Response to European Commission

Consultation request to cases AT.39398 – Visa MIF & AT.40049 MasterCard II

January 2019

About CMSPI

CMSPI is an international, independent payments consultancy that has worked with hundreds of leading international merchants to develop optimal payments strategies and cost reductions. As an independent consultancy, we have no affiliation with any supplier globally. We work with some of the largest merchants in the world and are proud to be considered merchant champions and trusted impartial advisors to our clients.

Consulting with merchants across the globe, we have offices in Europe (UK), Singapore and the U.S., and work across all areas of global consumer payments. We are experienced internationally, and work with many multinational merchants with complex cross-border arrangements.

Our team of analysts and consultants has over 25 years' experience of supply chain market intelligence and an ongoing visibility of true supplier costs. Our knowledge, in-depth market insights, and benchmarking data, enables us to give our clients significant competitive advantage in complex and highly concentrated supplier industries. We use that knowledge to calculate the underlying charging structures behind the fees merchants pay and to help them reduce those costs and optimise their payment arrangements.

We have a unique visibility into the fees merchants pay globally to accept card payments and process cash transactions.

This document includes the following definitions:

- *Domestic – transactions where the merchant and the cardholder's issuing bank are located in the same EU country*
- *Intra-regional - transactions where the merchant and the cardholder's issuing bank are located in different countries within the EU*
- *Inter-regional – transactions where the merchant is located within the EU, but the cardholder's issuing bank is located outside of the EU*

The Commitments could deliver significant savings – unless eroded by other fee increases

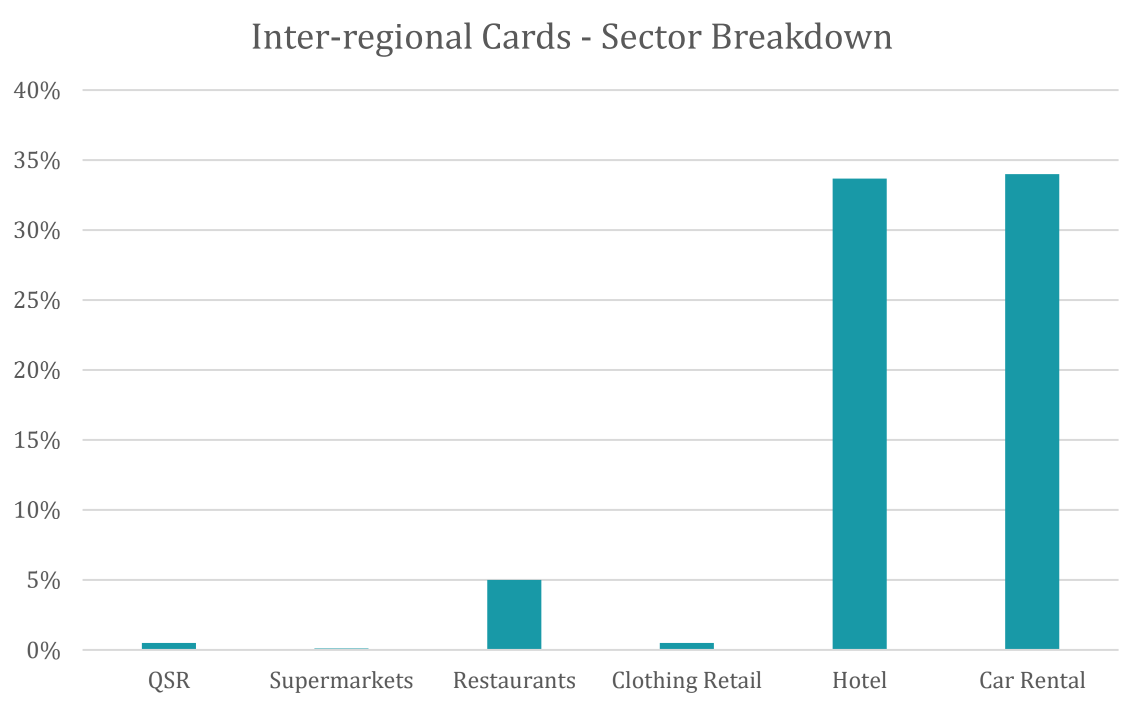
We commend the European Commission (EC) for investigating inter-regional interchange fees. To our knowledge, the EC is the first regulator to address these fees, which have been a large burden to merchants for several years.

We are pleased that card present (CP) transactions will be lowered to the regulated levels. Evidence from CMSPI's client base suggests that this will deliver hundreds of millions of cost savings per annum for merchants across Europe. There are two main reasons for this:

1) Average inter-regional interchange fees are very high
   Domestic and intra-regional interchange fees have been covered by the EC's interchange fee regulation (IFR) since 2015 (and lower intra-regional fees existed prior to that). Unregulated inter-regional interchange fees are far higher, averaging around 1.5% of the transaction value – five times the regulated credit card rates (0.3%) and more than seven times the debit card rates (0.2%).

2) Inter-regional transaction volumes are very high in some sectors
   Inter-regional interchange fees provide a far bigger issue for some merchant sectors than others. As we can see from Figure 1, some sectors see less than 1% of their transaction volumes from outside Europe. However, for other high average transaction value (ATV) sectors such as airline, travel, hotels and car rental, this can be as high as 35%.

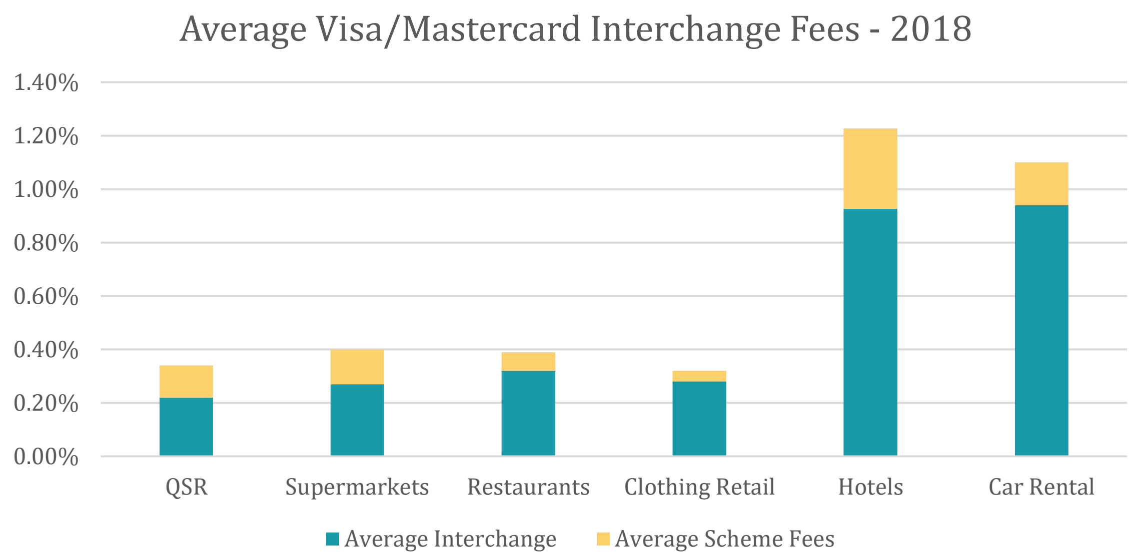
   Figure 1: Inter-regional card transaction share by sector



   Source: CMSPI
   These are also the sectors that already have by far the highest average card fees (Figure 2). High ATV sectors are being hit with high fees in the following main areas

1. These sectors see high levels of commercial card usage. Commercial cards are unregulated and have high interchange fees.
2. They also have high inter-regional card usage (as already discussed).
3. High ATV sectors suffer from the absence of a per-transaction interchange cap on debit card transactions. Many EU countries had such a cap before the IFR, so high ATV merchants in these countries have seen an increase in average debit card interchange fees.
4. As can be seen in Figure 2, scheme fees are on average three times higher for high ATV sectors.
5. The surcharging restrictions imposed by Payment Services Directive II (PSD2) from January 2018 have reduced the ability of merchants to steer consumer card transactions through a cheaper payment method. As a result of this, CMSPI has noticed a migration away from debit cards towards higher cost credit card transactions. The impact of this has been highest in high ATV sectors, such as travel. We should note that most merchant acquirers are unable to decipher between commercial cards and consumer cards at the point of sale, so the surcharging ban is effectively relevant for all transactions.

Figure 2: Average interchange and scheme fees by sector



Source: CMSPI

Key Considerations for the European Commission

We have a number of concerns about the commitments that we believe the EC should consider:

1. **Separate treatment of CP and CNP**

   Our main concern is that CP and card not present (CNP) transactions will be treated differently by these commitments.

   We do not think there is any fundamental difference in terms of the handling of a CP and a CNP transaction. No distinction was made within the IFR 2015/751 , and we do not see why this needs to be proposed by the card schemes now.

It is possible that fraud will be a key reason cited for the differential. Although fraud is generally higher for CNP channels[1], it is expected to fall with 3D Secure v2 and PSD2's strong customer authentication (SCA) mandate. Also, fraud liability is allocated by Visa and Mastercard's scheme rules, so the interchange mechanism is not necessary for redistribution.

The CNP exception will prove to be a significant financial burden for European merchants. Volume analysis from CMSPI's client base suggests that there is a much higher proportion of CNP transactions for inter-regional cards than for domestic or intra-regional cards. This is largely because many of the sectors that have the highest volume of inter-regional transactions are also largely transacted (and paid for) online – the aforementioned sectors such as airline, hotel, travel and car rental. CNP is also a faster growing channel.

We also believe that the CP to CNP differential will introduce unnecessary complexity to merchant fee structures. Empirical evidence suggests that this will provide an opportunity for acquirers to increase their own fees rather than pass on the savings to merchants. There are likely to be a high number of CNP fee line items if the CNP caps are imposed as a weighted average. In Australia and Canada, the schemes have struggled to keep to weighted average interchange caps for two main reasons. First, card issuance patterns change over time and there will be a natural tendency towards issuance of higher interchange reward card products. Second, it is very difficult for regulators to monitor compliance – in Australia this happens only every three years and there have been compliance concerns[2]. To alleviate this fear, we would like the wording around Clauses 2.1 and 3.1 of both the Visa and Mastercard commitments strengthened to confirm that weighted average interchange fees will not be applied.

Our final concern is related to the treatment of in-store mobile payments using near field communication (NFC)[3] at the POS. Under the definitions of CP transactions provided by Visa and Mastercard, we think there is a possibility that in-store transactions can be redefined by the card schemes as CNP and so attract the higher interchange level. The EC needs to make sure that this kind of circumvention from the commitments is not feasible.

2. **Time Period**

   The five-and-a-half-year time period is substantial and will provide medium-term benefit for merchants. However, we would prefer a permanent commitment and the we would like the EC to include inter-regional fees within the scope of its ongoing IFR review.

3. **One foot out/one foot in**

   The scope ostensibly only seems to include non-EU cardholders purchasing goods and services within the EU. We would like clarity as to whether or not European cardholders purchasing goods and services outside the EU are included within the scope of the commitments. If not, then we would like the EC to address this in future.

[1] https://www.fico.com/europeanfraud/index
[2] Source – RFI Intelligence
[3] NFC is the technology behind contactless

4. **Scheme Fees**
   Scheme fees are far higher for inter-regional card transactions than they are for domestic or intra-regional transactions. They can be as much as 1% of the transaction value for inter-regional, and average around 0.05% for domestic and intra-regional transactions. However, we think that the non-circumvention clauses proposed by Visa and Mastercard[4] need to be tightened much further to ensure that any replacement fees, that may result in an increased merchant service charge, are prevented.

Final Remarks

Inter-regional interchange fees have long represented a significant cost burden for merchants without an adequate economic justification and we are pleased that the European Commission is looking to address this. Our major concern is that inter-regional CNP transactions will have significantly higher interchange fees than CP transactions without adequate explanation or justification.

However, inter-regional interchange fees are not the only source of concern for merchants. We have similar concerns that we'd like to see addressed by the IFR review.

These include scheme fees, commercial card interchange fees and a per-transaction cap on debit card interchange fees.

[4] Clause 7 for Visa and Clause 8 for Mastercard