

New card schemes for Europe

Speech by Jean-Michel Godeffroy
Director General Payment Systems and Market Infrastructure
European Central Bank

Télécom-Paris, Paris, 26 October 2007

Good morning ladies and gentlemen,

I would like to congratulate Télécom Paris on the excellent idea of focusing their annual conference on payment systems issues in general and on the Single Euro Payments Area (the SEPA) in particular.

Originally I was asked to speak about the future of the SEPA in general. In fact, the SEPA is well on track: SEPA credit transfers (“*virements SEPA*” in French) will be available as of 28 January 2008. SEPA direct debits (“*prélèvements SEPA*” in French) will not be universally available until November 2009, but these already exist on paper and some banking communities may start offering them as of July 2008.

Even when things go well, central banks tend to focus on what could improve. A former chairman of the Federal Reserve once said that the role of a central bank is to “take away the punch bowl just when the party gets going”. Consequently, you should not be surprised to hear that, instead of congratulating banks – which they certainly do deserve – for their achievements regarding credit transfers and direct debits, I will concentrate today on the area in which they have still to deliver: that of SEPA card payments.

In a slightly provocative way, I would summarise the present situation as follows. Card payments are very widely used in Europe. 15 billion such payments were made in the euro area in 2006 (with 25 billion in the EU as a whole). These are now the most frequently used means of payment, after notes and coins. Most of these payments are made using cards belonging to national card schemes with a very high degree of satisfaction among cardholders. Merchants are more critical, but of the various schemes in existence, they certainly prefer the national schemes.

However, these national card schemes are not SEPA-compliant, because their acceptance bases (i.e. the networks of merchants who accept the cards) are purely national, and it would be very costly for them to extend such networks across Europe.

Consequently, many banks have considered phasing out their national card schemes and replacing them with the two most highly developed international schemes, Visa and MasterCard. Because these schemes are global, and “*qui peut le plus peut le moins*”, they would easily cover the entire euro area.

This situation entails a double paradox. Although the SEPA seeks to improve customer satisfaction, it could lead to the disappearance of well-liked schemes; and although the SEPA

seeks to promote Europe, it could create a duopoly situation comprising two schemes which have their roots, business models and policy logic in the United States.

This was the reason why, more than a year ago, we asked the banks to come up with a proposal for at least one new European card scheme which could compete with the international schemes in the SEPA environment. We refrained from specifying the form that this proposal should take. But since things are moving too slowly, I felt that I should try today to make some more precise suggestions. In the first part of my address, I will look at what the main features of a European card scheme could be. In the second, I will look at how this vision could be realised.

1) The main features of possible European card schemes

Unbundled and four-party

My first proposal would be that European card schemes offer unbundled services. Today national card schemes are very different. Some offer only scheme management services (e.g. establishing scheme rules, encouraging banks to become members and coordinating the fight against fraud). Others offer processing services – or even issuing and/or acquiring services. Some schemes offer credit card services or delayed debit services. Others offer only traditional debit card services. Virtually all the models you can imagine exist somewhere in Europe.

Which model should be selected in the new European context? I would suggest that a European card scheme should offer only pure scheme services. First of all, as already agreed, processing should be separated from scheme services. This principle now needs to be implemented everywhere. Second, I would suggest that the European card scheme should be a pure four-party system in which issuing and acquiring is a function carried out by the banks, not the scheme. Finally, I feel that the European card scheme should primarily offer debit card services, leaving issuing banks the option to offer credit card services and/or delayed debit card services.

“A chacun son métier.” Everybody should concentrate on what he is good at. A European card scheme should be completely unbundled and focused on its core business. This is in line with the views of the regulators, as it maximises competition. This is also practical, as it minimises the effort and the money needed to create a new scheme.

Co-branded

As a European, I would of course prefer banks to develop a truly international scheme based in Europe, with that scheme competing on a global level with the US-based Visa Inc. and MasterCard International, the Japanese-based JCB and China Union Pay. I still hope that this could one day be the case. But my feeling is that the creation of an international acceptance network is so expensive that it would provide arguments to those who wish to kill off the concept of a European card scheme. *“Qui trop embrasse mal étreint.”* Those who want to do too much run the risk of doing too little in the end.

Most national cards are already co-branded with Visa or MasterCard in order to allow cardholders to pay merchants outside the country. I would simply suggest that – at a minimum –, the issuing banks do exactly the same with a European card scheme in order to allow their cardholders to use their card outside the euro area.

Bank-owned

Until recently, all four-party card schemes were bank-owned, and therefore the result of interbank coordination. This is not necessarily easy, because there is, in practice, a fine line between useful cooperation between banks and anti-competitive practices. In order to avoid risking court cases in the United States, Visa Inc. and MasterCard International have become publicly listed companies.

Several market infrastructures have recently become publicly listed – and therefore profit-oriented. I am not sure that the final customer benefits from this. Market infrastructures, like physical infrastructures, incorporate natural monopoly elements because of the huge economies of scale and network externalities potentially embedded in them. Consequently, market infrastructures typically function in markets with very few actors. Publicly listed companies in oligopolistic markets could be much worse for the final customers (i.e. consumers and merchants) than interbank cooperation.

Of course, interbank cooperation, which is good for the functioning of the market, could from time to time spread to the less desirable area of bank-customer relationships, in which case cooperation becomes collusion. But competition authorities are there to punish abuses. The tradition in Europe is for the national card schemes to be bank-owned. It seems to me that European card schemes should continue to follow this model.

Low interchange fee

From a theoretical standpoint, I have no problem with the concept of “two-sided markets” which support the existence of interchange fees in the card business. I will not come back to this, as other speakers have explained the concept in depth during this conference. However, interchange fees are challenged today by regulators all over the world. I think there are three reasons for this.

The first is that, in a market economy, the relationship between banks and their customers should be regulated by market forces only. Therefore, interchange fees, which are determined by the card schemes, should be used exclusively as a means of distributing the costs of the system between merchants and cardholders. They should not have any impact on banks’ profitability. In practice, banks have never been able to convince regulators that the interchange fees charged to merchants are entirely for the benefit of the cardholders.

Secondly, interchange fees are justified by the need to provide an incentive for cardholders to use cards instead of other payment instruments, particularly cash. But they may also provide an incentive for cardholders to use cards with the highest interchange fees, despite the fact that the cards in question may not be the most socially useful.

Thirdly, while it is understandable that interchange fees could be useful when a scheme has just been created, it is questionable whether they are still justified once the scheme has become well-established. In Europe nowadays it is very difficult to book a hotel room without providing a card number as a guarantee. My conclusion is that interchange fees should diminish as card schemes develop. This has not always been the case.

Profitable

I am aware that my speech today contains many elements that banks will not necessarily like. But they will at least like this one: European card schemes should be profitable for the banks

that own them. Central bankers do not like banks making losses, because loss-making banks create a threat to financial stability. Moreover, central banks do not like banks making losses on their payment activities, because it triggers cross-subsidisation between products, and therefore an inefficient allocation of resources, as has been seen in France for so many years in the case of the cheque. Several studies have shown that banks in some countries – particularly in Belgium and the Netherlands – have been making losses on their card activities. Even if merchants and cardholders appreciate these systems, they are not necessarily the models on which European card schemes should be built.

Standardised

Obviously, the future European card scheme should take stock of the expected results in the field of standardisation. Progress is being made in the four areas of card standardisation: 1) card to terminal; 2) terminal to acquirer; 3) acquirer to issuer; and 4) terminal certification. We can expect that by end-2008 a single set of standards will have been established for use throughout Europe. To be a little more specific, the objective will be, for example, to have a single set of standards in Europe for merchants' POS terminals. There will be several constructors, but they will all use the same standards and a single approval procedure for the whole of Europe, resulting in one pan-European market for terminals and thus lower prices.

Moreover, it has already been agreed that the EMV standard, based on the chip card, in combination with the PIN identification number, will become the industry standard across Europe by 2010, as it has been in France for many years. This is an important element in order to make the future card scheme very secure.

2) From vision to reality

How should we move from vision to reality? How should we preserve the heritage of the present national card schemes, based on the debit model, with their relatively low fraud rates and relatively low interchange fees? There are several initiatives on the table at the moment. But it is not certain that any of them can develop into the ideal system that I have just described.

The present initiatives

Visa is currently restructuring. Visa Inc., the US-based company, will become publicly listed, but Visa Europe will become an independent European entity which will continue to be owned by its users, the European banks. In principle, Visa Europe will be independent of Visa Inc. We lack the experience to see whether independence is possible when you use the brand name of a firm which follows a different governance structure, and a very different business model. Moreover, Visa Europe cannot be seen as a successor of the present national card schemes, particularly as it has limited experience in the field of debit cards.

Nevertheless, there is no doubt that Visa Europe has a role to play in the SEPA for cards. I would like to take this opportunity to make very clear indeed that the ECB and the Eurosystem have nothing against Visa and MasterCard operating and competing in Europe. We welcome them and see very clearly that they will probably benefit greatly from the SEPA. We also welcome the restructuring of Visa Europe. But we have a problem with the idea of their being the only schemes in Europe. We want them to compete with at least one other scheme, which would derive its business model from the present European experience.

The Euro Alliance for Payment Schemes (EAPS) seems to be close to achieving this objective. This is why the ECB and the Eurosystem have always looked kindly upon this initiative, the objective of which has been to link national card schemes. However, EAPS has been criticised by several major banks, particularly – but not exclusively – in France, which have argued that EAPS is simply helping existing national card schemes to survive, whereas the euro area needs more than this. EAPS will be operational as of January 2008, and we will then see whether it is able first to attract more schemes than at present, and second to become a real card scheme, not just a “scheme of schemes”.

Several major banks have floated the idea that European banks should set up an international scheme to compete at a global level with Visa, MasterCard and the rising giants of Asia. This was, of course, music to our ears at the ECB and in the Eurosystem. However, this initiative has had difficulty in taking off, partly for regulatory reasons linked to uncertainties concerning interchange fees, and partly because it would require huge amounts of resources to establish global acceptance from Buenos Aires to Vladivostok and from Dakar to Sydney. We would certainly not oppose this initiative. But we fear that at some stage its cost could be used as an excuse to do nothing.

I am aware of other initiatives which are not public at the moment. In particular, major retailers are seriously considering setting up their own scheme, like Discover in the United States, to avoid the perceived negative effects of a possible duopoly comprising Visa and MasterCard. I hope this threat will stimulate initiative on the banks' side.

The missing initiative

It seems to me that one obvious avenue has not been explored: the progressive merger of the national card schemes, which have been successful to date at national level but, individually, cannot meet the SEPA challenge. Why could they not join forces in order to progressively establish the new scheme that regulators and public authorities are calling for?

What is important in this respect is that the Eurosystem and the European Commission sit together with banks and card schemes and agree on both a model towards which national schemes should converge and a realistic time frame for such convergence. Moving at its own speed, each national scheme could unbundle its services, migrate towards the new technical standards, adopt the chip-and-PIN strategy, adopt harmonised business rules, decide on a single interchange fee level, and so on.

Gradually, those national card schemes, which are still so different today, would look more and more similar. At some stage, a European logo could be introduced on the cards. One day the national names (*cartes bancaires*, *ec-Karte*, *PagoBancomat*, etc.) could simply disappear. Hopefully cardholders who were happy with their national schemes would continue to be happy with the European scheme which took them over. Migration would not be a problem, and investment costs would be limited. The main difference would be that a scheme which today can be used between Brest and Strasbourg could be used, under the same conditions, between Helsinki and Lisbon.

Why has such an obvious solution not been presented before? There are probably two main reasons for this. One is possibly linked to the sense of urgency that the ECB and the Eurosystem gave to the SEPA when we insisted that the 2008-10 calendar be respected. We have now made it clear that national cards co-branded with an international scheme (or the

EAPS initiative) will meet the immediate needs of the SEPA. We are thinking here from a longer-term perspective.

Second, it is also fair to say that some banks believed that they could replace national systems generating very small profit margins with more profitable international schemes. Quite understandably, merchants have opposed such moves.

Two difficult issues

Would this route towards a European card scheme be an easy one? Certainly not. At least two difficult issues still have to be resolved.

First, should the payment guarantee be unbundled?

Several major European retailers challenge the existence of the payment guarantee embedded in most European card schemes. In the context of the unbundling I've just described, one could imagine that – as in Germany today – a merchant might opt in or out of the guarantee scheme and pay the insurance fee only when it feels it needs it. However, I wonder whether this would be a good solution in other countries where the guarantee is an established feature of the instrument. Ultimately, it seems to me that this issue should be discussed with the major stakeholders as a matter of urgency.

Second, there is the issue of the future of interchange fees.

From what I said earlier, you may have gathered that I am not a great fan of interchange fees. The European Commission, acting as competition authority, is about to issue a ruling in the MasterCard case. I think it is very important that this ruling be sufficiently explicit to provide clear guidance for the future. Otherwise, I would agree with many bankers that it would be difficult to construct a new European card scheme. Ultimately, it is clear that, in this field, regulation would be better than uncertainty.

A second point is that, were the Commission to decide to substantially reduce interchange fees (or even to prohibit them entirely), the ECB and the Eurosystem have recommended that a long lead time (perhaps up to five years) be given to allow schemes to implement those measures. The ruling might eliminate undue profits, but it has to be borne in mind that a sharp reduction in interchange fees could also mean substantial increases in cardholders' fees. If this coincided with the introduction of the SEPA, and with the emergence of a new European card scheme, the impact would be disastrous and, once again, Europe would be presented as a negative development for ordinary citizens.

It's now time to conclude.

I would like to clarify once again that the ECB and the Eurosystem do not intend to set up a European card scheme. We believe that such a scheme must be organised by banks according to market conditions. My objective today was simply to stress that one option seems to have been neglected so far: the possibility of organising, over time, a merger of the efficient domestic card schemes that exist today.

I would also like to make clear that my proposal does not condemn the EAPS initiative, which might be useful – as a first step – in order to link card schemes before merging them.

Equally, the proposal made here does not seek to prevent the creation of an additional fully fledged international scheme based in Europe. My proposal today is simply a fallback option in case this very ambitious proposal appears ultimately to be ... too ambitious.

Europe is increasingly becoming a reality. Card payments have become the most frequently used cashless means of payment in Europe. We need at least one new European card scheme.

At the beginning of next year, the ECB intends to organise a conference on the future of card schemes bringing together all major stakeholders. I hope this will be the occasion to launch the European card scheme project.