EMERGING AND DEVELOPED: TERMINOLOGY OF THE PAST?

Market infrastructures in emerging markets are making use of more advanced technologies than their counterparts in developed economies. In markets with high market capitalizations and significant volumes of transactions, change will always seem riskier and costlier, but inertia exacts a price too. MI Forum asked Chris Hamilton, CEO of BankservAfrica and moderator of a panel at Sibos on this question, what he thinks governs the pace of technological change at market infrastructures.

"Is it better to have old technology or no technology?" asks Chris Hamilton, CEO of BankservAfrica. It is a characteristically provocative question, and one which pierces to the heart of this topic. In theory, legacy-less emerging markets are free to reinvent their world with the latest technologies, while developed markets with ageing systems dare not take the risk of transitioning to a new technological platform. In reality, argues Hamilton, technology per se is not the issue. "Technology is certainly a factor, but one that is less important than market circumstances," he says.

His argument is that emerging markets are under-banked, with most consumers making payments not from bank accounts but mobile telephones. "There is a whole generation of people growing up in Africa, for example, who have a mobile long before they think about getting a bank account," explains Hamilton. "For banks and other financial service providers, that is a strategic challenge but also an extraordinary opportunity."

The challenge is not infrastructural (the telecommunications are in place) or technological (developing apps to provide banking services on mobile telephones is straightforward) but cultural. "When there is no widely-accepted methodology for payments, how do you create ubiquity?" asks Hamilton.

In developed markets, on the other hand, banking as an industry is not suffering from a shortage of customers and there are universally understood ways of making payments that, because of their ubiquity, are slow to change. The network effects of ubiquitous debit cards and electronic funds transfer (EFT) makes the obstacles to shifting millions of consumers on to new methods of payment almost insurmountable.

Getting customers is harder than holding them

Nothing illustrates the power of those network effects better than the failure of the threat of disintermediation by the FAANGs (Facebook, Apple, Amazon, Netflix, Google) to materialize. The main reason no FAANG has become a bank is the difficulty of detaching customers from a well-entrenched and ubiquitous network service used by nearly everyone.

"It is much easier to get people who have no service to adopt a new one than to get people off an existing service on to a new one," says Hamilton. "This is the `installed base' problem. It is not about whether the new service is better or worse - people just stick with what they know, and even more so when there is a big network effect. Put it this way: if I *know* I can pay with my bank app, but I *might* be able to pay with a social platform, depending on who I am paying, which one will I use?"

In an emerging market such as China, by contrast, where mobile usage outstrips bank account ownership, social media platforms such as AliBaba and WeChat have taken over the consumer payments market. "It is hard to see how the banks get back into ordinary consumer payments in markets like China," says Hamilton. "It provides an important lesson for other emerging markets with large populations where mobile is taking off fast. Wherever the tools of networking are available to the consumer, because of the mobile revolution, and nobody has got used to the idea of owning a bank account, what is going to happen to banks?"

This is not a question that is yet being asked of banks in developed markets. There, the challenge is to retain existing customers. The dominant banks in smaller developed markets, such as Australia, Canada and Singapore, are sufficiently concerned about losing customers to FinTechs to have worked together to place some large infrastructural bets to maintain their competitiveness.

Co-ordination to meet a common competitive threat has proved harder in other markets. It entails reaching agreement with other users of the same infrastructure, and that consensus is hard to achieve, partly because incumbents dislike sharing information with competitors and partly because they are concerned not to be susceptible to allegations of collusion.

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"The co-ordination problems translate into conservatism when it comes to market infrastructure," explains Hamilton. "It means incrementally improving networks used by everyone, rather than taking market-wide risks on radical new approaches that might or might not appeal to the entire population of banks."

Obliquely, developed market regulators reinforce this conservatism, by insisting systemically important infrastructures cannot be allowed to fail, even for short periods. "Risk can trump innovation, especially in developed markets," as Hamilton puts it. "If you are proceeding from a much lower level of legacy infrastructure, as in emerging markets, the equation is different."

Market participants must be persuaded of the case for change

But even the different equation ultimately requires the same outcome, if a market infrastructure is to change its platform successfully: the endorsement of change by market participants. "A market infrastructure needs a strong idea of why the change is going to be good for the market, and therefore for everybody, and then have that conversation with its participants," says Hamilton. That conversation always takes time.

"The participants are heavily invested in the services they offer now, and it is hard to ask them all to change at the same time, simply because you want to do something transformative with the platform," explains Hamilton. "Even if a sizeable proportion of the participants think your plan suits their strategy, you can guarantee an equally sizeable group will take the opposite view. You are never going to get them all singing from the same hymn sheet at the same time."

This is an observation rooted in experience. Hamilton spent a decade in clearing and settlement at the Australian Stock Exchange (ASX), where he helped the Australian equity market migrate to CHESS, then the state-of-the-art in securities settlement: an electronic name on register system, instead of a depository. "It was a significant network transformation that had to be agreed by a large number of people," recalls Hamilton. "It took sustained persuasion by the ASX over a long period of years to get everybody to buy into such a (then) radical concept."

As CEO of the Australian Payments Network (APCA) for the subsequent ten years between 2006 and 2016, Hamilton had a similar experience in the payments industry. He worked with the Reserve Bank of Australia and the major Australian banks on the New Payments Platform (NPP), the next generation real-time payments infrastructure that went live in Australia in February this year.

Clearly a glutton for campaigns of persuasion, Hamilton is now joining the same debate in South Africa, where the Payments Association of South Africa has an ambitious modernization programme. From his Johannesburg office he can see that, when it comes to a major infrastructural upheaval, the similarities between developed and emerging markets are more obvious than the differences. "The conversation with the banks in Africa about changing the infrastructure to keep up with technology is in this respect the same as in a developed economy," says Hamilton. "It requires sustained, inclusive debate over long periods of time."

Infrastructural change must fit participant strategies

Where developing markets do differ is in the ranking of policy priorities. Developed market regulators emphasise efficiency, competition and innovation, which are relatively easy for commercial banks to understand and incorporate into the development of their businesses. But they also worry about systemic risk and consumer protection and can impose costly and less efficient requirements on payments networks as a result.

Emerging market regulators are less concerned about systemic risk, and more interested in including consumers than protecting them. They are readier to allow market concentration to occur, provided it is associated with financial inclusion and deepening, and are usually supported in that policy by non-governmental organizations (NGOs) and development agencies. "Neither Ali Baba nor mPesa would have

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prospered under a formal, risk-averse, European style of regulatory structure,” says Hamilton.

Incorporating measures to counteract systemic risk and protect consumers, or to include and deepen involvement in the financial system, are bound to jar with the purely commercial imperatives to generate revenue and make profits. Yet a successful campaign to shift a market on to a new technology platform requires that these conflicting interests be reconciled.

A transition to a new platform cannot succeed without a high degree of congruence between the ambitions of regulators, financial market infrastructures and commercial banks. Yet consensus is hard to achieve, even among banks. “You often hear complaints that all big banks think the same,” says Hamilton. “That is not my experience. In fact, the biggest challenge is they all have different opinions. They all think quite differently about where their strategic interests lie.”

While strategic variation is the lifeblood of an open market – no market can work without different firms offering different services and trying to differentiate themselves from their competitors – it does inhibit consensus on infrastructural change. “Any transformation of the underlying infrastructure – the network – requires the members of the network to have some form of strategic view in common,” says Hamilton. “They do not have to have the same strategy, but they do have to agree that the change you want to make is a net positive for their business.”

In his experience, market participants can never be persuaded to change at the same time, no matter how appealing the prospects after the transformation is complete. The temptation is to accelerate change by regulatory intervention. Hamilton urges people not to succumb.

Do not ask regulators to accelerate change

“I am not a fan of using regulation to short-circuit the persuasion,” he says. “The reason for that is that compliance is not the same as commitment. In my experience, if you tell a bank to do something because it is a regulatory requirement, they will do so, but only in a way that formally meets the strict letter of the law. They are commercial organizations. What they want to spend their money on is not compliance but developing their products and services and winning new customers. It is much better if they can see what you are trying to do with the network is a genuine business opportunity for them. Then you get a completely different level of engagement.”

Where regulators can get involved constructively is in encouraging innovation, including by opening market infrastructures up to new entrants. But Hamilton warns that even “enabling” regulatory measures of this kind can backfire, by increasing the size of the interest group that is dependent on the technology currently used by the market infrastructure.

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Open networks, not incumbents

One model Hamilton likes is IndiaStack. Initially inspired by a regulator, the Unique Identification Authority of India (UIAI), IndiaStack is a set of APIs that allows government, corporates and start-ups in India to provide payments services across a common digital infrastructure. It facilitates competition between incumbents and new entrants without enlarging the interest group invested in the old infrastructure.

In the developed markets of Europe, by contrast, the European Union (EU) has opted to foster competition not by creating a network open to all-comers, but by making it easier to detach customers from existing providers through the second Payment Services Directive (PSD II).

Hamilton knows which he prefers. “IndiaStack has opened up access not to each bank but to the

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payments network," he explains. "The beauty of this is that you can now do a WhatsApp payment or a Google payment on your preferred social media platform but using your underlying bank account. You are no longer required to put money into a digital wallet on your social media platform. It creates competition not by opening up established banks to competition for their customers, but by allowing both new entrants and incumbent banks to compete for customers across a common digital infrastructure."

As Hamilton points out, even an apparently novel idea such as IndiaStack does not require the leaders of financial market infrastructures to undergo a mental revolution. He likens modern infrastructure to a railway network in which the track and the rolling stock are owned by different companies, but both contribute to the safety and reliability of the service delivered to the customer. The infrastructure sets minimum standards for safety, reliability and resilience, while allowing multiple competing and complementary services to flourish on top of the same infrastructure.

The "overlay services" provided by Australian banks, but facilitated by NPP, are a contemporary instance of this brand of thinking. Hamilton argues that "layering" to separate the definition of the customer experience from the safety, reliability and efficiency of the underlying platform will be a part of every new payments market infrastructure in the future.

However, Hamilton does place limits on the risks market infrastructures can assume. "The track can assume certain types of liability, but it cannot assume total liability for every transaction because somebody else has always had a hand in it," he argues.

It is a reminder that infrastructures should remain exactly that: a foundation for risk-taking enterprise, not risk-taking enterprises themselves. Their triple responsibilities are to implement the minimum standards regulators have devised to protect investors, to deliver the services their users expect efficiently and to ensure there is no interruption to the services. "Otherwise," notes Hamilton, "the only responsibility of a market infrastructure is to leave the market as open as possible to allow new types of services to develop."

Occasionally, it will prove impossible for a market infrastructure to fulfil its core responsibilities of safety, efficiency and reliability, and remain open to any newcomer that does not imperil the soundness of the whole system. The cause will usually be technological.

"Whatever your particular problems are, there is an overriding imperative for every market infrastructure," concludes Hamilton. "You do actually have to engage in network transformation at various points. There will come a point where you cannot put it off because the technology has changed and customer expectations have evolved. It might be hard, but that is not a reason for not doing it."

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