Blowing Smoke

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Polaris Partners

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Brussels takes a stand

It's hard to know how to judge the EU's proposal to slash interchange. But here are a few adjectives to start with: naïve, wilfully ignorant, showboating.

Trouble is, the EU isn't alone.

Take naïve first: who has made the loudest noise about the supposed unfairness of interchange levels? Consumers – or merchants? Answer: around the world, it's been merchants, hands down. In the US, the Merchants Payments Coalition[1] runs the noisy, well-funded Unfair Credit Card Fees campaign out of Washington - where else? North of the border, the elegantly-named "Stop Sticking it to Us" movement[2] is managed by the Retail Council of Canada.

It's a global pattern, and the argument is always the same: consumers lose out (fabulous sums are quoted - $50 bn a year, according to the Merchants Payments Coalition) resulting not only in higher prices for customers, but also charges that, again according to the MPC, "in many cases, equal or exceed what the merchant earns on the sale." In which case, one would respectfully suggest, these merchants have a bigger problem than simply interchange levels.

But regulators have bought these arguments wholesale. Here's EU Vice President and Head of the Competition Commission, Sr. Joaquín Almunia: *"The interchange fees paid by retailers end up on consumers' bills…. Consumers will benefit through lower retail prices."*[3]

Splendid stuff. Now let's look at the evidence.

The view from the real world.

One of the earliest regulators to tackle interchange, as far back as 2006, was the Reserve Bank of Australia. Philip Lowe, then Assistant Governor of the RBA, enjoyed describing what he saw as the defects of the interchange environment, and set out in glowing terms the benefits that consumers and retailers would enjoy from a "more rational" regime.

According to Mr Lowe, *"The (RBA-led) decline in interchange fees has also reduced merchants' costs, and we have no doubt that this is flowing through into lower prices of goods and services than would otherwise have been the case*."[4]

Eager to learn from these bold trend-setters, US regulators quizzed them on the results. Here is the US General Accounting Office on the Australian experience: *"RBA…officials acknowledged that it would be very difficult to provide conclusive evidence of the extent to which these savings have resulted in lower retail prices because so many factors affect such prices at any one time.*
In Australia, issuers reduced rewards and raised annual fees following that country's interchange fee cap." [5]

Apparently choosing not to learn from this, under heavy pressure from retail lobbyists, in 2010 the US Congress passed the Durbin Amendment, aimed at slashing debit interchange. The results? *"It turned out that many merchants instead of passing to consumers, as previously declared, quite large savings from the reduction in the interchange fee in the form of lower prices, increased or maintained prices in the first two months after the introduction of the Durbin amendment, thus increasing their profits."*[6]

These findings were echoed in a MasterCard study in Spain, which also identified that merchants failed to pass on reductions in interchange.[7] It's telling that customers, perhaps more worldly-wise than their EU representatives, have little faith that merchants will pass on any savings: another MasterCard study recently found that 42% of European consumers doubted that merchants would pass on any reduction, compared with 32% who were more optimistic.[8]

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[1]http://www.unfaircreditcardfees.com/site/page/about
[2]http://www.retailcouncil.org/mediacentre/newsreleases/pr20130723.asp.
[3] *Payment News,* 24 July 2013
[4]http://www.rba.gov.au/Speeches/2006/sp_ag_140306.html.
[5] http://www.gao.gov/new.items/d1045.pdf Nov 2009
[6]http://www.nbp.pl/en/system_platniczy/interchange_fee.pdf, p91
[7] *Dow Jones Business News*, 24 July 2013
[8]http://www.finextra.com/news/fullstory.aspx?newsitemid=24164

All this, one would have thought, holed the consumer benefit argument below the waterline.

Interchange caps in action.

In fact, Messrs. Barnier and Almunia have rather hedged their bets: squirreled away in the text of the statement is a note that the extent of savings for consumers "will depend on the retail sector considered, the size of the merchant, its use of payment instruments, and the basket of purchases." Unsurprisingly, they have chosen not to headline this. Rather, even such a modest caveat is blithely ignored because the same proposal argues, without troubling itself to offer evidence, that "Banks' revenues may also remain relatively steady because lower fees would likely increase the number of transactions."[9]

It's hardly a secret that merchants pocket the savings on reduced card fees. Worse, many of them, in a classic case of having your cake and eating it, boldly continue to surcharge card payments at levels far in excess of what they actually pay.

At this writing, for example, Qantas impose a credit card surcharge of AUD30 on a return Sydney/Singapore fare of AUD 1044 – a swingeing 2.87%. These are internet bookings, heavily promoted by the airline to cut its distribution costs, and wholly dependent on cards, which it nevertheless charges its customers a premium to use. It would be interesting to hear the Reserve Bank of Australia's view on this outcome for public value.

Nor is it only airlines that bash the customer: in the UK, an institution as august as Her Majesty's Revenue and Customs charges a chunky 1.4% on the hapless taxpayer who settles up by credit card.

Even the much-ballyhooed benefits for business aren't equally shared: in the US, Durbin left small merchants worse off than before – but the big box retailers won't lose too much sleep over that.

Let a thousand flowers bloom… perhaps

The Commission's other argument is that, between them, MasterCard and Visa effectively operate as global monopolists. This would come as a surprise to anyone who actually works in the industry, and sees the payment schemes wrestling fiercely for share.

It also ignores the long-established competition from American Express and Discover, re-invigorated domestic networks like Interac in Canada, established operators like PayPal, the mushrooming e-transfer businesses, ambitious new entrants such as ISIS, Square, and iZettle – let alone what will happen when the heavy hitters like Apple finally take the plunge.

Apparently unaware of the battles for dominance already roiling the industry, Sr. Almunia has apparently persuaded himself that reducing interchange to rock bottom levels will make the business highly attractive to "new entrants".

Sadly, experience suggests that few turkeys vote for Christmas.

In any event, given that typical new entrant iZettle, targeting micro-businesses and small merchants, has charges that range from an entry-level 2.75% to 1.5% for very large volumes, it's not immediately obvious where the benefit is for either merchant or customer.

Have the confidence to tell the story

The plain fact is that cards have a value, for consumers and merchants alike.

As to whether card acceptance is a value to merchants, here's a simple test: suggest to your local supermarket chain that for a month they take only cash and cheques. As a mirror image, suggest to customers that from now on, they can only make payments using cash and cheques. Then stand by for the uproar.

The fault lies squarely with the card industry.

Too long focussed on the opportunities to generate revenue from optional add-ons, issuers in particular have lost sight of the amazing functionality that the simplest card offers. For their part, acquirers should have done a better job of comparing the costs of handling cash and cheques with card. [10]

Clearly, there are anomalies that need to be addressed: the variation in interchange rates from

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[9] *Dow Jones Business News*, 24 July 2013

[10] The Swedish Central Bank has done excellent work in this area: see, for example, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2092577)

country to country, at one time perhaps justifiable by reference to local conditions, is hard to justify.

And there's no doubt that the schemes have made a rod for their own backs by building a hugely complex array of charges, a reconciliation nightmare for acquirers and merchants alike. At both local and regional levels the networks are tackling these issues, though arguably the pace could be faster.

Regrettably, perhaps chastened by unremittingly negative media coverage, the card industry has been nervous about telling what is a genuine value story.

Counting the costs

But what are the likely effects if the EU proposal goes through? For sure, there will be a very sharp reduction in industry revenues. The question is, how will issuers in particular deal with it?

In truth, competition makes card fees unlikely. But when customers are perfectly willing to pay up for subscriptions to candy-floss services like Spotify and Netflix, issuers can only look on in envy. Unfortunately, they must also accept responsibility for persuading consumers that facilities as fundamental as payment should be free.

Looking at the big picture, it's a fairly safe bet that cash-back, rewards points and CBTs will disappear, be scaled sharply back or incur a charge. And then, really, where would be the customer gain?

It's hard to believe that, with the resources at their disposal, regulators like the EU cannot find what a couple of hours' research on the Internet will clearly demonstrate. Simply reading the magisterial review developed in 2012 by the National Bank of Poland[11] would have helped avoid obvious flaws.

And let's not underestimate those flaws: there's a real risk that, taken together, the Commission's proposals will reduce the opportunity for new entrants to compete by undercutting existing current network costs, and do nothing to stop merchants trousering the savings.

A hidden agenda?

We've seen that there's reason to doubt merchants' motivations, especially their promises to pass any interchange reductions along to customers.

And there has to be at least a suspicion that industry overseers have their own agenda. Could it be at all possible that, around the world, regulators are looking to hit banks when they're unpopular? In particular, could it be that Brussels, widely criticised for its alleged lack of democratic accountability, is disingenuously seeking to put itself on the side of a sceptical public?

Surely, they're above all that. Aren't they?

And yet… Sr. Almunia's Competition Commission is also investigating the privileged tax position of four Spanish football clubs, said to give them special advantages in the transfer market. The investigation has been running for four years so far, with no result in sight. The Commission's own guidelines say it should take no more than a year. The European Ombudsman has issued a scathing report on the Commission's handling of the case[12]. One of the clubs is Athletic Bilbao. Sr. Almunia is an enthusiastic Bilbao fan.

Smoke, anyone?

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[11] *Analysis of the operation of the interchange fee in cashless transactions on the Polish market,* National Bank of Poland, January 2012 http://www.nbp.pl/en/system_platniczy/interchange_fee.pdf

[12] *The Independent,* 7 August 2013

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With more than 20 years of experience in the payment card industry, Roy was previously with American Express, where as VP and General Manager, he launched the highly successful commercial card business in the UK, going on to lead product rollout across EMEA and latterly Latin America/Caribbean.

As a consultant, Roy works with banking and payment card clients around the world, identifying and advising on best practices in customer marketing and relationship management. He has also undertaken assignments in media, utilities, airlines and retail.

He has developed and audited coalition and bank loyalty programmes in the UK, Ireland, the Netherlands, Spain, Canada, Dubai, Kuwait, Australia, Singapore, Spain, Israel, Turkey, Saudi Arabia, Brazil, Chile, Venezuela and Mexico.

Roy has also advised on airline FF programmes, and has been the rewards lead in the MasterCard Advisors pool.

He speaks fluent Spanish, reasonable French and is the author of Marketing Planning for Financial Services (Gower Publishing). He has a B. Com, holds an MA in Management Studies and is a Fellow of the RSA.

About Polaris Partners

Polaris Partners is a young company led by directors with decades of experience as senior managers and consultants. We specialise in helping businesses reach their sales and marketing goals.

Most of our work is in the financial services and leisure sectors, but we've also completed major engagements for household names in utilities, travel, media and retail. Our clients span the world: we've undertaken projects on every continent, and are comfortable working on-site when necessary.

"No job is too big, no job is too small." In our case, the cliché is true. We've advised banks on the strategic management of their payment card portfolios, we've helped start-ups write a business plan, we've built strategic alliances between leisure sector leaders, we've put sales forces on the road.

We have great respect for the numbers – data analysis and financial modelling are important tools for us – but we also believe in the power of creativity.

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