

# An interbank payment card system for the benefit of all



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# CONTENT

- 3 **DESPITE ITS BENEFITS, THE INTERBANK PAYMENT CARD SYSTEM IS CHALLENGED BY THE COMPETITION AUTHORITIES**
- 4 **WHAT IS AN INTERBANK PAYMENT CARD SYSTEM KNOWN AS THE FOUR-CORNER PAYMENT CARD MODEL?**
- 5 **CHALLENGING THE FOUR-CORNER PAYMENT CARD SYSTEM: MAJOR AND INEVITABLE CONSEQUENCES**
  - 7 Towards a higher cost of payment per card for consumers?
  - 7 Towards the end of a simple system, with guaranteed payment for merchants?
- 8 **THE POSITION OF THE BANKING INDUSTRY**
- 9 **THE INTERBANK PAYMENT CARD SYSTEM CARD: 8 FREQUENTLY ASKED QUESTIONS**
  - 10 1. What is the Four-Corner Payment Card model?
  - 11 2. What are the benefits of the Four-Corner system in France?
  - 12 3. How does the Four-Corner Payment Card economic model work?
  - 12 4. What are Multilateral Interchange Fees?
  - 13 5. Why is the economic model being challenged now?
  - 14 6. What are the European Commission's criticisms of the Four-Corner Payment Card system?
  - 14 7. Do other European countries use the same model?
  - 15 8. What would be the main consequences of eliminating MIFs?

# DESPITE ITS BENEFITS, THE INTERBANK PAYMENT CARD SYSTEM IS CHALLENGED BY THE COMPETITION AUTHORITIES

Thirty years after its introduction, the bank card has become the preferred method of payment for the French citizen. 63% of them prefer to pay for their purchases with their cards, while just 15% would rather pay in cash<sup>1</sup>.

The success of the payment card in France can be attributed to the determination of market participants to build an interbank model known as the "Four-Corner model"<sup>2</sup> based on:

- **the universality of payments:** customers are able to pay merchants with their cards, regardless of their respective banks, and merchants can accept several ranges of payment cards with the same equipment;
- **guaranteed payment:** merchants know they will get paid regardless of the customers' financial situation;
- **and payment security:** thanks to anti-fraud systems managed individually and collectively by the banks, making the card one of the most secure method of payments available.

Because it is universal and open to a wide range of operators, the "Four-Corner model" must be operated collectively, with:

- legal and technical rules applicable to all participants;
- an economic model based on multilateral interchange fees (MIFs), which are primarily used to pay for the services provided by the customer's bank to the merchant's bank. MIFs are what ensure, among other services, the guarantee of payment.

Despite its success, as reflected in the constantly growing number of card transactions, this model has been called into question due to the multilateral - and thus organised - nature of the interchange

fees and its lack of transparency. In December 2007, the Directorate General of Competition of the European Commission adopted a ruling prohibiting MasterCard Europe's interchange fee approach for cross-border transactions. A subsequent agreement maintaining MIFs was reached between the European Commission and MasterCard Europe in 2009. This agreement applies a new methodology for the determination of interchange fee levels. It should be noted that the European Commission's ruling was upheld by the Court of Justice of the European Union in 2012. Finally, in a Green Paper published in early 2012, the European Commission clearly questioned the need to clarify the legal status of interchange fees.

In France, after a complaint was filed by a merchants' association, in July 2011 the anti-trust authority approved commitments undertaken by the economic interest group GIE Cartes Bancaires to lower MIFs for transactions carried out on the CB network by one-third.

The economic model of the "Four-Corner" payment card system has been undermined by these latest measures. If MIFs were to be eliminated altogether, the economic model is not the only thing that would have to be changed. As it stands, it would mean the end of the interbank payment card system and the promotion of private card systems. This would dramatically affect all participants, including customers, merchants, banks, manufacturers and public authorities.

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1. (TNS Sofres/GIE Cartes Bancaire 2009 survey).  
2. See diagram in the appendix

# WHAT IS AN INTERBANK PAYMENT CARD SYSTEM KNOWN AS THE FOUR-CORNER PAYMENT CARD MODEL?

Today, consumers are able to use their bank cards at stores without worrying if they have the same bank as the merchant or if their card is accepted by the merchant. The apparent simplicity of this system is made possible by the Four-Corner payment card model, which is a model involving four types of participants:

1. the consumer (i.e. the cardholder)
2. the cardholder's bank (called the issuing bank)
3. the merchant that accepts payment cards
4. the merchant's bank (called the acquiring bank)

This system is open to a variety of participants, thus **establishing the universal acceptance of payment cards by allowing cardholders to pay merchants regardless of their respective banks**. In order to ensure this universal acceptance and reduce unit transaction costs, the Four-Corner model is based on collective, multilateral agreements between participants. The greater the number of participants, the more open the market is to competition, and the less suitable it would be to replace this system with bilateral agreements.

In an environment like the Single Euro Payments Area (SEPA), several thousands of payment institutions are responsible for issuing and acquiring

payment cards. On a same-scope basis, replacing the collective agreement with bilateral agreements would call for the negotiation and **signing of several million agreements**, with potentially different contractual clauses and price ranges for each agreement. Given the level of complexity involved, there is a major risk that some agreements would not be completed.

**This would put an end to the universal acceptance of payment cards and most likely to the participation of smaller players as well. New market entrants would also face a major struggle to implement such a complex system of bilateral agreements.**

The economies of scale generated by the multilateral interchange system would be lost, leading inevitably to higher prices for users without any identifiable benefits.

**Multilateral interchange is key to maintaining an open system, allowing any new entrants to access the market under identical conditions and, more importantly, ensuring the protection of end customers.**

# CHALLENGING THE FOUR-CORNER PAYMENT CARD SYSTEM: MAJOR AND INEVITABLE CONSEQUENCES

## **Consequences for society and the economy as a whole: From the day-to-day simplicity of the universal Four-Corner system to private Three-Corner systems**

In France, since 1984, the payment card systems based on the Four-Corner model have seen the development of a single comprehensive network in which all customer and merchant banks can participate. It is now the norm for customers to have their payment cards accepted at any given store or ATM.

## **A significant reduction in multilateral interchange fees....**

... would necessarily diminish the quality of service provided by the card-issuing bank;  
... and would favour private Amex-type card systems, as seen in Australia. The user-friendliness of the payment card would become a thing of the past, forcing consumers to have multiple cards depending on the network accepted by the merchant. Universal acceptance would no longer be guaranteed, which would be a real step backward from the way it is now.

## **An obstacle to reducing the cost of payment instruments for society:**

### **● Towards the development of more expensive payment instruments?**

Particularly in France, **the predominance of payment cards has helped reduce, or at least contain, the use of other payment instruments which are more costly for society, such as cheques or cash.** For comparison's sake, in Germany 75% of transactions are paid for in cash (versus 55% in France)<sup>3</sup>.

**It should also be noted that private Three-Corner systems are more expensive than Four-Corner systems,** for all users, be they cardholders or merchants. Even some of the newer payment instruments charge more than the payment card: for example, one of the card's main online competitors charges very high fees to merchants (from 1.4% + €0.25 to 3.4% + €0.25 depending on the e-merchant's sales volumes).

## **An impact on traceability**

If the payment card ends up being used less, in favour of cash for example, there would also be a **decline in the traceability of payments.** And yet, this is the very traceability sought after by the public authorities to aid in the fight against money laundering. For example, French Act No. 2011-900 of 29 July 2011 on the settlement of retail purchases of ferrous and non-ferrous metals (Article L-112-6 of the French Monetary and Financial Code) requires payments to be made by cheque, wire transfer or payment card for amounts in excess of €500. Furthermore, public authorities **encourage the use of payment cards to pay for smaller purchases,** thus promoting the widespread use of this payment instrument regardless of amount<sup>4</sup>.

3. See *The Pauget Constans report march 2012 "Avenir des moyens de paiement en France"*

4. See the proposal in the report by Parliament members Mallié, Brangé and Debré, submitted on 7 July 2011 to the Minister of the Economy, Finance and Industry, aimed at reducing the fees paid by merchants on payments made by card for smaller purchases (less than €15). Note: French banks have agreed to apply this measure.

### **An impact on bank's investment budgets for card system innovation and security:**

#### **● Since the advent of the payment card system in France, banks, as the pioneers of smart cards, have invested heavily in:**

→ **anti-fraud system security** (transition from the French Chip card implemented back in 1991 to EMV, scoring tools, anti-cybercrime tools, dedicated Back Offices, etc.)

→ **technological innovation:** recent examples include the launch of contactless and mobile payment (roll-out of technical infrastructures, subsidised payment of part or even all of the additional cost of contactless operation for payment terminals and cards, etc.), development of mobile acceptance solutions for merchants and professionals/craftsmen...

The banking industry is the sector that has invested the most in new information and communication technologies (ICT): banks account for 16% of IT spending in the world, according to a Gartner study.

According to another study conducted by the Celent firm, ICT spending by European banks will be up 0.3% in 2012 to USD 59.2 billion. This amount has been estimated at USD 59.5 billion for 2013.

● An artificial reduction in interchange fees could force banks to apply cost-cutting measures, with a direct negative impact on their budgets for security and innovation or on the level of service provided to cardholders: for example, there could end up being a decrease in the number of ATMs...

### **An impact on employment and on a pioneering industry in France:**

● The payment card industry in France accounts for tens of thousands of direct and indirect jobs with French banks. In addition, there are jobs for manu-

facturers and service providers in the payment card market (production of cards, chips and payment terminals, chip insertion, personalisation, engineering, upkeep of merchant equipment, etc.) and jobs provided by payment institutions in France specialising in electronic payment systems.

● "Economic independence": the elimination of interchange fees, or their uniformisation in Europe, could undermine the very existence of domestic networks (and thus the existence of a major European player such as GIE Cartes Bancaires) to the exclusive benefit of international networks. Even now, with the termination of the European card network project, Monnet, the market is essentially an oligopoly dominated by Visa and MasterCard. New, very powerful players in new technologies, not bound by MIF regulations, are entering or will soon enter the payment market. And all of them, from already established players to new entrants, are American (with the exception of Visa Europe).

### **An unproven impact on free competition:**

The European Commission's affirmation that MIFs are an obstacle to free competition on the payment market has not been demonstrated. Even PayPal, one of the leaders in online payments, refuted this argument in its response to the Green Paper "Towards an integrated European market for card, internet and mobile payments" (page 7): "Without interchange it would be difficult for the multiple entities in a 4-party scheme to cooperate in providing payment services to the users. Removing interchange would also undoubtedly result in less competition and choice which would be bad for the internal market."

On the contrary, interchange fees ensure a level playing field for existing and new participants alike, where all market players are on equal footing and thus have the same potential to be competitive.

## Towards a higher cost of payment per card for consumers?

### **An impact on the cost of using payment cards, and possibly other payment instruments as well:**

As a reminder, interchange fees are the fees charged for interbank services between the consumer's bank and the merchant's bank, which notably allow them to guarantee all the transactions carried out for their customers.

For equal services, a decrease in MIFs received by the card-issuing bank would mean this bank could no longer guarantee the transactions carried out with its customers or that it would decide to pass this cost on to them. **Without an interbank agreement, consumers would bear the cost of the payment guarantee enjoyed by the merchant.**

This is particularly unfair in an environment where each party must pay for the cost of the services it receives. Through the annual fees they pay, consumers have access to a vast network of acceptance; through their bank fees, merchants receive many services, including guaranteed payment (a guarantee they do not have on cash or cheques), quickly credited accounts, transaction management, security, etc.

**What's more, any economic model imposing the transfer of these costs to the consumer due to very low MIFs would hit the most vulnerable**

**populations head on;** bearing in mind that other customers will have the resources to negotiate with their bank to obtain the lowest prices. This consequence would be exacerbated with the arrival of new entrants on the payment market seeking to win over these high-potential clients, thus further enhancing their negotiating power.

Depending on the measures card-issuing banks would take under these new circumstances, cardholders could end up facing:

- higher annual fees on payment cards;
- higher fees for the use of cards (for payments and/or withdrawals);
- higher fees on at-risk services such as deferred debits.

The example of Spain, detailed in the FAQ section shows the direct impact on fees charged to consumers when MIFs are significantly reduced.

### **What would be the impact on prices at the register?**

If merchants end up paying lower fees to their banks following a reduction in MIFs, what would be the actual impact on selling prices for the consumer?

## Towards the end of a simple system, with guaranteed payment for merchants?

### **An impact on guaranteed payments:**

If the amount of MIFs no longer covers interbank costs, banks could end up revising the services associated with cards, including guaranteed payment for merchants. It is this very guarantee, however,

that makes the card so attractive for merchants. For smaller and mid-size stores in particular, guaranteed payment (not available on cash payments) is essential.

### **An impact on the principle of universal acceptance:**

While it might be attractive for mass retailers to develop their own private payment cards, smaller merchants might be forced to enter into a contract with each card issuer that they wish to accept, with the possible consequence of having:

- a payment terminal for each card issuer...
- ... and different prices for each issuer similar to those currently charged by existing private networks (fees of up to 3% for some).

### **An impact on fraud, primarily incurred by merchants:**

As underlined by the French authorities in their response to the European Commission's Green Paper, "the significant reduction or elimination of multi-lateral interchange fees would generate the major risk of potentially increasing cases of fraud, which undermines the objective of security".

## THE POSITION OF THE BANKING INDUSTRY

**The consequences of challenging the current payment card model largely exceed the financial impacts for card issuers and acquirers. The very balance of this ecosystem, which has been adopted by all participants, would be threatened with extinction.**

This is why the French banking industry reaffirms its support for the following principles:

- **ensuring a level playing field for all participants** - banks and non-banks alike - and for all three-corner and four-corner systems offering the same services, with the same rights and duties to ensure fair and open competition on the payment card market.
- **protecting the four-corner model which has paved the way for the widespread use of payment cards:** the sustainability of this model calls for the continued application of MIFs, which alone can guarantee the interoperability and mass distribution of this payment instrument.

Any regulation on MIFs must therefore be based on an impact study aimed at precisely quantifying the consequences for the payment market, including consequences for consumers, merchants and card issuers/acquirers. This impact study should also cover the Three-Corner model and **provide a comprehensive analysis of the payment instruments market (cash, cheque, payment card, etc.), comparing each payment instrument in terms of direct and indirect costs, security and ease of use in France and abroad.**

# THE INTERBANK PAYMENT CARD SYSTEM CARD: 8 FREQUENTLY ASKED QUESTIONS

While the Four-Corner model is now used throughout Europe, use of payment cards is most widespread in countries like France and the UK, where they now account for nearly one out of every two payments. Key figures for payment cards in France:

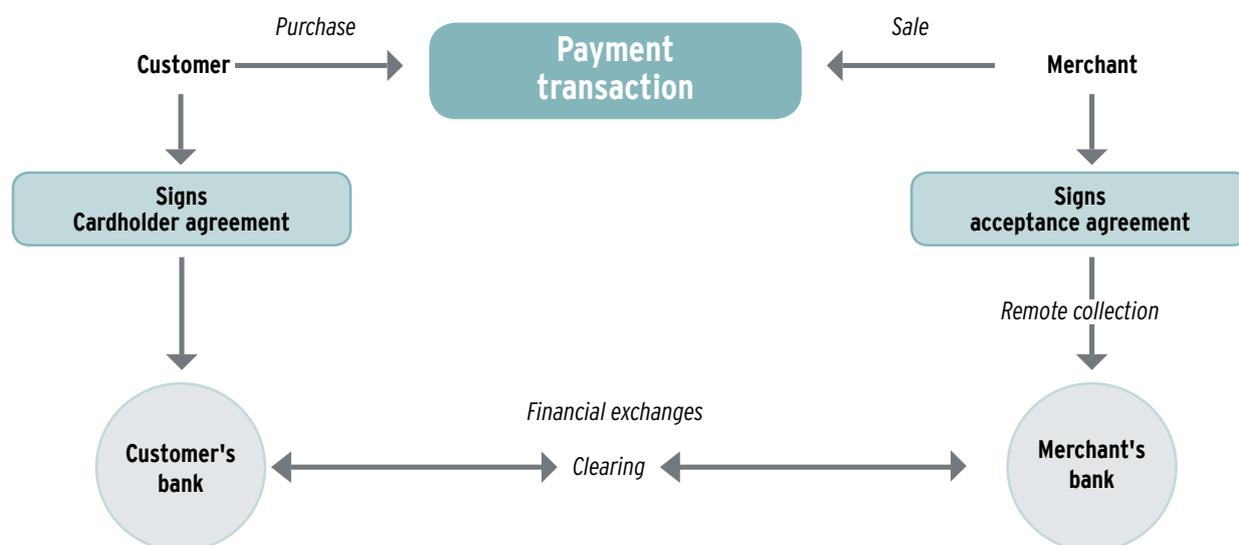
- Over **60 million interbank cards** (CB, Visa or MasterCard) were issued in 2011, for a total of 104 million cards (payment and withdrawal) (*Source: Pauget Contans Report - March 2012*)
- **45%** of non-cash payments by card, with 7.9 billion annual transactions (*source: ECB Payment Statistics - September 2011*)
- **Broad network of multi-card acceptance:** 58,170 ATMs and 1,163,000 local points of sale, 156,000 remote points of sale (*source: GIE CB management report*)

## 1. WHAT IS THE FOUR-CORNER PAYMENT CARD MODEL?

It is the principal payment card system in Europe: one system based on four participants (see diagram in appendix):

1. the cardholder
2. the cardholder's bank (called the "issuing bank")
3. the merchant that accepts payment cards
4. the merchant's bank (called the "acquiring bank")

Four-Corner systems are collectively governed by legal and technical rules underpinning the cooperation between issuing banks and acquiring banks. As a result, consumers can use their cards everywhere. In France, there are 1,163,000 local payment card points of acceptance, 156,000 remote points of sale and 58,170 automated teller machines.



### → Diagram of the Four-Corner Payment Card system

**Review: features of "three-corner" or private system:** The card network directly enters into a contract with the consumer and the merchant. The acceptance network is more restrictive and use of the payment card is limited to merchants holding a contract with the private network.

## 2. WHAT ARE THE BENEFITS OF THE FOUR-CORNER SYSTEM IN FRANCE?

### **Considerable convenience:**

- Access to interbank payment and withdrawal services 24/7
- Interoperability between the domestic payment card network and the two international VISA and MasterCard networks
- Time savings, easier accounting oversight for merchants

### **High security**

- Smart chip with a pin code for local payments and withdrawals
- Non-reusable authentication protocol (3DSecure) for e-payments
- Sensitive data protection (PCI standards)
- Guaranteed payment for merchants
- No cash transport, no cash drawer errors

### **A method of payment suited to...**

**... all payment channels:** local payments, automated payment systems (e.g. purchasing transport tickets) and remote purchases (online, telephone, etc.)

**... all payment amounts,** with the introduction of contactless cards and payments of small amounts (within the card limits specific to each range and bank)

### **... and all sizes of merchants:**

- from professionals and small local shops...
- to mass retailers

### **Constant innovation and expertise in French industry**

- In hardware and software, thanks to a continuous technology watch by all industry players
- Constant development of new cutting-edge solutions (IP payment, mobile and contactless payment, banks investing in studies on the creation of a European payment card network, etc.)

### 3. HOW DOES THE FOUR-CORNER PAYMENT CARD ECONOMIC MODEL WORK?

The Four-Corner Payment Card system is based on a multilateral agreement involving the operators that supply the payment instruments to the consumers (which are called card-issuing banks) and those that supply the necessary equipment to the merchants (acquiring banks). This agreement establishes the rules of operation of the system for all participants, including the level of Multilateral Interchange Fees (MIFs) paid between banks in exchange for services rendered.

This payment system is used by a very large number of customers and merchants; it combines a maximum number of transactions, providing a very broad usage base which helps optimise the unit cost of each transaction. The more operators participating in the multilateral agreement, the more efficient the system in terms of service rendered and unit cost.

### 4. WHAT ARE MULTILATERAL INTERCHANGE FEES?

Multilateral Interchange Fees (MIFs) are the fees charged for interbank services between the consumer's bank and the merchant's bank, which notably allow them to guarantee all the transactions carried out by their customers.

The levels of MIFs are closely related to the services, the security environment and processing costs involved. This is why there are several interchange fees within the European Union, because they are directly linked to individual domestic features that still vary from one country to another, and to the features of the products offered by the different payment card networks.

**For example, here is a partial list of cost items covered by MIFs in France:**

**List of processing cost items:**

- management of card number ranges used to identify card issuers
- management of relations with cardholders regarding payment cards
- commercial and legal management of cardholder disputes
- management of cardholder information
- clearing management
- management of credits/debits and archiving
- management of cardholder claims
- management of authorisations with an issuer call service
- management of IT infrastructures

**List of security cost items:**

- secure delivery of cards and pin codes
- management of card and security product manufacture
- management of card verification codes

- fraud detection
- management of authorisations
- issuance of payment arrears and document requests
- cancellation service costs
- statements submitted to the Payment Card Information System concerning cancellation flows and numbers of cards to be cancelled
- management of captured cards
- data supply to regulation and oversight systems

## 5. WHY IS THE ECONOMIC MODEL BEING CHALLENGED NOW?

- Since 1984, interchange fees have been monitored closely by the anti-trust authorities both in France and Europe. These fees have been authorised up to now, based on specific criteria (methodology, cost study, etc.).
- In December 2007, the DG Competition of the European Commission adopted a ruling prohibiting MasterCard Europe's interchange fee approach for cross-border transactions, considering that their impact was to increase consumer prices without offering any demonstrable benefits. This ruling was upheld by the Court of Justice of the European Union in 2012.
- **An agreement maintaining MIFs was subsequently reached between the European Commission and MasterCard Europe in 2009.** This agreement applies a new methodology for the determination of interchange fee levels (the "tourist test").
- Furthermore, MIFs have also been called into question on credit transfers and direct debits, and will be permanently banned by EU Regulation No. 260/2012 as from 2017. At present, the consequences cannot be quantified due to the small volumes of SEPA (Single Euro payment Area) direct debits. However, the loss of income for debtor banks will clearly have direct or indirect consequences for users.
- In the Green Paper entitled "Towards an integrated European market for card, internet and mobile payments" published on 11 January 2012, the European Commission questioned the need to clarify the legal status of MIFs. Lastly, **the presentation of the timetable for Act 2 of the Single Market by Michel Barnier calls for the proposal of a regulation on card interchange fees in Q2 2013.**

## 6. WHAT ARE THE EUROPEAN COMMISSION'S CRITICISMS OF THE FOUR-CORNER PAYMENT CARD SYSTEM?

The European authorities have levelled two major criticisms against the economic model of MIFs:

- the multilateral and thus organised way in which the level of MIFs is established
- the lack of transparency on MIFs

### **On the multilateral aspect:**

According to the DG Competition of the European Commission, MIFs are the result of collusion between economic players and multilateral agreements (national and cross-border agreements) and should be replaced with bilateral agreements between payment institutions. On the European market, where several thousands of banks and payment institutions issue payment cards, this would require several million contracts to be signed. Managing these contracts would be expensive and could lead the market to organise around a few large-scale players, casting aside mid-size payment institutions which would have the hardest time managing such a complex environment with respect to cardholders and merchants alike.

### **On the transparency aspect:**

Payment card networks (CB, Visa and MasterCard) freely publish their interchange rates, the rules of operation applicable to merchants, and comprehensive information to help merchants understand these rates and how they are applied. These provisions are designed to promote continuous dialogue with merchants, consumers and anyone else for that matter on interchange rates and their disclosure. Meanwhile, merchants are free to disclose the various costs they incur, covering everything from bank charges to lease payments to electricity bills.

## 7. DO OTHER EUROPEAN COUNTRIES USE THE SAME MODEL?

The vast majority of Four-Corner payment card systems are based on MIFs. However, a few small countries have been able to develop a clearing system without multilateral interchange fees. Banks in these countries offer payment instruments that are very similar to what is available in countries which have opted for interchange fees. The reason is simple: these banks operate on small markets with few participants (issuing and acquiring banks), which therefore cannot be compared to large-scale domestic or international payment systems.

**There are several possible situations:**

- Either there is a single acquiring bank in the country (merchants have just one or two intermediaries). In such case, this acquiring bank redistributes the dividends from its activity to the issuers at the end of the year, comparable to an ex-post interchange;
- Or the costs are passed on via a cross-subsidy mechanism and are recorded under other services offered by banks (loans, cash facilities, etc.), in a totally non-transparent way, allowing them to offer what appear to be "free" services to their customers;
- Or the small number of players makes it feasible to enter into bilateral agreements.

## 8. WHAT WOULD BE THE MAIN CONSEQUENCES OF ELIMINATING MIFS?

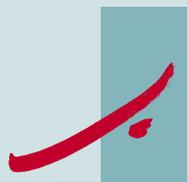
If issuers are not paid MIFs to offset guaranteed payment, fraud risk and the cost of all the benefits they provide to merchants through acquiring banks, a number of changes could be expected, which might or might not occur all at once:

- An increase in the cost of using payment cards for customers and merchants (a higher annual fee paid by cardholders, increased costs of services such as deferred debits, higher prices for payment and/or withdrawal transactions, etc.);
- Some transactions would likely be carried out using less modern and less traceable instruments (cash, cheques, etc.);
- Banks would have fewer resources to invest in anti-fraud system security.

Ultimately, the fewer cards in circulation and the fewer cardholders, the higher the unit costs; merchants and customers would end up losing the benefits currently enjoyed with electronic payments.

**In Australia**, where interchange fees were reduced by the government, consumers must now pay additional fees and higher interest rates. Promotion campaigns and other benefits have also waned.

**In Spain**, interchange fees were cut by over 57% from 2006 to 2010. In an article published in the 6 December 2012 edition of the AGEFI HEBDO, Enrique Calvet explained the consequences of this reduction, stating that "a study conducted by economists at Universidad Rey Juan Carlos, Universidad Autónoma showed that consumers have not benefited at all. Meanwhile, merchants saved EUR 2.75 billion in five years. **Costs for consumers, primarily via annual fees paid to their bank for their payment card, soared by a staggering 50% over the same period, i.e. a total expense of EUR 2.35 billion.** Other fees have also increased, such as overdraft fees, and the bonuses and promotions usually associated with payment cards have declined, and in some cases have been eliminated altogether [...]"



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