The background of the slide is a gift box wrapped in grey and white diagonal striped paper. A wide red ribbon is wrapped around the box, forming a cross shape. A large, multi-looped red ribbon bow is centered on the front of the box.

# **Unbundled Pricing**

## **Merchants Due for Uncomfortable Surprises**

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September 2010

### ***From January 2011, all European acquirers must offer “unbundled” merchant service charges. But what might be the impact on Europe’s acceptance pricing structures?***

Until now, acquirers have priced Merchant Service Charge (MSC) on the combined costs of card transactions for both major card schemes to create a single rate. In some European markets credit and debit products are charged separately but again use a common rate. This practice reflects acquirers’ limited ability to charge by card product and scheme separately, so most merchants have not had the option of a more detailed break-out of acquiring fees. Only a small number of large merchants have been able to negotiate “interchange plus pricing” and thus receive a full break-out of interchange, card schemes’ fees and acquirers’ charges.

This is about to change. In 2009 Visa and MasterCard were pressurised (some would say mandated) into an agreement by the European Commission that acquirers would introduce unbundled or unblended MSCs as the default pricing method by 31<sup>st</sup> December 2010. The rationale was to ensure merchants would know the exact costs of each transaction processed and, of course, could compare the cost of each international card payment type.

In practice unbundling means that acquirers must separate out the costs associated with processing each card scheme and further subdivide by card programme; for example, consumer, commercial and debit cards. European acquirers will no longer be able to combine all credit and/or debit card products unless specifically agreed with merchants.

Importantly, the agreement does not apply to the national debit card schemes which are the dominant method of payment in Belgium, Denmark, France, Germany, Ireland, Italy, Netherlands, Portugal and Spain. Nor is a break-out required for online, mail and telephone order transactions. The markets most affected will be those with high Visa and MasterCard debit/credit card acceptance (UK particularly) and those tourist nations with high cross border acceptance.

### **The Impact**

So what will be the impact on acquirers and merchants from the new pricing regime? MSC calculation has always been complex. Pricing models draw on many costs including: interchange rates (country, sector, product types); the cost of providing the acquiring service; POS devices; transaction processing; risk management; settlement processing; and, of course, the calculation of the acquirers’ profit. Most merchants are unaware of these components and bundled pricing meant, in the main, that acquirers did not have to explain the detailed, complicated calculations to them. Simple single rates, ad valorem or unit, made it easy to understand the cost of accepting cards. Unbundled pricing will change all this!

As is well known across the EU, acquiring commercial models and pricing practices vary considerably. A consistent policy is difficult to identify. In some markets terminals are owned and maintained by larger merchants; in others owned by the banks and rented; elsewhere banks bundle terminal costs into the MSC. As Table 1 indicates, there is a wide diversity of charging practices with many free of charge components reflecting local custom and practice.

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Fees Charged for:	BE	DK	FR	DE	IT	NL	PT	SP	UK
Initial set up/application	Yes	Yes	Yes	No	N/Y	Yes	Yes	Yes	No
Annual/monthly service	No	No	Yes	No	No	No	No	Yes	No
Minimum monthly service	No	Yes	Yes	No	N/Y	Yes	Yes	Yes	No
Terminals	No	No	No	No	N/Y	No	Y/N	Yes	No
Terminal maintenance	No	No	No	No	N/Y	No	Y/N	Yes	No
Telecoms	No	No	No	No	No	No	No	Yes	No
Statements	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Consumables	No	No	Yes	No	No	No	Y/N	Yes	No
Voice Authorisation	Yes	Yes	Yes	No	Yes	n/a	Yes	Yes	No
Chargebacks	Yes	Yes	No	No	Yes	Yes	Yes	Yes	No
Excessive chargebacks	Yes	Yes	No	No	Yes	n/a	Yes	Yes	No
Paper transaction	No	Yes	n/a	No	Yes	No	No	n/a	Yes

N/Y = a proportion; n/a = not available

Source & Copyright: PSE Consulting survey, 2008

**Table 1: Components Included and Excluded from EU MSCs**

Some markets have a lower headline MSC but acquirers often have special extra tariffs covering exceptional items. Also several countries charge low processing-only or no fees for national debit schemes with many service components provided free of charge.

When acquirers unbundle the charge category “other services” will need to be isolated within the merchant agreement. Other services include many of the items until now embedded in the bundled MSC, which will now require greater explanation such as: processing fees, operational support authorisation, clearing and settlement, risk and so on. Inevitably acquirer pricing teams will now have to pay far greater attention to such items.

Acquirers also have other challenges (see Table 2). New pricing models which require IT updates to produce detailed merchant statements, as well as changes to operational procedures.

Implementing unbundling will mean a huge communication exercise, internally and externally, to provide clear guidance to staff and merchants on how to interpret the new rules.

### **System Changes**

- Changes to split out card types and fee programmes.

### **Merchant Contracts**

- Changes to existing/new merchant agreements

### **Application Form**

- New fields on merchant applications

### **Operational Processes**

- New processes to capture new data
- Merchant support training on new structure

### **Statements/Online/Reporting**

- Unbundled card products - details on all statements
- Online merchant reporting to reflect more detail

### **Merchant Support Material**

- Updated to reflect new pricing structure

### **Communication**

- Communications programme for merchants and staff

### **Ongoing Compliance**

- Processes to ensure interchange rates updated and communicated

Source: PSE Consulting analysis, 2010

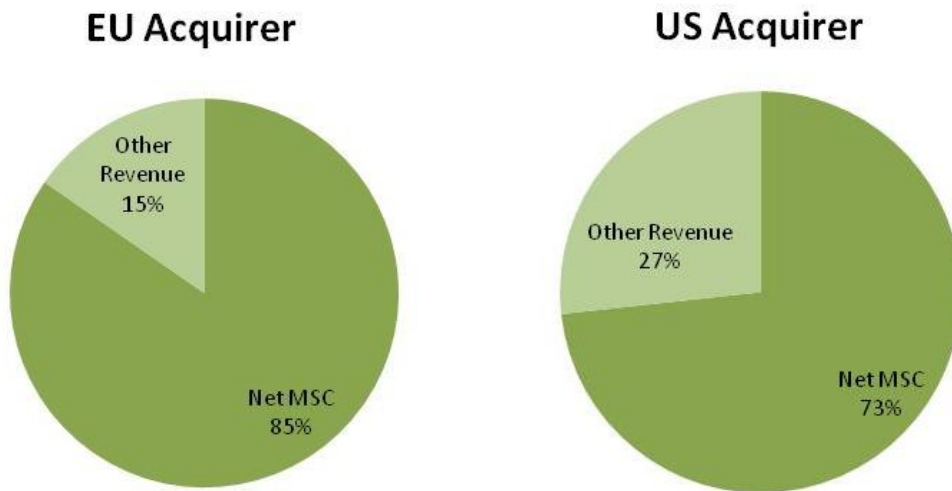
**Table 2: Key Challenges for EU Acquirers from Unbundled Pricing**

With the recent agreement by MasterCard and Visa Europe on EU lower intra debit card interchange rates, plus continued regulatory attention, many merchants are expecting a general reduction in MSCs. This may happen but acquirers, just like merchants, are in business to show returns. As MSCs decline acquirers will seek to maintain their current margins and will find other ways of externalising costs and generating income.

For example, the recent increases in card schemes' fees has resulted in acquirers increasing MSC rates to protect their margins and pass on the additional costs to merchants. Headline MSCs may fall significantly as a result of the combination of lower interchange and unbundling but the overall costs to merchant may not.

From an acquirers perspective the new MSC structure will enable a much higher degree of accuracy in pricing the acquiring service. For example, it is often difficult for acquirers to calculate exactly the volume split of domestic and international interchange for each card type accepted by merchants. As a result, acquirers often take a loss on certain card products under the bundled pricing method. The detail in the unbundled pricing model will enable greater accuracy and consistent margins.

On the other hand, price unbundling has the potential to drive even more radical change. If acquirers compare their pricing policy with those of the US, they will notice that typically the EU generates between 10% to 20% of other services, whereas US acquirers generate 25% - 35% (see Table 3). Higher US revenues reflect the common practice of price unbundling through interchange plus pricing which ensures that interchange and scheme fees are fully passed onto the merchant at cost. This reduces the acquirer's risk of mispricing these components. In the US there are over 200 different interchange rates and large merchants need sophisticated IT systems to ensure the correct pricing of each transaction.



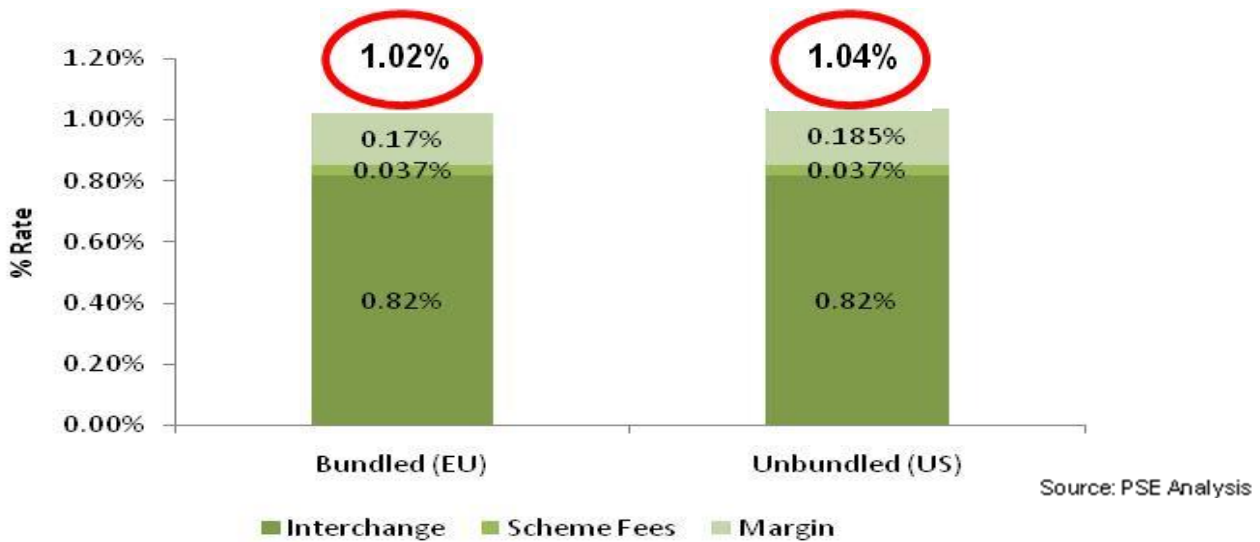
Source: PSE Analysis

**Table 3: Comparison of EU and US Acquirers' from other Services as a percentage of total revenue**

It is predicted that EU acquirers will offer interchange plus pricing to many more merchants than is currently the practice. In addition, acquirers are expected to start charging separately for individual elements of the acquiring service, for example, automated clearing house rejects, chargebacks, refund processing and statement fees.

Inevitably unbundled MSCs will also present opportunities to increase profit margins by charging for embedded services now broken out, particularly the high costs of free POS terminals and telecoms. In addition, some acquirers will also seek to remove cross subsidies and unbundle domestic debit costs currently recovered as an uplift on Visa and MasterCard acquired brands.

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**Table 4: “True” MSC Rates, including all Fees, are Higher in the US**

If we return to the US market model, Table 4 compares the current EU bundled average credit card MSC with the average US unbundled MSC. This shows US rates are two bases points higher. If the US model is followed, acquirer pricing becomes more accurate and costs are externalized, actual MSCs will inevitably be higher. This outcome would be contrary to the European Commission’s objectives and would disappoint the merchants lobby.

So who will be the winners and losers from unbundled pricing? Table 5 summarises the advantages and disadvantages to acquirers and merchants. Merchants will have much greater transparency and detail on the costs of acceptance. Many will initially struggle to understand the new pricing structure fully. As interchange rates continue to decline, merchants will see a decline in headline MSC rates but will begin to pay for services previously embedded in bundled pricing.

## Unbundled Pricing – Merchants Due for Uncomfortable Surprises

	Current – Bundled Pricing	Future – Unbundled Pricing
Merchants	<ul style="list-style-type: none"> <li>• Easy reconciliation of both credit and debit cards</li> <li>• Simple process - all products accepted and processed</li> <li>• Easy for merchant's staff to understand</li> </ul>	<ul style="list-style-type: none"> <li>• Much more detail – differently priced products, complex reconciliation process</li> <li>• Potential to move to interchange plus with even more detail</li> <li>• Only process/accept card products configured</li> <li>• Complex for staff to identify high rate card types during sale</li> <li>• Potential to decline/surcharge for high priced products</li> <li>• Potential increase in overall MSC</li> </ul>
Acquirers	<ul style="list-style-type: none"> <li>• Pricing assumptions cause unprofitable accounts</li> <li>• Increased revenue from bundling products under one rate</li> <li>• Simple operational processes - clear and concise offers to merchants</li> <li>• Easy to rollout new products designed to be processed under one card product</li> </ul>	<ul style="list-style-type: none"> <li>• Externalisation of costs of each card product acquired/processed</li> <li>• Potential increase in overall MSC revenue</li> <li>• Increase in merchant communication and costs</li> <li>• New card products require updates to T&amp;Cs</li> <li>• Major system changes to ensure full breakdown</li> <li>• Increase cost of operational processes, data capture documentation etc</li> </ul>

Source: PSE Consulting analysis, 2010

**Table 5: Current versus Future Unbundled Pricing**

EU acquirers will incur substantial costs in modifying their systems, changing contracts and communicating a large volume of detail to the merchant community. However finer cost detail and better pricing will enable acquirers to increase their profit margins and to externalise the cost of services that are currently provided free of charge.

Merchants will have greater choice as a result of unbundling and will be able to pick and chose which card product to accept. Products with high interchange costs (such as business cards) may be declined or surcharged.

Once all the different aspects of pricing are assessed and charged, the reality may be that merchants will end up paying more for their acquiring services rather than less – an opposite outcome to the legislation's objective. was designed to achieve!

### About PSE Consulting

PSE Consulting is a leading European payment business and technology consulting organisation. The company was founded in 1991 by Peter Jones and operates from offices in London.

PSE Consulting is a founder member of the European Payments Consulting Association (EPCA), an association of like consultancies operating in six European nations.

PSE Consulting provides independent advice to many of the European institutions mentioned within this article and to many other players who are currently shaping the European debit market place.



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