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1. Co-badging woes: Visa versus CUP and BC Card

On February 11th the USA brought a complaint of Visa to the World Trade Organization (WTO).[1] The USA wants China to open access to its card market, in line with its obligations under Articles XVI and XVII of the GATS (General Agreement on Trade in Services). The matter will be handled via the usual dispute resolution mechanism of the WTO. On 25 March 2011, the Dispute Settlement Body (DSB) established a panel and on 4 July 2011, the Director-General composed the Panel.

The US government criticizes Chinese regulations that allow only China UnionPay (CUP) to supply electronic payment services for payment card transactions denominated in Renminbi in China. Others can only supply such services for payment card transactions in foreign currency.

Visa itself has also been active. The company argues that international transactions involving co-badged CUP-Visa cards must be routed through VisaNet.[2] It has threatened to fine banks that do not comply. So far, however, Visa seems to have been reluctant to fine Chinese players. But Visa has acted against the South Korean card scheme BC Card, which is a partner of CUP.[3] BC Card allowed holders of CUP-Visa cards to by-pass VisaNet when carrying out transactions in Korea. Similarly, holders of BC-Visa cards may use the Star network when withdrawing cash in the US. Visa argues that this is a breach of contract and has fined BC Card. BC Card in turn, has appealed to the Federal Trade Commission of South Korea (South Korea's antitrust watchdog) arguing that Visa is abusing its market power.

[1] DISPUTE SETTLEMENT: DISPUTE DS413, China — Certain Measures Affecting Electronic Payment Services (http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds413_e.htm)
[2] See Dominic Hirsch: Winners and losers from China UnionPay and Visa spat, (http://www.atmmarketplace. com/blog/5808/Winners-and-losers-from-China-UnionPay-and-Visa-spat)
[3] See Kwaak Je-yup: Is Visa predatory?, (http://www.koreatimes.co.kr/www/news/nation/2011/08/182_92308.html)

Our Comment

Co-badging is an uncomplicated matter when the two brands on a card do not compete. Thus, in France or Germany, most card holders own a card that displays two brands – a local one and an international one. For many years this has worked without producing any major conflicts. The reason is simple. The schemes behind the brands agreed on clear rules like "local brands for domestic transactions, international brands for international transactions". However, once the brands in question start to compete, the relationship becomes more prone to conflict.

In the case described above, Visa would like to handle domestic transactions in China and CUP has found partners that allow it to circumvent Visa for international transactions. Thus, both have become competing brands. We have repeatedly argued that co-badging of competing brands may be conflict-prone and that it may not be viable in the long run.[4]

In addition, the case has domestic US implications. CUP and BC Card have partnered with (mostly) domestic US schemes such as Pulse and Star. These schemes can improve their product offering by providing their customers with a more international offering. Thus, partnerships with players such as CUP or BC Card enhance their competitive position vis-à-vis MasterCard and Visa in the US market.

2. The evolving regulation of co-badging in the USA and the EU

As reported in our July newsletter, the Federal Reserve (Fed) has made co-badging compulsory for debit cards. The new regulation of the Fed also explicitly rules out scheme rules that restrict the co-existence of brands on a debit card: *"Network rules or contract provisions limiting or otherwise restricting the other payment card networks that may be enabled on a particular debit card, or network rules or contract provisions that specify the other networks that may be enabled on a particular debit card."*[5] Thus, in the future, we will see competing brands on US debit cards. This may include cards with both, a Visa and a MasterCard brand (for instance, Visa signature debit and Maestro).

European regulators have not gone that far. However, the ECB sees co-badging (or "co-branding") as an important medium term strategy on the way to "SEPA for cards": *"For an*

[4] See, for instance, the May and September 2007 issues of this newsletter.
[5] See Federal Reserve System, Debit Card Interchange Fees and Routing, § 235.7(a)(2)(iii). (http://www.federalreserve.gov/newsevents/press/bcreg/20110629a.htm.)

interim period, co-branding is necessary until more choices emerge with additional card scheme(s).'[6] The Dutch anti-trust authority NMa goes one step further. In its "2010 Vision Document on the Payments Market".[7] The NMa argues that co-branding with competing brands would foster competition and states that it will continue to monitor the market and take regulatory action if necessary. Thus, European regulators may adopt some of the regulations of the Fed. So far, however, they have not yet voiced support for a mandated co-badging. Thus, issuers are likely to remain free to put a single brand on a card.

Our Comment

On both sides of the Atlantic, regulators seem to think that co-badging of competing brands is a good thing. Therefore, in all likelihood, we will soon see a card with both, a Visa and a MasterCard brand. Truly, an innovation!

The regulation of interchange fees has absorbed almost all of the attention given to card regulation. However, in the long run, current developments in the field of the regulation of co-badging and application selection/routing restrictions may have more fundamental effects. "Gresham's law of payments"[8] *would no longer hold. Rather, those brands would be used at the POS that are the cheapest for merchants. That could easily lead to a "race to the bottom" for interchange fees. In such a case, maximum fees set by regulators would become irrelevant.*

In Europe, a likely response of issuers would be the return to single-branded cards. In the US, however, such a move is made impossible by regulation. At least in the case of debit cards, there have to be two unaffiliated brands on each card. But since the Fed's regulation only applies to debit cards, a potential reaction of issuers would be to promote credit cards at the cost of debit cards.

However, such moves might simply trigger another round of regulation. In Europe, regulators could follow the example of the US and mandate co-badging. In the US, regulators could extend current rules to credit cards.

[6] ECB, 7th SEPA Progress Report, October 2010, p. 22

[7] NMa: Visiedocument Betalingsverkeer 2010, Den Haag, December 2010. (http://www.nma.nl/images/Visiedocument_Betalingsverkeer_december_201022-157764.pdf)

[8] This „law" has been formulated by the Governor of the Reserve Bank of Australia, I.J. Macfarlane. It says „that the most expensive way of paying was driving out the cheaper ways." (I.J. Macfarlane: Gresham's Law of Payments, Talk to AIBF Industry Forum 2005, Sydney, 23 March 2005.)

But before moving along on the regulatory spiral, regulators should contemplate the issue anew and ask themselves if it really fosters competition to have competing brands on one card.

3. M-Payments: the acquiring side

M-payments are all the rage. As 10 years ago, the mobile phone captures the imagination of many market participants and market observes. And again the mobile phone is predominantly seen as a consumer device and correspondingly as a potential replacement of the payment card. Little noticed are developments on the acquiring side of the market. The mobile phone is increasingly used as low cost payment terminal for POS payments. To name just a few examples, in Germany: B+S, ConCardis and TeleCash; in Spain: Euro6000; in the US: Square. In most cases, no additional hardware is required. Apart from the mobile phone and an acceptance contract, merchants only need to download a payment application. In case of Square, the phone is converted into a simple form of POS terminal via a card reader that is connected to the phone. So far, Square seems to be the most successful supplier with a transaction volume of approximately USD 100 million in July.[9] Square plans to expand outside the US in 2012.

Our Comment

It is yet too early to draw any conclusions. But current developments show that there may be a strong business case for m-payments in a segment that went mostly unnoticed: the merchant side of the market. If merchants do not have to buy expensive terminals and if they can carry out software updates by themselves, card acceptance becomes much cheaper. Consequently, the range of potential card acceptors becomes much larger than it used to be. This is good news for merchants, card holders, schemes and issuers. For PSPs on the acquiring side, the implications may be less favourable. Renting and servicing terminals may become a shrinking business segment. But, there are still some important issues to be addressed.

First and foremost, there is the security issue. Payment terminals are sophisticated pieces of hardware and software that do not come cheap. But there is a good reason for that: security. We have all learned that a flexible and intelligent device like the PC that is capable of running

[9] See Square Now Processing $4 Million In Mobile Payments Per Day (http://techcrunch.com/2011/07/31/square-now-processing-4-million-in-mobile-payments-per-day/)

new programs is very convenient. But we also learned that convenience comes at a cost. Intelligent machines can get infected and do things we do not want to do them. The smarter mobile phones get and the more they are used for payments the bigger the danger becomes that they also will be infected by malign viruses. Given this threat, it remains to be seen whether the smart phone will become a payment terminal used beyond the segment of small traders with a low payment volumes.

Like PayPal, Squares is another example of the successful use of the sub acquiring model. Square allows merchants to accept credit cards without entering into an explicit contract with an acquirer. Only under certain conditions do merchants have to enter into a contractual relationship with the acquirer with whom Square works (Paymentech). One wonders whether an upstart like Square would also have been possible in Europe. A European player would be required fairly soon to become a payment institution. For a young company this may be quite a hurdle that could slow things down significantly. Moreover, compared to the US, the European card market remains fragmented.

Should you have any questions or comments please contact

Dr. Hugo Godschalk (hgodschalk@paysys.de)
Dr. Malte Krueger (mkrueger@paysys.de)
Christoph Strauch (cstrauch@paysys.de)

PaySys Consultancy GmbH

Im Uhrig 7
60433 Frankfurt / Germany
Tel.: +49 (0) 69 / 95 11 77 0
Fax.: +49 (0) 69 / 52 10 90
e mail: info@paysys.de
www.paysys.de

PaySys Consultancy is German member of

epca
european payments consulting association

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