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1. **European acquiring: Do the banks sell out?**
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3. **Consumer price effects of mandatory interchange fee reductions in Spain**

1. European acquiring: Do the banks sell out?

Yet another large US payment processor has set its sight on Europe. Within a few weeks EVO Payments International announced the acquisition of Deutsche Card Services, a wholly owned subsidiary of Deutsche Bank, and the acquisition of a controlling interest in Banco Popular's merchant acquiring business in Spain (both deals are subject to regulatory approval). In both cases, EVO and the selling bank agreed to a future acquiring cooperate.

EVO is a privately held payments processor and acquirer. EVO serves nearly 300,000 merchants processing nearly $28 billion in annual processing volume and nearly 385 million transactions.[1]

Meanwhile, in Austria the sale of PayLife Bank, the Austrian acquirer and card service provider seems to come to an end. The Swiss Six Group is rumoured to be the successful bidder.[2] There is still some uncertainty, though, because Raiffeisen Zentralbank (RZB) has a right of preemption and has not ruled out that it will make use of it.

Our Comment

In recent years, we have seen a number of deals in which banks have (partly) sold their acquiring businesses to third parties.

In 2010, there were three deals

- *the sale of payment services provider RBS WorldPay (with its acquiring arm "Streamline") to private equity firms Advent International Corporation and Bain Capital Investors.*
- *the sale of Montrada to Equens.*

[1] See https://www.goevo.com.
[2] See Paylife geht an Schweizer Six-Gruppe, 28. Jänner 2013 (http://derstandard.at/1358304850725/Paylife-geht-an-Schweizer-Six-Gruppe)

- *Global Payments buys a controlling interest in La Caixa's merchant acquiring business in Spain (both becoming co-owners of "Comercia Global Payments")*

Some of these deals have been triggered by the financial crisis and the banks' struggle for capital. Regulation has also played a part. But the large number of deals also brings up a fundamental business issue: What is the relationship between banking and acquiring? Sometimes even banks do not seem to know the right answer.

Take Deutsche Bank, for example: For many years owner of 50% of the PSP Pago, it purchased the other 50% in 2008 and took Pago inhouse, re-branding it as "Deutsche Card Services" (DCS). Less than 5 years later, the whole venture is sold to an American PSP.

So why should a bank be in the acquiring business? First may aspire to offer acquiring as a profitable business. Second, it may wish to prevent clients from switching to other bank-owned acquirers (which might also try to steal other business). But the problem is that success in acquiring requires scale and focus. For an individual bank it is difficult (but not impossible) to reach the required scale. Therefore, in many cases, banks have put the acquiring business into a co-operative venture, either bank-PSP or interbank. Co-operative efforts of the banks are increasingly running into anti-trust problems, however (see PayLife case mentioned above). That opens the door for third party providers – either as co-operative partners or independent providers.

Given the existing regulatory and financial pressure, we may see more such deals in the future. For the moment, there are still some large bank-owned processors with European ambitions on the buying side (as for instance, Equens buying Montrada or Six potentially buying PayLife). But scarcity of capital may tempt banks to sell these as well – or at least the acquiring bits.

2. Australian debit: Reversal of interchange

eftpos, the domestic debit card scheme in Australia has changed its interchange structure. The body governing the scheme (ePAL) announced a new multilateral interchange fee structure in March 2011.[3] It replaced bi-lateral interchange fees and came into effect in October 2011. For participants that do not opt-in, the bi-lateral agreements will remain in place. ePAL says that the new fee structure is meant to encourage investment into eftpos enhancements, such as mobile and online payments.

[3] See Payments System Board, Annual Report 2011.

The new standard rate is:

- 5 cents from acquirer to issuer for purchases above A$15.
- 0 cents for purchases below A$15 without cash-out, charity payments and Medicare Easyclaim.
- 15 cents from issuer to acquirer for purchases with cash-out and cash-out-only transactions.

In April 2012, ePAL announced the introduction of ‘differential’ merchant rates to take effect from 1 October 2012. These rates imply lower purchase fees and higher cash-out fees for strategic merchants.[4]

Our Comment

In theory, interchange can flow either way: from acquirer to issuer or from issuer to acquirer. In practice, however, most schemes apply an POS interchange fee that is paid by the acquirer. Thus, an interchange from issuer to acquirer seemed to be more an idea from the ivory tower of academic economics. However, theorists could always point to one prominent example with an interchange flower the other way round. That was the Australian “eftpos” system. In this system interchange (agreed bi-laterally) was paid by the issuing banks. This set-up had been chosen to encourage merchants to invest in card acceptance.

Until 2009, eftpos lacked a governing body and consisted mainly of bi-lateral agreements and some common rules. The Payments System Board, the Australian payment regulator was concerned that this set-up would be unable to compete with the international schemes and pressured banks to convert into a full-blown scheme. The banks obliged and in 2009 ePAL was founded as governing body for eftpos. In the light of competition coming from the international schemes and the need to upgrade the systems, ePAL decided to introduce a MIF flowing from acquirer to issuer.

It seems difficult to please regulators. MIF from acquirer to issuer is often deemed “too high” and regulated downward. MIF itself is seen as problematic because it seems to contain an element of collusive price setting. But bi-lateral fixing of interchange fees is also seen as potentially harmful for competition because some participants may get a better deal than others. Finally, regulators seem quite happy with the replacement of an interchange from issuer to acquirer by an interchange going the other way.

[4] See Payments System Board, Annual Report 2012.

3. Consumer price effects of mandatory interchange fee reductions in Spain

In our last newsletter we discussed the new Spanish study of the mandatory interchange reductions in Spain in the period 2006-2010[5]. The result was a not surprising: a huge shift of the costs of card payments from retailers (lower MSCs) to cardholders (higher annual fees). Within this 5-year-period, the retailers benefitted from cost savings of approx. 2.75 b. Euro.
In the view of regulators, the question arises whether the merchants´ cost savings (caused by the reduction of interchange, respectively the MSC) was passed through to consumers via price reductions or improved service. If so, all consumers would have benefitted, while only the cardholders would have borne the additional costs. This question is also asked by the authors of the Spanish study. They conclude, *"the reduction in interchange fees has had no impact on final prices: it has not been passed on to consumer"* (p. 33). In the final conclusions of this study, the authors are somewhat more cautious: *"Furthermore, there is no evidence that even a fraction of this cost savings has been passed on to consumers via reduced prices or through an improvement of the services provided"* (p. 38).

Our comment

A few years ago, this issue was already a hot topic during the interchange debate in Australia. Both, the regulator (RBA) and the card schemes tried to prove the existence or non-existence of any effects on consumer pricing after the mandatory reduction of card interchange rates. The schemes argued that there was no or little pass-through, while the RBA estimated a price-lowering effect of 1.1 b. A$ in 2007. But the Australian Payment System Board concluded that the parties could not present concrete evidence.
Statistically, it is almost impossible to identify the multiple causes of price changes and to separate and measure their individual effects. The effect of MSC-reduction on merchants' prices can statistically not be measured on the basis of the existing macroeconomic data. In Spain, the financial crisis has affected the entire economy. This also led to a deflationary development. As the authors state: "it is therefore very difficult, a priori, to strictly separate the drop in prices caused by falling demand and that which corresponds to the reduction of MSC"*. The authors' empirical studies by means of surveys of merchants and consumer*

[5] 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

organizations do not provide additional insights. The merchant organizations could or would not answer the question whether they have passed on cost savings to consumers. The 7 interviewed consumer organizations answered this question consistently with "no". However, due to the fundamental measurement problem mentioned above, the questions arises how such a firm conclusion has been reached. The consumer organizations' uniform responses are probably not only interest-driven but also qualitatively worthless for answering the questions whether there was a pass-through or not. Nevertheless, the authors simply concluded that – based on these surveys – merchants did not pass through their savings to the consumers.

Obviously, counter evidence is also missing. It is simply not possible to prove empirically whether retailers have passed on their savings or not. In an independent study, this conclusion should have been expressed more neutral. Thus, one has to rely on economic theory. Under the condition that competition and market activity are working well, standard economic analysis says that competition will reduce the temporarily interchange-induced improvement of retailer-margins over time. This should also apply in the Spanish case?

What other conclusions can be drawn? If – before regulation - on the merchant side the costs of accepting cards were higher than the costs of accepting cash and if merchants were not willing or allowed to surcharge their card-using customers, merchants had to include the extra costs in the prices of goods or services that all customers had to pay. Thus, customers who used cash paid for the (more expensive) card usage of other customers. Therefore a cost-induced shrinkage of the merchant´s prices would result in a better transparency and an improved allocation of resources. However, from a general economic point of view the allocation of costs and benefits of cards vs. cash could still be sub-optimal if, for instance, cash-usage of consumers was cross-subsidized.

Whether the cost savings of the interchange fee reductions are passed through or not, it will not affect card usage. A truly startling point that needs to be emphasised is the behaviour of card holders. The shift of the cost-burden from merchants to cardholders through higher annual fees has not had a significant impact on the growth rates of total cards issued or on card usage. Even low-priced debit cards were substituted by high-priced credit and charge cards, in this period. The Spanish card issuers were obviously able to exploit the cardholders' net-benefits from card usage. Before, this path could have been blocked by cross-subsidization or ruinous competition.

If the interchange income flow dries up, issuers have to review their pricing and product policy. If card acceptance is cheap and cards are widely accepted, the key player in the war *on cash is the (potential) cardholder and not the payee. The payer is in the driver seat. He has to be willing to pay high card fees (higher than in the past) and is thus deciding the question "cash or card". In a future with less or no interchange, card business will turn to issuer-centric.*

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

european payments consulting association