European Payment Card Systems for the 21st Century

A paper from MasterCard Europe

For four decades, MasterCard Europe[1] has been working successfully with European banks to deliver secure, efficient and convenient payment methods to European consumers and merchants. Today over 172 million MasterCard credit, charge and debit cards, and 295 million Maestro cards, are held by European consumers and accepted by more than 8 million merchants in Europe.

The success has been enabled by a common understanding among card schemes, financial institutions and policy makers of the benefits of cards to economic and societal development, and of business models that make international card payment systems feasible. Recently this understanding has been fundamentally challenged from two main sources – from regulators raising questions about the strength of competitive pressures with regard to interchange fees; and from some trade associations representing large retailers seeking to reduce their costs.

At this time of rapid development in the European payment card industry, both through industry innovations and regulatory initiatives, MasterCard Europe offers this short paper as a contribution to debate on the best way forward for payment card systems for the 21st century in Europe. It seeks to answer several questions that are currently being asked:

- What benefits do payment cards bring?
- What are interchange fees and should they be regulated?
- How will card schemes such as MasterCard Europe's contribute to the Single Euro Payments Area (SEPA)?
- What is the proper role of MasterCard Europe?

MasterCard Europe looks forward to continued dialogue and co-operation with European regulators, policy makers, financial institutions, merchants, consumers, and other stakeholders to ensure a level playing field for card payments and a vibrant and highly competitive European payments market.

The Benefits of Card Payments

There can be no doubt that consumers, businesses and government agencies benefit from the ability to pay for goods and services with payment cards, or that retailers and other merchants that accept cards and financial institutions that issue them also benefit. Card payments also act to further the goals of EU and national policy makers, such as increasing economic efficiency,

[1] MasterCard Europe is the successor organization to Europay International, which merged with MasterCard International in 2002 to form MasterCard Inc.. Europay was created through the merger of two other European payment companies, Eurocard International and Eurocheque International in 1992.

integrating national markets, reducing crime and fraud, and facilitating the electronic provision of government services (e-government).

Consumers

Convenience**:** For consumers, payment cards are often the most convenient way to pay for goods and services. Recent surveys[2] have shown that eight in ten consumers in Europe find cards more convenient than cash as a means of payment, and many find it easier to control their finances through card payments. Consumers also enjoy the ability to make purchases anywhere, at any time – in stores, on the internet, through mail order and over the phone. Credit and debit cards greatly facilitate foreign travel, for both tourists and business travellers.
Security: Two in three consumers in Europe feel safer using cards over cash. Payment cards are a good way to reduce the risk of theft, loss and fraud.
Flexibility: With new innovations coming onto the market every day, payment cards present many different ways to facilitate transactions, for example as a credit or a debit payment, or via new electronic wallet options such as MasterCard PayPass.

Merchants

Cost Saving: Card payment systems help merchants to operate more effectively by reducing the costs of managing cash. Costs associated with cash safekeeping and transport, cash ordering, coin and note sorting and counting and interest losses are important examples of the downsides of cash handling for merchants.
Time Saving: Modern card transactions are fast. New contactless digital payments typically take half the time of cash transactions.
Security: Like consumers, merchants enjoy better security from card payments, as holding smaller amounts of cash reduces the risk of hold-ups, fraud and shrinkage (counting errors and employee theft).

Card payments do not just present opportunities for businesses to reduce costs. They also help merchants to grow their businesses by enabling them to open up new sales channels. E-commerce, mail order, and international sales are greatly facilitated by card payments. Moreover, the option to co-brand store and loyalty cards with an international payment network brand helps merchants to build customer loyalty and repeat business. Perhaps the most obvious benefit to merchants of card payments is that credit cards present a readily available source of credit to their customers, which boosts sales.

Financial Institutions

First and foremost, payment cards present the most efficient way for banks to provide, on the one hand, consumers and businesses access to their funds and to pre-agreed lines of credit. Banks offering access to card payment networks also enable their merchant clients to efficiently receive payment for their goods and services. Consequently card payment systems help banks to build their business by enabling them to offer vital services to their customers. From this, the opportunity arises to offer many other banking services to both consumer and business clients. And, as is the case for merchants, card payments also help banks to operate more cost effectively by reducing the infrastructure and costs required for handling cash. It is estimated that cash management costs alone imposes an annual burden of €32 billion on Europe's banks.[3]

[2] KRC Research.
[3] European Payments Council (EPC).

Policy makers

As the European Commission, the Council, the Parliament and Member States pursue the Lisbon Council 2010 goal of making Europe the most competitive, knowledge-based economy in the world, policy makers are aided by the important contribution payment cards are making to economic development.

Payment cards, both in the way that they facilitate purchasing and as a source of credit, make an important <u>contribution to economic growth</u>. They are playing an increasingly important role in the development of "new economy" business models, in that payment cards are an important <u>driver for e-commerce.</u> They also present opportunities to drive greater efficiency in the <u>provision of government services</u>, such as pre-paid cards preloaded with social security benefits.

The card payments industry is also an important ally in the effort to build <u>a secure financial environment</u> for consumers. Card payments are more <u>transparent and traceable</u> than payments with cash. As European policymakers today have the crucial task of helping to combat terrorism, organized crime, money laundering, tax evasion, counterfeiting and fraud, one important contribution of the growth in card payments is their ability to make illegal financial transfers more difficult and thereby reduce the impact of illicit activities.

What are interchange fees and should they be regulated?

Today, regulators in the EU and many Member States are grappling with the question of whether to regulate interchange fees. These are fees paid between banks when cardholders make payments using their cards. Interchange fees play a fundamental role in the efficient functioning of card payment networks. As such, MasterCard Europe urges regulators to consider the possible negative effects of any initiatives to cap or prohibit interchange fees, as described below.

When retailers 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 a service with a MasterCard or a Maestro card, the merchant sends a message with details of the transaction to the acquiring bank which enrolled it 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 all its costs, which typically includes the interchange fee.

Consequently the actual payment that the merchant receives will be a little less than the face amount of the transaction.

The payment cycle, however, is still not complete. The issuing bank has paid for the cardholder's purchase, but has not yet collected payment from the cardholder. In the case of a credit card payment, 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 (or longer, if the cardholder wishes to use the card's extended credit facility). 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 fraudulently. The payment guarantee is a major benefit to the merchant. The merchant also benefits from the issuer's extension of short and long term credit to the merchant's customer.

Without interchange fees as a source of revenue, issuing banks would have less interest in issuing payment cards, and be less willing to absorb the costs and risks involved in offering payment options such as credit to consumers for their purchases. Unless they could find other sources of revenue, 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 would have to charge their customers more for payment card usage, usage and related banking services.

European policy makers have evidence for this available to them. In Australia, where interchange fees were capped, 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 benefit consumers there. Instead, it resulted in their paying more to use cards with no detectable reduction in the prices of goods and services.

Interchange fees have a dual function: balance and return

<u>Balance</u>: The most important function of interchange fees is to balance the demand of cardholders and merchants for the scheme's cards and thereby to maximize the value of its cards to both groups of users. 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, consumers and merchants, 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. Conversely, 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. 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 encourage issuing banks to issue payment cards to their customers. Whilst they are not a direct reimbursement for any particular cost or service, they do encourage issuing banks to undertake the considerable investments necessary to market safe payment card products to their customers. Issuing banks have considerable outlays in offering card payment services to their customers, including those for:

- Card production and distribution
- Usage promotion and customer service
- Billing, and administration and collection
- The interest free period
- Fraud and credit losses
- Security and fraud protection technology
- New payment card products and services

If this incentive to issuing banks is significantly reduced or removed, growth in card issuing and usage 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.

Unintended consequences of regulating/prohibiting interchange fees

MasterCard Europe urges European authorities to carry out a full impact assessment before regulating interchange fees. At a minimum, public authorities must take into account the risks associated with regulating these fees, whether this involves capping or prohibiting them:

- Higher costs for cards: card usage would become more expensive, affecting the way customers pay for purchases. Customers might favour cash as a means of payment if cards become more expensive.
- More cash transactions: by facilitating or encouraging more cash transactions, authorities would inadvertently give a helping hand to tax dodgers, fraudsters, money launderers and other criminals.
- Higher profits for big retailers: available evidence indicates that capping or abolishing interchange fees would not lead to a lowering of retail prices to consumers. The cost reduction simply benefits the bottom line of the retailers. This is naturally something for which their representative organizations are campaigning hard.
- Less competition: smaller merchants would lose market share, as customers would favour larger merchants where they could use store cards. The result would likely be more concentration and less competition in the retail sector.
- Less payments innovation: with the removal of an important revenue stream, issuing banks would have fewer resources to innovate and launch new and more secure and efficient card payment services, like chip/PIN and new contactless technologies.
- Possible constraints on economic growth: by hampering the development of an important source of credit, there would be a corresponding negative effect on economic growth.

The Single Euro Payments Area (SEPA)

SEPA is a private-sector initiative, encouraged by European authorities, to establish a single domestic payments market across Europe in which businesses and consumers will be able to make payments as easily and inexpensively as when they are in their home town. The EU has also adopted the Payment Services Directive, which strengthens the legal framework for pan-European payments.

MasterCard fully supports SEPA and the competition and economic benefits it will bring to the Eurozone and the European Union. With Maestro, a debit card technology developed in Europe, by European banks, for European consumers, and now a globally recognized system, MasterCard Europe is already SEPA-compliant.

MasterCard Europe has announced critical initiatives on pricing, processing, and products that enable European banks to make SEPA a reality for their customers. By migrating to Maestro, banks can become SEPA compliant today. We at MasterCard Europe are fully committed to helping make SEPA a reality, and to participating in the increased competition that SEPA will bring. A four-party SEPA model will open up the market to new entrants, leading to enhanced competition for card acceptance services, increased standardization and greater innovation in card payments, and competitive offers on all major cost items for merchants such as the merchant service charges (MSC), terminal fees and telecommunication charges.

We believe that the SEPA project is undoubtedly a significant step forward in furthering economic growth and stability in the region. Across Europe, debit card interchange fees will likely converge around the current average. This could mean some increase in a few member states currently with low or no fees (usually due to loss-making, cross-subsidized, or monopoly systems). This is an inevitable consequence of establishing Europe-wide competitive systems, the benefits of which all European citizens will enjoy.

The Role of MasterCard Europe

MasterCard Europe is the entity responsible for managing MasterCard Worldwide's business in Europe. With headquarters in Waterloo, Belgium, MasterCard Europe works in 51 European countries organized administratively into three customer areas, incorporating the Single Euro Payments Area (SEPA), mature markets and the developing markets of Europe, stretching as far afield as the eastern border of Russia. Through its network of local offices, MasterCard Europe can understand and meet the diverse needs of customers in the very different types of markets throughout Europe, enabling people to do business in their own way in their own language.

Through MasterCard Worldwide, MasterCard Europe offers its European financial customers, merchants and consumers access to leading payment services throughout the world. MasterCard Worldwide provides a critical economic link among financial institutions, businesses, cardholders and merchants worldwide. As a franchisor, processor and advisor, MasterCard develops and markets payment solutions, processes over 16 billion transactions each year, and provides industry-leading analysis and consulting services to its financial institution customers and merchants.

MasterCard Europe is therefore part of a global economic system from which the European economy benefits and in which millions of European businesses and hundreds of million European consumers participate. This is no longer a business environment where it is easy to place national flags on individual corporations; economic nationalism can disrupt and hinder the free flow of commerce and the economic and social growth that goes with it. MasterCard Europe has structured itself to best serve the interests of its European customers. We call on European policy makers to give their firm support to an open and competitive payment system best suited to Europe in the 21st century.