

Stifling Payments Innovation with Overregulation: Nonbanks are leading the way in payments innovation because banks are stifled with overregulation

by Eric Grover

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With the advent of Apple Pay and Android Pay, Bitcoin and EBay spinning off PayPal, payments are in the spotlight. But you've probably noticed that nonbanks have spearheaded most of this innovation, which wasn't the case historically. Why is that?

Banks in the modern form have existed since Renaissance Italy, when they evolved to play the central role in the payments system. The problem is that politics determines who can obtain a government charter to be a bank, the operating environment and associated rents. In [*Fragile By Design: The Political Origins of Banking Crises and Scarce Credit*](#), Charles Calomiris and Stephen Haber describe this as the "Game of Bank Bargains," by which banks negotiate the terms of banking with the political powers, whether under democratic or autocratic systems. As a result, banking is among the most heavily regulated and politicized industries, which puts a damper on innovation and makes the system more prone to crises. The aftermath of the 2008-2009 financial crisis provides a good example, when Washington's regulatory grip tightened, putatively to prevent future crises.

The hard and indirect costs of that tightening have been massive. Citibank alone admitted spending \$180 million in the second half of 2014 submitting to the Fed's stress tests. More worrying are management's need to focus on Washington overlords rather than customers, new products and markets, the attendant opportunity costs and the stultifying effect on culture.

While banks continue to enjoy some advantages, including reach, public trust, capital, payments expertise, client relationships and, in the case of Too-Big-To-Fail Goliaths, a government backstop, a disproportionate amount of payments innovation now comes from outside banking. Nonbank cultures are

often more tolerant of experimentation and failure and freer to focus on the payments experience and economics, while banks increasingly prefer the sins of omission to the sins of commission and have become relegated to public utilities. And that's actually been occurring for a long time. Consider these examples:

- In 1950, the head of a finance company, Frank McNamara, invented the general-purpose payment card and network, which was the greatest payments innovation of the 20th century; MasterCard and Visa subsequently actualized open payment networks worldwide.
- After false starts by banks, MasterCard and Visa, fitness club manager and Muscle Magazine editor Pete Kight launched Checkfree, the breakout electronic bill-payment-and-presentment company.
- Notwithstanding having tens of millions of retail banking customers, banks' initial P2P-payments ventures all failed, including Citi's C2IT, Bank One's eMoneymail, Wells Fargo and EBay's BillPoint and HSBC and Yahoo's PayDirect. It was PayPal, launched by hedge fund operator Peter Thiel and computer scientist Max Levchin, that actually became the first P2P-payment scheme and digital wallet to achieve critical mass.
- Video-rental store Blockbuster pioneered gift cards and radio DJ Steve Streit invented the general-purpose-reloadable prepaid card. Streit didn't need enlightened Consumer Financial Protection Bureau mandarins to design a product the un- and under-banked would embrace. Twitter co-founder Jack Dorsey likewise pioneered Square, the first mobile-acceptance business to scale. And cryptocurrency trail-blazers are an eclectic bunch but one thing they're decidedly not is bankers.
- On the mobile wallet front, Apple Pay, Google Wallet, Samsung Pay, ModoPayments and Mozido all seem to have stolen a march on banks.

In emerging markets as well, banks are behind the eight ball in payments. Safaricom built mobile-payments phenom [M-Pesa](#), which is the leading payment system in Kenya. MNO [EcoNet's EcoCash](#) is Zimbabwe's biggest retail-payments system. In the Democratic Republic of the Congo, [MNO-led Airtel Money, M-Pesa and Tigo Cash](#), rather than banks, are at the vanguard delivering money-transfer services.

Banking's golden age of innovation may have been the 18th century in Scotland where, because of the nature of Scotland's and England's political union, the Scottish banking system enjoyed benign neglect from the crown. Calomiris and Haber describe the Scottish banking system from 1694 to 1825

as “the very model of competition, innovation, accessibility to credit for the private sector, and stability.” It was a laissez-faire environment, where freely chartered Scottish banks pioneered branches, interest-bearing deposits, interbank clearing of banknotes, lines of credit and deposits with options of convertibility.

Payments innovation matters. More convenient, secure, and efficient payment systems and systems with greater reach improve consumers’ lives and enhance commerce. Participation by more lightly regulated nonbanks in payments has been and continues to be good for consumers and merchants. But banks could do more.

That banks have to be regulated is a rhetorical straw man. Nobody suggests they shouldn’t be. But today’s banks operate in a regulatory straitjacket. Absent price controls, payments are profitable for banks and one would be hard pressed to cite instances where they put deposits at risk, much less threaten the financial system. Regulators, however, cannot be relied upon to restrain themselves. Nobel-Prize-winning economist [James Buchanan’s Public Choice Theory](#) explains how regulators act to maximize their own utility; they are persistent and resourceful in expanding their turf. The temptation to direct rather than simply enforce the law seems irresistible. The Fed, for example, now wants to shepherd the banking industry to faster ACH and CFPB director Richard Cordray, speaking at the bank-owned Clearing House’s annual conference last year, all but ordered banks to implement faster payments.

Earlier this year, the House formed a Congressional Payments Technology Caucus and the Senate a Payments Innovation Caucus. Instead of promoting new laws, Congress should worry that overregulation is preventing more payments innovation. Rather than trying to pick payment technology winners and losers, these caucuses should focus on getting Washington to take its boot off the banking industry’s throat.

If Washington played the role of the night watchman rather than mandarin, the 21st century could be a golden age for bank payments innovation.

Mr. Grover is principal with Minden, Nev.-based [Intrepid Ventures](#), which provides corporate development and strategy consulting to financial services, payment network, and processing businesses. He can be reached at Eric.Grover@IntrepidVentures.com.