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1. Unbundled Pricing of Merchant Service Charge (by Luke Purser¹)

From January 2011, all European acquirers must offer “unbundled” merchant service charges. Traditionally, acquirers have priced Merchant Service Charge (MSC) on the combined costs of card transactions for both major card schemes to create a single rate. In some European markets credit and debit products are charged separately but again use a common rate. Historically this practice reflects acquirers limited capabilities of separately charging by card product and scheme. Thus most merchants have no choice of a more detailed breakout of acquiring fees except the small number of large merchants able to negotiate “interchange plus pricing” and thus receive a full breakout of interchange, card scheme fees and acquirer charges.

In 2009 Visa and MasterCard were pressurised (some would say mandated) into an agreement by the European Commission that acquirers would introduce “unbundling” or “unblending” of MSCs as the default pricing method by 31st December 2010. The rationale was to ensure merchants knew exactly the costs of each transaction processed and, of course, could compare the cost of each international card payment type.

In practice “unbundling” means that acquirers must separate out the costs associated with processing each card scheme and further subdivide by card programme, e.g. consumer, commercial and debit cards. EU acquirers will no longer be able to combine all credit and/or debit card products unless specifically agreed with merchants.

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Some markets have a lower headline MSC but acquirers often have special extra tariffs covering exceptional items. Also several countries charge low processing-only or no fees for national debit schemes with many service components provided free of charge.

When acquirers unbundle the charge category “other services” will need to be isolated within the merchant agreement. Other services include many of the items until now embedded in the bundled MSC, which will now require greater explanation such as: processing fees, operational support authorisation, clearing and settlement, risk and so on. Inevitably acquirer pricing teams will now have to pay far greater attention to such items.

The future impact of Unbundling to both merchants and acquirers is outlined in the table below:

| | Current – Bundled Pricing | Future – Unbundled Pricing |
|------------------|--|--|
| Merchants | <ul style="list-style-type: none"> • Easy reconciliation of both credit and debit cards • Simple POS - all products accepted and processed, only scheme badged products accepted | <ul style="list-style-type: none"> • Much more detail – differently priced products, complex reconciliation process • Potential to move to interchange plus with even more detail • Only process/accept card products configured • Inability of staff to identify high rate card types during sale • Potential to decline/surcharge for high priced products • Potential increase in overall MSC |
| Acquirers | <ul style="list-style-type: none"> • Pricing assumptions cause unprofitable accounts • Increased revenue from bundling products under one rate e.g. UK debit cards • Simple operational processes - clear and concise offers to merchants • Easy to rollout new products designed to be processed under one card product | <ul style="list-style-type: none"> • Externalisation of costs of each card product acquired/processed • Potential increase in overall MSC revenue • Increase in merchant communication and costs • New card products require updates to T&Cs • Major system changes to ensure full breakdown • Increase cost of operational processes, data capture documentation etc |

It is predicted that EU acquirers will offer interchange plus pricing to many more merchants than is currently the practice. In addition, acquirers are expected to start charging separately for individual elements of the acquiring service, for example, automated clearing house rejects, chargebacks, refund processing and statement fees.

Inevitably unbundled MSCs will also present opportunities to increase profit margins by charging for embedded services now broken out, particularly the high costs of free POS terminals and telecoms. In addition, some acquirers will also seek to remove cross subsidies and unbundle domestic debit costs currently recovered as an uplift on Visa and MasterCard acquired brands.

Comment

EU acquirers will incur substantial costs in modifying their systems, changing contracts and communicating a large volume of detail to the merchant community. However finer cost detail and better pricing will enable acquirers to increase their profit margins and to externalise the cost of services that are currently provided free of charge.

Merchants will have greater choice as a result of unbundling and will be able to pick and chose which card product to accept. Products with high interchange costs (such as business cards) may be declined or surcharged.

Once all the different aspects of pricing are assessed and charged, the reality may be that merchants will end up paying more for their acquiring services rather than less – an opposite outcome to the legislation’s objective.

2. The ECB’s 7th SEPA Progress Report

In her speech² at the “Next Generation Cards & Payments” Conference in Brussels, Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB, picked five issues of the 7th SEPA Progress Report. She presented them as New Year’s resolutions for 2011, basically defining homework for the industry for the coming year. The headings are:

- “New Year’s resolution number one: let’s define a SEPA migration end date”
- “New Year’s resolution number two: let’s establish the requirements for a competitive cards market”
- “New Year’s resolution number three: let’s move forward with an additional European card scheme”
- “New Year’s resolution number four: let’s innovate”
- “New Year’s resolution number five: let’s not forget about security”

As we already planned to comment in the present issue the 7th Progress report in more detail,³ we have picked up three of the Ms. Tumpel-Gugerell’s issues:

² http://www.ecb.int/press/key/date/2010/html/sp101125_1.en.html

³ A first assessment has been provided in the October edition of the newsletter.

SEPA migration end date

Ms. Tumpel-Gugerell “welcomed the European Commission’s decision to organise a public hearing⁴ on the issue” of setting an end date and once again repeated that “the Eurosystem have been very explicit in our comments on this topic and we have been calling for a regulation setting a migration end date for SCT and SDD.”

Our comment:

Indeed, the ECB’s position on end dates and competing schemes for direct debits and credit transfers (giro payments) was crystal clear from the very beginning of the SEPA project. So Ms. Tumpel-Gugerell’s statement does not surprise us. What actually comes as a bit of a surprise was the Commission’s strong rejection of competing giro payment schemes. This is in line with the view of the Commission which also sees the rise of „multiple competing schemes“ as a key concern.⁵

At the hearing, the discussion focused exclusively on how to find a way to mandate the migration to a single set of giro payment schemes rather than on what should be regulated. In a brief statement⁶, we published before the hearing, we argued that the Commission should take seriously the concerns regarding anti-trust policy. In our view, to achieve the political vision “to make cashless payments throughout the euro area from a single payment account anywhere in the euro area“, it would be enough to mandate reachability and leave implementation to the industry in an entirely market driven process. Obviously the Commission values the achievement of their vision higher than a rigid application of competition policy. Of course one can argue for such a position, but in our view the referral to primarily the argument of efficiency is not convincing. Firstly, for card payments it is broadly agreed that there is enough room for competition. It never has been explained why this should not be true for giro payments, as well. Secondly, the proposed concept of “reachability” for direct debit is stronger than what is required for cards.

For direct debits reachability implies that a merchant with a single contractual agreement with a payment service provider can draw direct debits (in EUR) from any payment account offered by any payment service provider. Traditionally, for domestic retail payment schemes, this concept of reachability was fulfilled. But it never has been thoroughly discussed whether

⁴ <http://scic.ec.europa.eu/str/index.php?sessionno=dc40b7120e77741d191c0d2b82cea7be>

⁵ See introductory presentation to the hearing of Jean-Yves Muylle (DG Internal Market)
http://ec.europa.eu/internal_market/payments/docs/sepa/conf-2010_11_17-muylle_en.pdf

⁶ <http://www.paysys.de/download/Sepa%20End%20date%20-%20eng.pdf>

this strong requirement justifies to unify the various different national schemes to one single European scheme. In the field of card payments, the commission and the ECB have opted for a less stringent approach to reachability. The acceptance of various card schemes (“multi-homing”) is left to the discretion of merchants and requires a number of contractual agreements with acquirers. Reachability in the context of cards broadly means that multi-homing must not be restricted. The long term experience with competing card schemes suggests that almost all merchants actually practise multi-homing. Thus, the fears that competing schemes lead to a “Mini SEPA” have not been firmly substantiated.

An additional European card scheme and the role of interchange

Ms. Tumpel-Gugerell repeated the Eurosystems “calling for an additional European cards scheme” and admitted that all evolving schemes are facing the challenge of commercial uncertainty due to the issue of MIF. She urged the competent authorities to work on the issue of a regulation of MIF. Finally she closes with the statement that “An additional European card scheme – which is as safe and efficient as the best performing schemes today – is a necessary element of an integrated and competitive cards market. “

Our comment:

We are not convinced that regulation of interchange really is required. There is no evidence that a regulator will set a better interchange than the interchange rates which evolve in a competitive market. Interchange is one important parameter in the competition between card schemes. A card scheme can attract issuers and acquirers by an appropriate setting of the MIF and so enable both sides to make attractive offerings to consumers and merchants respectively. Undoubtedly it is the merit of the SEPA project that competition between (debit) card schemes is implemented whereas debit card schemes previously have been operated by national banking organisations. In most cases this implied the exclusive use of one scheme per country. Now, with the implementation of SEPA for cards, banks in all European countries actually will have the choice to issue debit cards of different competing schemes. On the other side of the market, merchants will have the choice to accept a scheme or to decline a brand without losing the entire card base. Standardisation will drive down the cost of change between schemes. Therefore, it can be expected that the mechanics of competition will work. Before a regulation of interchange rates is considered, one should wait and observe how the market develops. Even if the result were market failure, the authorities should analyse the reasons and consider appropriate actions.

Payment card security

Ms. Tumpel-Gugerell introduces into the issue with the observation that *“The risk-based approach applied by individual banks may not be sufficient to achieve the level of security that is required at the aggregate industry level. The reason for this is that commercial risk tolerance may differ from social risk tolerance.”* In the following she expresses the *“expectation that the cards industry in Europe will issue “chip-only” cards from 2012.”*

Our comment:

No question, the current levels of card related fraud are alarming and could undermine the confidence of consumers in the card payment system. However it must be thoroughly examined whether the proposed way to ban the magstripe from cards is appropriate. When looking at the history of the credit card arguments to keep the magstripe alive quickly come to mind. We observe that more than 20 years after the introduction of EFTPoS terminals credit cards still are embossed. Admittedly, the move from imprinters to magstripe has not been co-ordinated via mandated end-dates - as the current transition from magstripe to chip. But the move from paper to magstripe was strongly incentivised through risk allocation and interchange rates. Since there are regions where imprinters were (and are) still in use a ban of embossing would have limited the functionality of the card significantly. Finally, the embossing of the card still functions as a fall-back when a terminal is defect. One can easily draw the parallels with the move from magstrip to chip. A chip-only card is restricted in its international use and would require some other fall-back solution.

Today, it can be observed that banks employ manifold strategies to control fraud levels. Fraud control measures include product segmentation, realtime fraud detection, introduction of 3D Secure, and others. All of these strategies are less restrictive than the co-ordinated ban of the magstripe which the ECB proposes. In addition, there are also offerings of chip-only in the market. Most notably, Visa is trying to establish V PAY as a chip-only product – precisely with the selling point of high security. Thus, one regulatory strategy would be to leave it to the market to pick the solution with the best cost-security ratio. But the statement of Ms. Tumpel-Gugerell, quoted above, outlines the possibility of a divergence between “commercial risk tolerance” and “social risk tolerance”. Therefore, she sees a need to regulate. The Statute of the European System of Central Banks (ESCB) and the ECB provides the ECB with the power to regulate the payment system: „ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Union

and with other countries.“ (Article 22) However, if a very specific and far reaching regulation such as mandating chip-only is contemplated, it can be expected of the regulator that such a move only comes after a thorough assessment of all alternatives. It would be interesting to see such an assessment.

Should you have any questions or comments please contact

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