MasterCard Europe

The role of Interchange Fees in providing secure, efficient and transparent card payments in Europe

Introduction
MasterCard Europe strongly supports the plan to establish a Single Euro Payments Area (SEPA) by 1 January 2008. In developing credit and debit card payment services over the last four decades, European banks working together with MasterCard Europe have made available more convenient and efficient payment methods to European consumers and businesses. Interchange Fees have played an essential role in making this possible.

European regulators should recognize this, and fully acknowledge the function and positive role that Interchange Fees ought to play in the further development of a secure, fair, transparent and cost effective European payments market.

MasterCard Europe welcomes new entrants into the European card payments area, as long as all market participants operate under conditions which promote free, open and fair competition, not least on the issue of Interchange Fees. MasterCard Europe opposes regulations that would be applied on a selective basis to some market participants but not the others. This is an idea that has been mooted with regard to Interchange Fees.

What are Interchange Fees?
Interchange Fees are fees paid between banks when cardholders make payments using their cards.

When merchants or other businesses decide that they wish to start accepting card payments, they most often contact their bank, and ask to be enrolled in a card payment scheme, such as MasterCard. The banks that enrol merchants into credit card schemes are known as acquiring banks. Payment schemes however, only work if other banks are issuing payment cards to the merchant’s customers. The banks that issue payment cards to customers are known as issuing banks.

The more customers there are that are willing to use a particular payment card to purchase goods and services, the more attractive it will be for a merchant to enrol in that card’s payment network. The Interchange Fee is an important inducement to issuing banks to issue a particular payment card, to make that scheme a viable and an attractive option through which merchants can receive payments.
When a customer pays for goods or services with a MasterCard or a Maestro card, the merchant sends a message with details of the transaction to the acquiring bank which enrolled them in the MasterCard payment network. The acquiring bank then sends on that information to the bank that issued the card to the customer. After deducting a small fee, the Interchange Fee, the issuing bank sends payment to the acquiring bank, which in turn sends payment to the merchant. The acquiring bank charges the merchant a merchant service fee for the service rendered to the merchant, based on its costs, including the Interchange Fee. Consequently the actual payment that the merchant receives will be a little less than the invoice price to the customer.

The payment cycle, however, is still not complete. The cardholder’s issuing bank has paid for the cardholder’s purchase, but has not yet collected payment from the cardholder. It sends a statement to the cardholder, typically each month in the case of a MasterCard card, reminding the cardholder of the purchases he or she has made, and giving the cardholder a number of days, often 20 or 30, to pay for the purchases. Until that deadline passes, the issuing bank is in effect offering interest free credit to its customer, and absorbing the risk to the acquiring bank’s customer, the merchant, that the cardholder might not pay, or that the payment card has been used in a fraudulent manner. The payment guarantee is a major benefit to the merchant. The merchant and his bank also benefit from the interest free period.

Without Interchange Fees as a source of revenue, issuing banks would have less interest in issuing payment cards to their customers, and absorbing the costs and risks involved in offering instant credit to customers for their purchases. Unless they find other ways to set a price for this, issuing banks would suffer a lower return on the considerable investments and risks required to launch, offer and administer card services to their customers. To compensate, issuers may charge their customers more for payment card issuance, usage and other banking services.

MasterCard does not receive Interchange Fees. In the settlement process, however, there must be some way of determining what the fee paid between the banks will be. It would be very inefficient if this happened on a transaction-by-transaction basis, or if each acquiring bank had to negotiate bilateral agreements with every single issuing bank that might issue a card that is used to pay for a transaction. This is the reason why MasterCard Europe and other four-party payment networks (as opposed to three party payment schemes like American Express) establish default Interchange Fees that are applicable in the event (as is usually the case) that the issuer and acquirer do not have a bilateral Interchange Fee agreement.

MasterCard points out to European regulators, that where Interchange Fees have been capped, such as in Australia, there has been a slowdown in the growth of card payments. This is good news for those who benefit from a cash economy, but bad news for those who wish to reduce risks to society and the economy associated with an over-reliance on cash payments. Moreover, the capping of Interchange Fees in Australia and the resulting cost saving for merchants did not have an impact on the ultimate retail prices.

**Interchange Fees have a dual function – Balance and Return**

*Balance:* The most important function of Interchange Fees is to balance the demand of cardholders and merchants for the scheme’s cards. This is done by passing revenue (in the form of interchange) from one side of the business to the other so that both sides have
sufficient financial incentives to provide the products and services that the end-users want. If Interchange Fees are too low, acquiring banks will find it easy to sign merchants up to accept payment cards, but issuing banks will have less incentive to issue the kinds of cards cardholders want at the price they are willing to pay. An imbalance will occur that, in the long run, benefits neither cardholders nor merchants. Equally important, if Interchange Fees are too high, issuing banks will issue many cards, but merchants will be reluctant to accept them and will favour cash instead, despite the considerable costs and risks involved in handling it. Once again, an imbalance will occur that benefits neither cardholders nor merchants. Obviously, for the proper balance to be achieved, Interchange Fees need to be set by those involved in the business, since they have the strongest incentive to ensure that the scheme's cards are most widely accepted and used.

Return: As described above, Interchange Fees are part of the revenue package to encourage issuing banks to issue payment cards to their customers. Whilst it is not a direct reimbursement for any particular cost or service, it does encourage issuing banks to undertake the considerable investments necessary to market safe payment card products to their clients. Issuing banks have considerable outlays in offering card payment services to their customers:

- Billing and administration
- Innovation of new payment card products
- Investment in security and fraud protection technology
- Covering of fraud and credit losses
- The interest free period

When this incentive to issuing banks is significantly reduced or removed, growth in card issuing will decline. This is not surprising when one considers that there is convincing evidence that card payment schemes that operate with zero Interchange Fees, are cross-subsidised or simply operate at a loss.

Why interchange fees vary across borders
There are historical reasons why Interchange Fees vary across borders. Payment systems evolved separately, often reflecting different national public policy objectives. The Single Euro Payments Area will help to iron out the differences that have built up over decades. The level at which Interchange Fees are set can either speed up or slow down market development. This has to do with the ability to balance demand in a two-sided market, as described above. Card network operators need to be able to set Interchange Fees in accordance with conditions prevailing in the local market. With the establishment of a true single European payments market, MasterCard Europe looks forward to the application of SEPA Interchange Fees.

Unintended Consequences of regulating/prohibiting Interchange Fees
Before interfering with what has proven over 40 years to be a robust, highly competitive and efficient business model, MasterCard Europe urges European authorities to carry out a full impact assessment before regulating Interchange Fees, whether through competition law enforcement or through legislative initiatives. Such an analysis has thus far not taken place, as demonstrated by the industry's reaction to the publication of the European Commission's report on the retail banking sector inquiry. Representatives of the financial services industry reacted overwhelmingly negatively to the report, arguing that most of its assumptions regarding Interchange Fees were flawed, and that the report showed a serious lack of
understanding of the card payments industry. Regulators must take into account the risks associated with regulating these fees, whether this involves capping or prohibiting them:

- Because issuing banks will seek other ways to recoup their investments in card services, card usage could become more expensive, affecting the way customers pay for purchases. Customers might favour cash as a means of payment if card payments become more expensive.
- By facilitating the growth of inefficient cash transactions in favour of card payments, authorities would inadvertently give a helping hand to tax dodgers, fraudsters, money launderers and other criminals. This would not help in the global effort to improve societal security.
- Customers might favour larger merchants where they can use their store cards. Smaller merchants would lose market share, leading to concentration and a reduction of competition in their respective sectors.
- With the removal of an important revenue stream, issuing banks would have fewer resources to innovate and launch new and more secure card payment services, like new contactless technology.
- By hampering the development of an important source of credit, there would be a corresponding negative effect on economic growth.
- Beneficiaries of zero Interchange Fees would be larger merchants, and three party systems.
- There is no proof that capping or abolishing Interchange Fees would lead to a lowering of prices by merchants.

Card payment services without Interchange Fees
Card payment services do run in a number of countries without apparent or explicit Interchange Fees. Regulators have been known to make reference to this fact when discussing proposals to regulate or even abolish Interchange Fees. Zero Interchange Fees are associated with some debit card schemes, but not with credit card schemes. The Danish DanKort scheme, and other similar schemes in northern Europe are examples of this. Regulators might look more closely at such schemes. Some are loss making, price regulated or operate disguised Interchange Fees (e.g. in the form of dividends). Regulators might assess whether issuing banks have not simply found other ways to fund their investments in card payment products. MasterCard Europe is concerned that a number of zero Interchange Fee models are made possible through cross-subsidization from other consumer and business banking services, for example in fees that cover the management costs of current accounts. This is a less transparent method of funding investments in card payment schemes than through the establishment and publication of Interchange Fees. MasterCard Europe strongly advises not to view the loss making, price regulated or cross-subsidised domestic debit card schemes as the benchmark for the future open debit and credit card schemes the Single Euro Payments Area is looking for.