A Change of Paradigm in the Payments Industry: from Value Chains to Value Networks

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The largest endeavour in the payments industry today is undoubtedly the implementation of the Single Euro Payments Area (SEPA). Within SEPA, all payments in euros will be treated as 'domestic' payments, and the various national and cross-border payment systems will be harmonised. SEPA is a major step towards an integrated payments market in Europe, which will bring substantial economic benefits based on economies of scale.

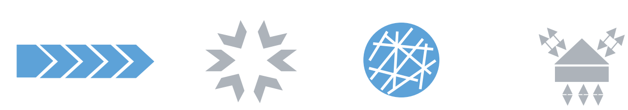
But in parallel with SEPA, there is a shift of paradigm in terms of the way value is created in the payments industry. Until now, the concept of the 'Value Chain' – developed by Michael Porter in 1985 – has been an accepted framework for representing value creation at the corporate level. The value chain gained a central role in the analysis of competitive strengths and weaknesses, and provided an important insight into the impact processes have on cost and value. As a result, payment service providers are used to describing their business in terms of 'production', and consider efficiency in 'producing' payment transactions their main capability. They analyse their costs from the perspective of pure economies of scale.

However, years before Porter, in his work of 1967, James D. Thompson described other concepts of value creation technologies. Those concepts were elaborated by Stabell and Fjeldstad in 1998 in their models of 'Chains, Shops, and Networks'. Although there is a fourth model, which can be considered to represent 'Transaction Management', it is the value chain and value network which are of fundamental importance in the context of the payments industry (see figure).

The transition from the value chain of the twentieth-century industry to the value networks of the twenty-first century means that payment service providers are involved in a paradigm shift from pure economies of scale to value generation by providing access to a network by means of its links and connections. SEPA will lead to considerable benefits in terms of standardisation, larger volumes and lower costs – all aspects of economies of scale. But the cheaper it becomes to 'produce' a single additional transaction, the more important it will be to leverage the production infrastructure or 'mediating technology' (James D. Thompson) and establish links between the different payment systems, the majority of which are still national. From a value network perspective, providing access to an ecosystem with a significant number of available connections is a much more effective way of generating value than simply handling payment orders.

An interesting example of this new shift is the recent development made by Equens, one of Europe's leading processors of card and payment transactions. In connection with the implementation of SEPA and ongoing migration towards it, Equens established a three-stage 'value network' of SEPA clearing and settlement mechanisms (CSMs). The first stage is the Equens CSM

Different Types of Value Creation



	Value Chain*	Value Shop*	Value Network*	Transaction Management***
Capabilities	Efficiency of Production	Solving of Problems	Leverage of Infrastructure**	Orchestration
Pricing Mechanism	Cost of Product	Value for 'Client'	Rights to Access	Management of Complexity
Result	Product	Outcome	Links	Sourcing
Value Generation	Process and Scale	Knowledge and Scope	Services and Connections (n^2)	Information and Transformation
Examples	Manufacturing	Hospitals	Telco Industry	Li & Fung ('Trading')

*) Source: Stabell, C B, and Fjeldstad, O D "Configuring Value For Competitive Advantage: On Chains, Shops, and Networks", Strategic Management Journal, Vol 19, 413-437 (1998); and James D. Thompson: "Organizations in Action", 1967

**) or 'mediating technology' (according to James D. Thompson).

***) based on ideas from: Victor K. Fung, William K. Fung, Yoram (Jerry) Wind: "Competing in a Flat World: Building Enterprises for a Borderless World", 2007

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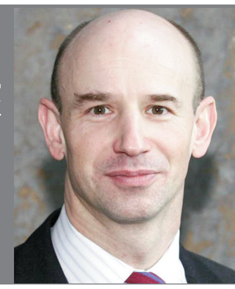

community for SEPA transactions, which connects Equens' clients. These include banks of varying sizes, from DZ BANK (Germany), ABN AMRO, ING, Rabobank (the Netherlands), Istituto Centrale delle Banche Popolari Italiane (Italy) and OP-POHJOLA (Finland), to the London branch of Bank of Tokyo-Mitsubishi UFJ and Banque Raiffeisen SC of Luxembourg. The second stage consists of inter-CSM links based on bilateral agreements. Equens has implemented these links for the exchange of SEPA payments with DIAS (Greece), Iberpay (Spain), ICBPI/Banca d'Italia (Italy), OeNB (Austria), SECB (Switzerland), and VocaLink (UK), based on the Interoperability Framework of the European Automated Clearing House Association (EACHA). These and future bilateral links will allow Equens to reach the majority, if not all, of the European banks. The rest of the necessary SEPA reach is currently provided via EBA.

The third stage is a question of thinking ahead. As SEPA transaction numbers rise, it is becoming increasingly apparent that processing payments outside the SEPA area still fails to offer the aforementioned advantages. Comparatively speaking, it will therefore become more and more expensive. However, given that the SEPA infrastructure is now in place and investments are being made in this 'mediating technology', why should we not go ahead and start connecting with partners abroad and overseas so we can also start leveraging on a global scale? With the aim of creating seamless reach around the world, Equens is participating in the International Payments Framework (IPF) – a membership organisation that currently consists of over twenty banks and central banks, CSMs, associations and software vendors based in Europe, the US, Canada, Brazil and South Africa. As part of IPF, Equens will start by providing reach to the world's leading economy, the United States.
In the US, the National Automated Clearing House Association (NACHA) is breaking down the walls between national payment systems by means of its new International ACH Transaction (IAT) rule. The Federal Reserve Banks and Equens are now implementing the IPF standard for the processing of payments from the US to Europe and vice versa. From early 2010, the Federal Reserve Banks, Equens and DZ BANK, who will act as a 'foreign gateway operator' in Europe, will be offering a completely new channel for transatlantic payments in euros, US dollars and other European currencies. This strategic partnership is based on an increasing market demand for cost-efficient processing of low-value/non-urgent credit transfers on a global level. Equens and the Federal Reserve Banks are building a bridge between their respective geographies with a transfer protocol based on the IPF ISO 20022 standard, which is very similar to the SEPA standard. This will open the gates for transatlantic traffic by translating the incoming messages into the common IPF standard, and sending them over the 'bridge', where they will be handled and transmitted to the recipient financial institutions.

While the theoretical concept of 'value networks' may not be recognised by every player in the payments industry, the benefit of connecting existing payment infrastructures and utilising the N2 rule concerning the number of links in a network with n participants is as clear as crystal. Consequently, other partners in Asia, Canada, South Africa, South America, etc. are looking to link in once the first transatlantic bridge is up and running.

This change of paradigm in the payments industry – from value chains to value networks – has started thanks to SEPA and the IPF. Clients connected to those value networks will benefit from the access provided by Equens, the Federal Reserve Banks and other partners in the future. This will help them to achieve considerable cost savings in their payment back offices and provide new payment channels to their customers.

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