

# Review of the Payment Services Directive

## The question of surcharges

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*The Payment Services Directive was intended to provide more price transparency for users and a level playing field for efficient competition among different payment services by decreasing the inhibiting effects of different legislation, cross-subsidisation and non-cost-based pricing. The European Commission, however, intended most of these effects to come about through market-led initiatives. In the run-up to the review of the Directive, it is time to ask whether more could be done to promote the use of efficient payment methods.*

### Introduction

The Payment Services Directive (PSD) 2007/64/EC is aimed at fostering the internal market on payment services and in particular the Single Euro Payments Area (SEPA). Covering all electronic and non-cash payments in all EEA countries, the Directive provides a fully harmonised simplified set of rules with regard to information requirements and reinforces the rights and obligations of the users and providers of payment services. The role of SEPA is to provide harmonised euro payment services to be treated as domestic payments within the EU. Together PSD and SEPA aim to create a common legal framework and a standardised environment for euro payment services in the EU.

The Directive will be reviewed in 2012. With the emergence of new market participants, new technologies and stronger emphasis on consumer protection, there are several issues that need special attention in the review process. As PSD constitutes the legal basis for the SEPA, the review should be considered as a possibility to correct the oversights and deficiencies currently hindering the full development of the SEPA. Following the financial crisis, payment-service providers need a framework that promotes efficiency while payment-service users need confidence in the payment systems. Furthermore, as banks still cover most of the world's payment services, the Directive should also be assessed in the context of the regulatory turmoil that banks are currently facing. New liquidity requirements are likely to necessitate strategic repositioning for banks, while ring-fencing banks' retail operations from the investment sector may put some of the requirements in the current PSD in a new

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light. Maintaining a level playing field between different payment services providers may have become more difficult.

In the process of designing the PSD, the Commission identified certain deficiencies in the EU payment services market. One of the main issues raised was the high cost of the payment system to the economy due to its inefficient use, with cash being significantly more costly to the economy than electronic payments. A second set of deficiencies was found in EU payment infrastructures and services, as the systems in the EU were predominantly national, making cross-border systems small in scale and costly to operate. Thirdly, the Commission noted the large differences in the efficiency of payment services in the Single Market as well as the fragmented nature of the legal framework for payment services, calling for more integration and harmonisation in order to achieve a more efficient EU payment market.<sup>1</sup>

With the SEPA migration still under way, the Commission decided to leave these problem areas to the market forces to determine the design and success of payment schemes and the consolidation of infrastructures. In lieu of regulatory intervention, general principles were formulated in order to eliminate or minimise the barriers to making payments as easily, safely, efficiently and inexpensively across borders as within national borders. The Commission acknowledged that attentive monitoring of the effects of self-regulation would be essential, and if monitoring should confirm market failures with respect to pricing, costs of payment the system or technical and organisational barriers to market entry, actions to propose binding legislation would have to be taken.

Now faced with reviewing the Directive, the Commission is asking whether the regulation is ideal for an efficient payments market. An efficient payments industry can reduce the economy's total payment costs as well as ensure higher transparency and better consumer protection. Authorities have indeed recently begun to pay more attention to retail payments and their efficiency. It is time to assess what could be done to better promote the use of the most efficient payment instruments in order to facilitate the full use of the Single Payments Market. The reasons for this assessment include of course the SEPA, but also the importance of efficient payments to the world economy.

### **Room for regulatory intervention?**

It is now widely acknowledged that cash payments are more costly to society than electronic payments<sup>2</sup>. Still, the EU continues to incur significant costs from rising euro cash-in-circulation. Even though there are variations between countries, euro banknote circulation has been consistently growing at a faster pace than the growth in non-cash transactions. Savings can be achieved by moving from paper-based payments to their electronic versions and from less efficient instruments to low-cost or high-benefit instruments, for example from cash to cards. The recent World Payments Report 2011 estimates that if the eurozone could reduce cash usage, it could save approximately €20 billion per year just through the proportional reduction in euro cash-handling costs and also improving tax transparency.<sup>3</sup>

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<sup>1</sup> See European Commission (2005).

<sup>2</sup> See Jonker (2011) for discussion.

<sup>3</sup> See World Payments Report (2011).

The key question, therefore, is how to provide a market framework that fosters efficiency of the payment system, especially through lowering the costs for the economy. For this purpose it is important to identify which factors determine the usage of different payment services. Earlier studies have shown that the two main factors determining the usage patterns of different payment services are price and ease of use.<sup>4</sup> Consequently, in the review of the Directive, the need for changes and amendments should be considered through these requirements in order to facilitate the use of non-cash payment methods, which provide the basis for an efficient SEPA. However, there are several levels of pricing, affecting different payment users differently. Merchants are mainly concerned with merchant service charges, while consumers act on the basis of the final price of the product they are buying. Therefore, from the perspective of improving consumer confidence and protection, the mechanisms affecting consumer prices are in focus.

Against this background, the option of imposing surcharges arises as an important question. If price transparency were to be used as an argument supporting surcharging, surcharges should be imposed on both electronic and cash payments. Surcharging cards and not cash effectively discriminates card payments against cash payments. Therefore, surcharges imposed on only card payments would discourage the highly promoted use of more efficient payment systems, i.e. cards, and secondly, they may provide merchants an opportunity to extract consumer surplus especially in e-commerce.

Under the current Article 52(3) of the Directive, payment service providers shall not prevent the payees (merchants) from requesting a charge or offering the customer a reduction for the use of a given payment instrument, but the Member States are allowed to prohibit payees from imposing surcharges on certain payment instruments in order to promote competition or encourage the use of efficient payment methods. This option has been used in some Member States, and today Austria, Cyprus, France, Greece, Italy, Latvia, Lithuania, Luxembourg, Portugal, Romania, Slovakia and Sweden prohibit all charges. Limitations to charges are applied by Bulgaria, Finland, Denmark and Hungary. Therefore, at the moment, the field for surcharges is highly fragmented throughout the European payment markets. Consequently, the Commission is now assessing the practical and financial consequences of the application or non-application of the surcharge rule. In particular, some Member States' decision to forbid surcharges and their impact on competition and efficiency is under scrutiny. The Commission is also interested to learn whether surcharges are actually being used as an additional source of income.

### **The role of surcharges**

Pricing payment instruments is a complex matter because payment networks give rise to large economies of scale and various types of externalities. Generally, production costs should be the basis of efficient pricing of payment services, allowing the consumer to make a choice that will result in the optimal use of society's resources. In certain cases, however, an adjustment for externalities is necessary, with positive externalities leading to prices below the production cost while negative externalities set the price above the production cost. One particular type of positive externality is created by network effects. Payment systems are generally characterised by network effects that arise when the benefit of a product to a user increases as the number of other users of the same product increases. In the case of cash, the network effects are largely direct and one-sided as it is practically accepted by all the players in the market. For cards, the network effect is two-sided as cardholders do not benefit from an increase in the number of

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<sup>4</sup> See Leinonen (2008) for a thorough discussion of payment habits and what affects them.

cardholders as merchants do, but cardholders benefit from an increase in the number of merchants who accept cards.<sup>5</sup>

The solution generally used by the payment services industry to cover its production costs has been subsidisation, where the market that benefits more from the system subsidises the other side. The price of cash and card payments are effectively hidden from consumers. Nevertheless, this type of pricing may lead to an overuse of less efficient payment instruments. With regards to the card payments market, this may result in too few payment terminals and too few customers with cards, leading to overuse of cash.

The observation that the payments industry is a two-sided market has stressed the fact that in setting payment prices, banks need to get both consumers and retailers on board by pricing both sides of the market in an effective way. The ability of the merchant to impose a surcharge on card payments affects the price structure, and therefore the total demand of card payment services (Bolt et al., 2010). Rochet & Tirole (2002, 2003) have shown that the price structure and therefore also the interchange fee, becomes irrelevant if merchants charge different prices for cash and card payments. Consequently, from a theoretical perspective, the surcharge option neutralises the impact of interchange fees on end-user tariffs and it gives merchants a tool with which to influence their customers' payment choice (Gans & King, 2003). This argument assumes, however, that all means of payment are surcharged, including cash.

### **Confronting theory with evidence**

Studies generally show that from a cost perspective, debit cards are underused<sup>6</sup>. The question of whether surcharges significantly contribute to this under-use is more difficult to answer. Empirical studies investigating the impact of surcharges on the usage patterns and consequently on the use of efficient payment methods show that surcharges steer consumers away from using debit cards towards the use of cash. Research by the Reserve Bank of Australia (2008) reveals that consumers use their cards less where surcharges are applied. Consistently, Bolt et al. (2010) show using Dutch survey data from both consumers and merchants, that removing debit card charges will lead to more debit card payments and reduce the use of cash. Therefore, imposing surcharges on card payments decreases their usage, increasing the costs payments to the economy.

Although less surcharges on debit card payments is favourable for the efficiency of payment systems, prohibiting the ability to surcharge may also have adverse effects as merchants face higher fees for card payments, leading possibly to lower card acceptance. Consequently, some theoretical arguments have emphasised taking into account the degree of competition among merchants and network externalities when assessing the justification of a no-surchARGE rule. However, the scale economies of card payments provide an important argument in favour of a no-surchARGE rule. Once unit transaction costs fall due to scale economies, more and more merchants will save transaction costs by accepting card payments and

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<sup>5</sup> Card payments require an infrastructure of terminals and systems for transferring information on the payment, representing a major fixed cost. The cost directly attributable to an individual card payment is minor. Cash payments do not require this type of infrastructure for the payment itself to be executed, but each cash payment increases the costs of handling cash, involving lower fixed costs but a more significant amount of costs attributable to an individual payment. This is why more card payments lowers the social costs associated with them, while the costs for cash payments remain relatively unchanged.

<sup>6</sup> Term underuse indicates that consumer makes the choice of payment method on the basis of his private incentives and so deviates from the social optimum (see Bergman et al., 2009).

they will be more inclined to not impose surcharges (DNB, 2010). Studies have also suggested that not imposing a debit card surcharge may result in higher sales (Rochet & Tirole, 2002; Bolt et al., 2010). Therefore, accepting debit cards can be a service to the consumer and therefore increase business. When the average transaction cost of card payments drops below that of cash payments, card surcharges no longer contribute to cost-effective consumer payment behaviour.

Furthermore, in the case of low competition, merchants only have to consider the impact of surcharges on the demand of their customers. Wright (2003) shows that when merchants with monopoly power are allowed to surcharge, they will do so excessively in order to extract consumer surplus from cardholders.

## **Conclusions**

The trend towards transparent and efficient pricing calls for abolishing cross-subsidisation. Price competition cannot exist in a market that functions without direct charges and where new entrants have to rely on cross-subsidisation in order to sell their services. If the end-users do not see the costs of different payment methods, they have little incentive to change their behaviour towards the more efficient payment methods. If given the option to impose a surcharge, merchants may be encouraged to start accepting payment cards. However, as the competitive environment may distort the pricing choices of the merchant, there is a risk that surcharges may be used to extract consumer surplus. Furthermore, surcharges influence consumers' perceptions of the cost of card payments and imposing a surcharge on cost-efficient means of payment may deter consumers from paying efficiently. Therefore, imposing surcharges on card payments comes with a risk of steering the pricing of payment instruments towards less transparency.

Having the well-functioning Single Payments Market as the ultimate goal, the Commission may have to take a stronger role in regulating the pricing of payments. If SEPA is expected to provide all the expected benefits, the use of electronic payments should be promoted. The question is whether surcharges play an important role in the use of electronic payment methods. The evidence suggests that imposing surcharges on debit card payments is leading to lower usage rates of card payments. Lower usage of card payments would likely decrease the vital economies of scale associated with card payments. As variable costs for merchants would increase, it would again lead to lower acceptance of cards at points of sale. This would be more expensive for the economy and run counter to the objectives of the PSD, not to mention failing to promote technological innovation in payment services.

The Commission should now carefully consider the pros and cons of surcharges and take into account their interplay with pricing structures of wider payment systems. If surcharges are to be generally forbidden, it limits the bargaining power of merchants vis-à-vis card companies, while allowing it hands merchants a tool to influence their customers' payment choice. In the review of the Directive, however, one has to keep in mind the objective of higher consumer protection through enhanced user confidence and price transparency. Consumers are dependent on payment services, which is why consumer protection is a corner stone of the PSD. Changes in customers' payment habits through payment services infrastructures have to be taken into account as they are the driving force behind the cost efficiencies achieved through economies of scale.

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