in a monopoly environment.
Edgar, Dunn & Company is an independent strategy consulting firm that is recognized globally for its expertise in the payments industry. Its team members, who serve clients in more than 45 countries on six continents, are also experts on emerging financial services channels and markets, retail financial services, and e-business.

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