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1. Card regulation in the U.S.

In 2009, Congress passed the “Credit Card Accountability Responsibility and Disclosure Act” (Card Act). The Card Act contains a large number of card holder protection measures and provides regulatory oversight to the Federal Reserve. In particular, the Federal Reserve may regulate certain card holder fees, notably late payment and other penalty fees. The Federal Reserve has published a rule that will amend Regulation Z and become effective August 22, 2010.¹ The amendment includes the following regulations:

- a prohibition to charge a penalty fee of more than \$25 for paying late (with certain exceptions),
- a prohibition to charge penalty fees that exceed the dollar amount associated with the consumer's violation,²
- a ban of "inactivity" fees,
- a prohibition to charge multiple penalty fees based on a single late payment,
- a requirement to evaluate whether the reasons for interest rate increases since January 1, 2009 have changed and, if appropriate, to reduce the rate.

In a second piece of legislation the Federal Reserve will be receiving even more power to regulate the card market. The “Restoring American Financial Stability Act of 2010” (Financial Stability Act) includes far-reaching provisions with respect to card payments, in particular debit card payments.³ The Financial Stability Act gives the Federal Reserve the authority to

¹ The new regulations are included in Regulation Z (Truth in Lending). See also the related press release: <http://www.federalreserve.gov/newsevents/press/bcreg/20100615a.htm>

² For example, card issuers will no longer be permitted to charge a \$39 fee when a consumer is late making a \$20 minimum payment. Instead, the fee cannot exceed \$20.

³ Restoring American Financial Stability Act of 2010. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173pp.txt.pdf, p. 1480-1486. The Act has been passed by the House of Representatives and is expected to be approved by the Senate in a few days.

regulate debit card interchange fees and gives merchants the right to offer discounts for particular means of payments and sets minimum values for credit card payments.

The Financial Stability Act requires debit card interchange fees to be “*reasonable and proportional to the actual cost incurred by the issuer or payment card network with respect to the transaction*”. The Federal Reserve is given 9 months to establish a standard against which current fees can be assessed. When defining these standards, the Federal Reserve has to take into account

- the similarity between debit card transactions and checking transactions and
- the actual incremental costs of the issuer (authorisation, clearing and settlement).

Costs not specific to a particular transaction shall not be considered. Prepaid cards are also treated as debit cards. Small issuers (with assets of less than USD 10 billion) are exempted.

The Financial Stability Act prohibits “non-discrimination rules” that prevent merchants from offering discounts for the use of competing payment instruments or payment networks. This regulation applies to credit cards, as well. Finally, the Financial Stability Act rules that merchants should have the right to set minimum or maximum transaction values for accepting credit cards.

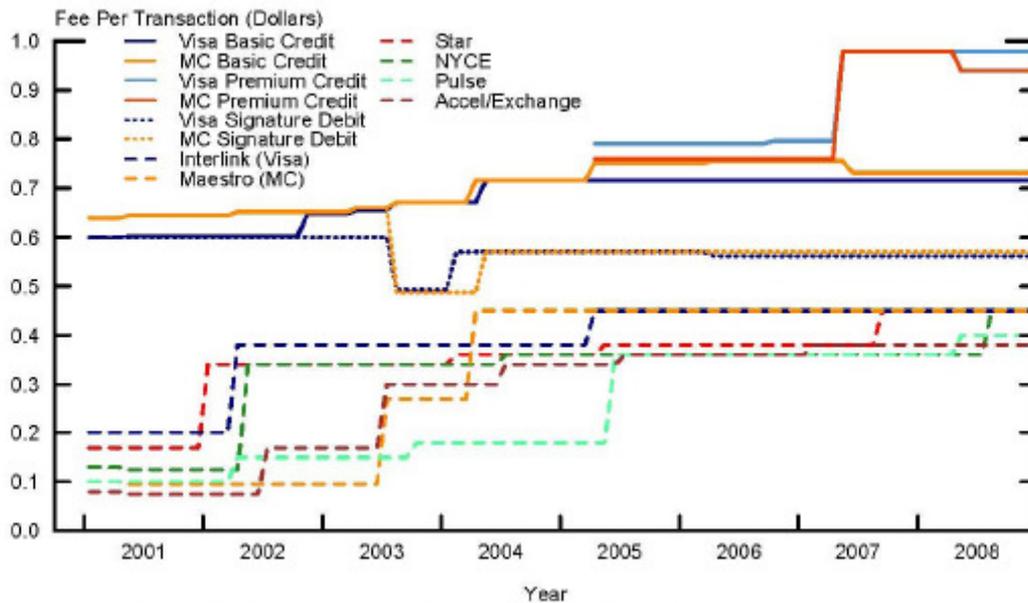
Our Comment

So far, most of the U.S. battle over interchange fees and payment card rules has been fought in the courts. But in 2009 Congress stepped in and endowed the Federal Reserve with regulatory power with respect to card payments. These powers are now about to be extended. While the 2009 Card Act can be interpreted as consumer protection legislation, the rules of the Financial Stability Act of 2010 can be seen as a kind of “merchant protection” legislation.

Evidently, from the point of view of acquirers and other service providers for merchants, the rules of the Financial Stability Act are more interesting than the Card Act. These rules are the result of successful merchant lobbying. US merchants have been battling against some of the payment card rules and against high interchange fees in the courts and in Congress. In the settlement of the so-called “Wal-Mart case” (in 2003), merchants received the right to make separate acceptance decisions for credit cards and signature debit cards. Still, card fees have continued rising and consequently merchants have continued to fight this

development (see Figure 1). Currently, a class action lawsuit against interchange fees is pending.⁴

Figure 1 Per transaction fees in the U.S.



Source: Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, and Ron Borzekowski (2009): *Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues*, Finance and Economics Discussion Series 2009-23, Board of Governors of the Federal Reserve System, p. 74

With the passing of the Financial Reform Act, interchange fees will be subject to regulation, as in some other countries. Interestingly, regulation will only address the setting of debit card interchange fees – not credit card fees. In the U.S., there are two types of debit cards, so-called “offline debit cards” (or “signature-based debit cards”) and “online debit cards” (or “PIN-based debit cards”). Offline debit cards are Visa or MasterCard branded and carry relatively high interchange rates (on average about 2%). Online debit cards can be used on networks such as Interlink, Star, NYCE and others. Interchange for online debit transactions is much lower (about 50 cents, on average).⁵ Merchants are particularly opposed to the high rates of offline debit cards. The Financial Stability Act improves the position of merchants in two ways.

⁴ See Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, and Ron Borzekowski (2009): *Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues*, Finance and Economics Discussion Series 2009-23, Board of Governors of the Federal Reserve System.

⁵ See Kate Fitzgerald: *A Crossroad Ahead for Interchange?*, Cards and Payments, March 2009.

Firstly, it prohibits non-discrimination rules that restrict merchants' ability to offer discounts for particular instruments or brands. Thus, merchants will have more scope in the future to steer customers towards low-fee means of payment.

Secondly, it gives regulating powers to the Federal Reserve and defines guidelines on how to assess interchange fees. While it is not yet known how the Federal Reserve will set interchange fees, the guidelines clearly seem to point to a lower level of fees. They are stressing the functioning of the check clearing system with settlement at par (equivalent to a zero interchange) and they rule that fees should be based on "actual incremental costs of the issuer" for authorisation, clearing and settlement.

All in all, in the U.S. – as in many other countries – regulators seem to follow the logic of "two knots are better than one":

- *restrictions of the honour-all-cards-rule*
- *restrictions of the non-discrimination rule*
- *regulation of interchange*

Do we really need all three of them?

2. SEPA and other issues at payments conference in Granada

On 21., 22. of June 2010 economists from the US and the EU met with representatives of the EU Commission, European banks, corporates and retailers to discuss payment card issues.

⁶Not surprisingly, SEPA was an important topic, as well as interchange fees.

-- SEPA

Javier Palmero Zurdo (DG Internal Market) stressed that SEPA is actually getting ahead successfully. Nevertheless, he strongly endorsed an end date citing other big projects like the internal market project and the introduction of the Euro that also involved end-dates. He reported that the Commission is planning to come up with end dates for SEPA Direct Debit (SDD) and SEPA Credit Transfer (SCT) by March-May 2011. The case for an end date was also endorsed by Gerard Hartsink (Chairman of the EPC) who reported that there still were two large banking groups that do not intend to offer SDD to their clients.

German reservations towards SDD are well known. However, as José Carlos Cuevas (Alstom) made clear, Spanish corporates share these reservations. Cuevas, who is also the chairman of the Association of Spanish Corporate Treasurers, expressed the view that SDD would not be implemented in Spain in the coming years ("SDD end 2012 -> NO WAY").

⁶ CONFERENCE ON PAYMENT MARKETS: THEORY, EVIDENCE AND POLICY Granada (Spain) - June 21-22, 2010. Papers available under http://www.ugr.es/~payment_market/

An issue often raised in the context of SEPA is the role of public entities. In theory, these should be “first users” creating critical mass. However, Manuel Varela of the Spanish Ministry of Economy showed how difficult things are in practise. Governments are not completely centralised. In Spain, large public payment users are the treasury, the social security system, the tax office, the provinces and the local authorities. For most of these institutions, SEPA is quite remote and moreover “too complex”. Thus, there is little enthusiasm to do anything at all. Therefore, he supports an approach with a mandated end-date – however with an important reservation: national authorities should have to agree to the end-date. That, in turn, would require some modifications of SEPA products.

-- Interchange fees

Martin Weiderstrand of IKEA presented the retailers’ case on payment cards. He criticised the continuing existence of different levels of interchange fees and expressed strong support for a flat fee per transaction rather than an ad valorem fee. He did not say, at what level the interchange fee should be. Instead, he reported that the average costs of cash at IKEA are 3 cents per transaction. Weiderstrand also provided some information about IKEA’s experience with surcharges/discounts. He said that IKEA would prefer not to do this (“Banks should collect their own fees.”) but given the high costs of payments, IKEA uses a surcharge in the UK and a discount for repeat customers in the U.S. Both measures were used to steer consumers towards cheaper means of payment. Both achieve this goal – with surcharges having a stronger impact on consumers.

Imfried Schwimann (DG Competition) reported on current anti-trust cases against Visa. She explained the methodology applied for setting interchange fees (“tourist test” or “avoided cost test”) and announced that a cost study would be launched. She also noted that the Commission did not see any justification for a direct debit MIF but that “a MIF for rejected transaction could be acceptable”. Such a MIF exists in Germany and has been proposed repeatedly by German market participants.

Harry Leinonen of the Bank of Finland made a strong case for a zero MIF in payment systems, arguing that it would promote transparent pricing and lead to more efficient payment choice by consumers.

And SEPA for cards? It was not a big topic. Gerard Hartsink (Chairman of the EPC) reported current progress in standardisation work. Imfried Schwimann (DG Competition) mentioned the “Risk of being left with only two schemes for debit cards” – once again stressing the need for a European scheme. However, in his dinner speech, Agustín Marquez (Deputy General Manager, CECA) questioned the need for a third scheme. As he pointed out, the

task of building a new scheme might be bigger than anticipated because, in order to make a new scheme successful, full international acceptance might be required. If that could not be achieved, one would still depend on co-branding arrangements with Visa and MasterCard.

3. German anti-trust authority opposes proposed ATM interchange

In Germany, the anti-trust authority (Bundeskartellamt) has announced that it would not support a collectively set maximum surcharge fee for ATM transactions of 5 EUR.⁷

Our Comment

For years, interbank fees have been spiralling upward in Germany. This is the outcome of three factors

- *competition between banking groups with and without large ATM networks*
- *lack of a common interbank fee for ATM transactions*
- *legal set-up: card holders are viewed as receiving a service of the issuing bank⁸*

Interbank fees have reached ridiculous levels (some banks charge 20 EUR or more) and most banks were forced to increase the fees their customers have to pay for “foreign” transactions (currently about 5,64 EUR per transaction). Consumer protection agencies and politicians have been alarmed and have tried to put pressure on banks. However, given the conflict between the banks with large networks and those without, it is difficult to find a compromise. One possible way out is a shift towards direct surcharging of card holders. That would re-instate the price mechanism. However, those banks without extensive ATM networks fear that surcharging may lead to very high fees for their customers – in particular in the country-side. A maximum fee would have limited these charges. But for the anti-trust authorities this limit was still too high.

4. Application selection in Australia

We have repeatedly discussed the issue of co-badging of competing schemes. In particular, in the future, there may be competing debit brands on one card. So, it is interesting to see current developments in Australia. Australia has a national EFTPOS system for payments (and cash-back) at the POS. In this system, there is an interchange fee from issuer to acquirer. For many years, this system has been the dominant debit card system but in recent

⁷ See Sven Clausen: 5 Euro am Geldautomaten sind zu viel, Financial Times Deutschland, 6.7.2010

⁸ Therefore, the issuing bank charges the card holder a fee – not the ATM bank. Usually, this fee is a uniform fee for all „foreign“ (at ATMs of other banking groups) transactions.

years banks have increasingly issued “scheme debit cards” (i.e. cards branded Visa or MasterCard). Often these cards were combined scheme debit / EFTPOS cards. If the holder of such a combined card wants to pay at the POS, he has to make a choice – a choice with drastic consequences for retailers. If the card holder is choosing EFTPOS, the retailer may actually earn a fee and if he is choosing scheme debit, the retailer has to pay a fee. In April 2010, Woolworths Australia changed its policy and disabled the scheme debit option.⁹ Customers can continue to pay with credit cards but no longer with scheme debit.

Our comment

We have repeatedly argued that two debit brands on one card may not be viable. In Australia, consumers had the choice of brands – often choosing the one that is more expensive for retailers. Woolworths reacted by disabling the more expensive one. Now it will be interesting to see

- *how other retailers will react and*
- *how the banks will react*

Banks could raise the stakes by issuing cards with only the scheme debit function.

⁹ See „Woolworths and debit cards“, <http://www.choice.com.au/Reviews-and-Tests/Money/Banking/Saving-money/Woolworths-and-debit-cards/page/Debit%20card%20changes.aspx>

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