

# Banking Automation **BULLETIN**

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## **Country profile: Germany**

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## Banking Automation

## BULLETIN



## A world with lower POS interchange fees

Until recently interchange fees were rarely discussed, and viewed by those involved in setting them as highly secretive – this is not that surprising as they are set collectively by competitors, and in

the case of POS interchange fees they represent a massive flow of funds from acquirers to issuers, and in reality from merchants to banks.

Despite the merits of POS interchange fees, particularly in less developed markets where high interchange fees encourage growth of the payment cards network, they are coming under ever increasing scrutiny by competition and regulatory authorities around the world.

A new report from RBR analyses the recent investigations into these fees, examines the latest trends in interchange rates and makes predictions of how the interchange fees debate will pan out (see pages 2-4).

The report describes how POS interchange fee revenues more than doubled worldwide between 2000 and 2006, to \$63.8 billion, despite this increasing scrutiny. Much of this increase is due to phenomenal growth in cardholding and spending, but in some countries, most notably the USA, interchange rates have continued to rise.

In Australia and much of Europe, interchange rates have been falling however, and RBR's new report predicts that this trend will expand to markets which have until now experienced static or rising interchange rates.

Falling POS interchange rates will have major implications for industry stakeholders. Issuers in particular will have to decide how to adapt to lower interchange fee income. Ultimately there will be a direct impact on cardholders – less profitable customers will find it more difficult to obtain cards, and those that remain will almost certainly encounter an increase in card-related fees. The good news for cardholders is that they should benefit from more competitive pricing at merchants.

Ironically, the biggest winners will be consumers who pay in cash – who will also benefit from lower retail prices and will avoid the increases in card fees.

Dominic Hirsch, Editor

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## INTERCHANGE FEES

# The \$64 billion controversy

**The massive growth in POS interchange fees has mainly been fuelled by a phenomenal increase in payment card purchase expenditure worldwide and increased interchange rates in the USA**

A new study by RBR analyses the evolving and increasingly complex landscape for POS interchange fees around the world.

The study predicts a decline in the levels of POS interchange fees, which in association with changes to interchange rate structures and payment scheme rules will have major strategic implications for payment card organisations, issuers, acquirers, merchants and consumers.

## Massive growth in POS interchange fees

POS interchange fees, the fees for payment card purchase transactions, account for a massive flow of funds between acquirers and issuers, and indirectly between merchants and acquirers. In 2000, these fees totalled over \$26.5 billion worldwide, but this figure grew 140% to \$63.8 billion (€48.4 billion) in 2006; including \$38.8 billion in Canada and the USA and \$10.1 billion in western Europe.

The massive growth in POS interchange fees has mainly been fuelled by a phenomenal increase in payment card purchase expenditure worldwide and increased interchange rates in the USA, the world's largest payment card market. It occurred despite reduced interchange rates in Australia, Europe and elsewhere, which resulted from the activities of competition and other public authorities, competitive pressure, litigation by merchants and

retailer associations, and the impact of reduced processing, fraud and other costs.

## Controversial fees increasingly under attack from competition authorities

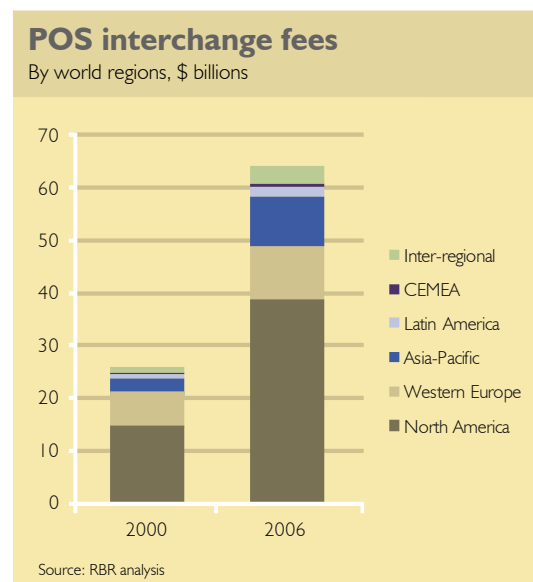
POS interchange fees have been the subject of analysis, controversy, legal actions and scrutiny since the Nabanco case in the USA in the mid-1980s. During the last decade, however, competition and other public authorities – central banks, regulatory and supervisory bodies and consumer protection agencies – have become increasingly knowledgeable about them. Either on their own initiative or as a result of complaints from merchants and/or retailer associations, they have undertaken numerous investigations and actions into interchange fees and related matters such as MasterCard and Visa's honour-all-cards and (no) price discrimination rules.

The list of countries where there have been recent legal, competition or regulatory actions is getting longer by the day and includes Austria, Australia, Brazil, Colombia, Germany, Hungary, Israel, Italy, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Singapore, South Africa, Spain, Sweden, Switzerland, the UK and the USA.

Although this list includes some relatively immature markets, it is activities by authorities in developed and mature payment card markets that have had the largest impact.

Some of the most prominent actions have been those of the European Commission, and primarily its Directorate General for Competition, and the Reserve Bank of Australia (RBA), which has undertaken a sustained campaign since the late 1990s to reform the country's payment card market and in particular its ATM and POS interchange fees. The decisions of these two organisations increasingly influence authorities in their own and other regions, part of a worldwide trend for one authority to refer to and/or incorporate the analyses and rulings of another authority in its investigations, in a mutually enforcing virtuous circle.

In the USA the status and legality of POS interchange fees has historically been established



by lengthy individual legal cases under anti-trust legislation. The most well-known litigation is the 'Wal-Mart case', which was resolved in April 2003 when MasterCard International and Visa USA agreed to pay merchants a total of \$3.05 billion over a ten-year period and unbundle their acceptance services to allow merchants to accept signature-based debit cards and/or the schemes' credit cards. At the beginning of March 2008, however, John Conyers, Chairman of the US House Judiciary Committee, and Representative Chris Cannon introduced the *Credit Card Fair Fee Act* in the US House of Representatives. If enacted, and the Act appears to have significant deficiencies, it would dramatically change the rates and terms of access of payment card acceptance in the USA and the country's POS interchange fees.

### Fee levels and structure vary significantly

There are significant variations in the levels of domestic POS interchange rates throughout the world, even between countries whose payment card markets are at a similar level of maturity such as the major economies in western Europe – and there is no consistent approach to interchange rate structures.

Some countries have relatively simple structures with a small number of interchange rate categories per payment card scheme and card type, whereas others have extremely complex structures with a multitude of categories. In 2007 in the USA, for example, the structure was bewilderingly complex: MasterCard had 156 interchange rate categories for purchases and 29 for refunds; while Visa had 126 and eight categories respectively. This complexity is made worse by the fact that both payment card schemes set interchange rates for consumer and commercial credit/charge cards that are not just dependent upon the merchant sector and transaction type but also upon the 'product group' of the card used in a transaction. The product group is not known by a merchant and reflects different levels of cardholder/company rewards, benefits and services.

Despite this variability, some trends are evident:

- Weighted average interchange fees in western Europe are falling. They fell by an estimated 10% overall between 2004 and 2007 with an even greater reduction in the fees for consumer credit/charge cards, which occurred despite off-setting increases in some countries. In the UK, for

example, the average POS interchange fee for a domestic debit card POS transaction increased by a third between 2002 and 2006 as a result of the migration of Switch debit cards to Maestro and corresponding increases in the multilateral interchange fees (MIFs) for Visa debit cards.

- The weighted average POS interchange rate for domestic transactions in the USA has increased continually since the late 1990s, but with lower rates of increase since 2005. In 2007, the average was around 1.77%, an overall rise of just 0.6% from the previous year's average interchange rate of 1.76%.
- In Australia, the RBA's payment system reforms have led to a halving of the weighted average POS interchange fee for credit card transactions, from 0.95% to 0.50%, and reductions of up to 80% in the average interchange fees for debit card transactions. As a consequence, Australian issuers lost an estimated AU\$2 billion (€1.2 billion) in interchange fee revenues from November 2003 to December 2006.

### Uncertain future for POS interchange fees

According to RBR's report, there are four main reasons why the future of POS interchange fees is now in doubt.

Firstly, competition and other public authorities' interest in POS interchange fees and related matters will undoubtedly expand in the future. Recent investigations have typically established that MIFs restrict competition, violate anti-trust or anti-competition legislation, distort competition between payment instruments, and do not have any or adequate mitigating benefits in terms of their contribution to technical and economic progress.

Secondly, authorities have not found the arguments put forward by payment card organisations, banks and others in support of current interchange fee arrangements either compelling or convincing. This has meant that authorities have taken increasingly tough stances on the MIF arrangements within payment card schemes. Their rulings have covered the processes by which MIFs are set, actual interchange rate levels, and the cost elements that can be included when a MIF is calculated, based upon an underlying issuer cost-reimbursement methodology in the absence of a cogent alternative.

Thirdly, the European Commission's actions in relation to POS interchange fees and related issues

**Investigations have typically established that MIFs restrict or distort competition and do not have any or adequate mitigating benefits**

### New RBR report

This article draws upon the latest RBR report

*The Future for POS Interchange Fees*

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- ▶ will increasingly influence those of other European National Competition Authorities (NCAs). In part this is because of EU Regulations, but also because of the 'European Competition Network' where EU NCAs and the Commission's Competition Directorate meet to ensure coherence in competition decisions and policies.

Lastly, because pressure from merchants and retailer associations towards reduced interchange fees (or even their removal) will intensify. In Europe this pressure will be amplified by political and regulatory pressures to converge and standardise interchange fees in the SEPA area, and by the overall 'war on cash' to replace cash transactions by what their advocates promote as more efficient card payments.

#### **Dramatic changes to the level and structure of interchange fees expected**

RBR's report forecasts a general decline in the levels of POS interchange fees around the world, accompanied by changes to interchange rate structures and enforced amendments to the international payment card schemes' honour-all-cards and price discrimination rules.

These movements are likely to occur more rapidly in Europe than in the USA, with those in Australasia proceeding at a medium pace. Within Europe, the rapidity of change will depend on numerous factors. In general those countries with relatively immature payment card markets may be afforded a degree of protection and their levels of domestic interchange rates may be sustained longer than countries with developed and mature payment card markets.

Resolutions are expected eventually in the European Commission's formal investigation into Visa Europe's MIFs and honour-all-cards rules, which began in March, and the MasterCard case, where the payment card organisation has appealed to the European Court of First Instance against the Commission's ruling of December 2007.

The outcomes are likely to consist of agreements that maintain MIFs but encompass a degree of compromise by both sides from their ideal positions.

Such agreements should at least cover all national and cross-border transactions within the eurozone and within the remainder of the EEA; removing certain costs from the MIFs for consumer credit/charge cards and debit cards, which will lead to significant reductions in the schemes' MIFs; changes to their honour-all-cards rules; and the removal of

Visa Europe's rule that bans price discrimination, which will make Visa's rules compliant with the Payment Services Directive.

RBR also anticipates that the upward trend in interchange rates in the USA will be reversed in the next three to four years; as a result of the cumulative impact of State-level legislation, litigation by merchants and retailer associations and merchant actions to accept and promote alternative payment methods such as those where debit card transactions are settled via Automated Clearing Houses.

Finally, there will be considerable changes in the short term to the interchange rate structures that exist in developed and mature payment card markets. The direction and pace of change will vary by region, country and regulatory jurisdiction, but the recurrent themes are likely to include the requirement to unbundle the various components of multilateral interchange rates into the three main cost categories of transaction processing; the payment guarantee; and the costs of fraud prevention, detection, monitoring and fraud-related technological developments.

#### **Major implications for industry participants**

Although the impact upon individual payment card industry participants will vary, the expected decline in the levels of POS interchange fees and the associated changes to interchange rate structures and payment scheme rules will have major strategic implications for payment card organisations, issuers, acquirers, merchants and consumers.

For payment card organisations, for example, one key strategic decision is their reaction to the new interchange fee environment. A payment card scheme with MIFs must take strategic decisions on its overall approach to investigations by competition and other public authorities. It has to decide if it is to continue to attempt to prove that its MIFs produce economic and technical benefits that outweigh their anti-competition, anti-trust and other negative effects, coupled with the continuance of damage limitation activities to decelerate interchange rate reductions; or to concede that the attempt is unlikely to succeed and therefore to adopt a policy of active and positive co-operation with the authorities. Although payment card organisations may not move away from the first option in the short-term, this is unlikely to be a viable long-term strategy. ■

**The report forecasts a general decline in the levels of POS interchange fees around the world, accompanied by changes to interchange rate structures**

**The expected changes to POS interchange fees will have major strategic implications for card organisations, issuers, acquirers, merchants and consumers**

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