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3. **The proposed SDD interchange fee: Incentive for or against SDD use?**

1. Deutsche Bank makes the case for Monnet

On the annual conference "Bankkartenforum" which took place on 18. September in Frankfurt, Herrmann-Josef Lamberti from Deutsche Bank (COO and Board Member) spoke about the recent developments in the Monnet Group. Besides some strategic considerations about necessity and objectives of the initiative he presented and explained a raw business case calculation. In the business model he compared the current profit which amounts to approx. 26mn. EUR with the profit in 2013 in two scenarios:
- an "as is" scenario: continuation of the status quo,
- a "target case" scenario: adoption of Monnet.

In the "as is" scenario current profits are eroding to a loss of -65mn. EUR in 2013, mainly due to a decrease of interchange rates. In the "target case" scenario, profits would increase eightfold, mainly due to three factors:

– cost reduction,
– adequate compensation and
– revenue from value adds.

Our comment:

Even if the detailed assumptions have not made public, the raw data presented are raising a number of questions:

The contribution of cost reductions to the positive effect of Monnet is not too large, and it is obvious that a concentration of volumes will reduce costs. More important are the contributions from "adequate compensation", amounting to the 3.5-fold rise of current profits

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(approx. 91mn EUR) and from value added services amounting to a 6-fold rise of current profits (approx. 156mn EUR).

Lamberti made clear, that "adequate compensation" mainly means "higher interchange rates". He also mentioned that the European Commission indicated that an interchange for a limited time to recover the costs for the investment into the new scheme can be allowed.

For three reasons we are not convinced that this rationale will survive a reality check:

1. *We do not believe that a higher interchange in the Monnet scheme will lead to higher profits compared to the "as is" scenario: An interchange is a balancing fee, i.e. the primary effect of an interchange fee is to balance revenues between merchants and cardholders (consumers), not to produce cartel profits.*[1]*. In a competitive market, higher income from interchange will lead to lower prices for cardholders. Moreover, to gain a profit from interchange compared to the "as is" scenario, revenues from interchange must be higher than investment costs. The EC may exempt interchange for a limited time, to recover investment costs. But we do not believe, the EC will allow an interchange which implies revenues significantly above costs. On the contrary, we believe that the EC will be concerned that interchange is well founded and strictly cost-based.*
2. *On the merchant side Monnet will compete with other schemes like Maestro where a lower interchange applies. Assumed that processing costs for Maestro and Monnet on the acquirer side are not differing too much, Monnet acceptance would be more expensive than Maestro. Accordingly, fewer merchants would accept Monnet, resulting in lower Monnet volumes. However, as Monnet is planning to co-brand cards with one of the international brands, a merchant actually would not need to accept Monnet, at all, as all cards can be accepted using the Maestro brand. To summarize, it appears doubtful to us whether Monnet will be able to gain significant higher revenues from merchants under the "all other equal" condition.*
3. *With regard to value added services, we doubt that Monnet really will provide USPs which other schemes lack. On the issuing side eCommerce and contactless explicitly were mentioned. Clearly these are innovations set Monnet apart from ec cash, but both services are already available with Maestro. To put it bluntly, no services have been mentioned which can only be realised through Monnet and not in other schemes like Maestro or even ec cash.*

[1] A correctly set interchange fee increases the use of cards and may increase profits in this way. Such profits have nothing in common with cartel profits based on a joint reduction of supply.

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2. The proposed SDD interchange fee and the meaning of "x-border" in SEPA

In our last newsletter, we reported that the EU Commission is prepared to accept a temporary interchange fee for SEPA Direct Debits (SDD).[2] In our comment, we wrote: *"In fact, in each member country, the national interchange rate would have to be equalised with the SDD rate. Otherwise there would either be different domestic interchange rates for SDD transactions within Europe or the SEPA principle would be violated."* (page 2). Having gone through the various statements of the EU Commission and the ECB, we realise to our surprise that the proposed interchange will imply just that: a violation of the SEPA principle. The idea is to have different rates for national SDD transactions and x-border SDD transactions. Thus, given that the idea will be put into practise, the situation would be as depicted in Table 1.

Table1: Direct debit MIFs during the transition period

	National Direct Debit (NDD)	SEPA Direct Debit (SDD)
domestic transaction	national MIF (zero or other)	as National Direct Debit
x-border transaction	not applicable	new SDD MIF

According to the EU Commission, there is a multilateral interchange fee for direct debits in eight countries. The sending party has to pay to the receiving party a fee that varies from 0.02€ to more than 2€.[3] Correspondingly, we would have two groups of countries, which differ in the treatment of domestic transactions (see Table 2). It is noteworthy that national MIF can be higher or lower than SEPA MIF (unless it is set below 2 cents or above 2 €).

Table 2: Direct debit MIFs – two groups of countries

	8 EU countries	The others
domestic transaction	national MIF (NDD or SDD)	zero MIF (NDD and SDD)
x-border transaction	new SDD MIF	new SDD MIF

[2] See "EU Comm and ECB support temporary debit interchange", EPSM Market Research Newsletter August 2008.
[3] EU Comm, DG Comp: INTERIM REPORT II: CURRENT ACCOUNTS AND RELATED SERVICES, Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, 17 July 2006, page 134.

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The direct debit MIF has been on the EPC wish list for a long time. Now the EU Commission has given in – albeit only to a very limited extent. The announcement comes with ties attached:

- the SDD MIFs (national and x-border) will be tolerated only temporarily
- it has to be objectively justified (i.e. it may not lead to additional profits to banks)
- for domestic transaction the current national MIF applies (which might be zero)

Thus, the EU Commission does not favour a (non-zero) direct debit MIF on a permanent basis – as the banks might have hoped for.

Our comment:

It really comes as a surprise that the EU Commission and the ECB should be in favour of a rule that implies that the SDD MIF for domestic and x-border transactions will differ. Surprise or not, what are the economic implications of such an interchange system? To answer this question, one first has to define what is meant by "domestic" and "x-border". This seems trivial, but there are at least two different definitions with different implications with respect to the consequences of the proposed MIF.

Table 3: Defining "x-border" and "domestic": an example with two countries

Company	*Company bank account*	*Customer*	*Customer bank account*	*Qualification according to def. 1*	*Qualification according to def. 2*
NL	*NL*	*DE*	*DE*	*x-border*	*x-border*
NL	*DE*	*DE*	*DE*	*x-border*	*domestic*
NL	*NL*	*NL*	*DE*	*domestic*	*x-border*
NL	*DE*	*NL*	*DE*	*domestic*	*domestic*

In the card world, one has to look at the underlying transaction between merchant and card holder in order to determine whether a transaction is "x-border" or "domestic". If the card holder's country of residence (according to the card BIN) differs from the merchant country, the transaction is "x-border". Another possibility is not to look at the underlying transaction but at the payment transaction. This is the case the EC and the ECB seem to have in mind. In this case, the locations of the bank accounts involved determine whether a transaction is domestic or x-border. In the "traditional" case, in which a corporate and a consumer maintain accounts with banks incorporated in their respective home countries both definitions yield the same result. An important difference occurs when the corporate (or the consumer) maintains

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an account with a foreign bank. In order to illustrate the difference, we have made a little model with just two countries (DE and NL), a corporate located in NL and a customer holding an account in DE (see Table 3).

Definition 1, which corresponds to the card world, implies that a Dutch company will always (indirectly) pay the x-border rate when it deals with foreign customers and always the Dutch rate when it deals with Dutch customers – no matter where the company or the customers have their bank accounts. Definition 2 would mean that the Dutch company (indirectly) pays the x-border rate when the customer maintains an account in another country and always the national rate, when the customer maintains an account in the same country as the corporate. It is questionable though, whether an interchange system based on definition 1 could be implemented in today's direct debit systems. Therefore, definition 2 seems to be more relevant when analysing direct debit interchange fees. But one has to keep in mind that definition 2 implies radically different definition of the meaning of "x-border" and "domestic" than is currently used for card payments. The fundamental difference between both definitions is that it is far easier to open a bank account with a foreign bank than to change the home country. This implies that a company is in a position to determine for itself whether it wants to carry out domestic or x-border transactions by simply maintaining accounts in the appropriate country. Again, the point can be illustrated with the help of a little model with just two countries (DE and NL).[4] In one country (DE), the national direct debit MIF is zero, in the other (NL) it is equal to b.[5] The crucial question is whether the SDD x-border MIF will be lower than b (say a) or higher than b (say c).

Table 4: Consequences of maintaining national MIFs for domestic SDD

x-border SDD MIF	***national MIF in DE***	***national MIF in NL***	***implications****
a	*0*	*b*	*incentive for corporates in NL to submit all direct debits (incl. domestic ones) in DE*
c	*0*	*b*	*no change*

*with 0<a<b<c; *: assuming that definition 2 of Table 3 applies*

[4] We are assuming that processing costs are the same for national direct debit systems and SDD. This is, of course, a strong assumption. SDD is not only more complex than most national schemes, it is also characterised by low volumes, at least initially. Thus, costs should be higher than for those national schemes with high volumes.

[5] The current rate in the Netherlands is 3.9 cents.

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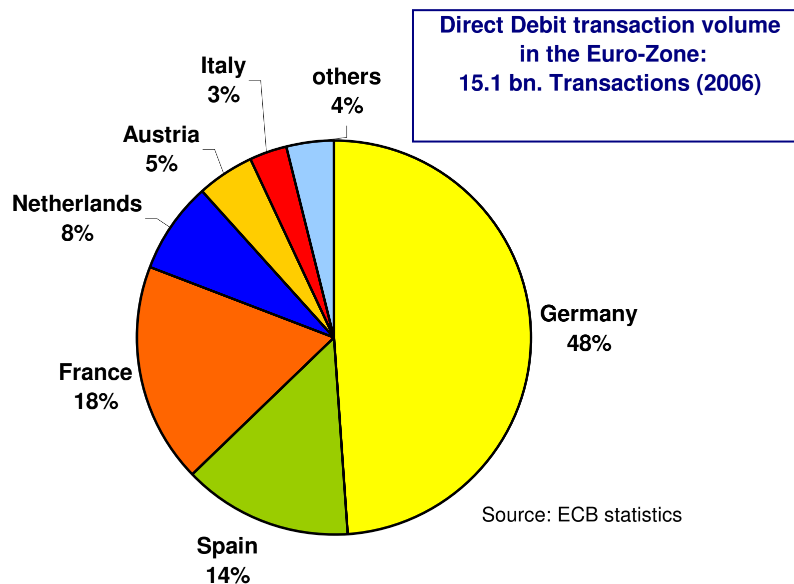
As Table 4 shows, if the Dutch MIF lies above the SEPA x-border MIF there will be an incentive for corporates to submit direct debits in Germany – if it is lower there is no incentive to migrate Dutch transactions to Germany.

This result can be generalised. For all countries with a national debit MIF higher than the x-border SDD MIF there is an incentive to submit direct debits in countries with zero MIF. If a corporate player is active in more than two markets, this player may have the choice between various countries with zero MIF. In this case, a corporate would pick the largest market in terms of transactions. Given its size in terms of people and direct debits, in many cases, this would be Germany. Thus, the proposed MIF system would provide an incentive for corporates in high-MIF countries to move direct debit submission to bank accounts in Germany.

Figure 1: Direct debits in the Eurozone (2006)



The strength of this effect depends on the differences in MIF and the differences in processing costs (see Footnote 4). Obviously, if processing costs for SDDs are higher than processing costs for national direct debits, the incentive to submit direct debits in foreign countries will be smaller.

Note that the migration effect applies independently of whether Regulation 2560 will be extended to direct debits or not. First, MIF is a price between banks. Therefore, Regulation 2560 does not apply to interchange rates. Second, as long as the ratio of x-border and

domestic transactions of a corporate customer is known, both a blended rate for domestic and x-border transactions would yield the same result as two different prices (see Table 5).

Table 5: Costs of 10 transactions under two different pricing rules

	Costs of 2 x-border transactions	***Costs of 8 domestic transactions***	***Total costs***
MIF	*a*	*b*	
Costs with separate pricing	*2(a+x)*	*8(b+x)*	*2a+8b+10x*
Costs with blended rates	*10[0.2a + 0.8b)+x]*		*2a+8b+10x*

x= other costs

Maintaining notions of "x-border" and "domestic" during the transition to SEPA does not only violate the common market principle. It is also highly unlikely that this distinction can be upheld. Once there are SEPA products in the market, the door is open for arbitrage between national and x-border transactions. This is precisely the effect, the EC has always been promoting: more competition in the internal market. Ironically, the unintended arbitrage activities would strongly promote the use of SEPA Direct Debit in those countries with a relatively high national MIF. Viewed from this point of view, the EC should set the x-border MIF to zero in order to promote the use of x-border SDDs.

3. The proposed SDD interchange fee: Incentive for or against SDD use?

The proposed SEPA Direct Debit MIF is clearly seen as an incentive for banks to go ahead with the implementation of SDD. As stated in the press release: "*In order for SEPA Direct Debit to take off, the right incentives should be in place. In particular, banking communities where an interchange fee for national transactions exists could be allowed to apply this fee as currently exists at national level also for SEPA Direct Debit transactions, but only during a limited and well defined transitional phase.*"[6]

[6] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1290&format=HTML&aged=0&language =EN&guiLanguage=en

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Our comment:

Both the EU Commission and the ECB are concerned about the problems surrounding the implementation of SDD. The announcement that the authorities might accept a temporary direct debit MIF can be interpreted as a move to help banks shoulder the burden of SDD implementation. The plan to help banks had to be balanced with anti-trust concerns. The resulting compromise is a half-house that at best will be ineffective and, at worst, will be counter-productive - contradicting the objective of the EC to give incentives to implement the SDD.

Direct debit systems, like many card payment systems, can be described with a four-party model: There are debtors (households and corporates), creditors (mostly corporates), a debtor bank and a creditor bank. Most banks usually are active on both sides of the market, submitting and receiving direct debits.

When addressing the question how to put the right incentives for the adoption of SDD in place, one first has to distinguish between

1. incentives to set up and implement the system and

2. incentives to use the system.

As to point one, all kinds of incentives are conceivable, including subsidies. But our understanding has always been that the main mechanism to push SEPA has been political pressure. In the words of Gertrude Tumpel-Gugerell: "We face a situation where bankers run the risk of not being able to deliver the direct debits by November 2009. This is not acceptable, because SEPA direct debits are a vital piece in the SEPA puzzle."[7]

However, at the same time the ECB and the EC are now contemplating "incentives". Does that mean that banks are free to decide not to implement certain SEPA products? Our understanding has always been that they are not free to choose such an option. Therefore, it is difficult to understand why banks need incentives. Another problem is the type of incentive chosen: interchange. Interchange affects the relative income on both sides of the market. The proposed interchange from the creditor side to the debtor side increases revenues for debtor banks and increases costs for creditor banks. If there is competition on both sides of the market, prices for submitting direct debits will be raised and prices on the receiving side

[7] Speech at the EPC Coordination Committee Offsite Meeting on 3 September 2008 in Château-de-Limette, Version 2, September 2008, page 4-5.

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will be lowered. So while interchange may be required to optimize market size, it is not a "reward" that can be bestowed upon banks.

When discussing the adoption of direct debits, there is a group that definitely seems to require incentives: users. If SDD is to be a success, debtors and creditors must be convinced to switch to SDD. Potential incentives are an attractive product offering and low costs – including low switching costs. Moreover, since the direct debit market is a two-sided market, not just the level of total costs is important but also the structure (debtor costs relative to creditor costs). This is where the proposed interchange fee comes in. As pointed out above, it affects the structure of prices: raising prices for companies submitting SDDs and lowering prices for debtors. Whether the resulting price structure promotes the use of SDD is open to debate. If the main drivers in the market are debtors (mostly households) it makes sense to shift costs to the other side of the market. If, however, corporates are the key players that have to be won over in order for SDD to succeed, the proposed SDD MIF seems to lower the chances of SDD to succeed. Rather, there should be a MIF in the opposite direction.

However, as in the case of card payments, it is very difficult to decide in which direction interchange should flow and how high it should be. What can be said is that an automatic conversion of existing mandates would make the corporates the ones that ultimately will decide the fate of SEPA direct debit. In this case, the proposed SEPA MIF is likely to be a burden for the implementation of SDD.

Another element of the proposed MIF scheme is the equality of interchange for national direct debits and national SDDs. Setting the SDD MIF for domestic transactions equal to the NDD MIF does not do any harm, but it also does not provide any incentive for corporates to switch (and incur switching costs) – unless regulators were highly confident that SDD provides substantial extra benefits compared to national direct debits.

On the whole, the proposed temporary MIF may prove to be a dis-incentive for corporate users and SDD implementation in general. This does not mean that MIF as a permanent balancing fee could have beneficial effects. Given the current state of knowledge, it would be difficult to say, however, in which direction such a MIF should flow.

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