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1. Visa Europe proposes reduced interchange

The European Commission has announced that Visa Europe has proposed a number of commitments in response to the objections of DG Competition against the level of Visa interchange fees and some business practises. [1] Vice President Almunia has welcomed these proposals.

Visa Europe undertakes for four years:

"(i) As regards 'cross-border acquiring': to reform its system in such a way that banks will be able to apply a reduced cross-border inter-bank fee when they compete for clients cross-border."

"(ii) As regards inter-bank fees: Visa Europe offers to cap its credit card MIFs at 0.3% of the value of the transaction for cross-border and domestic transactions, a reduction of about 40-60%."

The Commission has announced that it will soon publish a "market test notice" with a summary of the commitments. Interested parties will be invited to comment. Based on the results of the "market test" the Commission may decide to make the commitments legally binding on Visa Europe.

[1] European Commission: Antitrust: Vice President Almunia welcomes Visa Europe's proposal to cut inter-bank fees for credit cards. MEMO, Brussels, 14 May 2013.

Our Comment

After the agreement between the Commission and MasterCard in 2009 it was to be expected that there would be a similar agreement with Visa Europe. However, until fairly recently, Visa accepted lower interchange fees only for debit cards but not for credit cards. So the proceedings of the EU Commission against Visa continued. As the new announcement shows, Visa seems to have finally given in.

Even more important, Visa has made stronger commitments than MasterCard. It has agreed to change the interchange rules for x-border acquiring[2] and has committed to a maximum MIF that applies to x-border as well as domestic transactions in a number of countries (Belgium, Hungary, Ireland, Italy, Luxemburg, Malta, The Netherlands and Sweden).

This agreement will have much more important consequences than the MasterCard agreement. The new acquiring rules imply that a transaction between a German card holder and a German merchant will fall under x-border interchange rules when the German merchant has a contract with a foreign acquirer. Therefore, acquirers will have an incentive to move their legal basis to one of the countries in the list above. It remains to be seen how the new rules will be spelled out in detail. But we do not expect un-surmountable difficulties for acquirers to move their legal presence to another country within the EU. Given the high degree of competition in the acquiring market (especially in the key account segment) we expect acquirers to move fairly swiftly. Thus, if accepted by the EU Commission, these commitments will basically establish SEPA interchange rates for Visa debit card and credit card transactions.

For issuers, this implies that interchange income may decline. However, whether they will be worse off or not remains to be seen The much quoted study on the effects of interchange regulation in Spain seems to suggest that lower MIF and thus lower MSCs may encourage card acceptance and increase the volume of payments.[3] Furthermore, extended acceptance may allow issuers to raise card fees (paid by card holders).

[2] X-border rules for acquirers are also an important issue in a newly opened investigation against MasterCard. See European Commission: Antitrust: Commission opens investigation into MasterCard inter-bank fees, Brussels, 9 April 2013.

[3] See “New study on the effects of mandatory decrease of interchange fees in Spain” in the December 2012 and January 2013 issues of this newsletter.

The agreement between the EU Commission and Visa also shows that the European Commission does not seem to favour a zero interchange approach – as has been demanded by some members of the European Parliament.[4] Thus, overall, the announcement must not necessarily be seen as bad news for European card issuers.

2. New cost study: New Interchange caps for debit and credit cards?

At the moment, Deloitte is conducting a comprehensive empirical analysis on behalf of the European Commission of merchants´ costs of accepting and processing cards and cash. The analysis amounts to a huge data collection exercise. It is carried out with input of 500 large merchants (yearly turnover equal or above 50 m €) in 10 EU Member States (Austria, Belgium, Germany, Spain, the UK, France, Italy, the Netherlands, Poland and Sweden). These countries with a relatively high card usage account for approx. 87% of the retail turnover in the EEA. Based on a specified methodology, the participating merchants have to split up all their internal and external costs of handling cards and cash payments, in front and back office processing, in their face-to-face business and ecommerce. Even the processing time at the till shall be measured with a stopwatch on several days at each merchant. In addition to this analysis, a second survey is carried out to collect data on the number and value of payments of 200 merchants of different sizes in the same sample of EU Member States. The results of this second survey will be compared with the volumes of the big merchant´s sample of the cost survey.

The EU Commission states that the outcome will be important for two reasons:

- It will give the Commission robust data for a calculation of the benchmark for maximum MIF levels (Multilateral Interchange Fee) for card payments in a regulatory context.
- The results will be used to value the efficiency arguments of the payment card schemes (like MasterCard) in ongoing or new legal proceedings.

[4] See “European Parliament passes payment resolution” in the November 2012 issue of this newsletter.

Our Comment:

Based on the academic research of Rochet and Tirole the Commission changed its interchange regulation methodology in 2008 by using the so called "Tourist Test" or Merchant Indifference Test (MIT).[5] Banks will not be able to exploit market power if interchange fees are set in such a way that merchants are indifferent between the use of cards and the use of cash. Therefore, the new benchmark for the maximum level of the MIF should be merchants' costs for accepting a cash transaction minus their costs of accepting and processing a card transaction (like terminal equipment, fraud, internal back office costs and merchant service fees of the acquirer - excluding MIF).

At the end of 2008 the Commission issued a tender for a cost study which should have covered all 27 Member States with a low budget of 300,000 €. As was to be expected, there were no tangible results. In a new effort, the survey was downsized in order to develop a sound methodology for cost calculations to be tested in a pilot study limited to 3 Member States (Netherlands, UK, Hungary). In a press release of April 16th 2010, the Commission announced an extended survey to be launched 2010. But it still took almost 2.5 years until the project was initiated with support of Deloitte.

Although robust data has been lacking until now, in the past, the Commission made regulatory decisions based on its new MIT-methodology. In April 2009, the Commission agreed with MasterCard to reduce its maximum weighted average MIF for cross-border card payments to 0.2% for debit cards and 0.3% for credit cards.[6] Visa proposed a similar MIF-cap for debit cards in April 2010. In both cases the MIF-caps were calculated on the basis of the MIT-methodology. The Commission, as well as the ECB[7], stated that MasterCard and Visa used the aggregate data of the costs of cards and cash compiled by the Central Banks of the Netherlands, Belgium and Sweden which were published before 2009. The Commission confirmed that these proposed fees are in line with the MIT methodology.[8] The level of the revised MIF is calculated "using the difference between the merchant´s costs of accepting payments in cash and those of accepting card payments."[9]

[5] See "What the hell is a "tourist test"?" in the June 2009 edition of this newsletter.
[6] However, MasterCard is challenging the Commissions principle position on interchange fees in court.
[7] See European Commission Memo/09/143 of 1 April 2009 and Ann Börestam & Heiko Schmiedel, Interchange Fees in Card Payments, ECB Occasional Paper Series, No. 131, September 2011, p. 24.
[8] See European Commission, Memo/10/224 of 28 May 2010.
[9] Börestam/Schmiedel, p. 24.

Let us have a closer look at these 3 studies. Two of these studies, the surveys of the Dutch and Belgium Central Banks[10] calculated the <u>social costs</u> (as sum of all internal costs made by the relevant parties in the payment chain) for cash and card payments of the relevant parties (central bank, banks, issuer, acquirer and retailers - excluding consumers). Payment related revenues and fees between these parties were <u>not</u> considered. At the retailer level, we find the internal costs (front and back office) for handling and processing of cash compared to debit and credit card transactions (see Table 1).

Table 1: Merchant´s internal costs for handling cash and cards in Belgium, the Netherlands and Sweden

Social costs of retailers in % of the ATV[11]	***Debit cards***	***Credit Cards***	***All Cards***	***Cash***
Sweden (2002)	*0.19%*	*0.09%*	*0.17%*	*0.42%*
Belgium (2003)	*0.57%*	*0.57%*	*0.57%*	*1.56%*
Netherlands (2002)	*0.53%*	*0.21%*	*0.50%*	*1.75%*

Source: Central Bank surveys. See footnotes 10 and 13

A first result of these studies which are using the same cost calculation methodology is the fact that internal costs for the handling of cash and cards are significantly different across European countries.[12]

These two central bank surveys are useful to make statements about the economic costs (or "social costs") of cash vs. cards to make welfare comparisons, but they are not appropriate for the calculations of MIT-based caps for MIFs. However, the third survey, the one conducted by the Swedish Central Bank[13] also collected the <u>private costs</u> of retailers - including fees paid to the banks and acquirers for handling cash and cards. The results (basis: year 2002) are summarized in Table 2.

[10] See Hans Brits & Carlo Winder, Payments are no free lunch, DNB Ocasional Studies, Vol. 3, Nr. 2 (2005) and Nationale Bank van België, Kosten, voor- en nadelen van de verschillende betaalmiddelen, December 2005.
[11] ATV = Average Transaction Value
[12] Bank fees for recycling cash or acquirer fees (MIF included) for card acceptance were not published or even collected. For the calculation of interchange fees based on the MIT methodology, the private net costs of the merchants are required. These costs are currently collected by Deloitte.
[13] See Mats Bergmann, Gabriela Guibourg and Björn Segendorf, The Costs of Paying – Private and Social Costs of Cash and Card Payments, Sveriges Riksbank Working Paper Series, No. 212, September 2007.

Table 2: Costs of Retailers for handling cash and cards in Sweden 2002[14]

Costs of retailers in % of the ATV	**Debit Cards**	**Credit Cards**	**All Cards**	**Cash (for cash ATV)**	**Cash (based on debit card ATV)**	**Cash (based on credit card ATV)**
Social costs	0.19%	0.09%	0.17%	0.42%		
Fees - MIF (estimated)[15] - other fees	0.20% 0,08% 0,12%	1.38% 1.30% 0.08%	0.42%	1.15%		
Private costs (social costs + fees)	0.39%	1.47%	0.59%	1.57%	1.23%	1.19%
Private costs excluding MIF	0.31%	0.17%				
MIF-Cap (MIT-based)	**0.92%** (= 1.23% - 0.31%)	**1.02%** (= 1.19%- 0.17%)				

Source: see footnote 13.

The private costs of merchants (internal costs + fees) for a cash-transaction (1.57%) are much higher than their costs of card payments (0.59%). Moreover, the ATV of a cash transaction (18 €) in Sweden is noticeable lower than the ATV for cards (68 €). In order to make a proper cost comparison, we calculated the costs of cash for the average ATVs of a debit and credit card transaction. This estimate is based on data of the fixed and variable costs of cash contained in the Swedish study.[16] *Due to the fixed cost component, the costs of cash in % of the ATV go down if the ATV increases. Considering the costs of cash at the higher card ATVs, the MIT-benchmarks for the private cash costs of retailers 1.23% (debit card ATV) and 1.19% (credit card ATV). So, these two figures are the benchmarks for card costs. If card costs were exactly as high as these two benchmark estimates, the average*

[14] For merchants' costs, the authors mainly rely on: Svensk Handel 2004, "Kostnader för olika betalningsmedel", December 2004. As they point out "Svensk Handel (2004) reports the transaction cost for a card payment divided into time costs at the cash register and other costs. The latter consist almost entirely of merchant fees …". See Bergmann, Guibourg and Segendorf (2007, 13).

[15] Estimated by PaySys Consultancy based on average interchange fees which were bilaterally negotiated between the Swedish banking groups in 2002. The bilateral IF for debit cards was a flat fee per transaction (about 0,05 €). The IF for credit cards contained a flat fee (about 25 Ct. and an ad-valorum fee (about 1.2%).

[16] Ideally, the costs of cards and cash should be considered at the average POS ATV. It was not possible to calculate these figures because the Swedish study does not provide a break-down of card costs into fixed and variable costs.

Swedish retailer would be indifferent between accepting cash or accepting cards. If we subtract the internal costs and the fees paid by retailers for acquiring services, the maximum MIF based on the MIT would be 0.92% (debit cards) and 1.02% (credit cards).[17] *If the Swedish regulator would apply the results of this cost survey to a MIF-regulation based on the MIT-methodology, the schemes could increase the debit card MIF from 0.08 to 0.92% and would have to reduce the credit card MIF from 1.3% to 1%. Such an outcome would hardly harm the card issuing banks in Sweden.*

It is not clear why MasterCard (and later Visa for the MIF of debit cards) offered MIF caps to the European Commission (0.2% for debit cards and 0.3% for credit cards) which were about 70 basis points lower than the outcome of the Swedish Central Bank survey (0.92% resp. 1.02%). One reason could be that merchants' costs of cash handling in Sweden are not representative for the EU. The assumption that cash costs are higher in Sweden with its sparsely populated areas, compared to countries like Belgium or the Netherlands, does not seem implausible. But in these two countries the published social costs (without bank fees) are as high or even higher than the private costs in Sweden (social costs + banking fees)!

However, the Swedish figures are justifying different MIF-caps for credit and debit cards, with a difference of exactly 10 basis points - as used by the European Commission (0.3 vs. 0.2%). In the Swedish case this is due to the lower internal merchant´s costs (private costs minus fees) for credit cards and their higher ATV compared to debit cards. The often mentioned justification for this 10 basis points difference was the assumption that the cost of cash handling would be higher in typical credit card retailer segments as segments with a more debit card affinity (like super markets), although figures for this assumption are lacking.

So, as far as we can see, the Swedish figures would imply MIF-caps that are dramatically different from the ones that have been agreed between the EU Commission and the card schemes. Thus it is at least conceivable that the cost study will also yield values that significantly differ from today's MIF-caps. Moreover, it is quite likely that the MIT-values will differ across countries and it is an open question whether regulators will take such differences into account when setting MIF-caps.

But is the MIF-methodology still relevant? After all, the European Commission will come up with a regulatory proposal in the end of June 2013 (planned) – well before we can expect the results of the Deloitte survey. Moreover, even retailer organizations are not convinced of the

[17] A calculation based on the average POS ATV would probably yield somewhat lower maximum MIFs.

soundness of the MIT. EuroCommerce stated that it will not accept the MIT "as valid method for fixing a benchmark for MIF levels."[18]

3. SEPA-compliant or SCF-compliant: to be or not to be (follow-up)

In our Newsletter of March 2013 we discussed the compliance-status of card schemes in Europe. Since the scheme ***LaserCard*** *(Ireland) had been deleted from the ECB-list of SEPA-compliant card schemes we asked the LaserCard scheme owners for an explanation. They told us, that they were very surprised about the deletion by the ECB and that the scheme is, in fact, still SEPA-compliant. Therefore, we contacted the ECB. The ECB immediately put LaserCard scheme back on the list of compliant schemes (on April 23th, 3 working days after our request) without providing further reasons. Obviously a mistake.*

We were also surprised that the Danish debit card scheme ***Dankort*** *does not publish any self-assessment to its compliance (SEPA or SCF) although the scheme should be at least SCF-compliant based on our interpretation of the SEPA Cards Framework and the commitments of the Danish Banks as EPC-members. We asked NETS Denmark as scheme owner and it seems that it interprets the SCF-rules differently. NETS stated:* "Dankort has to be compliant according to Danish Law that regulates the area of payments in Denmark. This means that the Dankort scheme cannot be 100 % SEPA or SCF-compliant. The Dankort scheme however predominantly follows the SCF." *Another reason for the Cards Working Group of the EPC to work on a new, more clear version of the SCF (the actual version 2.1 is of December 2009), which has already been announced for 2010.*

[18] Position paper of EuroCommerce as reply to the Green Paper on payments of April 2012, p.7.

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