Topics of this issue:

1. **EuroCommerce on the basic payment application**
2. **New study on the effects of mandatory decrease of interchange fees in Spain**

1. EuroCommerce on the "basic payment application"

The basic payment application (BPA) was promoted by EuroCommerce in their response to the Green Book. Additionally, EuroCommerce has published a briefing and discussion paper[1]. We have already discussed some aspects of the BPA in previous issues of this newsletter. Whereas in previous issues we focused on policy issues we now want to discuss some more operational aspects. Below, we are taking up a number of issues raised by EuroCommerce.

EuroCommerce on similarities between the BPA and debit cards

EuroCommerce describes the BPA as being "very similar to the basic debit function on current bank cards", noting the following similarities:

- "Contains a payment guarantee for the merchant;
- On-line real-time authorisation;
- Option of real-time transfer;
- Totally secure and trusted by the consumer."

Our Comment

We would like to point out that the above stated similarities with debit cards require a complex technical infrastructure as employed by debit card schemes. Payments like the German ELV, which is mentioned later in the paper, are definitely not a blueprint for such a BPA. A BPA with the above mentioned features would require the implementation of the same security measures, the same certifications etc. as the existing card schemes.

EuroCommerce on the universality of service

"Universally available across Europe: the same payment method on any card, mobile phone or electronic device regardless of which bank, phone or provider you use."

[1] EuroCommerce, Introducing the basic payment, 2012 <http://www.eurocommerce.be/doc.aspx?doc=paymentsystems/q-and-a-basic_payment-16.10.2012.pdf>

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Hugo Godschalk, Malte Krueger, Christoph Strauch

Our Comment

This point can be interpreted in different ways:

1. *Every bank must offer a "basic card" with the BPA on it as one product; besides, consumers are free to select other cards.*
2. *Every bank must issue a "basic card" to every bank account, such that every consumer owns at least a "basic card"; besides, consumers are free to select other cards.*
3. *Every card must contain the BPA, besides other payment applications, which means that every card is "co-badged" with the BPA.*

EuroCommerce seems to have the third interpretation in mind. It would mean, for instance, that monoline issuer of credit cards, T&E card issuers or issuers of 3-party store cards are also obliged to issue cards with BPA on it. However, these types of cards are not necessarily linked to an account which can be addressed via an IBAN.

EuroCommerce on affordability

"Affordable: all merchants – big and small – could afford it: - it can be accepted everywhere by all retailers who wish to accept electronic payments."

Our Comment

The "affordability requirement" raises the question about an acquiring function for the BPA. If there is an acquiring function in such a BPA scheme, this requirement could be understood as an obligation to contract. Accordingly the (technical, operational and commercial) terms and conditions for acceptance of the BPA must be regulated as well. If the BPA is meant to function without the role of an acquirer, this requirement would imply that there is a kind of basic infrastructure which enables acceptance of the BPA and can be used by all retailers. Again, this requires regulations of terms for using this infrastructure and it requires an institution which runs the infrastructure.

EuroCommerce on competition

"Competitive: it would be open to non-bank payment providers – such as retailers - so it would increase competition and innovation."

Our Comment

We are not sure how this requirement should be understood. Thanks to the PSD, all card acquiring services are open to non-bank payment providers, namely to payment institutions. The roles of non-registered providers is limited by the PSD and this will obviously also hold for providers of the BPA. Pure technical providers, e.g. for terminal services, already do not need a license as payment institution. So does this requirement mean that the BPA lacks the *function of an acquirer and is provided as a pure technical service? We wonder whether this is in line with the proposed attribute "totally secure and trusted by the consumer". Anyway, together with the point above we believe that the concept of a BPA needs a clear idea of the underlying business model, which is in line with the regulatory environment.*

EuroCommerce on technology

“Independent of technology: it will be available on cards, mobile phones and any new technology that could appear in the future.”

Our Comment

We already commented the requirement of "universal availability". We understand the requirement of independence of technology as referring to the backend processing as described below in the discussion paper. So it appears that the heart of the basic BPA consists of the provision of an "access to account information" service and a clearing and settlement service - completed by the provision of the data which enable the use of these services on every card and other devices.

EuroCommerce on “How to make this happen”

“... Every payment provider who offers any type of payment tool would have to include this ‘level one’ payment option.”

Our Comment

We strongly disagree with the view that the BPA could be implemented as a sort of "level one" payment option in the meaning that all other related services are additional to the BPA. In reality, various card payment systems differ from each others with regard to features like speed, irrevocability, refund terms, transport of additional data, level of privacy, use of particular processing procedures and systems etc. All of the above features, which together make a card payment system, cannot be separated into a "basic payment operation" and "additional services". The combination of these features, <u>in total</u>, defines a payment scheme. It does not make sense to label some of these features as "basic" and then to define all of the other features as "additional". The BPA proposed by EuroCommerce would have to be implemented as one particular payment scheme beside the existing card payment schemes. We accordingly propose the view that a BPA would have to be implemented as a "scheme" of its own rather than an unbundled payment operation which could be processed within each card payment scheme. Given that EuroCommerce wants regulation to ensure universal availability of the BPA the result would be a general obligation to contract with the "BPA card scheme" for all payment providers.

EuroCommerce on the “access to account information”

"The bank could charge a reasonable fee for this service. The consumer's bank could

ringfence those funds for a period of time to allow clearing & settlement to take place in order to guarantee payment."

Our Comment

The idea of access to account information has extensively been covered in the document of the European Commission and the European Parliament.[2] *Just a side note, we do not understand what the difference is between an "interchange fee" and a "reasonable fee for this service". Effectively, the retailer pays a certain amount of money to the issuer for the authorisation and processing service. It is similar to the former cost-based interchange methodology of the regulators, which was also referring to some dedicated costs of the issuers.*

EuroCommerce on Clearing and Settlement

"This essential element of the payment chain is operated by clearing and settlement mechanisms (CSMs) and currently only useable by banks. Card scheme rules tie the banks to using particular CSMs. If this closed system were opened to competition and nonbanks could choose a CSM to use directly, …"

Our Comment

Basically this defines two requirements: Card schemes should open up backend processing to CSM's and CSM's should be open for the direct use of non banks. The first requirement is not really new and already in the focus of regulators, so it does not appear to be specific for a BPA. The second point is difficult to understand. If the BPA is a "way to transfer money from the consumer's account to the account of the merchant" (as stated in section 1), there will always be a bank which is part of the process. If retailers can directly access CSMs they would be able to submit the clearing files to a CSM rather than to a bank. But what is the benefit of direct submission when the funds are ultimately credited to ta bank account?

[2] See European Commission: Green Paper "Towards an integrated European market for card, internet and mobile payments", 2012 and European Parliament: Card, Internet and mobile payments. European Parliament resolution of 20 November 2012 on 'Towards an integrated European market for card, internet and mobile payments' (2012/2040(INI)).(http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2012-426).

2. New study on the effects of mandatory decrease of interchange fees in Spain

Spanish economists have published a study on the effects of interchange regulation on the Spanish card market.[3] The regulatory changes in Spain took effect over a period of five years: 2006-2010. The authors provide some interesting estimates of the effects of regulation on the card market. In this period, there was a 57.3% average reduction in Interchange and a 51.3% reduction of merchant service charges (MSCs). At the same time, card fees paid by consumers rose by 50%. Moreover, consumers had to pay more for overdrafts and card rewards were reduced. There is no evidence that merchants passed on the cost savings to the consumers.

Over the 5-year period

- The interchange reduction amounted to €3.329 billion
- The MSC reduction amounted to €2.749 billion
- An increase of card fees amounting to €2.350 billion

The authors also argue that

"The reduction in interchange has clearly harmed consumers by raising cardholder fees and reducing card benefits."

"There is no evidence that consumers have benefitted from lower prices following the reduction of interchange fees."

"The Agreement has altered the four-party system, affecting competition and reducing incentives to innovate."

"The Agreement has slowed down cash displacement."

Some of these findings are particularly interesting for regulators. For the industry, the most important result is that the interchange reduction has hurt the card business of 4-party card schemes. However, as will be argued below, this claim does not seem to fit the facts.

Our Comment

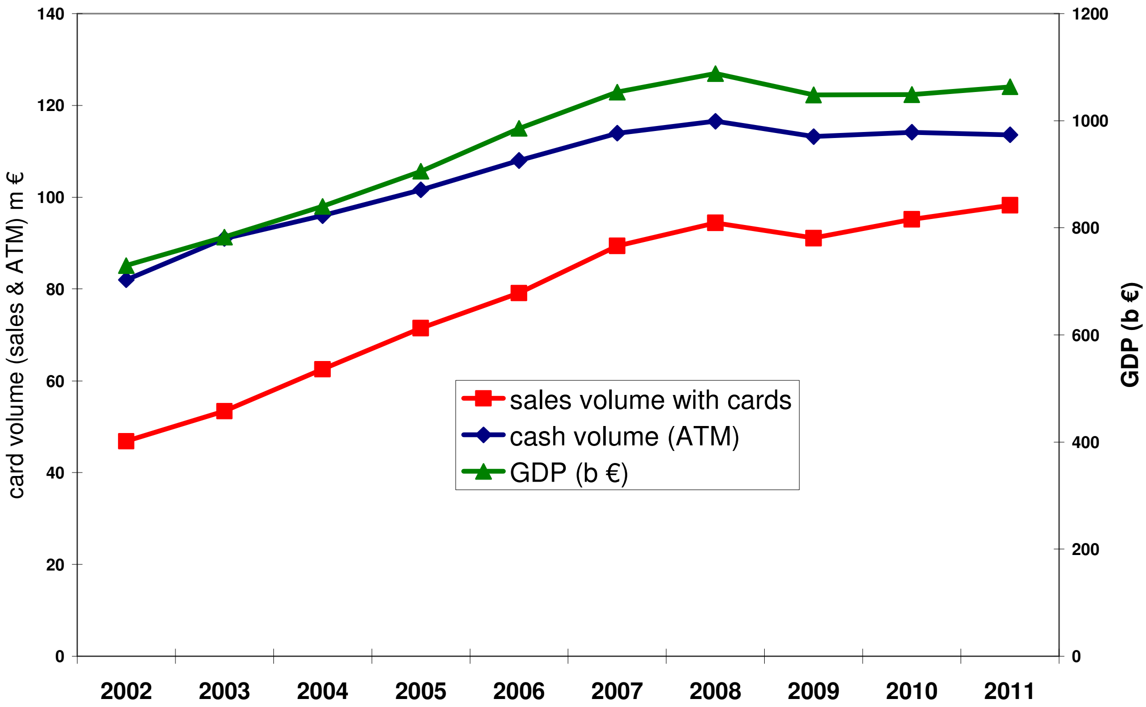
The argument: the reduction of interchange has caused slower growth in the Spanish card market (Study 2012, p. 16)

In the period 2006 – 2008, in Spain, the card payment volume at the POS continued its medium-term growth path. In this period, there is no evidence of a negative influence of the

[3] Juan Iranzo, Pascual Fernández, Gustavo Matías and Manuel Delgado: The effects of the mandatory decrease of interchange fees in Spain, 2012 (Study June 2012). Another version of October 2012 is downloadable: http://mpra.ub.uni-muenchen.de/43097/1/MPRA_paper_43097.pdf

interchange or MSC reduction on the sales volume at the POS – in spite of the fact that the mandated interchange reduction was particularly strong in this period (interchange 2005: 1.55%; 2008: 0.81% and 2010: 0.64%). In the period 2001 – 2008, card payment volumes <u>and</u> the volumes of cash withdrawals at the ATM both grew continuously. The (presumably) temporary stagnation of sales' volumes in 2009 is clearly due to the financial crisis and the ensuing economic depression (see chart). In Germany and in other European countries where there was no interchange regulation, the sales growth of card payments at the POS was also interrupted in 2009. Thus, the main driver of the slow-down in card payment growth seems to have been the financial crisis.

Chart 1 Evolution of the Spanish card market



Source: Study 2012 and Bank of Spain.

There is also little evidence to support the claim that the reduction in interchange has led to higher withdrawals of cash and thus higher use of cash as a means of payments.

The argument: The reduction of the average transaction value (ATV) proves that card payments have been hurt by the reduction in interchange (Study 2012, p.20 and p. 39)

In the study, a particular reference is made to the decrease in the average sales value (ATV) for card payments (2005: € 52.1, 2010: € 44.3) and the increase in the average cash *withdrawal amount (2005: 91.2 € 2010: € 117.2).*[4] *The authors use these figures to strengthen their case that the interchange reduction has slowed down card spending and promoted cash use. However, it is not clear at all why a reduction of ATVs should prove their point. The lowering of ATVs in a growing card market is a normal process that can be observed in many card markets. When card usage spreads from the T&E sector to other sectors with low ATVs (eg food retailers) the average value of a card payment declines. In Germany, for instance, the ATV fell from € 65.78 (2005) to € 60.25 (2010) (Source: ECB). Therefore, the reduction of ATVs should be seen as an indicator of growing card use. The reduction of MIF, and thus of MSCs, resulted in higher card acceptance as witnessed by the growth of the POS terminals in the period of the agreed interchange reduction. Consequently, the reduction of ATVs suggests that the interchange reduction in Spain has led to a further expansion of card payments in low-price segments.*

The argument: The reduction of interchange has hurt the card business in 4-party card schemes (Study 2012, p. 39)

Under the assumption of no profitability of the banks involved (issuers & acquirers) and constant card transactions an interchange reduction inevitably leads to a relieve of the acquiring side and an additional burden on the cardholder side. The key question is, however, whether the new balance on both sides of the market leads to a change in the overall credit card spending and a change in total profitability (of the issuers and acquirers). This effect is dependent on a number of factors that are different and hardly predictable per national card market: price elasticity of cardholders, competition between providers on both sides of the market, competition with other payment media, expansion of acceptance, etc. In the past, the card schemes and the card issuers have often expressed fears that an interchange reduction will affect the card business negatively because a higher financial burden on the cardholder side would lead to a lower card usage. Regulators (such as the European Commission), however, have assumed high profit margins of the card issuers. Therefore, regulators were confident that an interchange reduction would mainly reduce the profitability of card issuers. So what has been the impact of the interchange reduction for the Spanish card business?

- *The study shows that Spanish issuers were able to compensate lower interchange income in the period with higher annual cardholder fees (change of average fee per*

[4] First of all, the numbers are not quite correct. The correct figures for ATM cash withdrawals are 106, 11 € (2005) and € 115.62 (2010). The authors seem to have confused data from different years.

card per year 2005-2010: debit card: + € 6.18; credit card: + € 11.45). The feared price-induced decline in card sales failed to materialize, however. On the contrary, the card portfolio increased over this period by 6.5 million cards (+ 10%). Within the entire card stock, there was even a shift from the less expensive, the debit card (- 3.2 million) to the relatively expensive credit cards (+ 9.7 million including delayed debit cards). The market share of credit cards in 2010 is approximately 60% (2001: 50%). This atypical reaction of market participants suggests a very low price elasticity of consumers or a low level of competition on the issuing side.

- *The revenues of card issuers (interchange plus annual fee and interest income) increased not only in total from € 2.9 billion (2005) to € 3.5 billion (2010), but also per issued card (+ 5 € per year). Assuming constant costs, the profitability of the issuing business must have improved. Banks also increased the interest earned from revolving credit from € 660 million (2005) to € 960 million (2010) which amounts to an increase of 45%.*
- *On the acquiring side, the card business used to be unprofitable. According to the study, in 2005, interchange fees (1.55%) were higher than the average MSC income (1.52%). Because many acquirers were also active as issuers, the deficit of € 21.4 million (2005) was probably cross-subsidized by revenues of the issuing business. In addition, acquirers receive income from the terminal business. Given the actual development of the card market, without interchange reduction the deficit would have accumulated to about € 580 million in the period 2006 -2010. However, the interchange reduction has led to a positive spread between the acquirer MSC-rate (2010: 0.74%) and interchange (0.64%). The accumulated income from this margin is approximately € 450 million. On the acquiring side, the interchange reduction thus led to an overall improvement in revenue of around € 1 billion in the period under consideration.*

Conclusion: In the period 2006 - 2010 the interchange rates in Spain have been steadily reduced from an average of 1.55% to 0.64%. This led to financial savings for card-accepting merchants and an additional burden of cardholders. In spite of the emergence of the financial crisis, in this period, the number of cardholders increased (+ 10%), the number of POS terminals increased (+ 25%), the card transaction at the POS increased (+ 36%), the issuer revenue per card increased (+ 12%), and the income of the acquirer from the margin MSC/interchange increased by about € 1 billion.

From the perspective of card issuers, the acquirers and the national or international card schemes, this development is very encouraging. Given the Spanish experience, these players in the card business do not have to be concerned with respect to any interchange regulation of the European Commission. In fact, such regulation may even have positive effects for them. Of course, one should not rely too much on one example. Still, the Spanish experience with regulation remains interesting, It shows that a shift of costs from the acquiring side to the issuing side need not lead to lower card holder demand and a deterioration of the card business.

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