



**Eurofi 2008 –
Thursday 11/09/08
Session [3C] CARD
PAYMENTS: AN UNDERUSED
OPPORTUNITY: Innovative
National Authorities’
initiatives - Conditions for
an equitable balance among
different stake holders.**

The Panel

Moderator: **Wouter de Ploey**, Director in McKinsey & Company’s Antwerp office, and Leader of McKinsey’s European Payments Practice.

Panellists: **Fabrice Denèle**, Head of Interbank Relations, Caisse Nationale d’Epargne (CNCE)

Steve Perry, Executive Vice-President, Relationship Management, Sales and Commercial Development, Visa Europe

Irmfried Schwimann, Acting Director & Head of Unit Antitrust, Financial Services, DG Competition, European Commission

Narinda Viguié, Director of Strategy and Interbank relations at Cedicam, part of the Credit Agricole group

The Debate

Introducing the session, **Wouter de Ploey**, Director in McKinsey & Company’s Antwerp office, and Leader of McKinsey’s European Payments Practice, said the key issue was how to develop the card market in Europe, especially in terms of innovation, setting up the market, cross border contacts and initiatives that might be needed from regulators or government to enable these things to happen.

Fabrice Denèle, Head of Interbank Relations, Caisse Nationale d’Epargne (CNCE), said it was difficult to talk about further innovations when, despite all the work done to build SEPA, with all the parties involved, the first SEPA product, the direct debit, was “very much in danger”. He said a recent joint press release from the Commission and the European Central Bank (ECB), which stated their intention to forbid interchange after an initial transitional period – without real study and discussion with all the stakeholders – had led to an “amazing” situation. The players had invested huge resources in the project, but now faced a lack of understanding on the fundamentals of the payment market. Electronic payments, he said, were “in essence, a network industry”. The present situation put the whole SEPA project in jeopardy, he said.

Improving the cards market had huge potential to create value via a single European landscape for payments. What had banks achieved, and how? If we looked at the existing situation in the cards market and the usage in different member states, clearly domestic particularities had to be considered, he said. The policy mix of payments was quite different between countries, and banks had to take that into consideration if they were to make SEPA for cards a success. The question was not which system was best, but how to build out of the diversity a common space for cards in Europe. Much had been achieved at the European Payments Council (EPC) Round Table, and one of the first deliverables was the SEPA cards framework (SCF).

This achievement was a “pure product” of the co-operative space between competitors, he said. He did not believe it could have been achieved without that co-ordination. This posed a real question for regulators: was there any remaining space for co-operation and self-regulation in the payments industry? Was there any way to achieve SEPA other than co-ordination between members? “I don’t think so. The only alternative is regulation of market practices, regulation of prices, regulation of standards, and so on.”

Within the next few months, the EPC would deliver complete standardisation for cards. This was very important in order to improve the card business. Standardisation and inter-operability would thus be “at the rendezvous” for SEPA within months.

A glance at the market initiatives around cards showed that the SCF had designed a transition period for economies to become SEPA compliant, but it was not enough. It was impossible to imagine achieving SEPA for cards if barriers remained at the domestic level due to the logic and efficiency of national schemes – at least in countries, which had achieved state-of-the-art schemes. But it was unacceptable to imagine a SEPA for cards system only handled by national schemes, with SEPA perimeter transactions treated as international transactions. Nor was it realistic or acceptable for banks that had invested a lot over the past 15 years supporting international schemes to give up existing partnerships. The industry was facing a huge problem with multiple dimensions, he said. No-one knew where things were going in the card business, said Mr Denèle.

Within the market place, there was a clear and progressive adaptation by Visa and Mastercard to the European landscape, but it was still unclear, in terms of value proposal and business model, partly because of uncertainty about interchange. The Mastercard strategy still needed to be explained to players, and the Visa model needed to be improved, and show efficiency and durability for SEPA for cards. The Euro Alliance for Payment Schemes (EAPS), an alliance of pre-existing payment schemes, and Monnaie, a new alternative that took a building blocks approach. “My personal feeling is that EAPS seems to miss an efficient next-step, while Monnaie for the time being probably misses the transition period.”

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Groupe Caisses d'Épargne, a leading French issuer with 6-8m cards, had decided to keep in touch with all the initiatives and was waiting for clarity.

The second remarkable thing was the appetite of the market for innovation. The payment industry was ready to design new products. "Banks are genetically programmed for innovation in their business lines." The main initiatives discernible in the market focused on contactless payments and mobile payments, and/or mobile banking, he said.

Contactless payments offered good opportunities to expand the range of services on cards, both for consumers and retailers. Mobile banking followed social revolution towards mobility. Mobile payments could be contactless payments. The developments were therefore closely linked. Both mobile and contactless payments would be key factors in reducing the use of cash, even if the security issue still needed to be fully resolved. Interoperability and standardisation would be key issues.

The business model also needed to be defined, because new players, including telecoms companies (telcos) would provide part of the value chain in mobile payments.

It was still possible to envisage a sustainable business case for cards, but "we face a huge risk with the interchange debate," Mr Denèle said. Equilibrium and a fair sharing of the cost and the revenues were absolutely vital to organise the business line between all the different players.

Four-party models were very transparent, and encouraged competition between players. But it was hard to foresee what side effects would arise from the Commission decision on interchange. So the present situation was troubling, he said. "If we collectively really want to achieve SEPA based on an efficient cards market, then we have as an emergency to solve the business case problem." However, he was confident the parties would return to the table to define a new business model "based upon some interchange, but also something else".

Narinda Viguier, Director of Strategy and Interbank relations at Credit Agricole group, said she shared many of Mr Denèle's views. But a serious economic crisis was causing a slowdown that was affecting consumers. "I think we are unlikely to see rates for payments being maintained at the levels we have seen in the past few years," she said. But at the same time, banks were being asked to help build the internal market by setting up SEPA, because despite the establishment of a monetary union, euro payments markets were still national both in their nature and operations. Most transactions still took place within domestic systems: cross-border transactions were still only a very small proportion – perhaps two or three per cent, according to the payments instrument of total transactions. Difference between member states in terms of services, technical standards and legal frameworks made the emergence of the SEPA a highly complex task. The Payments Services Directive voted by

the European Parliament would regulate the rights and obligations of the payments services providers and users across Europe.

The Directive would open markets to increased competition. It sought a level playing field by allowing non-banks to enter the European payments market. It sought also to enhance efficiency of electronic payments and ensure consumer protection and transparency. The shift over the past decade from cash and cheques to debit card payments had been confirmed. But even if cash transactions had decreased by four per cent in recent years, cash still accounted for 80 per cent of transactions by volume. "So it is a very slow decrease rate." Against that background, regulators and politicians were trying to accelerate and shape the future of the card industry in Europe. The ECB wanted a European infrastructure. The EPC sought to define a road map for SEPA compliance and the Commission ("in my view, the major driver") had established a comprehensive legal framework to allow it to happen.

For banks, the question was whether it was bad or good news. The downside was possible losses – especially if pricing converged to the lowest levels on offer (sometimes with a limited level of service). A long, and therefore expensive, migration to SEPA could also cause losses for banks. Cross-border competition without a level playing field could allow payments institutions to penetrate the market with fewer financial constraints than banks, jeopardising security and consumer confidence. Consumers could also experience surcharging in some countries, whilst other states banned it.

On the other hand, banks had a chance to restructure their value chain to improve efficiency and processing, achieve economies of scale and more importantly, the opportunity to shift consumers away from cash to electronic payments. Banks' investments had to be shaped by the business case. The technology for contactless and mobile payments was available. The issue was market acceptance. "We have to ensure the security level that is paramount for our business."

Pan-European services could remain basic, and fail to provide users with the "right" level of service. Uncertainty on legal, competition rules, and compliance of EPC discussions could also jeopardise a standardisation and harmonisation process that was crucial to ensure inter-operability of payment services across Europe.

Though the SEPA transfer was launched in January, after a few months SEPA transfers were hardly one or two per cent of total credit transfers. Either consumers didn't need to change, because they were satisfied with their banks' services, or were not being offered services they needed. "If the market keeps this rhythm, the migration path will be long and costly, and this is a situation that we want absolutely to avoid." The launch of SEPA direct debits, expected at the end of next year, could hit banks' revenues. Creditors were willing to migrate to the new scheme, but would need full

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support from debtor banks. Debtor banks might be “less enthusiastic to promote a payment instrument that is not that profitable for them”. That could endanger the four-corner model, because corporates could give their transactions directly to debtor banks, paying only for those services.

The decision of the European Competition Directorate on the Mastercard case was creating new uncertainty for the market, which would not encourage investment in new channels and methods of payment, such as the internet and mobile. Banks needed much more support from the authorities to make SEPA happen. Governments should develop electronic payment options and inform consumers. The banking industry was ready to work hard, but provided it could develop its activities on a secure and fair business model. “Because we don’t ask turkeys to prepare Christmas, do we?”

Steve Perry, Executive Vice-President, Relationship Management, Sales and Commercial Development, Visa Europe, said he was “single-mindedly focused” on “taking the title of this conference and making it happen”. Electronic payments were an “under-used opportunity”, he said. For Mr Perry, the future was a war on cash. For him, the issue was persuading banks, retailers and consumers to use cards, because cards were more efficient than other methods of payment. Cards were “the way to deliver the vision that is SEPA”. Cards were cheaper than cash. Cards were a way to improve social inclusion. Electronic payments squeezed the black or grey economy, and improved efficiency and integration. In Iceland, 75 per cent of consumer spending was on a Visa card.

Mr Perry said: “Electronic payments are all about the currency of trust. Standards like EMV work.” Consumers were “looking to us” to deliver contactless cards, so Visa could attack low-value payments, as well as high-value, mobile and Internet payments, and improved security. To make SEPA a success, the value it would create had to be shared between stakeholders: banks, retailers and consumers. “Banks have an economic right to enjoy profitability from electronic card payments.” He urged governments, regulators, the Commission – any interested party – to “wake up to the fact that the cost of cash is significant”.

Though it was hard for consumer and the media to grasp, cash was not free. A stable and profitable business model for the banks was a necessary condition for SEPA and electronic payments to happen. And it was currently absent. “It is difficult to invest. It is difficult to make mobile and contactless pay back. It is difficult to make PCI (security standards) pay back” – all because of interchange uncertainty.

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The second pre-condition was an open and honest dialogue on the cost of cash. It was necessary to “move the macro-economic benefits that exist” to the stakeholders, to provide a stable and profitable business model, and to have a dialogue on the cost of cash.

Irmfried Schwimann, Acting Director & Head of Unit Antitrust, Financial Services, DG Competition, European Commission, said that whilst in other areas the Commission’s primary role may be that of proposing legislation, in the case of the MIF for SEPA Direct Debit the Competition Directorate had a different role. “If we establish that there is an agreement between companies which restricts competition, then there has to be a good justification for that in terms of efficiencies benefiting consumers,” she said. “It is for the companies who co-operate to come up with the justification.” The DG’s position with regard to direct debits was the same as its position with regard to payment cards. “We don’t say a priori that a MIF (multilateral interchange fee) is not OK, but you have to come to us with a proper justification, you have to explain what the methodology is, what the underlying efficiencies are because - that is also very clear in the rules – most of the underlying benefits have to trickle down to the consumer.” No such justification had been made for direct debit and DG Competition was “still waiting for the payment industry to come forward”.

Though there was room for co-operation, the DG wanted to ensure that there was effective competition.

MIFs have the effect of raising the marginal costs of acquirers and lowering the marginal costs of issuers, she said. In practice, that meant higher merchant fees and lower cardholder fees. That could be useful to promote a payment method that was more efficient, but MIFs could inflate charges to merchants, so were only justified if they could bring efficiencies to consumers. One side of the market could subsidise the other.

But evidence showed merchants could face higher costs, which they then passed to customers as higher prices. Banks could also set interchange fees at excessive levels, passing only limited benefits to cardholders. The assessment in the Mastercard case - which provided clear criteria on MIF assessment – showed that there had to be a realistic model underlying a MIF, and that it was verifiable. Verification required detailed data, and some MIFs could be considered illegal.

In practice merchants are induced to accept cards for fear of losing customers, as a consequence of which they are willing to accept higher merchant fees than if they would not fear this ‘business stealing effect’. More transparency was needed. The no-surcharge rule masked price signals to cardholders, said Ms Schwimann, including those about relative costs of different payment methods. Several practices raised concerns, and some also arose in SEPA plans, including how cards could be issued across borders.

Ms Schwimann said she shared concerns about lack of transparency over the cost of cash. But “I don’t think consumers are stupid. I think they can bear the truth.” But these were “long-term solutions”.

Mr de Ploey, in the chair, invited panellists for their comments. Mr Perry said that Visa was “absolutely” engaged with the DG and exchanging data. “We know our interchange isn’t illegal. We have had the exemption.” He acknowledged that the DG had opened proceedings, but said that was the necessary mechanism to allow the data exchange. “We believe we have been good citizens within the confines of the agreement we had with the Commission.”

Ms Viguier sought more explanation from Ms Schwimann about the offer of payment card services to consumers. Would consumers feel comfortable with prices that varied according to the method of payment? Ms Schwimann said some states had much more transparent practices than France, which gave scope for educating consumers. Mr Denèle said consumers might simply get cash from ATMs to avoid surcharges.

Bernard Dutreuil of the French Banking Federation asked where his members should invest. For DG, was the market limited to cards or phone payments, or to all competing payment mechanisms, including cash and cheques? Ms Schwimann replied that competition issues would be dealt with on a case-by-case basis.

A question was asked as to who would win, and who lose, from any ‘war on cash’. Mr Perry replied that Visa had been displacing cash and cheques. Really, he said, it was a war on the cost of cash.

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