

The End of Multilateral ATM Interchange?

Despite the fact that interchange has been used in Europe for the past 25 years, it's a concept that still makes the regulators uneasy. The cause of their discomfort has never been fully understood by bankers and card schemes. After all, the bankers argue banks are perfectly entitled to charge the cost of providing services to each others customers. Logic dictates that an ATM owner should raise a charge on a UK cardholder's bank when cash is dispensed in France. Similarly, when the cardholders bank guarantees a POS payment, some form of cost transfer should be paid by the merchants bank to cover the issuers cost of risk and transmission. Bankers also argue that the principle of interbank charging has been embedded for decades in cross border payment systems where a correspondent bank acts for a partner bank and charges for it's services.

So to the financial community interchange is very straight forward and simple. "What's all the fuss about we are only doing what we have always done!". Well like it or not, the bankers messages have not been well received. Interchange is under review by regulators in the UK, Australia and most ominously by the Competition Directorate (DG4) of the European Commission. The reasons for this new focus by the regulators is summarised in Table 1.

Issue	Concern
Transparency	Unclear calculation basis. Set by costs of least efficient operator.
Cost Formula	No logic. Why ad-valorem for credit and unit costs for most debit?
Cost Levels	Overcharging and excessive costs
Illegal Agreements	Suspicion interchange agreements are price fixing.
Territories	No logic to intra-regional and domestic territories.

Table 1 Key Concerns of Regulators

Visa has suffered most on the issue of transparency. Traditionally their credit card interchange formula includes cost components such as the free of charge payment period generally perceived by most observers as an issuer cost and not part of interchange. For all schemes, regulators are unhappy with the different bases on which interchange is raised for credit and debit cards. Why an ad valorem fee for credit and unit fees for debit when the core costs of transmission and guarantee are similar? The UK Cruickshank report also highlighted the issue of overcharging for ATM transactions and high MSC fees for SME's.

Regulators also have suspicions that multilateral interchange agreements are an indirect form of price fixing given they can represent 65-80% of the final MSC. Lastly the issue of territories. With the introduction of the euro, the international card schemes are finding it difficult to justify a common intra-regional interchange for cross border transactions whilst

allowing different domestic rates in each country. In some cases intra-regional interchange is lower than domestic thus damaging the case of domestic schemes.

The EU multilateral interchange agreements are now under close scrutiny following representations from Eurocommerce, the European Retailers Association. DG4 indicated in October 2000 that prima face the agreements breach EC anti trust rules. Schemes have found it difficult to provide convincing reasons why intra-regional interchange should be excluded.

It now appears that multilateral intra-regional interchange has nowhere to go unless a compromise deal can be agreed. Clearly the regulators recognise that interchange has been a key component in facilitating the growth of card acceptance domestically and cross border. Interchange, card scheme agreements, and common acceptance criteria are the pillars that support domestic and worldwide plastic card certainty of settlement. Changes that are too radical could destabilize the structure to the disadvantage of consumers and merchants.

At this stage it's difficult to envisage the consequences of it's possible outlawing as an anti-competitive practice. However, the following paragraphs attempt to examine the consequences of the different courses of action the regulators could adopt.

First, **Option 1 - all multilateral intra-regional and domestic interchange is outlawed. Only a low transmission fee allowed.** The rationale for this policy would be that such agreements are against the public interest and that the costs of payment guarantee should be recovered from the cardholder not the merchant. The possible impact of this approach is summarised below:

Transaction	Consequence
ATM Usage	<ul style="list-style-type: none"> ▪ Debit card - little impact in most countries ▪ Major reduction in credit card fees – growth in usage ▪ Low transaction fees discourage growth of ATM networks
POS Usage	<ul style="list-style-type: none"> ▪ Banks no longer guarantee payments – merchants liable for bad debt and fraud ▪ MSCs for credit cards and some debit fall substantially ▪ Debit card MSC's implemented where currently no fees ▪ Annual card fees may rise, and transaction fees raised ▪ Chargebacks rise and separate and higher acquiring fees raised

Table 2 Consequence of Total Outlawing of Multilateral Interchange – Transmission fee only Allowed

There would be little impact on debit card ATM usage given most domestic schemes already raise unit interchange transaction fees. Credit card usage would rise because cardholder charges should fall substantially. Issuers could see benefits in additional revolving revenues. If rates were set too low then ATM networks would probably grow more slowly and this would damage the placement of remote units.

The greatest impact would be on POS transactions. MSCs would fall radically for credit in many (and debit in selected) countries. Banks would no longer guarantee international card scheme credit and debit cards and would adopt the German ELV structure. Issuers may also raise annual card and transactions fees in some countries to offset revenue loss. Bad debt and fraud would be passed to the merchant and there could be a rise in chargebacks and in acquiring fees. In some countries (those without MSCs) banks would introduce fees for debit and in others with very low unit costs would rise to the EU norm.

So is this a policy that should be adopted? Can a single solution be implemented to resolve such a complex issue? This approach has worked for Belgian debit cards for many years but would it work EU wide? Also what is a fair transaction cost and how would it be set? By the card schemes or an EU payments regulator? Which card schemes would be included international, T&E, private label domestic debit and ATM? Many anomalies would need resolution.

Second, Option 2 - **only multilateral intra-regional interchange is outlawed. Domestic multilateral to be locally regulated.** Some consequences could be as follows:

Transaction	Consequences
ATM and POS Usage	<ul style="list-style-type: none"> • Domestic multilateral interchange substitutes • Scheme rules changed or use agents/correspondents • Domestic regulators to monitor • International card schemes administer and settle

Table 3 Consequences of Outlawing of Multilateral Intra-Regional Interchange

The impact of banning multilateral intra-regional interchange would be to oblige banks to fall back to domestic multilateral for cross border transactions. Given overseas banks are not members of each domestic scheme either scheme rules would have to change or foreign banks would use their correspondent bank to pay and collect ATM and POS fees on their behalf. The latter would be more costly to operate in that the agent would want a revenue share. Domestic international card scheme interchange costs would have to be registered with the local competition authorities if not already.

This approach has several merits in that the international card schemes are taken out of the Pan European interchange loop devolving all interchange agreements to the domestic schemes. Local regulators would be responsible for monitoring domestic agreements on the basis of subsidiarity. MSC's could be driven down through encouraging Cross Border Acquiring.

Third, **Option 3 - intra-regional and domestic interchange is replaced by an EU wide common ATM unit and POS ad-valorem interchange set by the international schemes and regulated centrally.** This option has similarities to Option 1 the difference being that banks are allowed to recover the costs of both transmission and an agreed core payments guarantee for POS. The consequences could be as follows:

Transaction	Consequence
ATM Usage	<ul style="list-style-type: none"> ▪ Minor changes (+) in interchange some countries ▪ Major reduction in credit card fees – growth in usage ▪ No radical impact otherwise
POS Usage	<ul style="list-style-type: none"> ▪ MSCs would fall substantially in many countries ▪ Issuers' revenue streams fall – pressure to recover from cardholders ▪ Fees for debit introduced where currently none ▪ Terms of acquiring may change ▪ CBA less attractive

Table 4 Consequences of Common EU Wide Interchange

If one common interchange is introduced, merchants would benefit most because MSCs in many countries would fall radically. Issuers would see a drop in revenues and again there could be pressure to increase annual fees and raise transaction charges. Significantly, Cross Border Acquiring (CBA) within the EU could become less attractive to merchants because high MSCs could no longer be undercut.

The Option 3 has more attractions than Option 1 in that banks still guarantee payments for merchants, fraud is contained and there is minimal impact on ATM structures. Again the key question is who will set rates and how will they be reviewed given EU wide Codes of Practice have traditionally failed to be effective in the banking sector?

Finally, **Option 4 - the outlawing of all forms of multilateral interchange and no card scheme involvement**. The rationale for this policy is that all such agreements are considered to be anti competitive either EU wide or within domestic markets. This would be the most radical change and the consequences could be as follows:

Transaction	Consequence
ATM Usage	▪ Bilateral domestic interchange substitutes
	▪ Agents/correspondents pay cross border fees
	▪ Many different fee structures
	▪ Complex to administer cross border
POS Usage	▪ Operational costs increase
	▪ Bilateral domestic interchange substitutes
	▪ Agents correspondents collect cross border fees
	▪ MSC structures move to unbundled
	▪ Cross border complex to administer

Table 5 Consequences of all Multilateral Interchange Agreements Outlawed

This is the most complex option to review. If all forms of multilateral interchange are outlawed banks will have no option but to agree bilaterals for both domestic and cross border ATM and POS transactions. The assumption is that international and domestic card schemes would not be allowed to conduct interchange studies nor administer on behalf of members. They might however continue to carry out clearing and settlement.

EU banks have little or no experience of card business bilateral negotiation. Only one EU scheme (to our knowledge) uses bilateral agreements leaving the multilateral cost as a maximum fallback. The negotiating outcomes are difficult to predict. Large bank to bank agreements (ie. the top 5-6 banks in each country) should be relatively simple to agree. Large ATM acquirers have the potential to force up rates. Large POS issuers may also do the same. Small banks would be disadvantaged and where there are many the complexities are horrendous. Some banks might find their cards cannot be accepted in some ATM's and POS devices.

Cross border fees could be established using correspondents as described under Option 1 with foreign banks agreeing to pay the domestic bilateral rates agreed by the local partner bank.

Because of the multiplicity of interchange rates acquiring would in many countries move to an unbundled fee structure with interchange quoted at "cost plus" fees for acquiring.

Would this option work? Overall Option 4 would be highly complex to administer. New structures and processes would be needed in each domestic market. Interchange rates may fall for large banks but could rise for the small. Small banks would be generally disadvantaged domestically and cross border. There would also be a risk that scheme acceptance structures might collapse.

To conclude of the four possible actions the regulators could adopt none are totally satisfactory. **Option 1** – a transmission fee would result in the demise of the POS payments guarantee which would disadvantage merchants. **Option 2** – outlaw multilateral intra-regional would mean schemes would fall back to domestic multilateral. This is an attractive approach which leaves interchange to be locally regulated. However new scheme rules or processes would be needed for cross border interchange. **Option 3** – one common lower EU interchange for ATM and POS is the most attractive provided such a fee can be set by the schemes and regulated to an open and transparent formula. **Option 4** – the banning of all multilateral interchange and it's forced replacement by bilateral is high risk concept which would be complex to operate and could have a major impact on card acceptance across Europe.

Interchange has taken 25 years to grow in Europe and for this reason cannot be easily uprooted. A common level of interchange may not result in common MSC's because the costs of acquiring vary substantially in each local market. In addition interchange is not only mandated by the international schemes and their local operations. It is also set by locally branded debit and ATM schemes. Solutions that suit the international schemes may not fit the domestic environment. Similarly T&E and private label card issuers have no interchange and would gain advantage if excluded from any regulation.

Regulators should be suspicious of simple solutions which have a dramatic impact on headline MSC's. One way or another banks have to recover the costs of services they provide to each other. Workarounds will inevitably be identified!

Peter Jones
Director
PSE Consulting
+44 (0)20 8891 6244
e-mail: peter.jones@pseconsulting.com