An analysis over EU's proposal on cross-border payments regulation

By Eric Grover

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As the EC requires better disclosure of credit card foreign exchange fees, Eric Grover*, Principal at* Intrepid Ventures*, analyses the impact this decision might have over payments.*

Payments are the oft-taken-for-granted lifeblood of commerce. Better payments systems ultimately improve people's lives. Security, speed, features, benefits, network coverage and protection are all components of better. Informed users are the best judge of what's better and competition will continuously and dynamically improve payments. In 2016 there were a whopping 59.6 billion card payments, 30.6 billion credit transfers and 24.8 billion debit transfers in the EU.

In March 2018, the European Commission proposed a new regulation that requires better disclosure of credit card foreign exchange fees and that charges on intra-EU cross-border euro and domestic non-euro payments be equalized. To improve payments markets and further economic integration, the EU has intervened repeatedly. Interventions may be justified and useful where there's a market structural problem or imperfection harming consumers.

Brussels' interventions have been highly prescriptive. It imposed price controls on payments to address perceived problems, notwithstanding attendant market distortions and shortages. Payment Services Directive 2 mandated banks provide payments for free. In 2015 the EU imposed price caps on networks like Cartes Bancaires', Mastercard's and Visa's interchange fees. And, its March, 2018 proposal would direct that prices for cross-border euro and domestic payments in other currencies be identical.

In contrast, other regulators' and policymakers' interventions have been discrete, one-time fixes improving market performance. UK banks owned the monopoly interbank-payment-processing utility Vocalink. The UK

Payments Systems Regulator pressured banks to divest it and required them to put processing out to bid, its thinking being competition – particularly if banks didn't own their processor, would improve performance. In the US, Mastercard and Visa prohibited banks using their payment products from also using competitors American Express and Discover. However, the US DOJ forced Mastercard and Visa to eliminate their competition-suppressing bans. And, the 2010 Dodd-Frank Act mandated banks offer US merchants debit routing choice between at least two networks. These interventions tweaked rules and market structure to boost competition.

The EC's proposal for enhanced disclosure of credit card foreign exchange costs is unambiguously pro-market and pro-consumer, and long overdue.

Travelers abroad paying with a card are routinely offered the option by the merchants and ATMs to pay in their familiar home rather than the local currency. The service is called Dynamic Currency Conversion (DCC). Lo, payment processors and merchants mark up the exchange rate, typically 400 to 500 basis points, but often considerably more. The Brussels-based consumer-advocacy organization BEUC reported DCC transactions at ATMs in non-euro EU countries were from 2.6% to 12% more costly than if they'd been made in local currencies.

The temptation to fleece one-time customers who will be none-the-wiser is almost irresistible for many merchants and ATM owners. Cardholders' alternative is to pay in the merchant's currency and have payment networks such as Mastercard and Visa perform the currency conversion at close to the wholesale rate. Few consumers, however, know that's their choice.

There are significant DCC information asymmetries between consumers and merchants. Consequently, competition, perversely, systemically harms consumers. DCC is enormously profitable for merchants and payment processors. Consumers have no idea they're being ripped off. Processors not offering DCC would forego profits and be competitively disadvantaged. Merchants not offering it would leave money on the table.

Given the competitive dynamics and information asymmetries, DCC use is exploding. Between 2013 and 2017 the number and value of DCC transactions within the EU increased by 128% and 65% respectively. And the average EU DCC transaction declined from EUR 128 to EUR 85.

Regulators worldwide haven't been interested in DCC because it's foreigners being fleeced and national merchants and payment processors benefiting. The supranational EU, however, has eleven currencies, and millions of consumers under its jurisdiction gouged every year by DCC.

As American Supreme Court Justice Louis Brandeis observed, "Sunlight is the best disinfectant." Once merchants and ATMs offering DCC have to disclose side-by-side the costs of cardholders paying in their home and the merchant's currencies before choosing how to pay, the market will work. Consumers will be able to make informed decisions. Few will choose to pay 5 to 10% to see payments in their native currency immediately.

The EC's second notion of forcing equalization of fees for euro payments with domestic non-euro money–transfer fees, at first blush, sounds good for consumers and greater EU economic integration. Sweden and Romania chose to do so. In practice, however, it's problematic. It would force payment systems with different costs, value and competition, to price the same.

Domestic and cross-border interbank payments in most national markets are monopolies, or, best case, oligopolies. While there is an emerging patchwork of cross-border payment systems, for would-be new entrants building network critical mass, and, therefore, commercial relevance is challenging.

If the EU wants to enhance competition and consumer choice for cross-border payments, it might require every bank offering cross-border euro payments offer consumers and merchants at least two choices. That would spur competition and development of a deeper market, and leave banks and interbank-payments systems free to price and compete as they saw fit.

Bank-owned payment systems likely to be in the mix include dominant global cross-border payments network Swift, French banks' STET, and Italian banks' SIA/SSB. European commercial payment processors Worldline Equens and Nets support national interbank payments and could step up. Mastercard with relationships and real-time connections with most major banks planet-wide and its UK interbank payment processor Vocalink, could also be a compelling player. And, dark horse cryptocurrency Phenom Ripple is trying to build a cross-border payments network to rival Swift.

The EU should mandate full DCC disclosure sooner and harness market forces rather than price diktats to improve the intra-EU cross-border payments market.

About Eric Grover

Eric Grover is Principal at Intrepid Ventures, providing corporate development and strategy consulting to financial services, payment network, and processing businesses, principally in North America and Europe. He’s a payments thought leader with a comprehensive understanding of the global payment network and processing space, including each stage in the payments value chain: credit, debit and prepay issuing, issuer processing, payment networks, and merchant acquiring and processing.