

# The Goldfinch Report

## Regulators View Must Be Wider

Published by *Paycre8*

Written By Peter Goldfinch

### About the Author:



Peter is one of the founders of Paycre8 and has been writing the Goldfinch Report for approximately 3 years.

He has been working in the payments industry for over 20 years and as a consultant completed assignments for clients in 20 or more developed and emerging markets.

Many would consider Peter to be a technology oriented professional but he also has a strong business background.

This report is an opinion piece and is not intended to do more than reflect Peter's views at the time of writing. The subject matter often relates to current experiences resulting from his consulting experience. The purpose is to generate debate

For at least two decades global payment practitioners especially in the industrialized countries have been trying to minimize the use of cash. Emerging markets are attracting the attention of aid organizations, payment service providers and the payment schemes as the building of cashless payment methods are viewed as the catalyst for economic development. The progress in industrialized countries now seems to be threatened or sabotaged by regulators who are acting as if 'market purity' is all that matters.

The focus of attention is particularly on card scheme interchange. Surcharging and scheme membership are also on the agenda plus in some markets we have seen changes to ATM interchange or its replacement.

I must state my position. I am not a fan of interchange. For well established payment networks I see no reason for it and the card schemes misuse interchange to manipulate the behavior of their affiliated (once member) banks. I believe there is a strong case to overhaul the consumer payment system to deliver more efficiency and greater equity to all. Simply tinkering with a few elements of one payment method will have a negative impact across the total payment system. A total view must be taken.

For the emerging payment markets there is a strong argument for interchange to be used as originally intended, as a mechanism for cost sharing.

The New Zealand Commerce Commission allege card scheme rules, (among other things) provide for the payment of multilateral interchange fees, substantially lessening competition by artificially inflating the cost to retailers of accepting credit cards and ultimately raising prices paid by all consumers.

This regulator believes it has introduced competitive pricing for interchange by allowing negotiations between issuers and acquirers. In effect, it has introduced bilateral interchange for consumer card payments.

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through examination of current industry developments and directions. The author hopes you enjoy reading these reports.

## *About Paycre8:*

The three founders of Paycre8 have been working in the payments industry for collectively over four decades. Most of this time they have worked as consultants, designers, integrators, developers and project managers on various projects internationally. They have experience in a wide range of payment channels, instruments and networks, normally working at the leading edge.

The demand and referrals from old clients plus a passion for the creative aspects of the industry motivated the three founders to build what they believe is a unique and niche consultancy practice.

Before discussing this further I believe we need to separate out cross border and card not present transactions. The Internet is by definition borderless and we all know it has payment challenges. So the discussion needs to firstly focus on domestic, card present transactions.

We see in both New Zealand and Australia bi-lateral agreements for ATMs and in Australia for EFTPOS. This interchange model has become tiered and the Australian model is particularly messy and restrictive for the entry of new participants. Multilateral models that Visa and MasterCard operate are far more efficient. Multi versus bi lateral interchange is a discussion for another paper as I am sure there are many valid views.

Interchange originally was considered as a mechanism to balance out the cost to ensure the commitment of both parties in building the system.

Whether interchange should continue now these electronic payment services have matured is possibly a more important issue than the level of the rate.

When all a merchant needed was an imprinter to accept cards the balance between benefits and cost was considered to be in the merchant's favor.

Merchants no longer needed to handle cash; they no longer needed to provide credit. By being prepared to accept a discount on the value of their sales they received almost immediate and guaranteed payment. It was considered only fair that the merchants should contribute to the cost of issuing cards.

In a mature payment system many of these original arguments used to justify interchange are but a fading memory and are no longer relevant.

I also believe that ATM interchange is different to interchange on consumer card purchases. Generally ATMs are directly owned by the bank or by one of its agents. ATM interchange is a price because ATM services are being purchased. Replacing ATM interchange with direct customer charges supports this view and makes the fee transparent, especially if the issuing bank is passing on the fee and not absorbing it as a cost.

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## *Paycre8* - Value

### statements:

*Purpose* – to provide payment system advisory services to an international client base. Clients who currently operate payment systems or who are investigating starting up electronic payment services.

*Vision* - By providing fast responsive, informed expertise, and consistently high quality service, *Paycre8* aims to build an international reputation for excellence.

*Mission* – To be recognized as the foremost group of experts in payments.

New Zealand regulators believe the market will settle at a zero price for consumer payments. It is interesting the Australian regulators still consider interchange as a mechanism for cost sharing as they have set the interchange rates based on submitted costs.

### **Card Payment Structure**

The payment system is a complex array of relationships among multiple financial institutions cemented together by technology-based processes. The primary payment services used every day by those participating in commercial activity have evolved through industry co-operation. Social development in emerging economies is being held up because of fractured financial sectors that have not been able to pull themselves together to collude on the development of an efficient payment infrastructure.

No market is perfect. Often markets are distorted by other factors. The New Zealand market has a high percentage of on-us transactions. Four large banks also dominate in the Australian market but it is multi tiered to support the many smaller institutions. The factor that is unique in the Australian market is the dominance of a few large merchant organizations whose collective influence, many would argue, leads to market distortions.

### **Selective Surcharging Leads To Cross Subsidization**

What is more concerning is Visa and MasterCard are increasingly agreeing to relax their no surcharging rules on domestic transactions. Merchants are being allowed to pass onto their customers the acquirer fee.

All payment methods carry a cost. In the retail space the most common forms of payment are card and cash. For card the costs are identifiable and to a great extent measurable. The cost of cash is far less identifiable and by no means measurable. Large merchants who are required to handle large amounts of cash appreciate this point and have implemented systems to minimize their cash handling costs. The average individual still sees cash as being free.

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*Paycre8* - delivers a range of payment advisory services:

- Market Surveys and Analysis
- Requirements Definitions
- Solution Development
- Business Planning
- Business Modeling
- Process Planning
- System Design
- Solution Evaluation and Selection
- Project Directorship
- Project Management
- Specialist Project Resourcing
- Business Training
- On-Going Business Reviews and Audits

A recent Visa Europe publication titled, 'The Future of Everyday Payments in Europe – Who Cares?' provides interesting information on the cost of payments and cash in the European Union. Quoting a pan-European study by McKinsey & Company, which estimates that society spends 200 Euros per person per year. Apparently the Dutch Central Bank estimates 300 Euros per family per year. Again McKinsey are quoted to estimate the transaction cost of cash at 1.3% of its value. This percentage is unlikely to measure the amount stolen by staff, (which for some retailers is particularly high) or the impact of cash on tax revenue.

By using a card to make payment, surcharging or no surcharging, you are covering the cost of cash sales because those costs like the card costs are intrinsically part of the purchase price. It could be argued surcharging allows merchants to double dip.

In Singapore where surcharging by small retail businesses is common, as a consumer I would always use cash at these merchants. It is interesting that the Visa report also supports this behaviour with one survey indicating that 60% of people in Europe would withdraw sufficient cash out of the ATM rather than pay a surcharge.

The impact on the gray economy must also be considered with the taxation authorities seeing less revenue especially from the smaller retailers.

## **Impact Of Scheme Debit**

The penetration of the scheme debit card is noticeable in many markets. In markets where the bank issued proprietary cards have built up a significant market penetration they are now under threat. In Australia from May 2008 to Oct 2009 purchases via scheme debit grew by 54.1% and proprietary debit by 18.5%, based on RBA published figures. There was a market share shift to scheme debit of approximately 5%. Proprietary debit is still dominant but there is a shift as scheme debit builds its market acceptance. I am also noticing but I have no hard facts that the minimum transaction

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value for card acceptance is rising. In Australia \$20 seems to be the magic value. This may be positioning us for PayPass and VisaWave but I doubt if the local banking market is being so strategic.

There is a general sense that we are being pushed back to using cash. Is cash the new payment instrument? The Australian ATM cash withdraw statistics do not yet indicate a different trend back to cash but there is a small up swing in the value of the average ATM withdrawal.

## **Time To Rethink The Process**

For domestic card present transactions my argument is for the regulators to examine the complete end-to-end process and act to improve payment efficiency and therefore lowering of the costs. Matters to consider are:

1. The evolution and maintenance of the backbone payment services requires the participation of all parties. New participants need to be able to enter the system at the same level and at the same cost. The larger and foundation participants will always believe they should be in a privileged position because they carried the initial establishment cost and their volume creates the economies of scale. Sometimes banks seem to be prepared to pay more as long as the competition pays a greater amount. A challenge for the regulators is to manage inclusion, which is what they are doing with forcing the schemes to allow non-bank participants.
2. As the payment business model is volume driven it is unlikely in the smaller and medium markets that costs will not be driven down if there are competing services. Competition will lead to compromises in the services and in particular decreasing robustness and security elements leading to increase payment risk. Competition therefore should be restricted to service delivery and not the provisioning of the service. Where the two are separated is another challenge for the regulators.
3. Regulators need to examine some of the practices and in particular the interest free period on credit cards. I am amazed the regulators have not

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forced the card issuers to revise this practice. The claim may be that interchange covers the cost but I am not totally convinced. Somebody other than the beneficiary is paying for the credit. Eliminating interchange and making the charging of interest equitable would deliver a fair service.

4. Why is the merchant discount fee (MDF) a percentage when the transaction processing charges are a fixed cost (excluding the interest free period)? Firstly it is designed to cover the interest free period and other costs relating to fraud, chargebacks etc. where cost relates to transaction value. If MDF was a fixed amount the pressure again would go on eliminating the interest free period as well as chargeback services.
5. In many industrialized markets consumers are protected by legislation and banking ombudsmen exist to resolve customer - bank conflicts. With the increasing use of PIN authentication fraud is declining. Therefore why do card schemes for domestic card present transactions need to play this role of arbitrator by offering a chargeback service? A different requirement exists for Internet and cross border transactions.

We quickly arrive at a domestic card present payment system that supports non-repudiation, fixed amount transaction fees, with merchants through acquirers covering the cost of acceptance and the cardholders through issuers covering the cost of issuance. Very similar to many EFTPOS services. Of the three payment methods in the wallet - cash, scheme card and EFTPOS, the most efficient payment method but the one under the most threat is EFTPOS, thanks to market forces and regulators taking a narrow view.

The essence of the argument is a modified EFTPOS model should apply to domestic card scheme card present payments.