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1. **The proposed Regulation on Interchange Fees**
2. **New Study of the Social Costs of Cash and Cards in Germany**

1. The proposed Regulation on Interchange Fees

On July 24th, the EU Commission finally published the long-awaited proposal for a regulation on interchange fees (IFs) for card-based payment transactions (Proposal).[1] The interchange caps proposed by the Commission are the expected rates of 0.2% for debit card transactions and 0.3% for credit card transactions. In addition the Commission wants to restrict a number of "restrictive business rules and practices". On the whole, the proposal of the EU Commission constitutes a drastic intervention into the card market. Therefore, it is worthwhile to take a closer look at the most important elements of the proposed **price-regulation** as well as at the justification of the Commission for taking such a far-reaching step.

We will discuss the heavy regulation of the **business rules** (like co-badging, choice of application, Honour All Cards Rules etc.), which is also part of the proposed regulation (Chapter III), in our next newsletter. This part of the regulation could have much more impact on the card market than the price-regulation. One thing is certain, this part of the regulation cannot be entered into force on the twentieth day after publication of this regulation (as planned somewhere in spring 2014), even if all stakeholder would support it and will already start the implementation today.

But let´s have a look first to the proposed price-regulation of the IFs.

<u>The EU Commission's general case against IFs</u>

The Commission basically restates the (in)famous "Gresham's law of payments", first formulated by the former Governor of the Reserve Bank of Australia, Ian Macfarlane.[2] : This

[1] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on interchange fees for card-based payment transactions, Brussels, 24.7.2013, COM(2013) 550 final.
[2] Gresham's law of payments, address by Mr IJ Macfarlane, Governor, to Australasian Institute of Banking and Finance Industry Forum 2005, Sydney, 23 March 2005.

"law" implies that scheme competition for card issuers leads to higher fees rather than lower fees. Therefore, the Commission does not want to rely only on competition to force interchange fees down (Proposal, p.2).

According to the Commission, IF plus other restrictive business rules and practices lead to:[3]

- higher retail prices for all customers
- reduced innovation
- lack of choice of service providers, including on a pan-European level
- limitations on x-border acquiring
- limitation on entry by new schemes
- disappearance of national card schemes

The EU Commission hopes that regulation will

- create a level playing field
- take away market fragmentation
- lead to wider choice of PSPs for consumers and retailers
- create more innovation
- create benefits for merchants and consumers

Below, we will take up these issues in more detail.

IF-regulation rather than MIF regulation

The proposed regulation covers interchange fees (IF) rather than multi-lateral interchange Fees (MIF). Article 3 sets a cap for interchange fee offered or requested by payment service providers regardless whether such a fee is bi-laterally agreed between two PSPs or multi-laterally agreed between PSPs or the fee is set uniformly for all issuers by a payment card scheme. Moreover, according to article 5 (prohibition of circumvention) "any compensation received by an issuing bank from a payment card scheme [...] shall be treated as part of the interchange fee". That means that even if a scheme would agree individual rates with particular issuers, the cap will apply.

Initially, the European commission - like national competition authorities around the globe - were concerned about the multi-lateral setting of interchange rates which was supposed to violate European (and national) competition law. We never recognized that bi-lateral

[3] Proposal, p. 3-4.

agreements of an interchange fee were considered by the authorities to be anti-competitive as well. On the contrary, the German cartel office is requesting German merchants and issuers to proceed with bi-lateral agreements of interchange fee for the local debit scheme ec cash. The card organizations again and again made the point that bi-lateral agreements of IF would practically not work due to complexity and the pure number of participants, but it never was mentioned that even bi-laterally setting of IF's would be prohibited as well. In the MasterCard case also the setting of a fallback interchange fee was recognised to infringe European competition law, not the interchange fee as such.
Some years ago - as multi-lateral agreements of Interchange fee was prohibited and bi-lateral setting was considered to be practically not operable in large scale - we discussed a model of "5-party card schemes" in contrast to 3- and 4-party card schemes where the scheme (as fifth party in the model) would individually negotiate interchange rates with issuers and acquirers. In the proposed 5-party-model, the scheme would earn interchange from acquirers and pay interchange to issuers on its own commercial risk. That time we considered this model as compliant with competition principles and personal communications with representatives of competition authorities confirmed or view. Now according to the proposed regulation the cap would also apply to this model.

Following the long and exhaustive discussion about interchange fee, we expected from the EC to propose a regulation which will provide legal clarity for setting **M**IF's in a manner which complies with principles of competition. We could imagine price caps for MIFs or the mandatory provision of a sound methodology like the Merchant Indifferent Test (MIT) for setting MIF's. What we really not expected was the recent turn of the Commission to direct regulation of IF. So the intervention into the market is far more reaching than we ever expected from previous explanations and communications of the commission about the objectives and the rational of regulation.

<u>The proposed caps for debit and credit card transactions</u>

As in the past, the EU Commission uses the Tourist-Test or Merchant Indifference Test (MIT) methodology to justify the values of 0.2% and 0.3%.[4]
"*The 0.2% and 0.3% caps envisaged are based on the so-called 'Merchant Indifference Test', which identifies the fee level a merchant would be willing to pay if he were to compare*

[4] See also June 2009 issue of this newsletter.

the cost of the customer's use of a payment card with those of non-card (cash) payments. The figures were calculated on the basis of this test, using data gathered by four national central banks. These figures have been accepted by Visa, MasterCard and the French domestic card scheme Groupement Cartes Bancaires." (Proposal, p.16)

It is laudable that the Commission wants to use a (more or less) sound methodology. However, it is difficult if not impossible to derive these two figures from published results of cost studies made by central banks. By the way: Some of the published figures would imply much higher interchange fees![5] Moreover, the Commission is currently conducting a cost-study to produce a firm empirical basis for its interchange regulation. Therefore, it is somewhat surprising that it proposes a regulation before this study has been completed.

So what remains is the impression that the two values of 0.2% and 0.3% are simply the result of a negotiation process between the Commission and the schemes. For regulating interchange fees the Commission shifts obviously tacitly from the MIT-methodology to a "negotiation-with-one-stakeholder-group"-methodology. Are the other stakeholders (merchants and consumers) happy with this simple approach?

<u>Different time lines for x-border and national transactions</u>

The proposed IF caps would apply to x-border transactions two months after the entry into force of the proposed regulation (Proposal Art. 3 (1)). National transactions would be included two years later. Thus, there is a transitional period of 22 months for national transactions. According to the Commission, the different treatment of national and x-border transactions has the following reason:

"As a consequence of unilateral undertakings and commitments accepted in the framework of competition proceedings, a large number of cross-border card payment transactions in the Union are already carried out respecting the maximum interchange fees applicable to the first phase of this Regulation. These elements can therefore be introduced rapidly. However, domestic interchange fees would need to be modified. It is therefore necessary to grant a transition period for domestic payment transactions." (Proposal, p. 15)

This seems plausible. However, there is a problem. The definition of „x-border" applies to the two payments service providers – not at payer and payee.

"Cross-border payment transaction' means a card payment or card-based payment transaction initiated by a payer or by a payee where the payer's payment service provider

[5] See June 2013 ("New cost study") issue of this newsletter.

and the payee's payment service provider are established in different Member States or where the payment card is issued by an issuing payment service provider established in a different Member State than that of the point of sale" (Proposal, Art. 2 (8)).

So, if there are higher national interchange fees, foreign acquirers will enter the market and offer fees based on the lower x-border MIFs. Thus, right from the start, both – x-border and national interchange fees – will be affected by the proposed regulation in the same way. Interestingly, the Commission is aware of this because it points to the example of direct debit interchange fees. These have been regulated in a comparable fashion. As the Commission points out, the French banks have agreed to reduce the national interchange fee to zero, well ahead of the deadline of the end date regulation (Proposal, p. 15). Thus, it is difficult to understand why the Proposal contains different timelines for national and x-border transactions. The consequence of transition period would be a competitive disadvantage for small and medium-sized retailers and for (small) local acquirers, who are not able to move their headquarters to Luxembourg, Cyprus or Malta in order to offer its local merchants the regulated lower XB-MIF for their domestic transactions during this 22-months-period. However, less competition as result of well-intentioned market regulation is not a new phenomenon. The only winners of this self-defeating game of musical chairs are big acquirers, lawyers and moving companies.

The effects on consumer welfare

Although the Commission sometimes fails to mention that lower interchange fees may lead to higher card fees, it is careful to study the question in some detail in the Proposal (p. 10-12) as well as in the Impact Assessment.[6]

The Commission particularly looks at the experience in Australia and Spain and concludes that card fees may rise but that merchant fees and, as a result, final retail prices will fall.

"From evidence in Australia, it seems that retailers would benefit integrally (100%) from lower IFs – as acquiring markets tend to be more competitive than issuing markets, whilst the potential increase in cardholder fees is limited to 30-40% of the amount of the IF decrease." (Proposal, p. 12)

However, the Commission admits that it is difficult to draw firm conclusion from a few individual country cases. This is certainly true. For instance, it is by no means clear that the

[6] Commission Staff Working Document, Impact Assessment, Brussels, 24 July 2013, SWD (2013) 288 final, p. 209 – 211.

level of competition in retailing is generally high in all European countries. Conversely, competition in card issuing may be high in some countries. Take the example of Germany, where a large number of specialized issuers have captured an impressive share of the market. Some did so with an aggressive pricing policy, including no-fee cards. Such offerings would be hard to sustain in a low interchange environment. Thus, in any market with such offerings, fee hikes are bound to occur.

The effect of lower MIF on card acceptance

When considering the effects of lower MIF on issuers and consumers, the Commission also points out that lower MIF may lead to wider card acceptance. Wider card acceptance, on the other hand, may have a positive impact on issuers (Proposal, p. 10). In this context, the Commission mentions "scale effects". One could also argue that wider acceptance makes the card more useful for cardholders and thus increases their willingness to pay. As the Commission rightly points out, the evolution of the Spanish card market in recent years can be interpreted in this way.[7] Thus, a reduction of MIF may not be as harmful for issuers as often claimed. It could even be beneficial.

Interchange fees, market entry and innovation

The EU Commission repeatedly argues that high interchange fees restrict market entry and reduce innovation (Proposal, p. 3 and 14). Moreover, it argues that high interchange fees of some schemes have led to the disappearance of low-fee national schemes.

The mechanism behind this seems to be the alleged working of "Gresham's law of payments" cited above:

"*Interchange fees also restrict market entry as their revenues for issuing payment service providers function as a minimum threshold to convince issuing payment service providers to issue payment cards or other payment instruments, such as online and mobile payment solutions, offered by new entrants.*" (Proposal, p. 3)

This argument does not take into account that the payment market is a two-sided market. High fees for issuers do, indeed, make it difficult to attract issuers. But such fees make it easier to find acceptance points because merchants can be offered lower fees. Moreover, new entrants in the online or mobile market often follow the 3-party model. They are acting

[7] The study analyzing the effects of the Spanish interchange reductions are discussed in the December 2012 and January 2013 edition of this newsletter.

as sole issuer and acquirer. Take PayPal, for example, the most successful internet payment provider launched within the last decade. For PayPal, high fees have made it easier to enter the market. Conversely, the existence of convenient low-fee schemes such as iDeal has made it difficult for PayPal to enter the respective market. Thus, lower interchange fees may make it hard for new entrants to enter the market.

So, on the whole, the argument presented by the Commission is not convincing, at all. This becomes particularly clear, when considering the example of iDeal which the Commission uses to support its point that low interchange fees promote innovation.

"*A real-life example of this, for interchange fees below 0.2%, is the Netherlands, where the cheap online payment solution (Ideal) was developed largely because the low interchange fees prevailing there encouraged banks to innovate. In consequence, Dutch consumers do not have to pay high credit card subscription fees in order to shop online.*" (Proposal, p. 12)

First, it is stated that there is an interchange fee below 0.2% in the Netherlands. It is certainly true that there was (and still is even after the swift to the international debit card schemes) a comparatively low interchange fee for debit card transactions in the Netherlands. At the time of the establishment of iDeal, Dutch consumers used the PIN scheme of Dutch banks. But this scheme was a POS scheme that could not be used on the internet. Why should the interchange fee of such a scheme matter for internet payments? Second, it is stated that there were "high subscription fees" for Dutch consumers who wanted to use credit cards on the internet. According to the argument of the EU Commission, such high fees should have prevented issuers (the Dutch banks) from offering new and cheaper means of internet payment. But the reverse was true. In spite of high credit card fees, the Dutch banks offered a new and relatively cheap internet payment system probably cannibalizing their revenues from the credit card business.

Interchange fees and the exit of low-fee national schemes

The EU Commission not only argues that high interchange fees prevent market entry, it also argues that such fees have led to the disappearance of low-fee national schemes. Referring to high interchange fees, the Commission states:

"*This also explains why in a number of Member States, national (normally cheaper) card schemes have tended to disappear.*" (Proposal, p. 4).

This statement is really surprising. After all, low-fee national schemes such as the Dutch PIN scheme and the Finnish Luottokunta have been thriving in times of generally high interchange fees of the international schemes. The political pressure to become SEPA-compliant (including the implementation of EMV) and the offer of low interchange fees of the international schemes have finally led to their disappearance. So, the responsibility lies with politics – not with high interchange fees. The termination of the low-fee debit card schemes was the result of the end-of-national-schemes mantra of the SEPA-policy, initiated or at least strongly supported by the Commission itself!

2. New Study of the Social Costs of Cash and Cards in Germany

In May 2013 the Center of Payment Studies of the Steinbeis Research Center for Financial Services in Munich published the results of the analysis of the social cost[8] of cash and card payments in Germany, based on market figures of 2011[9]. The result shows the total cost of cash amounting to 10.8 billion Euro compared to 0.8 billion € for cards (debit cards, credit cards and retailer cards). Although Germany is still a cash dominated market with huge volumes, the unit cost per cash transaction are twice the costs of a card payment (0.59 € respectively 0.28 €). Considering the different average transaction value (ATV) of cash and card transaction the gap of the unit costs in % of the ATV widens into 4.49% for cash and 0.47% for cards. From a marginal costs perspective a cash transaction would only be cost-efficient for low value payments below 6.20 €. The authors conclude: "Contrary to the widespread opinion cash is – from an overall economic point of view - not the best payment instrument."[10] To steer consumers and retailers into the "right" direction they suggest incentives and regulation to reduce the cash payments (increase of ATM fees, lower limits for cash transactions, prohibition of cash usage in vending machines etc.).

Our comment

The results of the Steinbeis-study are surprising. Economies of scale are a crucial driver regarding cost figures of payment instruments. The predominance of cash in Germany should result into relatively low unit costs for cash and high unit costs for cards compared to other European countries. Last year the ECB published an extended social cost analysis of

[8] Social costs: the total sum of the pure costs of producing payment instruments within the relevant segments in the market (central bank, banks, retailers and consumers). The costs incurred by consumers are usually not considered. Transfer payments between the segments (e.g. fees paid by merchant to banks) are excluded.
[9] Cost of Cash, Status Quo und Entwicklungsperspektiven in Deutschland, Munich 2013
[10] P. 12.

cash and cards, based on figures of 2009 of 13 EU member states[11]. Germany did not participate, but some giants in card payments did e.g. Denmark, Netherlands, Finland and Sweden. It should be expected that the new Steinbeis figures of the unit costs of cash will be lower than the weighted average of the other 13 member states or at least more or less the same. But the result of Steinbeis is exactly the opposite. The unit cost per cash transaction in Germany is 40% higher than the weighted average for this European sample. Based on a percentage of ATV, the cash cost in Germany (4.45%) are almost 100% higher than the average (2.30%) and therefore the highest in Europe. In the card segment exactly the same contradiction is evident. According the Steinbeis-study Germany seems to have one of the most cost-efficient card schemes in Europe with only 0.47% social cost per Euro spent compared to 1.70% of the European average and even more than 40% lower than the most efficient scheme of the ECB sample (0.80%; probably Netherlands or Denmark?). That is really surprising.

Unit social costs		
	Cash	Cards
per transaction (in €)		
ECB 2012 (2009)	**0.42**	**0.99**
- max	0.78	8.07
- min	0.13	0.22
Steinbeis 2013 (2011)	**0.59**	**0.28**
per 1 € of sale (in %)		
ECB 2012 (2009)	**2.30%**	**1.70%**
- max	3.40%	8.10%
- min	1.30%	0.80%
Steinbeis 2013 (2011)	**4.45%**	**0.47%**

So what could be the (premature) conclusions?

- Economies of scale have obviously no relevance in the payment market,

- The ECB-figures are wrong,

- The Germans spent all their efficiency efforts in card schemes by totally neglecting the cost savings potential in the cash area.

[11] ECB (2012), The social and private costs of retail payment instruments – A European perspective, Occasional Paper Series No. 137, September 2012. We discussed this ECB study in our newsletter of October 2012.

Should foreign card experts visit Germany to investigate this miracle of "made in Germany"? Before doing so, let us have a closer look to the assumptions of the Steinbeis-study.

Crucial for unit cost calculations are the volumes. For both payment instruments the study considers only the transactions in the German retail trade, excluding hotels, restaurants, travel, public transport, vending machines, leisure & entertainment, P2P-payments (which is strongly dominated by cash), repair services by craftsmen etc. Therefore approx. 35% of the transactions are missing at the cash side according figures of the German Bundesbank. At the card side the study neglected approx. 37% of the card transactions with a value of 100 billion €. The assumption of a cash ATV of 13.20 € is definitely too low regarding the extended empirical investigations of cash transactions issued by the Bundesbank (published in 2009 and updated in 2012), which showed an ATV of approx. 20 € per cash transaction in both cases. Taking these improved metrics into account, the results of the Steinbeis-analysis will change dramatically. The amended unit cost of cash will bring Germany more into line with the weighted average figures of the ECB for other European countries. But considering the total volume of card payments including the missed 100bn € (267bn € vs. 168bn € as assumed in the Steinbeis-study) the unit cost per card transaction would fall to a totally unrealistic level compared to the ECB-figures. Is Germany the lonesome efficiency champion in the card payments league?

What about the cost components considered by Steinbeis? By issuing 129m cards the cost of the issuing and acquiring banks are limited to the production of plastic and embedded chips, estimated by the Steinbeis-analysts at 129m € p.a. (1 € per card p.a.). That´s all! No cost for card issuing & acquiring processing, authorization, fraud, bad debt, interest for delayed payment, front/back office customer service for merchants and cardholders, charge backs, marketing, clearing & settlement etc are regarded in this result. Several hundred million Euros are missing in this cost template for the banking sector! On the merchant´s side the cost for approx. 350,000 terminals are missing, which will generate social cost of about 80m € p.a. The internal merchant cost for the ELV scheme and retailer cards are interpreted as transfer payments (fees) to the banking sector (a curious assumption of the Steinbeis-study!) and therefore not considered as social cost. But these cost are also not counted in the banking sector or somewhere else! Obviously nobody has to bear these cost. As consequence: another 115m € should be added. What about the cost of issuing and acquiring of private label cards outside the retailer segment (like fuel and trucker cards), *which are not considered at all? So forget the fairy tale of Germany being the most cost-efficient card market in Europe as the Steinbeis-report is connoting.*

Based on the remarkable findings of this study the banks´ yearly revenues of retailer fees in card business would be added up to 665m € with cost of 129m €. Even without any revenue from the cardholder (annual card fees etc.) card business in Germany seems to be an exorbitant profitable business. If German banks took the results of this study seriously, they could be very relaxed regarding the upcoming IF-regulation of the Commission.

LETTERS TO THE EDITOR:

Please, send your comments to: sepa-newsletter@paysys.de.

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
email: info@paysys.de
www.paysys.de

PaySys Consultancy is German member of

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european payments consulting association