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1. **The end of the Dutch PIN system**
2. **Application selection at the POS: Merchant options**
3. **US report on interchange fees**
4. **An extra charge for the payment guarantee?**

1. The end of the Dutch PIN system

On 24 November the Dutch newspapers ran the headline “Payment with PIN will disappear in 2012”. Based on this headline one could erroneously conclude that biometric features will now replace PIN authentification. But as already discussed in this newsletter[1] the domestic debit card scheme “PIN” will be terminated and be replaced by European debit card schemes. This will occur no later than the end of 2011, much earlier than expected. Banks and retailers agreed on joining forces to complete the migration to the new EMV infrastructure for POS terminals. This agreement was based on the understanding that the retailer acceptance fees of January 2009 will be frozen until 2014. A crucial part of the joint campaign “Het Nieuwe Pinnen” (the new way of debit card payment[2]) is the subsidisation by the banks of the replacement of about 20,000 of the old POS-terminals (total terminal stock is about 240,000) with new EMV-terminals. The subsidized rebate for buying a new EMV-terminal will vary from 50 to a maximum of 500 Euro per replaced terminal. Most of the debit cards issued are already fit for EMV. The agreed deadline of EMV compliance (cards and terminals) is the end of June 2011.

Our comment:

Obviously all Dutch stakeholders are smiling at the funeral of the PIN-scheme - often described as best-of-class domestic debit card scheme in Europe. Banks are happy by avoiding the burden to build up a new European scheme together with other banks in Europe; retailers don´t care about a brand name as long as the low (flat) acceptance fees (about 5 ct. per transaction) are guaranteed and the consumers are told that the new pin-system will be much saver (no skimming attacks etc.). Consumers are told that the only

[1] See our issue from May 2009
[2] See www.hetnieuwepinnen.nl

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consequence of the new EMV chipcard is the slight change in handling the card at the terminal ("put-in" into the chipcardreader instead off "put-through" the magstripe reader). No reason for any consumer objections. Even the Dutch competition authority (Nma), who raised some preliminary objections against a common agreement to end the scheme[3], could be satisfied after a formal process of individual decisions of the banks. After the official start of the campaign on 24 November 2009 we do not even see critical statements in the press: Consensus right down the line. As long as the issuers use the former processing infrastructure of PIN (offered by Equens) nothing will change except that the brand name will be different (Maestro). It is expected that the banks will continue the issuance of Maestro cards, so banks will even maintain the common single-brand-issuing strategy. In card payments brands obviously do not have the importance often attributed to them by the brand owners. But does the brand not matter at all?

A remarkable (but until now hardly discussed) consequence of SEPA in card business is the paradigm shift from uniformity of a single domestic debit card scheme to more competitive brands at SEPA level. May be the Dutch way is showing us that this is a dead end. Would competition between issuers and acquirers not be enough - with a single scheme infrastructure as in the case of SDD and SCT, the other SEPA payment instruments?

Another lesson to be learned from the Dutch public campaign is the marketing approach chosen to introduce the new way of debit card payments. What is the story: Why is a change of the undoubtedly sucessful PIN scheme necessary? The main argument of the campaign is the EMV chip. The chip is a requirement of SEPA and it will help to avoid skimming fraud (0.023% in 2008). The old system is based on magstripe and this should be terminated latest by the end of 2011. While the campaign stresses the switch from magstripe to EMV chip, hardly a word is lost on Maestro. Only a thorough reader can find the information somewhere down the line that the shift to EMV will be realised by a change-over to a new scheme. Moreover, hardly any explanations are given. There only is a vague statement that the usage of an international scheme will raise benefits because it is used also in other countries. That´s all and probably, it is enough for users.

So the lesson learned is: Keep it simple. Don´t explain the strategic options of the Sepa Card Framework regarding the different ways to realise a SCF complied card scheme based on EMV. Don´t communicate the loss of ownership and governance if you terminate the domestic scheme. EMV and security should be the striking argument. Another argument

3 See our issue from November/December 2008.

should be the reference to European constraints. "The necessity of an early migration is due to European agreements". That´s all. Who will remember the waiver for EMV migration for the Dutch market in a footnote of the SCF?

The Dutch stakeholders seem to be quite happy. Outside the Netherlands some observers and regulators may have mixed feelings. The "American" scheme Maestro conquered an important fortification on the SEPA-map. Dutch big banks will not take an active role in the next 5 years in building up a new European card scheme, like Monnet, EAPS or PayFair.

2. Application selection at the POS: Merchant options

We have dealt repeatedly with the topic of application selection at the POS. For the moment, there still does not seem to exist a concensus how to deal with this topic. Banks mostly refer to EMV rules that have to be applied (as in the SEPA Cards Standardisation Volume) and do not seem to be willing to discuss the topic.

Retailers fear that "card holder choice" of the brand (mandated by EMV) may easily become "issuer choice". Obviouisly retailers are against such an outcome. Moreover, as Ulrich Binnebößel of the HDE (the German retailer association) stresses, retailers do not want to have a particular technical solution for card holder choice imposed on them. Rather they would like the customer to communicate her preferences to the merchant who then may push the right button.

At the moment, it seems difficult to imagine that issuers will accept such a solution. However, if it should be impossible to find a compromise, merchants may even be willing to resort to rough measure. As communicated by some merchants, they are prepared to install separate terminals at the POS – one for each brand. This would allow them to comply with EMV-rules and still decide the applicable brand.

Our comment:

Application selection is a question of utmost strategic importance. If issuers thought that they could hide the decision how to settle this problem in a technical annex they are in for a rough ride. Merchants (at least the big ones) and merchant associations are completely aware of the importance of this topic. And the comments heard from the merchant side show that they will not be willing to become hostages of the issuers.

One wonders whether issuers are equally clear about this topic. In the past, issuers had a strong position because most cards either had only one brand or, if there were two brands, there were clear rules as to which brand could be used at a particular POS and which not. Such rules have become obsolete. They are violating SEPA rules. Brands that so far co-existed without competing have become competing brands. That may shift the strategic balance in favour of merchants. If issuers continue issuing cards with two brands (co-badged cards) merchants may even consider not to accept a certain brand at all. Finally, the implementation of the PSD will give merchants the right to use surcharges to steer customers to those instruments and brands with the lowest costs. Overall, current changes seem to favour the merchant side (see table below).

Changes increasing the bargaining power of merchants

Option	Problem in the past	Change
Select brand in case that the card is co-badged	Scheme rules	Old rules have been prohibited, new rules are easier to circumvent
Do not accept all brands	Loss of many customers	If card are co-badged customers can use the other brand
Use surcharging to steer customers	Scheme rules	Anti-surcharging rules prohibited in many countries

Thus, it seems time for issuers and merchants to discuss the topic and find a compromise. A return to the old days of one terminal for each brand would be a paradox and unfortunate outcome of SEPA for Cards.

3. US report on interchange fees

On November 2009 the United States Government Accountability Office (GAO) has published a report on interchange fee.[4] Given current initiatives in the US Congress to regulate interchange fees, it is not surprising that has already received a lot of attention. Both

[4] GAO: Credit cards. Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges. Report to Congressional Addressees, November 2009. http://www.gao.gov/new.items/d1045.pdf

sides in the debate, merchants and issuers, claim that the results of the report vindicate their cases.

The report provides a broad overview of the topic but refrains from making concrete proposals. The topics covered are:

- The current level and the evolution over time of merchant fees in the US
- Costs and benefits of cardholders and other consumers
- The balance of costs and benefits of merchants
- Various options to lower interchange fees

The report mostly contains well known facts about the card market in the U.S. Interchange fees have been rising over time and there are concerns that this may signal lack of competition on the issuing side. It is pointed out that card payment systems benefit merchants in many ways but that today's costs may outweight the benefits. On the consumer side, card holders have generally benefitted from lower fees, lower interest rates and, possibly, higher rewards. But those consumers without a card might have been negetavily affected by higher retail prices.

Finally, the GAO discusses four possible ways to reduce interchange fees:

1. Outright regulation of interchange fees
2. Consumer information on interchange fees
3. Allowing merchant surcharging or non-acceptance of certain cards
4. Allowing merchants and issuers to negotiate rates

The report highlights that option 2 may not be very effective and that option 4 may be impossible to implement due to reservations of anti-trust authorities. Moreover, the GAO highlights the fact that small merchants have a weak bargaining position and may therefore be worse off. Thus, options 1 and 3 may be more effective. But the report points out, these options also present challenges for implementation. On the whole, the report does not come out with a clear position in favour of or against interchange regulation.

Comment

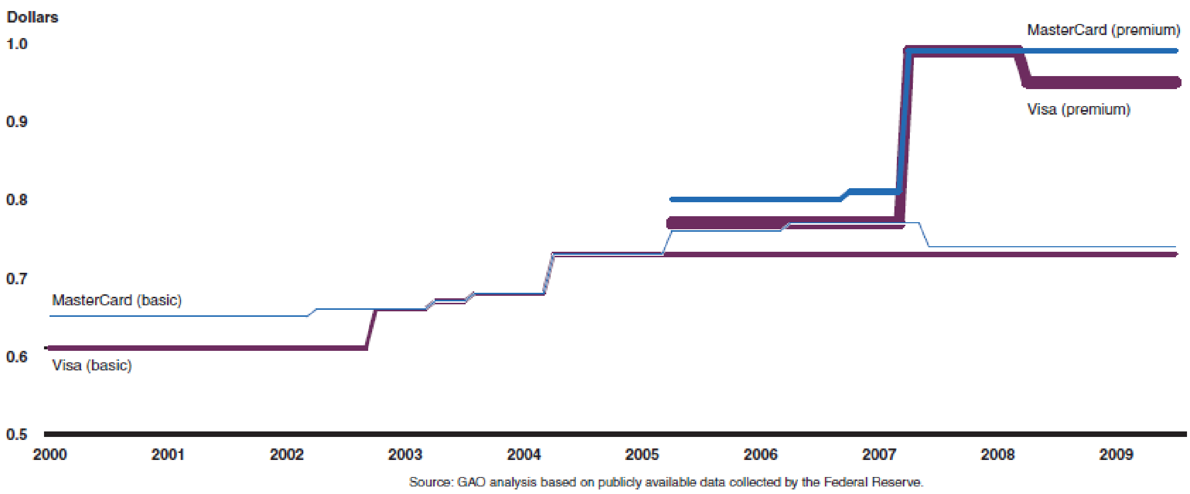
Situated somewhat between the lines of fire, the GAO has chosen not to take sides. It expresses some sympathy for action on interchange fees but it is also quick to point to potential problems, such as negative effects for small issuers (community banks or credit unions) and severe problems of implementation.

As noted by the GAO report, currently, interchange fees are subject of several federal legislative proposals. One of them, the "Credit Card Fair Fee Act", would exempt negotiations *of interchange fees between merchants and issuers from anti-trust restrictions. Moreover, it wants to make interchange fees publicly available. The second initiative, the "Credit Card Interchange Fees Act" proposes, inter alia, to scrap the "honour all cards" rule. Thus, the report can be interpreted as leaning more towards the second legislative initiative.*

In the overall battle between merchants and issuers, the GAO remains fairly neutral, however. Therefore, not surprisingly, the two sides in this battle have both interpreted the report as a vindication of their respective positions. The Electronic Payments Coalition highlights that consumers could be hurt by legislation and that merchants receive many benefits from the card payment systems. The National Association of Convenience Stores highlights GAO's concerns regarding market power in the card issuing market.

As an aside, an interesting detail of the report may be noted. In recent years, the increase in interchange fees in the U.S. has been mainly brought about by premiums cards with high card holder rewards. Could this be a model for Europe?

Figure 1 Interchange fees in the U.S.



Interchange fees displayed assume a $40 purchase at a typical merchant. Fees are reported for each month in each year. Thicker lines are for premium cards (gold or platinum cards, usually with high rewards). Source GAO: Credit cards. Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges. Report to Congressional Addressees, November 2009, page 17.

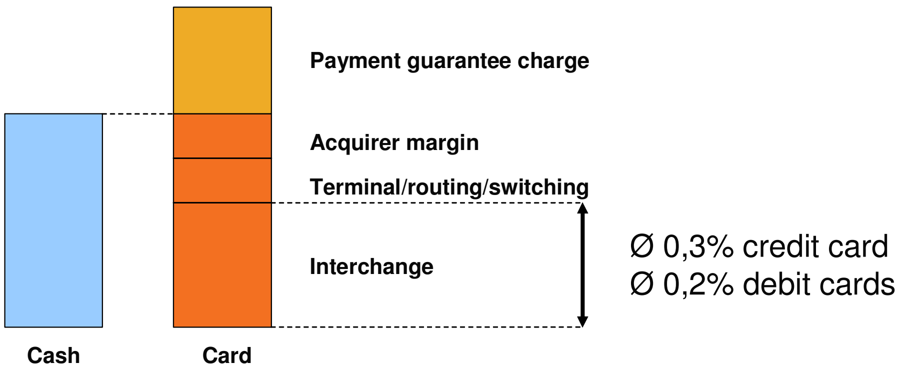
4. An extra charge for the payment guarantee?

As reported in our June newsletter, the EU Commission has proposed the so-called "tourist test" or "avoided cost" methodology for the determination of interchange fees. In order to have a sound empirical basis for the determination of the "correct" level of interchange fees, the EU Commission has commissioned a study of payment costs in 27 countries, to be completed in 2010. Meanwhile, experts have started to discuss the implications of the use of the tourist tests and possible reactions by banks. One proposal is to let merchants choose between payment with a payment guarantee and payments without payment guarantee.[5] In this case, it would be possible for issuers to determine, how much they wanted to charge for the guarantee. In this way, it would be possible for issuers to create an attractive business model in spite of lower interchange fees.

Our comment

The proposed model has its merits. As pointed out, it has - to some degree – already been implemented in Germany, where merchants can chose between ec cash, the PIN-based bank guaranteed scheme, and ELV, the signature based scheme without bank guarantee. Moreover, when chosing ELV, merchants have the possibility to buy a guarantee from a PSP. Thus, in a way, the payment guarantee has been unbundled and there is competition between different providers of a payment guarantee. The crucuial question, however, is whether issuers could receive interchange fees and, on top of that, charge for the payment guarantee. The proposal clearly suggests that the payment guarantee charge comes on top of interchange (see Figure 2).

Figure 2 Payment guarantee charge on top of interchange

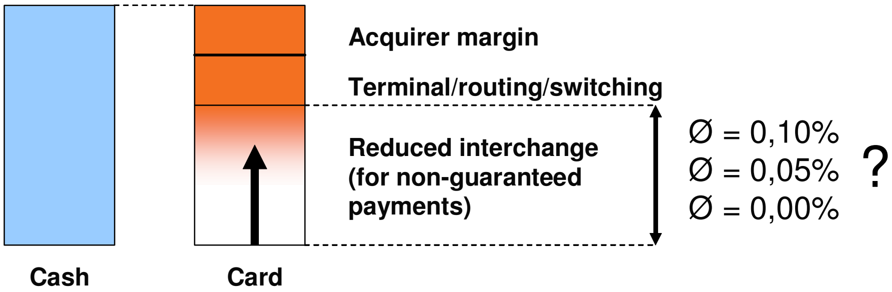


The logic of the tourist test, however, would imply a comparison of the costs of cash ("cash in hand") with a guaranteed payment, because cash as a definitive means of payment does

[5] See Peter Jones: The tourist test: time for change?, in: Payments Cards and Mobile Sept./Oct. 2009.

have a build-in payment guarantee. Thus, if the payment guarantee is provided as an extra service, the costs of the non-guaranteed payment would have to be lower. Consequently, interchange fees for un-guaranteed payments would also have to be lower (see Figure 3). When looking at the German example, we even find that the interchange fee for the non-guaranteed payment is zero.

Figure 3 Payment guarantee charge included in interchange



So, while it is definitely worthwhile to think about unbundling, the consequences for issuers may not be as rosy as currently anticipated.

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Subscription info: The PaySys SEPA-Newsletter is published 10 times a year in English in electronic format (pdf) and contains about 4-6 pages. The price is
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