CONFERENCE ON PAYMENT MARKETS: THEORY, EVIDENCE AND POLICY
21-22 June 2010
in Granada (Spain)

EUROJÄRJESTELMÄ
EUROSYSTEMET

From two-sided subsidization to transparent price competition in card payments

- Potential benefits of a more efficient business model

Harry Leinonen

21 June 2010

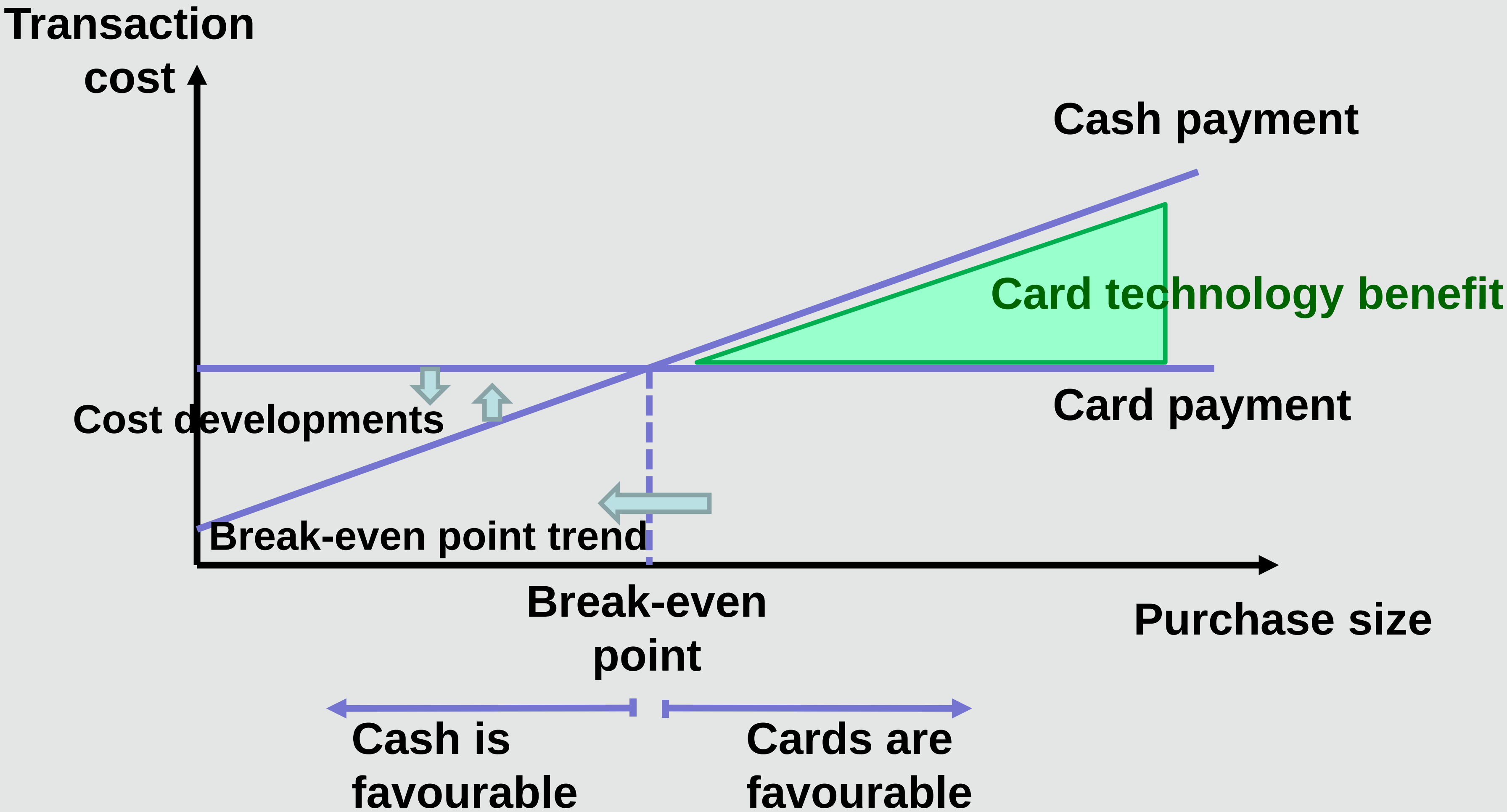
Main issues

a) Technology developments and benefits and their distribution among payment service stakeholder

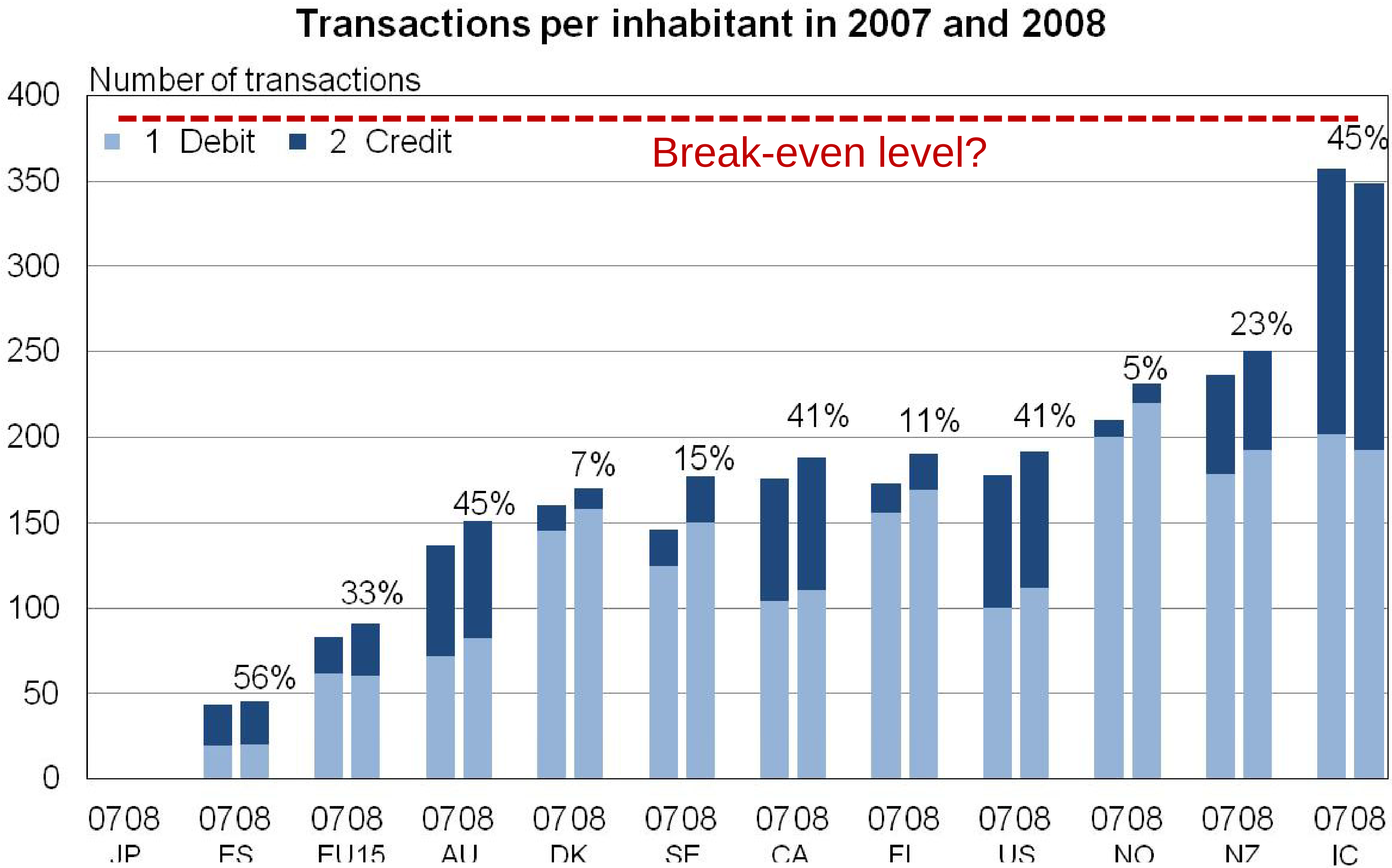
b) The impact business models: Open vs hidden pricing and awareness of cost differences

c) Changing the business model for increased efficiency and the role of authorities

Card technology benefits according to central banks' cost studies



Basic finding 1: Efficient payment instrument selection at POS striving for maximum cost benefits - in normal circumstances - must be based on break-even point according to payment size.



Basic finding 2: Card usage in most countries is clearly below the optimal level from social cost point of view.

Card benefits over cash

Issuer

Benefits due to
- lower processing costs
- more interest income

Acquirer

Benefits due to
lower process cos

Payer

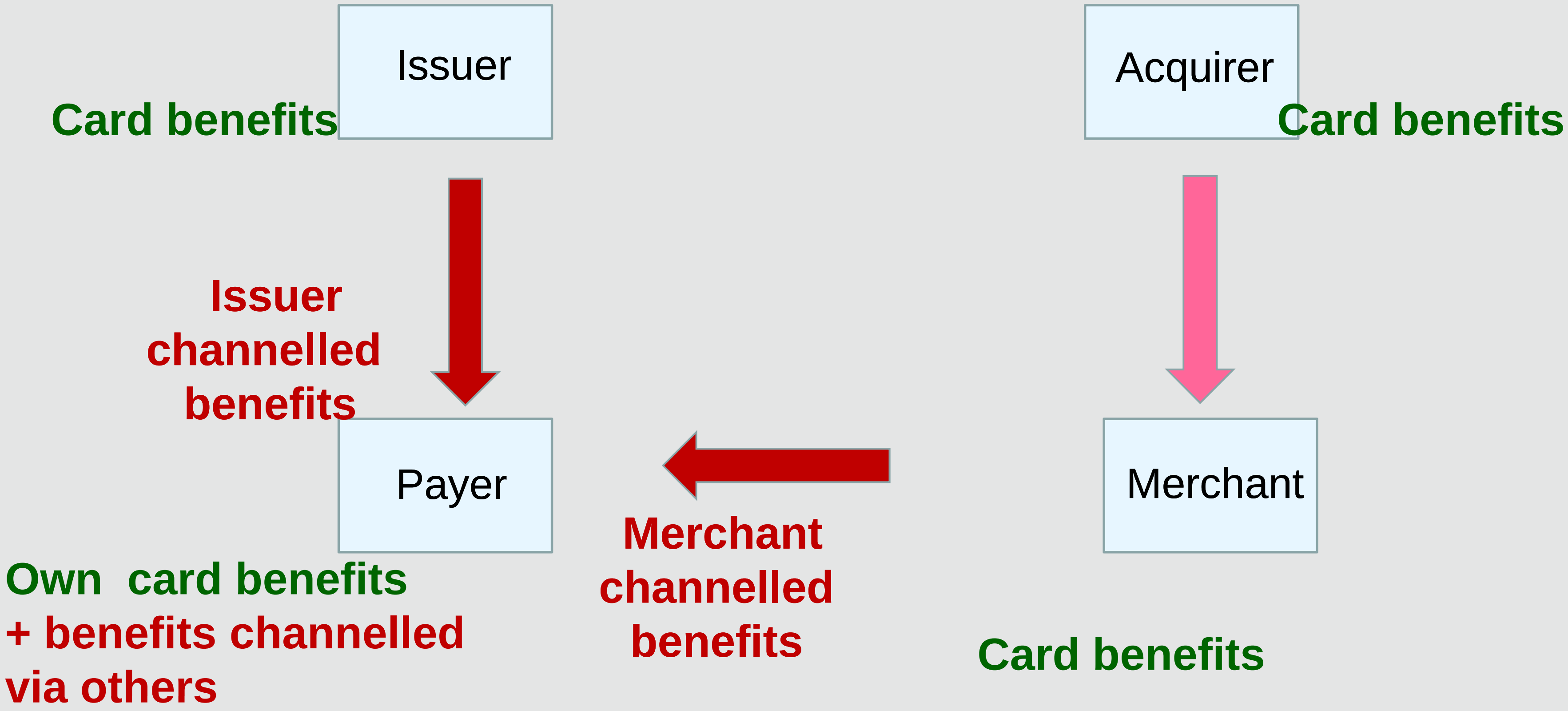
Benefits due to
- **improved liquidity**
- **reduced cash acquisition costs**
- **share of others' benefits**

Merchant

Benefits due to
- **lower proc. costs**
- **reduced risks**
- **customers' improved liquidity**

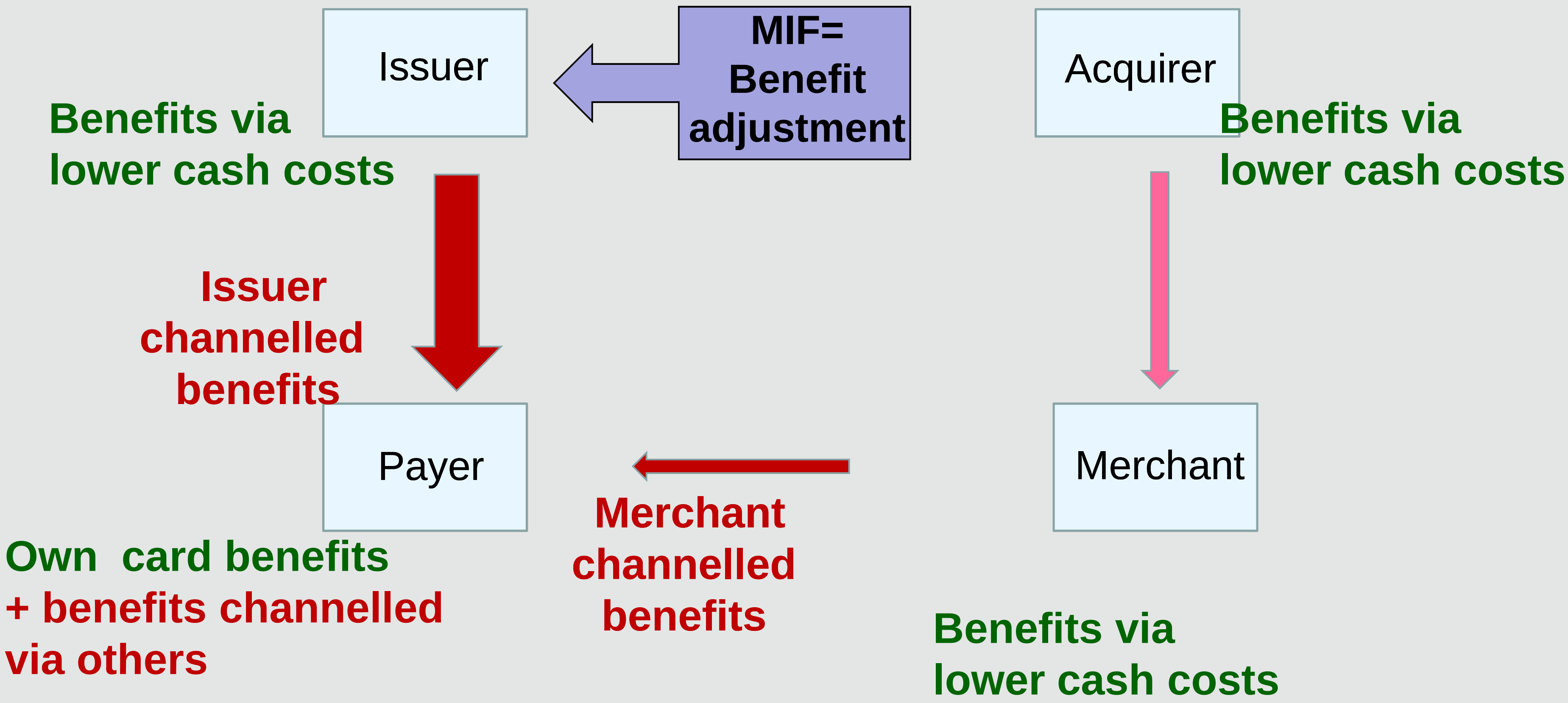
Basic finding 3: All stakeholders benefit from cash payment conversion to card payments above a given transaction size

Two benefit channelling routes from service providers



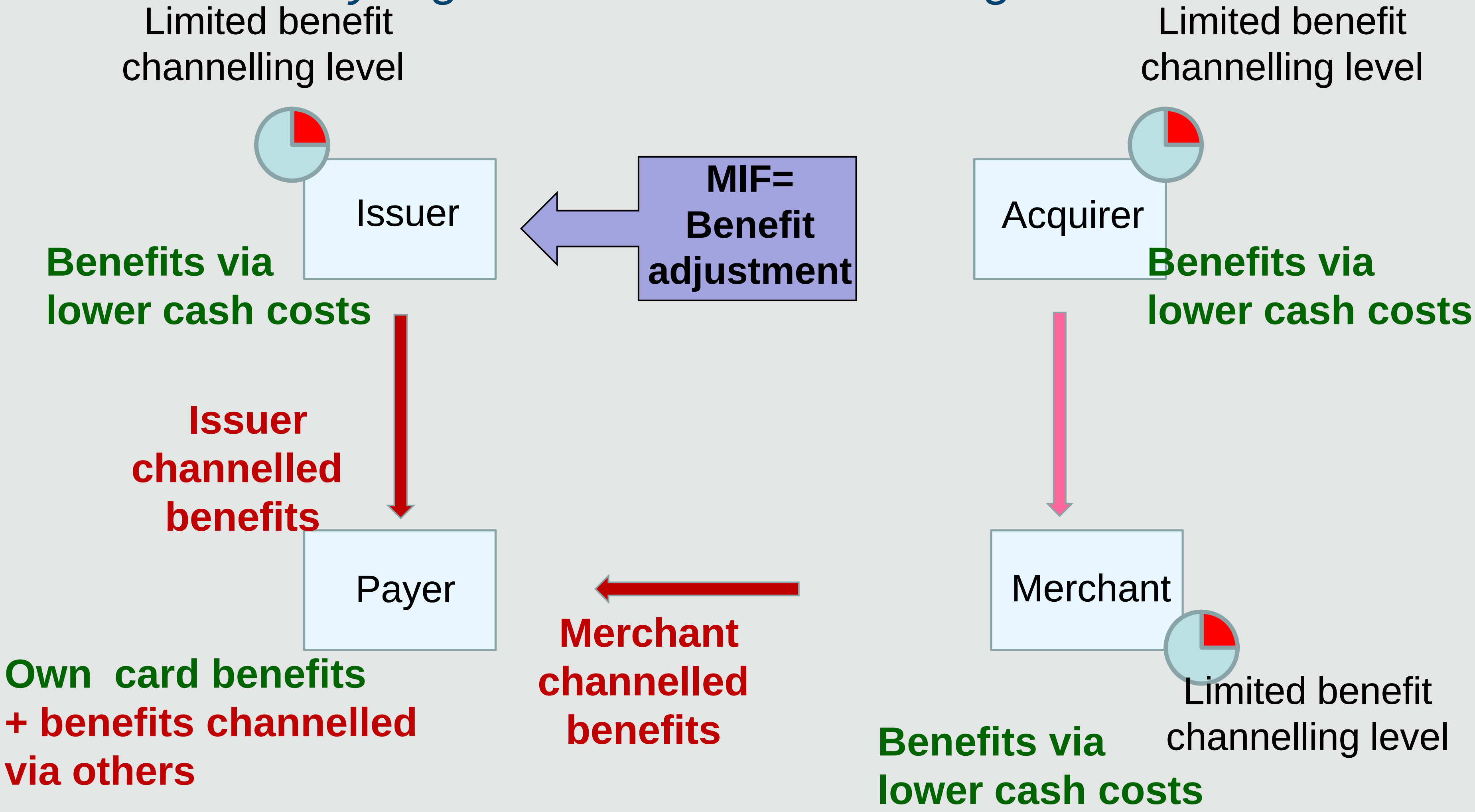
Basic finding 4: Service providers' card technology benefits can be channelled to consumers via two routes - via issuers and via merchants.

The impact of an interchange fee



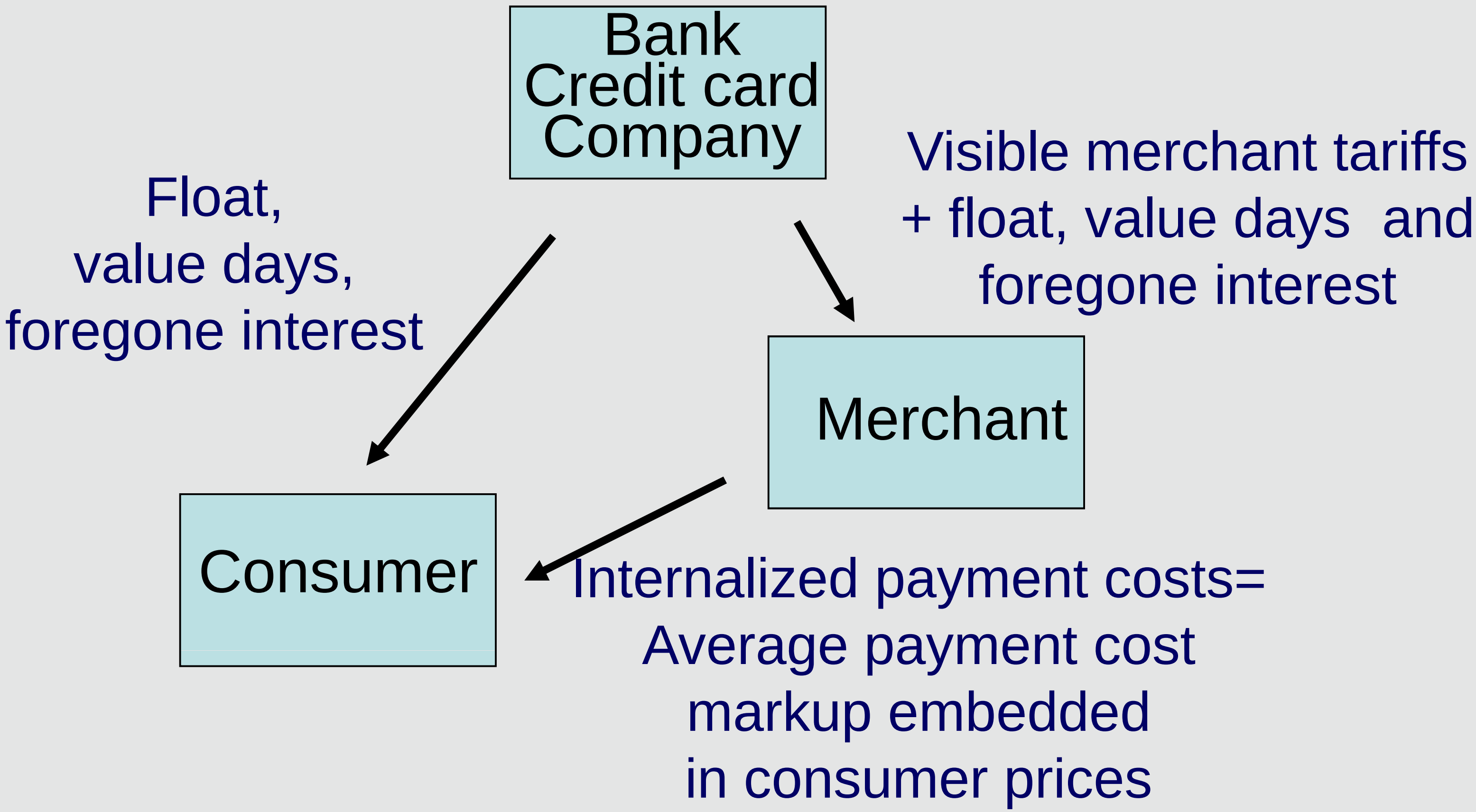
Basic finding 5: The possible (multilateral) interchange fee between issuers and acquirers adjusts the benefits to be channelled via the two routes.

Varying benefit channelling levels



Bf 6: Insufficient competition enables service providers to limit benefit channelling to payers.

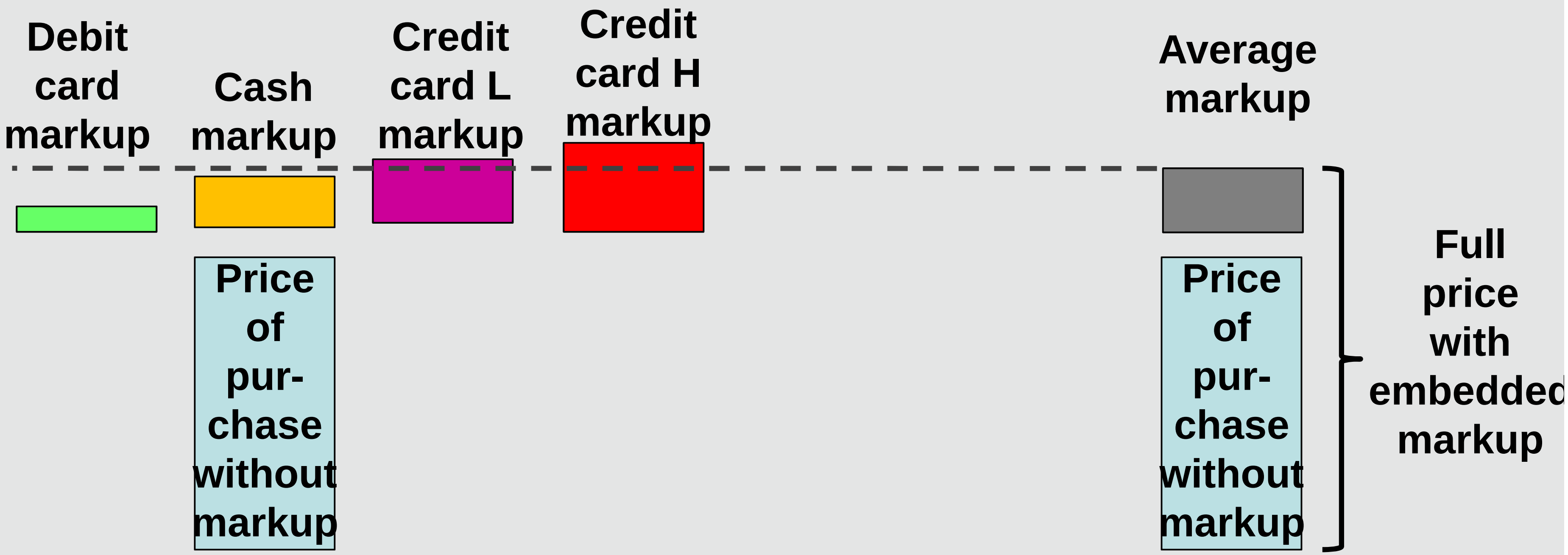
The majority of payments tariffs are hidden = the biggest barrier to change?



Bf 7: In the end, consumers always pay for all payment costs

BF8: Non-transparent and biased price signals will distort volumes towards an inefficient mix.

Transparency or non-transparency at the merchant end ?



BF 9: An average merchant markup results in cross-subsidisation between payment instruments

BF 10: Visible surcharges and an average markup results in the same markup total but surcharging eliminates the cross-subsidisation.

BF 11: Transparency also achievable via discounts for efficient instr.

Negative social consequences of hidden/embedded current business model

i. price competition is limited; there cannot be price competition without price visibility for payers

ii. cost differences between payment alternatives remain unseen by the payers; no awareness of differences

iii. payers lack incentives to economise when they cannot see the cost factors (in contrast, visible prices on disposable plastic bags promote economising and reduce embedded markups)

iv. higher overall costs due to distorted volumes when economies of scale benefits for efficient instruments are reduced

v. new efficient entrants have difficulties in entering the market without visible price/cost factors revealing their superiority

vi. the development pace in payment services is slow owing to the lack of price/cost incentives.

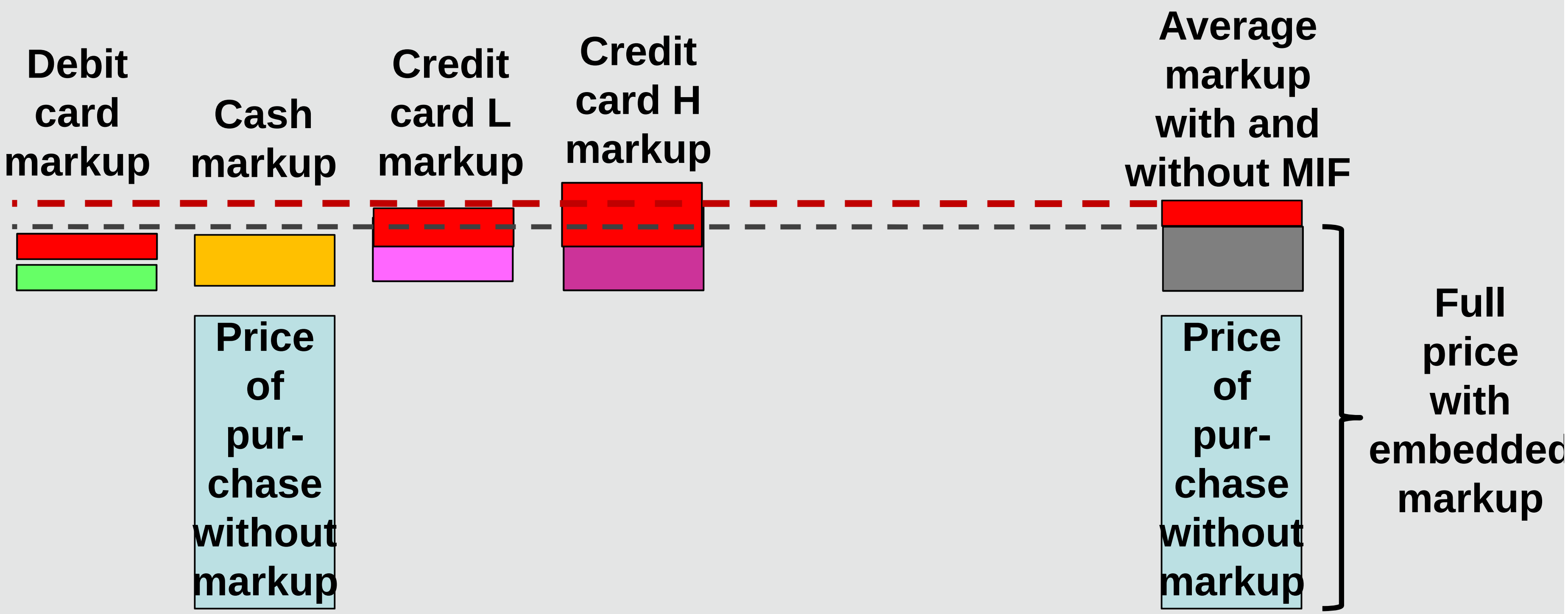
BF 12: The current non-transparent business model promotes inefficiency

Weaknesses in two-sided market theory and tourist test arguments

- Unbalanced comparison of instruments and bundled services
  - Cash vs debit cards or consumer credits vs credit card credits
- MIF is an unnecessary increase in issuer benefits
  - ATM costs decrease and bank seignorage increase with more EFTPOS
- Neglecting merchant fee transmission into payment markups
  - Merchants do not pay; they merely mark up their costs
- Credit sales benefits attributed to cards
  - Credits can be provided at lower costs via transparent consumer credits attached to cards in different ways
- Limiting merchants' interest via high (tourist test) MIFs
  - The higher the MIF, the less the merchant interest and card acceptance

BF 13: The MIF adjusts inter-service provider benefits, while consumer visible cost-benefit differences promote efficient instrument selection

The tourist test outcome

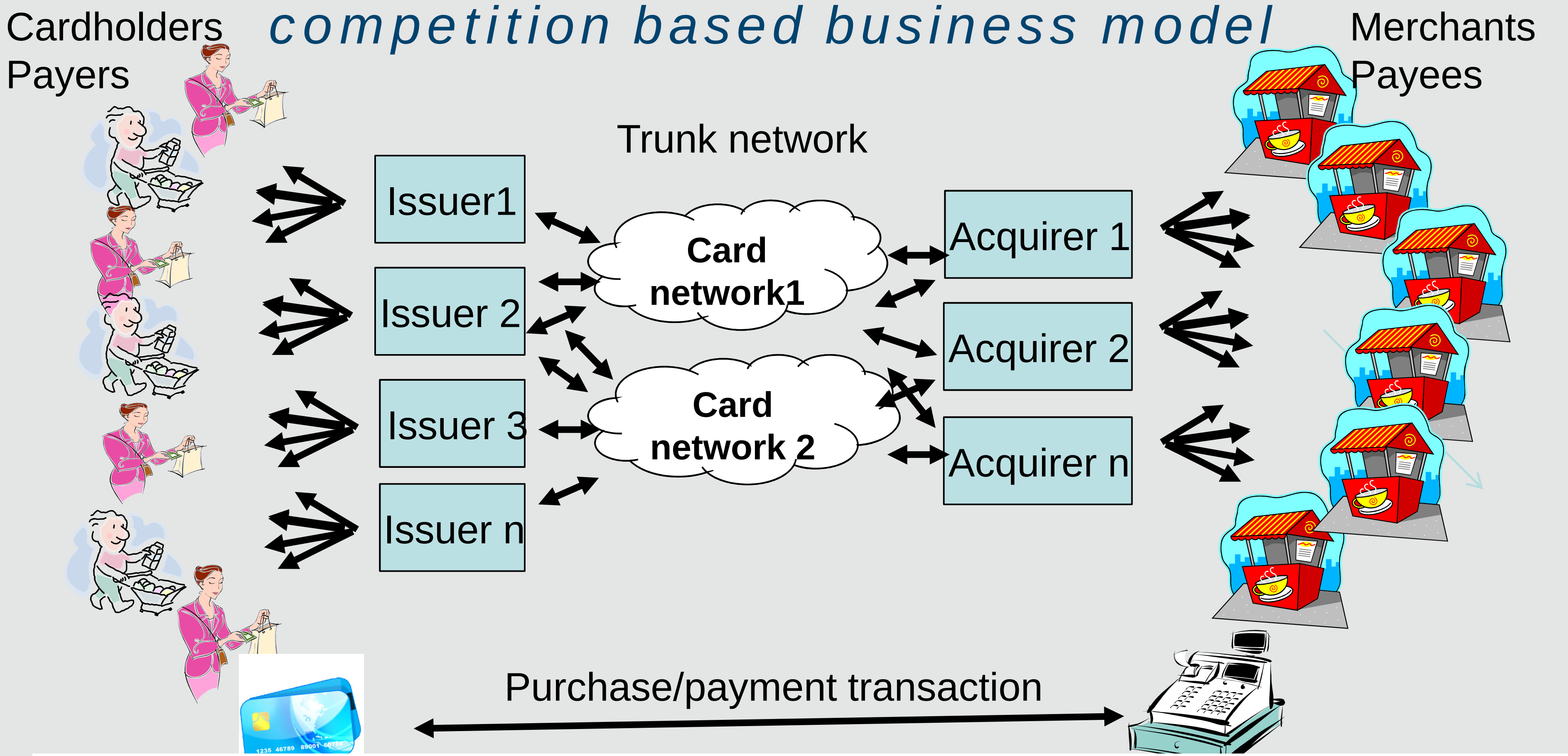


BF 14: MIFs will increase the average merchant markup compared to a no-MIF situation

BF 15: A tourist test level MIF will remove merchant interest in cards

BF 16: Different debit and credit card MIFs is not in line with tourist test 'indifference'

Necessary features of a transparent and competition based business model



BF 17: Competition can be increased for the benefit of consumers by

- common interoperable standards for issuing and acquiring services,
- an open interbank trunk network,
- issuing acceptance at par (MIF=zero),
- providing unbundling possibilities and
- giving merchants rights in free surcharging.

Fair merchant surcharging

- Clear customer information on surcharging
  - Visible signs and pre-calculations eg at hotels/restaurants
- Clear reference price for surcharges/rebates
  - Clear price tags eg cash prices on tags with + card surcharges or – card rebates (eg a debit card discount)
- Information on costs included in surcharges
  - eg acquirers' merchant fees, float, terminal costs etc
- Information on price changes during changeover period
  - Moving from embedded pricing to transparent pricing will probably change the reference price level, but this depends on current volumes and acquirers' fees

BF 18: Surcharging makes achievable card technology benefits visible and channellable to customers who create them.
BF19: Transparency on surcharging policy is merchants' best defence against 'unfairness' accusations.

Regulatory issues regarding a transparent business model

- Promoting open and transparent pricing (=reducing MIFs step-by-step to zero and supporting surcharging)
- Unbundling of services
- Promoting interoperability, creation of common standards and rules, both for issuers and acquirers
- Promoting common and open trunk network infrastructure

BF 20: The industry is trapped in the current inefficient business model, and regulatory efforts are needed to increase payment efficiency.

Benefits of increased transparency and competition

- Overall costs will decrease when customers' selection is closer to break-even point
- The infrastructure will become more efficient
- Increased service provider competition improves services and efficiency
- Service content will improve and customer interests will get more attention

BF 21: Moving towards increased transparency would increase the use of debit cards and
reduce the use of cash and credit cards.
BF 22: Regulatory developments that reduce transparency and openness can have the opposite impact.

Conclusions

- We are **<u>still</u>** in a transition phase from paper-based and manual to efficient and electronic instruments
- The transition is delayed by an out-dated legacy business model
- The industry is ”trapped” by this legacy model
- Regulatory measures seem to be the fastest way out
- The sooner the business model is changed, the faster the transition speed and the sooner the benefits start to flow

BF 24: The difficulty seems to be to get consumers to understand that transparency is in their interest

BF 23: The industry will survive a business model change towards increased competition (as in all other industries)
<u>it will simply become more efficient</u>