

IMPACT OF THE EUROPEAN REGULATION IN THE AREA OF INTERCHANGE FEES FOR EXECUTING CARD-BASED TRANSACTIONS

by

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Paying for goods or services by credit cards is becoming more extended. This fact can be accepted very positively. According to the European Commission, however, the payment services market remains very fragmented and inconsistent among other things due to the fact that they are used on the card issuers or as well as its processors interchange fees. Therefore, the European Commission carried out to issue a proposal Regulation on the interchange fees, which complements an amendment to the Directive on payment services in the internal EU market. The Commission's proposal is including the introduction of a maximum amount of interchange fees for debit and credit payment card.

This paper will deal with the issue whether the proposal of pan-European regulation can be seen as a positive step for the development of the payments made by credit card or not. It will further include assess of the impact of upcoming regulation on the individual market

KEYWORDS

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1. INTRODUCTION

The habits relating to purchases of goods and services have recently been significantly changing, both globally and on the European level. For example, online payments, payments via mobile phones or payments by means of one of the most widespread payment instruments – a payment card – have all represented dramatic changes. According to information of the European Commission (hereinafter the “EC”), nearly every account holder possesses a payment card in the form of a debit card, with 40 percent of people also having a credit card. In total, 34 percent of EU citizens shop online and 50 percent of people already use a smartphones, which allow them to execute payment services in other than paper form¹. However, in spite of all efforts on the part of the EC or the private SEPA² project, the European payment service market continues, for the time being, to be fragmented and quite heterogeneous. The project results implementation is slow, even though the EC published generally binding legal regulations in support of its implementation, such as – for example - Regulation (EU) No. 260/2012 of the European Parliament and of the Council of 14 March 2012 establishing technical and business requirements for credit transfers and direct debits in euro or Regulation (EC) No. 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payments in the Community, and annulment of Regulation (EC) No. 2560/2001. The EC is convinced that the establishment of a functional internal payment services market is mainly prevented by different costs of payments for consumers and retailers (merchants), differences in technical infrastructure of banks or inability of payment card issuers, for example, to agree on the implementation of common technical standards. These barriers then, the EC believes, slow down the economic development of the relevant countries and of the Community, reducing their growth potential. According to the EC, the commercial model of the so-called “interchange fees” (see below) also represents a significant barrier for the development of a single payment

¹ See, for example, the material “Evropská regulace platebních služeb a její dopady na ČR”, EU-Media, s. r. o. Prague. 2013, p. 1 (“European Regulation of Payment Services and its Impact on the Czech Republic”).

² SEPA – Single European Payment Area. It is a private-law regulation project in the area of provision of payment services for domestic and cross-border payments, currently supported by the EC and the European Central Bank (ECB). The key objective of the project is the provision of selected cross-border payment services under the same economic and technological terms and conditions as such payment services are being provided on a national level. For example, compare SCHLOSSBERGER, O.: “Platební služby”, Management Press. Prague, 2012, pp. 257 - 293. ISBN 978-80-7261-238-3 (“Payment services”).

market. The EC is certain that the model promotes high inter-bank fees (or between card issuers and card-based transaction processors, as appropriate) and affects the costs of retailers, who then reflect such fees in their prices, predominantly paid by consumers (as end users of payment cards).

2. REGULATORY DEFINITION AND INTERCHANGE FEE

The European Union (hereinafter the “EU”) authorities started to deal with the issue of payment services in the EU internal market around 2005 already. Two years later, Directive 2007/64/EC of the European Parliament and of the Council was adopted, the objective of which was to introduce a harmonized legal framework for payment services. Consequently, individual member states were forced to implement the Directive in their respective national laws, which in fact occurred by October of 2009. To ensure further support, the above mentioned Regulations were adopted. As already mentioned, the way consumers purchase their goods and services has been subject to relatively rapid development since the implementation of the Directive, reflected in Act no. 284/2009 Coll., on System of payments, in the Czech Republic. For example, payment cards have become a standard part of daily life, whereas more and more people – as users – are getting used to making their payments online or via mobile phones. However, the EC decided to react to the changing situation on the market of payment instrument, publishing the so-called Green Paper in January 2012³. The aforementioned Green Paper documented and explained certain barriers preventing the development of a fully integrated payment market. The material was followed by a proposal for revision of the wording of the Payment Services Directive, which was – together with the Regulation on Interchange Fees – published in July 2013⁴. Prior to listing the reasons that led the EC to the decision to newly regulate the level of interbank (interchange) fees as well as potential impacts of such regulation on various market segment and participants, it is necessary to define the characteristics of such fees.

Interchange fees refer to an amount paid by a retailer to an issuing bank (issuer) via a processing bank (acquirer) from a processed card-based trans-

³ Green Paper - Towards an integrated European market for card, internet and mobile payments, European Commission, January 2012. Available at: http://www.cnb.cz/cs/platebni_styk/pravni_predpisy/.

⁴ Proposal for a Regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions, Brussels, July 2013. Available at: <http://www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0550:FIN:CS:PDF>.

action. This amount is usually defined as a percentage of the total value of the transaction carried out by means of a payment card⁵.

It is possible to illustrate interchange fees and their classification within the system of fees for card-based transactions as shown in Figure no. 1.

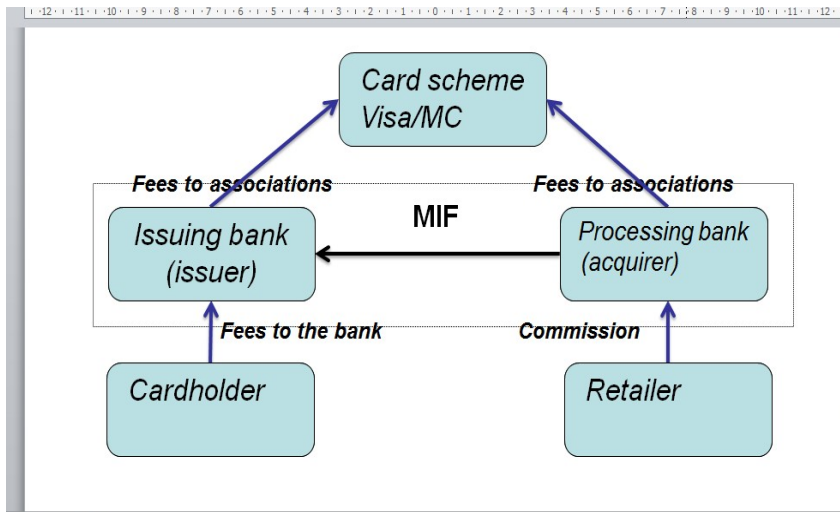


Figure no. 1 – Interchange fee. Source: HEŠNAUROVÁ, M.: Přeshraniční a zahraniční platební styk – workshop ČBA, September 2013 (Cross-border and foreign payments – CBA Workshop)

It is apparent from Figure no. 1 which depicts the so-called four-party scheme of relations in executing card-based payment transactions that card-based transactions are associated with several fees related to such payments. First of all, cardholders pay fees to an issuer (often a bank) for issuing a card or also for a transaction executed at retailers. The relevant fees are shown in the pricelist, which forms a part of contractual arrangements between a bank or another payment card issuer and a cardholder. The fees should reflect the costs associated with using the given payment card as well as the costs associated with fees paid to card associations for the payment card branding.

Retailers that accept cards in respect of payments for goods and/or services pay commissions to the processing bank (usually one of the larger banks) determined as a percentage of the transaction amount. The commis-

⁵ Cf. SCHLOSSBERGER, O., HOZÁK, L.: Elektronické platební prostředky, BIVŠ. Prague, 2005. ISBN 978-80-7265-073-4 ("Electronic payment instruments").

sion level is set down in an agreement entered into by and between a retailer and between an acquirer. In general, such commissions range from 0.8 to 7%, based on the retailer type and ability of the acquirer to negotiate the given commission. The commission reflects the costs of acquirer (processing bank) associated with the transaction processing as well as the costs charged by card associations, which authorized the bank – by means of a contract – to process the relevant transaction.

Interchange fees refer to fees always paid by an acquirer (processing bank) to an issuer. The level of such fees should express the share in the revenues for the transaction processing on the part of the acquirer. Very logical conclusion thus results from Figure no. 1 and from the characteristics of the fees: if the acquirer is identical with the issuer, then all fees paid by clients – as payment card users – accrue to the aforementioned bank, after the payment of fees to card associations. Consequently, the settlement of interchange fees does not take place at all, as the acquirer is also the issuer.

3. REASONS FOR REGULATING THE INTERCHANGE FEE LEVEL

Therefore, what reasons have led the EC to its efforts for regulation of the fees, which have, so far, been agreed by individual entities (i.e. by the processing bank/issuing bank) based on a contractual principle or determined in line with the card associations' rules, as appropriate?

One of the main reasons is the fact that it concerns mutually agreed interchange fees, usually agreed between processing banks and issuers under a specific scheme. Processing banks charge such interchange fees to retailers, who subsequently transfer them to consumers. Therefore, high interchange fees charged to retailers result in higher end prices of goods and services paid by all consumers. Apparently, practical competition of individual payment card schemes is predominantly aimed at convincing the highest possible number of payment service providers to issue cards under the given scheme, which – unlike the establishment of price discipline usually associated with competition in a market economy – generally increases the fees instead of reducing them.⁶ It is safe to say that - barring certain excep-

⁶ According to the Proposal for a Regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions, Brussels, July 2013. p. 2. Available at: <http://www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0550:FIN:CS:PDF>.

tions (e.g. Denmark) - interchange fees are currently not subject to any regulation.

The Proposal for a Regulation sets (Articles 3 and 4) the maximum levels of the fees charged for individual transactions carried out by means of consumer payment cards – both in terms of cross-border payments and of domestic payments – in the amount of up to 0.2% of the transaction value for debit cards and up to 0.3% of the transaction value for credit cards. The Regulation only foresees different force (in this case, the Regulation foresees the effect – author’s note relating to the terminology of Czech laws) for cross-border and domestic transactions. The implementation of the given interchange fee levels under cross-border regulation is foreseen to take place within two months from the force of the Regulation, while the process should take place up to two years for domestic interchange fees. However, it is important to note the condition that the regulation only applies to transactions executed by means of consumer payment cards. It is thus apparent from the aforementioned that interchange fees charged between the processing bank and the issuer may differ from the foreseen regulated maximum fee levels (in relative amounts) in case the so-called business (commercial) payment cards, intended for legal entities or businesses, are used.

4. POTENTIAL IMPACT OF THE INTERCHANGE FEE REGULATION

Since it has been said that the regulation only applies to four-party payment schemes, we can assume that the interchange fee regulation may have certain positive impact in the following areas:

On consumers;

On retailers – or on the internal market as such;

On market entry.

Individual effects will now be analyzed in more detail.

The EC, as the proposing party, relies on the assumption that interchange fees charged for transactions between an acquirer and an issuer ultimately increase prices for consumers. Moreover, the EC relies on the consideration⁷ that retailers pay different fees to different acquirers for the processing of their transactions; such fees are, among others, also affected by

⁷ See the Explanatory Memorandum to the Regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions, Brussels, July 2013. p. 3. Available at: <http://www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0550:FIN:CS:PDF>.

the interchange fee level. The introduction of regulation of the maximum interchange fee levels should result in higher transparency of such fees, with positive effect on consumer prices.

Moreover, the Explanatory Memorandum emphasizes that retailers are forced to pay different fee amounts to acquirers (processing banks) for the processing of card-based transactions, which are also significantly affected by various interchange fees charged to issuers. Furthermore, the EC relies on a relatively correct deliberation that interchange fees vary for individual retailers in one country, which certainly is true in reality. However, it is necessary to point out that consumers – as end customers – know the final prices, not its individual components – i.e. actual purchase price, margin level, transaction fee amount, VAT amount or consumer tax (if any; taxes are shown separately in some countries, e.g. in the United States). Therefore, the Proposal for a Regulation introduces one maximum level for interchange fees, thus consolidating the terms and conditions for all issuers/acquirers within the Community.

Another area, which should benefit from the regulation, is the easier market entry into the segment of payment card issuing. Allegedly, according to the statement of the EC that can be deduce from the Explanatory Memorandum to the Regulation, the heterogeneous fee levels prevent market entry.

*"The revenues for issuing payment service providers from the fees function as a minimum threshold to convince issuing payment service providers to issue payment cards or other payment instruments, such as online and mobile payment solutions, offered by new entrants. Also, market entry for pan-European players remains difficult, as domestic interchange fees in EU Member States vary widely and new entrants would have to offer interchange fees at least comparable to those prevailing in each market they want to enter. This has an impact on the viability of their business model, inter alia affecting potential economies of scale and scope"*⁸.

However, the author believes that the considerations that lead the EC to introducing regulation in respect of the maximum fee levels for transactions executed by means of payment cards do not reflect the substance of the fee as such. Similar as interest represents the price of money, fees represent the

⁸ Citation – see the Explanatory Memorandum to the Regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions, Brussels, July 2013. p. 4. Available at: <http://www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0550:FIN:CS:PDF>.

costs of providing a specific service, in this case a card transaction⁹. Therefore, the fee level may, above all, significantly affect a payment card issuer, due to the fact that existing fees associated with the payment card issuing would not cover the costs of such service. It is necessary to understand that today, as part of competition, payment card issuers (namely debit card issuers) issue such cards without any fee for issuing, often not charging any transaction fees to end consumers either. Their business models rely on the collected fees received from processing banks, as the share of executed transactions. The current deliberations are as follows: in case an issuer does not issue a card, the transaction would not be executed by a consumer, i.e. a retailer would not sell the goods and the processing bank could not ensure the card transaction settlement. It is clear from the aforementioned that the issuer, too, takes part in the transaction. However, the issuer's costs may vary and it may be the case (particularly in case of small payment card issuer) that the regulated commission reduces its revenues to an extent such issuer would be forced to suspend the payment card issuing due to the regulation of the maximum interchange fee levels. If the issuer is lucky, it will have to review its business model and start charging fees for the card issuing/use, for example. The maximum interchange fee levels may have certain positive effects on issuers, particularly on cost reduction. But this aspect is not applicable all the time, particularly at the moment of market entry, when costs always exceed revenue. However, regulated interchange fees may significantly extend such period.

Another entity that may be affected in an opposite manner than foreseen by the Regulation is the processing bank (acquirer). However, the author believes this bank has some advantage – it determines the total amount of the transaction processing fee. It is safe to assume that even if the acquirer's costs in the form of the interchange fees charged for the benefit of an issuer decrease, the reduction does not have to be reflected in the reduction of the transaction processing fee, i.e. it does not have to be reflected in the price of goods and/or services. Consequently, the processing bank's fees will increase by the amount not charged to the card issuer, because the amount is limited by 0.2 or 0.3% (as appropriate) of the transaction amount.

The author believes that a situation, where goods/services are cheaper if paid in cash and not by means of payment cards, is very unfortunate. This

⁹ Cf., for example, POLOUČEK, S. et al.: *Bankovníctví*, C.H. Back. Prague, 2006. p. 3 et seq. ISBN 978-80-7179-462-7 ("Banking").

was the case during a dispute of the MasterCard and the EC over the meaningfulness of interchange fees. Furthermore, Directive 2007/64/EC of the European Parliament and of the Council on payment services in the internal market, which was transposed into Act no. 284/009 Coll., on System of payments, also includes a provision stating that merchant's fees may be forwarded to customers on condition they are informed about it in advance¹⁰. This practically means that retailers offer their goods cheaper in cash than if the goods are paid by means of payment cards. Therefore, rational consumers are likely to reach into their wallets and pay their purchase in cash. However, banks essentially refuse such development. Cash processing operations are not operational and they are expensive and risky.

The proposal for a Regulation has resulted in different opinions on the part of many experts and other competent persons. Advocates of the proposal rely on various opinions supporting the idea that the interchange fees consolidation will result in a significant progress in the consolidation of payment services in Europe as well as in the limitation of unreasonably high fees currently prevailing (e.g. European Commissioner for Internal Market and Services Mr. Michel Barnier¹¹). On the other hand, there is a reserved approach that expresses concerns the new regulation would fail to contribute to the development of competition and innovations and that, ultimately, the efforts of the EC will turn not only against consumers, but also against retailers, since – in the end - banks will help each other. It is necessary to underline the fact that the EC does not intend, for the time being, to regulate the fee agreed between the acquirer and the relevant retailer.

Another factor not addressed by the proposal for a Regulation is the approach to payment transactions not executed by means of consumer payment cards. The Regulation proposal only states the following:

“Commercial cards and cards issued by three party schemes, even though they tend to be more expensive, would not be covered – as proposed under option v - under the various caps proposed for consumer cards...”¹²

¹⁰ Cf. Section 92(2) of Act no. 284/2009 Coll., on System of payments.

¹¹ Material „Evropská regulace platebních služeb a její dopady na ČR“, EU- Media, s. r. o. Prague. 2013, p. 3 (“European Regulation of Payment Services and its Impact on the Czech Republic”).

¹² See the Explanatory Memorandum to the Regulation of the European Parliament and of the Council on interchange fees for card-based payment transactions, Brussels, July 2013, p. 13. Available at: <http://www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0550:FIN:CS:PDF>.

The fact is that the number of issued “commercial/business” payment cards is much lower and, consequently, the number of transactions is lower as well. However, average individual transactions may be higher (e.g. purchases of air tickets, accommodation and meals during business trips, etc.). Are retailers – or their processing banks, as appropriate – going to distinguish between fees for the processing of consumer transactions or not? From the technological perspective, such differentiation would be possible based on the rules for determining the card number for individual card schemes (card associations – particularly VISA and MasterCard). The question is; however, whether it is ultimately practical and, above all, effective. Especially processing banks will have to invest some funds in their card systems to ensure the situation that the regulation of cross-border transactions applies as of the third month after coming into force (effect) of the Regulation. With regard to domestic transactions, it will be sufficient to implement the measures within two years.

The Regulation proposal introduces other regulatory measures that supplement the key objective of the Regulation – i.e. to regulate the interchange fees charged between banks for consumer payment cards. For the sake of comprehensibility of this paper, we should mention that the other efforts in the area of regulation are as follows:

No territorial restrictions or special requirements in respect of obtaining a license for cross-border issuing and acquiring (processing) may be applied within the EU;

Payment scheme (e.g. VISA or MasterCard) and processing must be legally and organizationally separate;

Schemes must allow the authorization and clearing of a single transaction by different processors;

Co-badging of two or more different brands on a single payment instrument must be allowed;

Brand/application for the transaction execution is to be selected by a client and may not be automatically preset;

Agreement with retailer must comprise a commission amount, interchange fees, and fees paid to association for each category and brand;

It is not possible to apply the retailer’s obligation to accept all cards of the given brand (only if identical IF), retailer must inform customers;

Issuers must ensure that cards are visually and electronically distinguishable: brand, prepaid/debit/credit cards, and commercial cards.

What has the experience been with already implemented interchange fee regulation? For example, it is possible to briefly summarize available information from the USA¹³:

Regulation of interchange fees for debit cards as of 1 October 2011;

Interchange fees decreased by 50%;

Absolute amount set down for the fees - fixed amount - 27 cents.

The regulation had expected as well as some unexpected implications:

Effect on issuers:

Significant reduction of revenue on the part of issuers;

Regulation does not apply to small issuers.

Effect on retailers:

Heterogeneous effects – interchange fees increased 2 to 3 times for retailers with low transactions (≤ 15 USD);

Higher prices;

Card acceptance annulled;

Court disputes in the area.

Effect on consumers:

Inconclusive price reductions at retailers;

Card benefits limited – bonus programs (50% of issuers cancelled rewards in 2011 already);

Account maintenance fees increased by 25%.

5. CONCLUSION

The EC takes all measures to ensure a single payment area within the EEA, as determined by the SEPA project some time ago. The proposed Regulation is certainly motivated by the effort to establish beneficial conditions for operations of all entities involved in the execution of card-based transactions in the internal market. It may certainly contribute to the removal of some barriers in the single provision of payment services in general. However, the question is whether a regulation of prices or fees is the way to go. Historically, it continues to be the same “struggle” of two worlds – leave the developments up to the market mechanism, which will – itself - regulate the fees as part of competition and contest for customers, or proceed to “government interventions” (in this case represented by the EC), setting mandatory prices or fee levels. However, neither way is positive for all market par-

¹³ HEŠNAUROVÁ, M.: Přeshraniční a zahraniční platební styk – CBA Workshop, September 2013. p. 14 (“Cross-border and foreign payments”).

ticipants – i.e. consumers, retailers, card issuers or card-based transaction processors in the case under review. Banks and payment scheme will always oppose any measures that disadvantage them, limit their revenue or even result in their losses. The EC tries to protect consumers in several areas – in terms of the provision of loans, execution of payment services, insurance of receivables from deposits, out-of-court settlements of disputes, etc. There are other areas as well. The question is; however, whether such “protective” measures do not turn against the entities being protected in the long run. Consumers are then convinced that they do not have to worry about anything, because “others” will take care of them.

The presented paper only partially addressed the analysis of expected effects and potential implications of the application of regulation within a small part of the internal market of the European Union. As a long-term professional in the field, the author is rather concerned about positive outcomes of the regulation. The results of the regulation in the United States only confirm the conviction that the interchange fee regulation will not bring the expected results and, ultimately, will not contribute to price reductions at all. It is more likely that the effects will be opposite – increase in the prices of services associated with the payment card issuing/use, which may lead to more cash payments. And this absolutely inconsistent with the objectives of the SEPA project, also promoted by the EC¹⁴.

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¹⁴ Compare for example: DAMBORSKÝ, M. a kol.: Role mezibankovního poplatku ve čtyřstranném platebním systému, Prague, 2012, studie VŠE („The role of interchange fee in the quadrilateral payment system“).

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