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1. Results of the Payment Cost Study of the EU Commission

On 19 February, the EU Commission finally has published preliminary results of the payment cost study it commissioned in 2011 ("Cost Study").¹ The study has been carried out by Deloitte Consulting. The study covers 253 large retailers in 10 countries with sales equal to or above 50 m €.

Table 1: Participating merchants: geographical and sectoral break down

	Merchants	Coverage 1	Coverage 2	Sector	Merchants
Austria	15	5.6%	7.1%	Footwear	20
Belgium	27	6.6%	5.8%	Clothing	52
France	33	14.2%	17.1%	Sporting equipment, books	13
Germany	24	8.6%	8.0%	Household electronics, furniture	37
Italy	18	9.7%	6.6%	Computer, telecom equipment	5
Netherlands	16	4.4%	4.9%	Petrol stations	10
Poland	24	22.0%	16.9%	Food, beverage stores	8
Spain	18	9.0%	5.8%	Supermarkets, department stores	37
Sweden	50	9.5%	14.6%	Car repair	4
UK	28	19.7%	37.0%	Restaurants	14
Total	253	13.8%	14.7%	Hotels	22
Total EU		12.2%	13.1%	Other specialised stores	31

Source: Costs study. Coverage 1: in terms of the value of card transactions, Coverage 2: in terms of the value of retail trade

It will be supplemented by another study focusing on smaller merchants. The results of both studies will be published in a final report expected "before the Summer". Given the partial and preliminary nature, the Commission is keen to stress that no firm conclusions can be drawn at the moment. Still, the Commission had to publish something at this early date

¹ European Commission. DG Competition: Survey on Merchants' Costs of Processing Cash and Card Payments Preliminary Results, 19 February 2014 (http://ec.europa.eu/competition/sectors/financial_services/presentation_results_en.pdf). See also: Imfried Schwimann: Data Collection on Merchants' Costs of Cash and Cards – Preliminary Results, Brussels, 20 February 2014. The results of an earlier study (a "pilot survey"), carried out in 2009 and 2010 have never been published.

because the ECON Committee of the European Parliament was pressing for more data to support the rates proposed in the interchange regulation.

The study looks only at POS transactions because – as the EU Commission points out – the alternative cash versus cards is not very relevant for eCommerce. Although the sample is relatively small, the market share of the participating merchants is impressive (see Table 1). The combined card value amounts to 249 billion EUR and the retail turnover to 414 billion EUR. Moreover, there is a quite good sectoral mix.

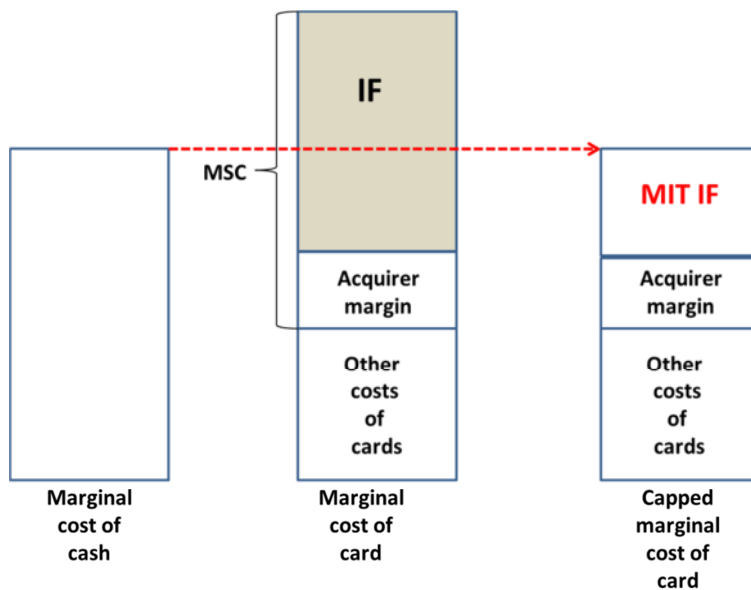
The aim of the study is ambitious. Not only does the Commission want an estimate of cash and card costs, it also wants an estimated cost function, i.e. the average marginal costs as a function of the number of transactions and the value of transactions.

$$MC = AVC = a + b \cdot ATV \text{ (estimated separately for cash, debit cards and credit cards)}$$

MC: marginal costs, AVC: average variable costs per transaction (weighted average of all participating merchants), *a*: variable costs independent of the transaction value (variable by number), *b*: variable costs that depend on the transaction value (variable by value), ATV: average transaction value. The underlying function for total costs is: $TC = F + a \cdot N + b \cdot V$ (where F stands for fixed costs).

Marginal costs are required to determine the “merchant indifference test IF” (MIT IF). The way the MIT IF is calculated is visualized in Figure 1.

Figure 1 Calculating the MIT IF



Source: Cost Study

The costs of cards have been calculated in a 2-step process. First, the “other costs” have been estimated. Second, an estimate of the average acquirer margin has been added. Subsequently, marginal card costs have been subtracted from marginal cash costs. To make things more complicated, the EU Commission presents two “Scenarios” – one in which 1 cash transaction is replaced by 1 card transaction and another in which 10% of cash transactions are replaced by 10% of card transactions. The results are presented below. Table 2 displays the estimated cost functions and Table 3 displays the resulting values of the MIT IF.

Table 2 Cost estimates

	Scenario 1		Scenario 2		Acquiring margin	ATV Card
cash vs. debit	a	b	a	b		
cash	0.08	0.13%	0.09	0.20%		
debit	0.09	0.01%	0.10	0.01%	0.06%	42
cash vs. credit	a	b	a	b		
cash	0.08	0.17%	0.08	0.24%		
credit	0.09	0.01%	0.10	0.01%	0.06%	51

Source: Cost Study

Table 3 Deriving the MIT IF²

	MIT IF	
	Debit	Credit
Scenario 1	0.02%	0.07%
Scenario 2	0.11%	0.15%

Source: Cost Study

Even if the higher values of Scenario 2 are used, the resulting values are far below the values of the Visa and MC commitments and the envisioned IF regulation (0.2% for debit and 0.3% for credit). At this point of the process, the Commission does not draw any strong conclusions from these results. It merely states that “preliminary results do not form a reason to question the 0.20% and 0.30% caps applied by the schemes”.

Our Comment

Considering that the first attempt to estimate cash and card cost goes back to 2008, it has taken quite some time. However, it is laudable that the EU Commission comes up with some hard numbers before the proposed IF regulation has passed all stages of the legislative

² Using the figures of Table 3, we were not able to replicate the results. This may, however, be due to rounding.

process. This is much better than the endless references to three central bank studies that allegedly have been used to derive the famous values of 0.2% and 0.3% as maximum interchange fees for debit and credit cards³

Thus, the Cost Study may at least improve the transparency of IF cap calculations. However, the question is, whether the figures are a sound basis for such calculations. One point that immediately draws attention is the estimate of the acquirer margin. For both, debit AND credit cards the estimated acquirer margin is equal to 0.06%. That is hard to swallow – especially for credit card acceptance.

0.06% on an ATV of 51 EUR is equal to 3 cents! That strikes us as pretty stiff. In countries that use Visa or MasterCard branded cards, the scheme fees that a large acquirer has to pay already amount to around 5 bp (or 2.5 cents on sales of 50 EUR). Having repeatedly tried to estimate the acquirer margin for Germany, we think that a German acquirer makes on average 0.35%. Looking at the UK, the biggest credit card markets in Europe, we carried out a back-of-the-envelope calculation and estimated an average margin of 0.14% for one of the large acquirers, Streamline.⁴ That is an average rate for both, credit and debit card transactions, and it is much less than what we estimate for Germany but still almost two and a half times as much as the 0.06% estimated by the Commission. Thus, for credit cards transactions, this figure is definitely too low. But even for debit cards, there are doubts. To be sure, the value of 0.06% seems to be right on the mark for the Netherlands. On the basis of an MSC 4 cents per transaction and an interchange fee of 1-2 cents, the average acquirer margin comes down to 2,5 cents. Considering an ATV of 39 EUR one gets almost exactly 0.06%.⁵ However, the Netherlands are hardly representative for the average European debit card market. Acquirer margins in other countries are likely to be higher.

So why does the Commission come up with an estimate that is too low, possibly much too low? This can be explained by the method used. In order to estimate the acquirer margin “public IF rates” have been subtracted from survey data on MSCs. Assuming that the survey data are representative⁶ the likely error stems from these “public IF rates”. In its “Impact

³ Looking into these three studies, we have been unable to come to results that are even remotely similar to these values. See “New cost study: New Interchange caps for debit and credit cards?” in the June 2013 edition of this newsletter.

⁴ Streamline reports a net income of 228 million £ (excl. income from terminals) on a sales volume of 168 £ billion. See WorldPay Annual Report 2012.

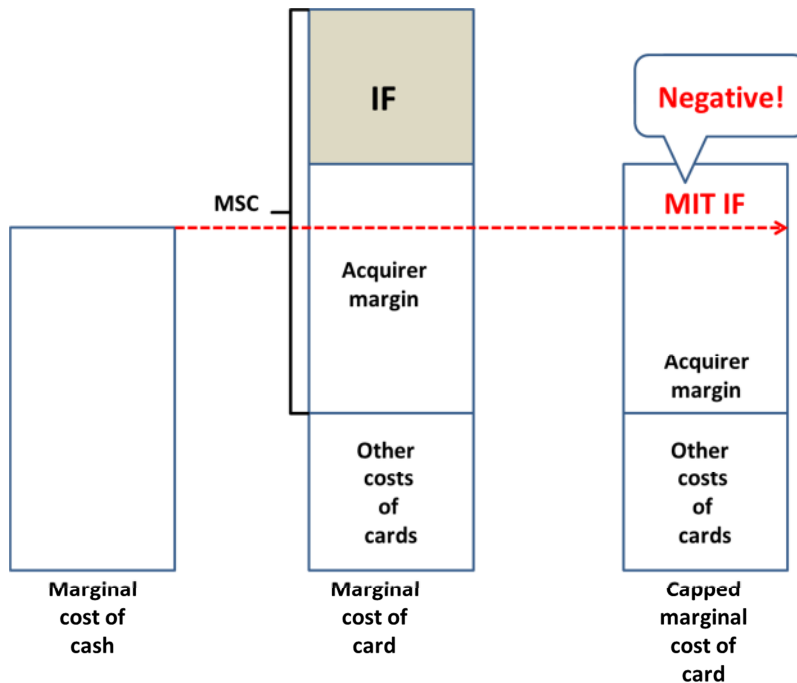
⁵ The source of the underlying figures is: Wilko Bolt, Nicole Jonker and Mirjam Plooij: Tourist Test or Tourist Trap? Unintended consequences of debit card interchange fee regulation. De Nederlandsche Bank Working Paper 405, December 2013. See in particular the figures in footnote 12 and Table 1.

⁶ At least for key accounts. When considering smaller merchants, MSCs are likely to be much higher.

assessment” accompanying the proposed IF regulation,⁷ the Commission has collected data on interchange fees. In all likelihood, these are the “public IFs” referred to in the Cost Study. However, as we pointed out in the December 2013 edition of this newsletter, the Commission estimates seem to be much too high.⁸ Therefore, the estimated acquirer margin is likely to be too low.

What are the consequences? If the true acquirer margin is substantially higher, the MIT IF is substantially lower, possibly negative!

Figure 2 MIT IF with higher acquirer margin



However, before jumping to the conclusion that IFs have to be reversed, it is necessary to take another look at the methodology. In the Dutch study cited above (footnote 5), it is shown that economies of scale in payments may have strange side effects. If there are, indeed, economies of scale a replacement of cash transactions by card transactions may lead to higher marginal costs of cash transactions and lower marginal costs of card transactions. In this case, the MIT IF would go up as cash is increasingly replaced by card payments. Therefore, the authors of the study doubt that the MIT methodology provides a useful benchmark for regulating interchange fees.

⁷ [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2013:0288\(52\):FIN:EN:PDF](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2013:0288(52):FIN:EN:PDF)

⁸ See : IF-Caps: Retailer benefits of 6 billion € per year?

2. MasterCard's legal interchange battles likely to continue

In the case MasterCard versus the European Union, the advocate general has published his opinion.⁹ The advocate general follows the line of argument of the EU Commission and proposes to dismiss the appeal of MasterCard against the decision of the Court of First Instance. Since the Court usually follows the proposals of the advocate general, it seems likely that MasterCard's appeal will be dismissed.

Meanwhile, new legal troubles are emerging. As a German retail magazine reports, a number of European retailers (inter alia Inditex-Group, Metro, Sainsbury's, Hertz and Deutsche Bahn) have sued MasterCard in London, in 2012 already.¹⁰

Our Comment

As the experience in the US shows, such legal battles may entail huge costs for the card organisations. In December 2013, a US judge approved a settlement of 5.7 billion USD payable to retailers by MasterCard and Visa.¹¹ However, large retailers have announced that they will not accept the deal. (An earlier class action led to a settlement in 2004 worth 4 billion USD.)

Thus, the current anti-trust case has important implications going beyond the current rate of IF. There may be substantial financial penalties in stock. Moreover, in the past, the threat of large damages has led to the incorporation of Visa and MasterCard as listed stock companies. Visa Europe is still organized as a membership organization. Weighting legal risks, European issuers may now come to re-think this structure.

⁹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62012CC0382:EN:HTML>

¹⁰ Bender, Hanno: Mastercard droht Schlappe vor dem EuGH, Der Handel, Online-Ausgabe, 30.01.2014 (<http://www.derhandel.de/news/finanzen/pages/Kreditkarten-Mastercard-droht-Schlappe-vor-dem-EuGH-10336.html>).

¹¹ See Christie Smythe and Chris Dolmetsch: Visa, MasterCard \$5.7 Billion Swipe Fee Accord Approved, Bloomberg.com, Dec 14, 2013 (<http://www.bloomberg.com/news/print/2013-12-13/visa-mastercard-swipe-fee-accord-approved-by-u-s-judge.html>)

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