# Implications of the Neutrality Rule:

# APPLICATION TO OTHER SECTORS

**Electronic payment systems. Acquiring business.**

**June 2015**

## CONTENT

# 1. Net neutrality in electronic payment services

The electronic payment system allows settlement of business transactions by credit or debit card. The electronic payment system is a network market, i.e. the greater the number of participants, the greater the benefit to be derived from the system.

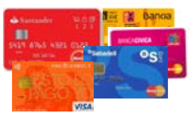
In this context the acquiring business, consisting of card transactions in shops and other points of sale, is particularly important. The acquiring business has been promoted by credit institutions because of its benefits in terms of lower transaction costs and improved payment system efficiency. Moreover, electronic payments are an important source of income and an interesting product attracting new customers.

**The acquiring business is part of the electronic payment system network. Hence, the greater the number of consumers who use credit cards, the greater the number of businesses eager to make this form of payment available to them. Similarly, the greater the number of establishments that accept credit or debit cards, the greater the number of consumers willing to acquire a credit or debit card to pay for their goods and services.**

The following players take part in the acquiring business:

1. **Consumers or cardholders** who purchase goods and services with a credit card.

2. **Business establishments** that allow payment by credit or debit card.



3. The **bank issuing** the credit or debit card, i.e. the bank that offers the card to consumers.

4. The **acquiring bank,** which provides retail outlets with Point-of-Sale Terminals (hereafter POS terminals) that allow electronic payment by card.

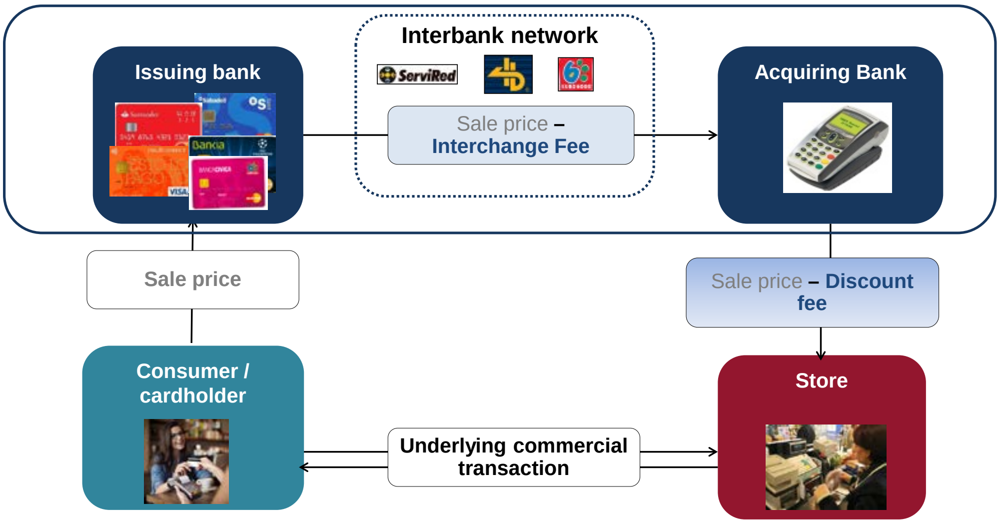
The relationship between these players revolves around inter-bank networks. These manage the processing and settlement of card purchases of goods and services. In Spain there are three interbank networks, Servired, 4B and Euro6000.[1]

Electronic payment consists of the following steps:

[1] Credit institutions arrange payments through one of these three interbank networks, Servired, 4B and Euro6000. Each interbank network is set up as a limited company whose shareholders are the credit institutions. For example, Servired's shareholders are BBVA, CaixaBank, Deutsche Bank among other credit institutions that issue cards under this interbank network. The three interbank networks are interrelated and represent their shareholders when setting fees for the use of their POS and ATMs.

1. Consumers or cardholders acquire a credit card in order to make electronic payments in retail outlets by paying an "issue and maintenance fee" to the issuing bank.
2. The card issuing bank transfers the amount of the transaction to the acquiring bank after subtracting an "interchange fee". The "interchange fee" is the cost charged by the issuing bank for the card payment. In addition, the issuing bank charges an "issue fee" for the cards it issues.
3. The acquiring bank pays the amount of the operation to the establishment after subtracting a "discount fee". The "discount fee" represents the income of the acquiring bank for providing the POS service.
4. Retail shops request a POS terminal to facilitate card purchases and are charged a discount fee and other commissions associated with the terminal.

**Graph 1. POS transaction flow chart**




**The acquiring business strategy is to maximise the number of participants, both consumers and retail shops. The higher the number of participants, the greater the value added of investment and network externalities. To this end, banks develop business strategies focused on store needs and to ensure that the costs of electronic payment are covered.**

## Pricing strategies applied to acquiring business between banks

**Interchange fees are the commissions paid by the acquiring bank (POS terminal owner) to the issuing bank to facilitate card** payment. Credit institutions set interchange fees multilaterally[2] through the interbank networks: Servired, Telebanco

[2] Regulatory framework for the setting of interchange fees on credit or debit card transactions (Year 2005).

and Euro6000. Rates are regulated[3] and maximum percentages are established depending on three aspects:

i. **Type of customer**: Rates are different for individual or company cardholders.
ii. **Type of transaction**: Transaction fees within the same interbank network are lower than transactions fees between two different interbank networks (intra- / inter-system respectively).
iii. **Volume of the transaction**: When the amount of the transaction is above a certain amount, the interchange rate applied will be lower.
iv. **Donations to social causes:** These transactions do not pay any fee.

The law thus establishes different ceiling rates depending on the type of operation as they have different associated costs. For example, interconnection computer costs are lower in intra-system transactions than those in inter-system.

Interbank networks, Servired, Telebanco and Euro 6000 may set lower rates based on several factors. **As a result, each economic activity obtains a different rate depending on the turnover and the volume of store sales.**

**Table 1: Interchange fee by activity**

| Retail sector | Interchange fee | |
|---|---|---|
| | Intra-system | Inter-system |
| Pharmacies | 1.03% | 1.13% |
| Supermarkets | 0.92% | 0.99% |
| Restaurants | 0.88% | 0.94% |
| Jewellery stores | 0.63% | 0.66% |
| Hotels | 0.58% | 0.60% |
| Petrol stations | 0.51% | 0.64% |
| Travel Agencies | 0.46% | 0.48% |
| Charity | 0.00% | 0.00% |

Source: Bank of Spain

## Acquiring business pricing strategies between banks and retail outlets

**Discount fees are commissions paid by the stores to the acquiring bank for the use of a POS terminal.** These fees are freely negotiated between the acquiring bank and the store. Following are the revenue sources for a POS:

[3] Royal Decree-Law 8/2014 of 4th July.

- Installation commission.
- Maintenance fee set according to the type of POS and the amount of monthly turnover or the number of POS transactions. For example:
    - ✓ For sales equal to or over €300 or 10 transactions, €15 for POS services.
    - ✓ For sales under €300 or 10 transactions, €25 for POS services.
- Discount fee

In this respect, credit institutions are free to set commissions which are based on cost structure and business objectives. In general, acquiring banks set different fees based on several factors. The following business strategies can be identified:

i. **Strategies based on turnover**. In these strategies, the main factor is the level of activity of the store. Here the payment structure is based on monthly POS sales, number of transactions or both.
ii. **Loyalty strategy**. Depending on the classification of the retail outlet and its overall relationship with the bank, preferential rates may apply.
iii. **Penetration strategies.** These consist of offering an advantageous rate to certain activities where POS terminal penetration is low. For example, a flat rate for taxis.
iv. **Corporate image strategies.** Charity donations have a very low fee.

As Table 2 shows, discount fees for stores depend on the sector of activity. This is due to discrimination practices by credit institutions which rely on turnover figures, number of transactions and other qualitative factors; for instance, charity donations are charged 0.28%.

**Table 2: Discount fee by sector**

| Retail sector | Discount fee |
|---|---|
| Charity | 0.28% |
| Petrol stations | 0.61% |
| Travel Agencies | 0.63% |
| Pharmacies | 0.74% |
| Supermarkets | 0.77% |
| Hotels | 0.80% |
| Jewellery stores | 0.80% |
| Restaurants | 0.86% |

Source: Bank of Spain

## Application of the net neutrality rule to the acquiring business

**The imposition of net neutrality criteria on the acquiring business would affect the determination of interchange and discount fees on which the electronic payment network is based.** In our definition of neutrality rules we mentioned that *"when the neutrality rule is applied, all market participants must be treated equally in terms of pricing, preferences, quality, quantity and priority".* **This would mean the mandatory application of a single uniform fee to all sectors using POS terminals regardless of the interbank network, the amount or the sector. This would interfere with POS network deployment and a number of business decisions taken by banks.**

Strict application of the neutrality rule would have implications for both sides, i.e. for acquiring and issuing banks and for consumers and stores.

The neutrality rule would mandate a single interchange fee irrespective of the cost and type of each operation. Hence, some electronic payments would no longer be profitable for issuing banks and others would be too expensive for acquiring banks. Uniform interchange fees could discourage the installation of POS terminals in some establishments or drive up electronic card issue fees.

A single discount fee would force acquiring banks to establish a single commission for all businesses, regardless of their characteristics or costs.

First, it would no longer be possible to apply lower rates to charitable donations or non-profit social organisations.

Secondly, with this policy of commissions in place, some outlets would be forced to forego electronic payment because the single discount fee would be excessively high for the type of transaction in their shop.

Lastly, with a single discount fee, POS transactions in some establishments would no longer be profitable for the acquiring banks and such establishments may therefore not have access to POS terminals.

Summing up, uniform rates could lead to a reduction in the number of participants and a smaller electronic payments network. Credit institutions would lose their incentive to encourage investment in the POS network, innovation and market development. Discount rates for donations to social organisations would also rise to the detriment of social solidarity.

In general, neutrality in the acquiring business would drive up the economy's transaction costs and would limit the positive external factors that always arise from network markets. This would give rise to a decline in productivity as a result of a less efficient payment system. A drop in productivity would undermine potential economic growth.

Summing up, the consequences of net neutrality would include:

a) **Impact of net neutrality on consumers:**
- Increased credit and debit card issue fees;
- Decreased availability of POS terminals;
- Increased transaction costs;
- Increased final price of goods and services.

b) **Impact of neutrality on stores:**
- Increased costs associated with POS contracts;
- Increased payment transaction costs;
- Fewer POS terminals;
- More expensive social solidarity payments.

c) **Impact of network neutrality on the economy:**
- Less efficient payment system;
- Decline in productivity;
- Decreased growth potential.

**Summary of business strategies that would be prohibited if net neutrality were applied and its impact on consumers and retail outlets.**

<table>
<tr><th>Business Strategy</th><th>Restrictions resulting from net neutrality</th><th>Impact on consumers and businesses</th></tr>
<tr><td>Interchange fees based on costs<br>- Different fees for intra- and inter-system transactions<br>- Volume fees<br>- Sector fees</td><td>All banks pay the same interchange fee<br><br>Impossible to differentiate fees by type of card and issuing bank<br><br>Fees for high volumes must be the same as those for small amounts<br><br>All sectors must pay the same fee</td><td>· Increase in card issue fees<br>· Reduction in the number of establishments accepting card payment.<br>· Increase in transaction costs for payments<br>· Higher cost for donations to social organisations</td></tr>
<tr><td>Strategies based on turnover<br><br>Discount rate based on<br>- amount of monthly sales<br>- Number of transactions</td><td rowspan="3">All retail outlets pay the same discount fee:<br><br>Discriminatory practices based on sales volume or number of transactions would be prohibited.<br><br>All sectors would operate under the same conditions<br><br>Discriminatory pricing based on customer relationships would be prohibited</td><td rowspan="3">· Increase in discount rates for retail outlets<br>· Impact on the price of goods and services<br>· Reduction in the number of establishments accepting card payment.<br>· Increased transaction cost for payments<br>· Higher cost for donations to social organisations</td></tr>
<tr><td>Penetration strategies<br><br>Sector-specific discount rates:<br>- Flat rate for taxis<br>- NGOs have very low rates</td></tr>
<tr><td>Loyalty strategies<br><br>Discount rates based on the overall relationship with the customer:<br>- Preferential fees based on customer quality</td></tr>
</table>

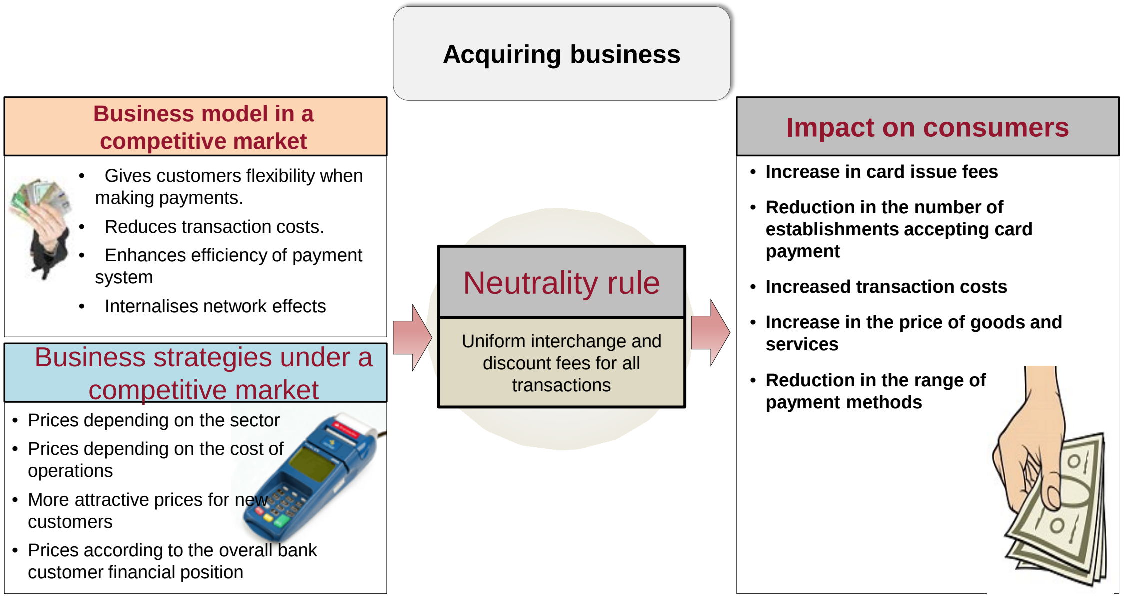
## Conclusions

If the neutrality rule were imposed on the acquiring business, the main effect would be a decline in the number of participants in the POS payment system due to an increase in transaction costs.

Consumers would suffer higher costs in acquiring credit and debit cards and would be forced to pay higher prices for goods and services.

The overall economy would suffer from neutrality in the acquiring business due to a decline in payment system efficiency resulting in a cost increase in the economy as a whole and a decrease in productivity curtailing potential growth.

**Graph 2: Summary of the net neutrality rule in the acquiring business.**



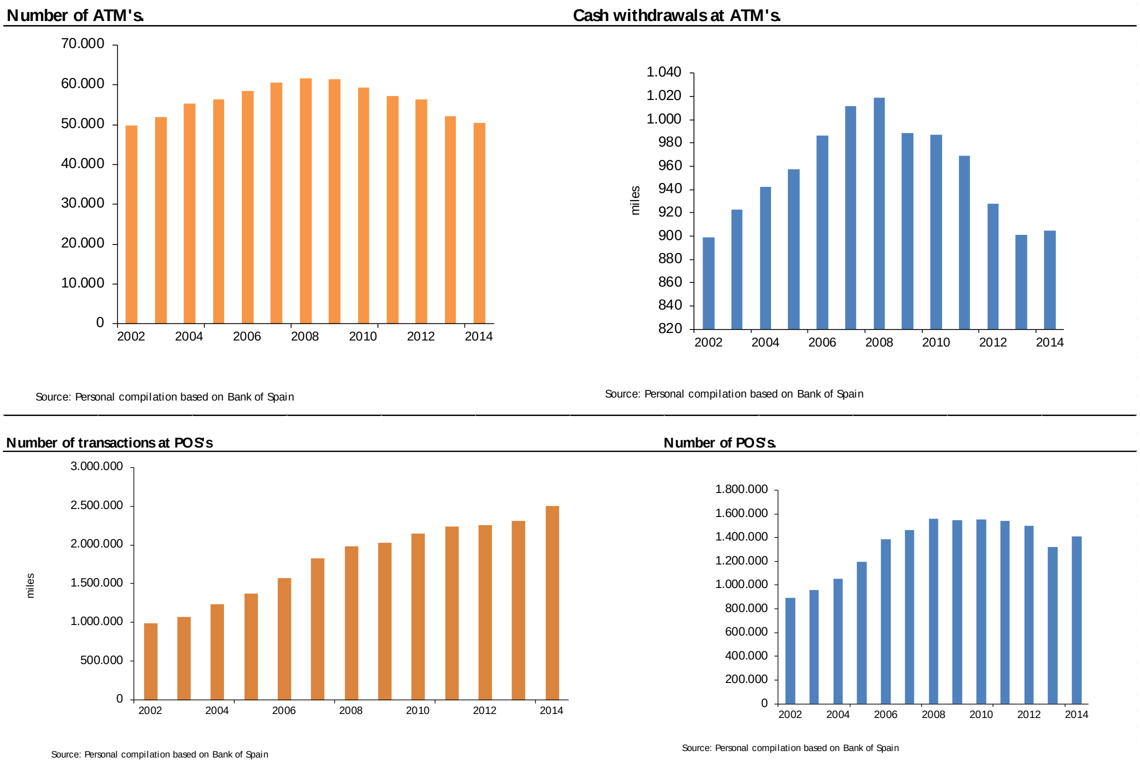
# Annex I: Description of the business model applied to acquiring activity

The acquiring business is part of the electronic payment system which also includes the ATM network. This system plays a fundamental role in the development of economic activity by speeding up the settlement of financial transactions. This reduces transaction costs inherent to the payment of financial transactions.

Specifically, electronic payments through POS terminals have increased notably in Spain. The number of POS terminals and the number of transactions processed by them have grown significantly in recent years. In Spain, there are now approximately 1.4 million POS terminals and their numbers are increasing at an annual rate of 5.0%. The number of transactions processed through POS terminals reached 2.501 billion in 2014 and has grown annually at an average rate of 13.7% since 2002. The total number of cards was  67.6 million, 43.2 million of which were credit cards and the rest debit cards.

In 2014, Spain had 50,411 ATMs. The activity in the network included 905 million cash withdrawal transactions for a total amount of 111.404 billion Euros.

**Table 3: Figures of Spanish ATM system**




### i) Description of the business model, market definition

Credit institutions offer a wide range of credit and savings products as well as services such as bank transfers, credit and debit cards, etc. In Spain, the prevailing banking model is universal banking, i.e. banks offer their products and services to both the retail and wholesale segments. The major banks are Santander, BBVA, CaixaBank, Bankia, Banc Sabadell and Banco Popular.

Together with POS terminals, ATMs allow bank customers to carry out a wide array of operations thus reducing transaction costs. For instance, customers have immediate ATM access to their current and savings account balance, can make transfers and deposits, buy tickets, top up mobile telephones, etc.

Each bank is responsible for developing its network of ATMs and POS terminals. Banks also join together in electronic platforms that handle the clearing and settling of transactions made through ATMs and POS terminals. These networks settle payment transactions between the various participant banks reducing transaction costs and improving the efficiency of the payment system.

Spanish banks join one of the three electronic payment Interbank networks: Euro 6000, Servired and 4B. These are set up as public limited companies whose shareholders are the banks. Thus, the 4B network is comprised of Banco Santander, Banco Popular and others, while La Caixa, Sabadell, Bankia and others are in the Servired network. Lastly, the Euro 6000 network traditionally includes former savings banks such as Unicaja, or BMN. These interbank networks are interconnected so that customers can use any ATM or POS terminal regardless of the network to which their bank is associated.

Electronic payment systems play an increasingly important role in banking strategies. The ATM network reduces the operating costs of banks improving their efficiency ratio as they reduce the number of branch offices needed.

Moreover, the commissions earned by the use of ATM's and POS terminals are an important source of income for banks. This is especially important in the current economic environment with very small operating margins.

ATMs and POS terminals are network-based. This means that the higher the number of ATMs and POS terminals the greater the number of users, reducing the costs of providing infrastructure and encouraging additional investment. Therefore, measures that distort prices will have negative effects on the market equilibrium.

**ii) Description of revenues and costs and maximizing revenue**

The acquiring business considered individually seeks to maximise the spread between discount and interchange fees. In light of small margins, this business is essentially based on turnover. Therefore, revenues are maximised by extending the bank's POS network to as many retail outlets as possible.

It is difficult to isolate the function of the acquiring business or the ATM network as these are typically linked to other products. Banks adopt customer-centred strategies rather than product-centred ones. In striving to maximise revenues, banks apply a joint strategy which includes ATMs and POS terminals along with other asset and liability products.

### iii) Understanding discrimination mechanisms.

All payment systems establish different rates depending on various parameters related to cost or customer characteristics. The neutrality principle is not applied since it would distort pricing mechanisms.

In the case of POS transactions, there is an EU regulation that sets a ceiling for wholesale prices. However, this regulation does allow for price discrimination based on factors such as volume of transactions, the card type with which the transaction is made and the price. Retail prices are set freely by banks based on certain parameters such as the type of establishment, the volume of monthly transactions, etc.

With respect to ATMs, banks also employ discriminatory criteria based on the degree of customer loyalty, the network on which the transaction was performed, the amount of the latter, etc.

## 2. Annex II. Bibliography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