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Opening Zengin System to nonbanks would reshape competitive landscape in Japan's payment services market

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Executive Summary

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The Japan Fair Trade Commission recently released research on competition policy measures to spur growth in FinTech-enabled financial services. The reports may be the opening salvo in a major competition-policy shakeup in the financial sector. With the competitive landscape changing dramatically amid ongoing unbundling of financial functions, a newly formed task force is set to redesign the Zengin System, Japan's interbank payment clearing system. Its progress is worth following.

JFTC drops a bombshell

In April, the Japan Fair Trade Commission (JFTC) created a stir in the financial sector by releasing findings on competition policy measures to spur growth in FinTech-enabled financial services. The JFTC studied and published separate reports on the state of competition in two markets: cashless payments (particularly QR code payments) and personal budgeting apps. The reports specifically raise concerns of Antimonopoly Act violations.

Both reports question whether a fair competitive landscape exists between new entrants and incumbent financial institutions. The research was conducted largely through surveys and interviews with a wide range of stakeholders including FinTech entrepreneurs, executives of incumbent financial institutions and IT vendors. The reports will likely have a major impact on the financial sector's competitive landscape going forward.

Antimonopoly Act concerns raised by JFTC

The report on personal budgeting apps notes that banks have the upper hand over app providers in terms of access to account information. It strongly warns against acts that unfairly disadvantage new-entrant service providers. It also mentions the risk of banks' existing IT system providers attempting to impede banks from offering new functionality (particularly APIs) by, for example, refusing to disclose system specifications or demanding a tie-in between the new functionality and the existing system.

The second report on cashless payments notes that banks are in a position of control over the accounts into which the public's wages are direct-deposited and which are the ultimate funding source of essentially all payments made by consumers. It describes the market's competitive structure as hierarchical, with banks and cashless payment services respectively situated "upstream" and "downstream" of each other, except in the case of certain banks that offer their own cashless payment services and therefore compete horizontally with cashless payment providers.

The JFTC urges banks to recognize that, like in the budgeting app space, they enjoy a superior bargaining position by virtue of being upstream. Considering that cashless payments compete with banks' core EFT (electronic fund transfer) services, the report cautions that acts such as unjustly refusing to reload payment apps with customer funds or charging unreasonably high fees may constitute abuse of banks' superior bargaining position.

For banks that horizontally compete with cash payment services, the report warns that acts such as refusing access to customer accounts or demanding unreasonable concessions for such access may constitute restraint of trade or abuse of a superior bargaining position.

Another issue addressed by the JFTC is the fee structure for payments between bank accounts. While fully recognizing the societal importance of financial industry's payment infrastructure, the JFTC finds the status quo problematic in two respects. First, Japan's two major payment infrastructure providers, the Zengin System (Japan's domestic interbank payment clearing system) and CAFIS (Credit and Finance Information System), are both naturally monopolistic, shielded from competition by a formidable barrier to entry in the form of heavy initial investment requirements. Second, interbank EFT fee rates have remained unchanged for the past 40 years even though they theoretically should have been reduced by economies of scale as transaction volume grew. The report dictates that the "set and forget" attitude toward interbank EFT charges, a cost ultimately passed through to customers/end-users, raises questions about governance and transparency deficiencies in the financial industry.

Competitive landscape is being reshaped by unbundling of financial services

The catalyst that prompted the JFTC's research on cashless payments and budgeting apps was the ongoing unbundling of financial functions. Payment processing, originally the exclusive province of banks, was opened up to non-banks by the Payment Services Act. In a sense, the Payment Services Act enabled payment processing, synonymous with banks' EFT services, to be unbundled from banks' previously intertwined trio of core functions, the other two of which are deposit taking and lending.

Today's payment services, however, mainly intermediate fund flows that originate and terminate in bank accounts. Payments usually originate from bank accounts because the only legal means by which wages can be paid electronically is EFT into a bank account. On the receiving end, payments' final destination is usually a bank account because cash is still much more widely accepted than cashless payments. Money loaded in a payment app account can be spent only at in-network merchants, while cash can be spent on anything (like, e.g., rent). Payment app balances also cannot usually be directly withdrawn as cash at a bank without first being transferred into your bank account.

For cashless payment services to gain equal footing with banks, they would have to have access to the Zengin System to directly process payments between bank accounts. Such access, however, has hitherto been restricted to banks and for several legitimate reasons.

One such reason is that the Zengin System should not be accessible to companies that do not meet robust security standards. Secondly, payment processing typically entails systemic risk. Thirdly, banks typically have maturity mismatches between their deposits and loans, necessitating the establishment of the Deposit Insurance Corporation of Japan to prevent bank runs. The Zengin System, whose membership consists solely of banks and which was optimized to its member banks' operational characteristics, did not initially envision the emergence of nonbank new entrants.

Specialized cashless payment services' advent, however, has substantially changed the Zengin System's standing. The Zengin System is being called upon to transform from an exclusively interbank network to an open-access platform that provides new payment functions. On May 22, the Japanese Banks' Payment Clearing Network, the entity that operates the Zengin System, announced it had established a task force to draw up plans for a next-generation payment system. We intend to closely monitor the task force's progress, including on the governance front.

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