EUROPEAN CENTRAL BANK

E-PAYMENTS WITHOUT FRONTIERS

Costs and Efficiency of Different Payment Instruments

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Focus of presentation

Cost efficiencies in payments

- Need to look at all key stakeholders

Payments are core element of retail banking profitability

- Payments profitability impacts current account profitability

There is already potential for substitution economic benefits

- Can substitution be accelerated?

THE KEY ISSUE

There are different views across stakeholders (consumers, retailers and financial institutions) and across countries about the costs and value generated by various retail payment instruments. Until there is alignment of perspectives and removal of cross-subsidies, harmonisation across Europe and cost-efficiencies driven by payments substitution will be difficult to achieve

Example of the issue:
Many consumers view payments as a 'public service'

Payments evolution based on substitution economics

Consumers do not understand the cost of providing transactional services

Consumer view of payments as a public service

Consumers expect free access to their current account funds

Regulators reinforce the public service perception

The commoditisation of payments does not imply optimisation of payment systems

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Example of the issue:
Many merchants argue debit card transactions should be regarded as a utility cash substitute and priced accordingly

Merchants believe cash is cheaper for them than debit

Merchants do not understand the real cost of transactional services

Merchant view of debit as a public service

Merchants expect ‘commodity’ pricing for debit

Regulators reinforce the ‘public service’ perception

Merchant recognition of the relative costs and value of different payment instruments to them should be a priority European banking objective

Example of the issue:
Across payment types many banks have not aligned revenue with cost

Reasons for Non-Transparent Consumer Pricing

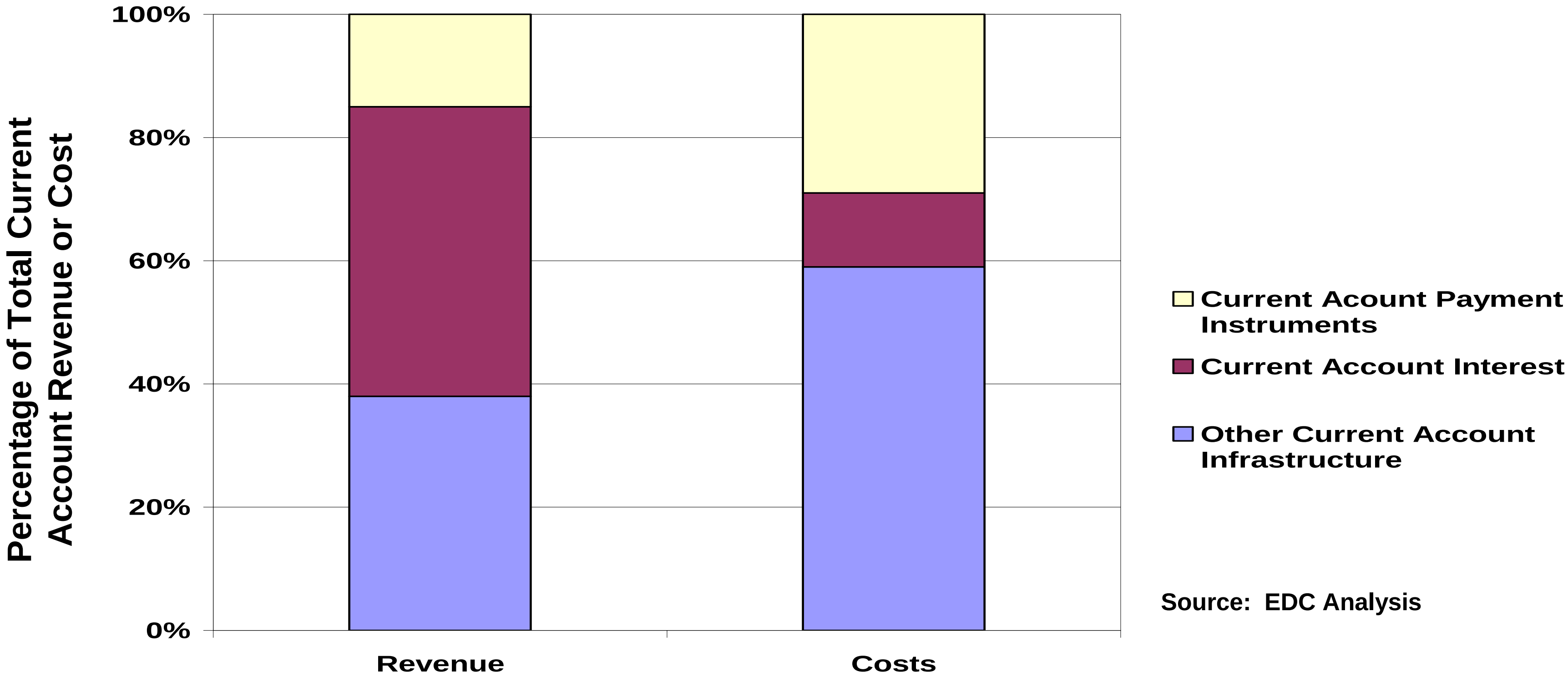
- Due to regulation or media pressure banks struggle to recoup true ATM costs
- Debit, driving the migration from costly branch cash withdrawals, has often been offered free of charge
- Giro and ACH payments have replaced more costly cheque transactions and to encourage usage have also been offered free of charge

Reasons for Non-Transparent Merchant Pricing

- Cash costs bundled in with more profitable bank products
- Merchants fail to calculate the true internal cost of cash
- Merchants compare pricing for cards to “free” provision of cash

The lack of profitability for payments linked with the current account impacts overall retail banking profitability

Breakdown of Total Current Account Revenue and Cost



Source: EDC Analysis

- **In Europe payment instruments often account for a high proportion of total cost and interest income a high proportion of total revenues**
- **As interest margins are squeezed the profitability of each payment instrument will need to be optimised**

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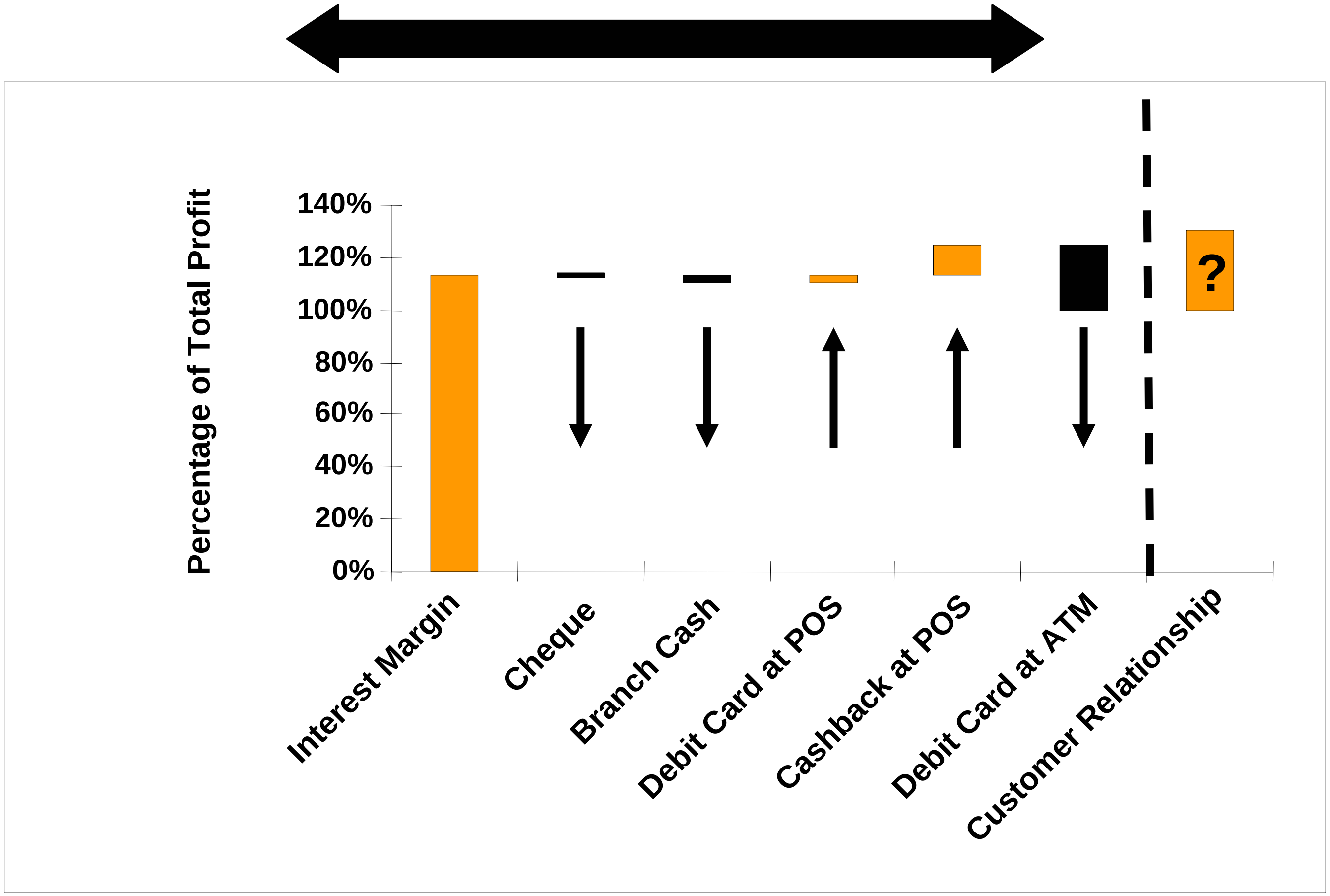
Current account profitability is hugely dependent on the interest margin contribution

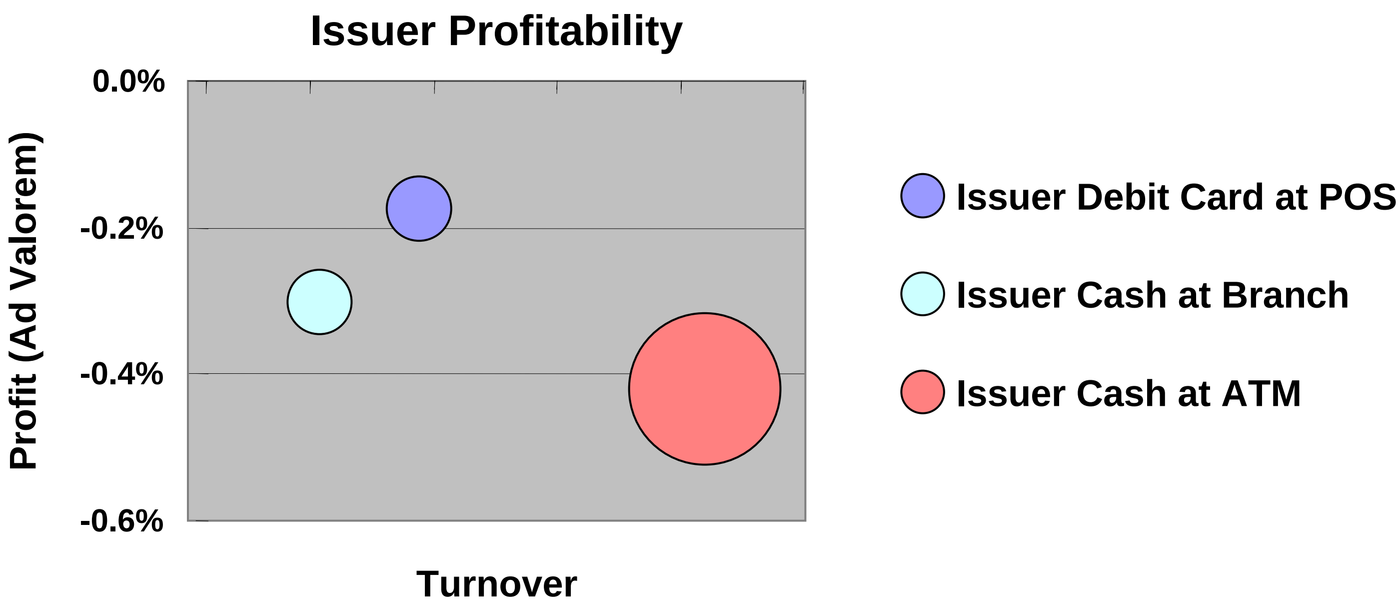
Profits generated directly from Current Account and associated payment instruments



Profits generated from broader customer relationship difficult to quantify

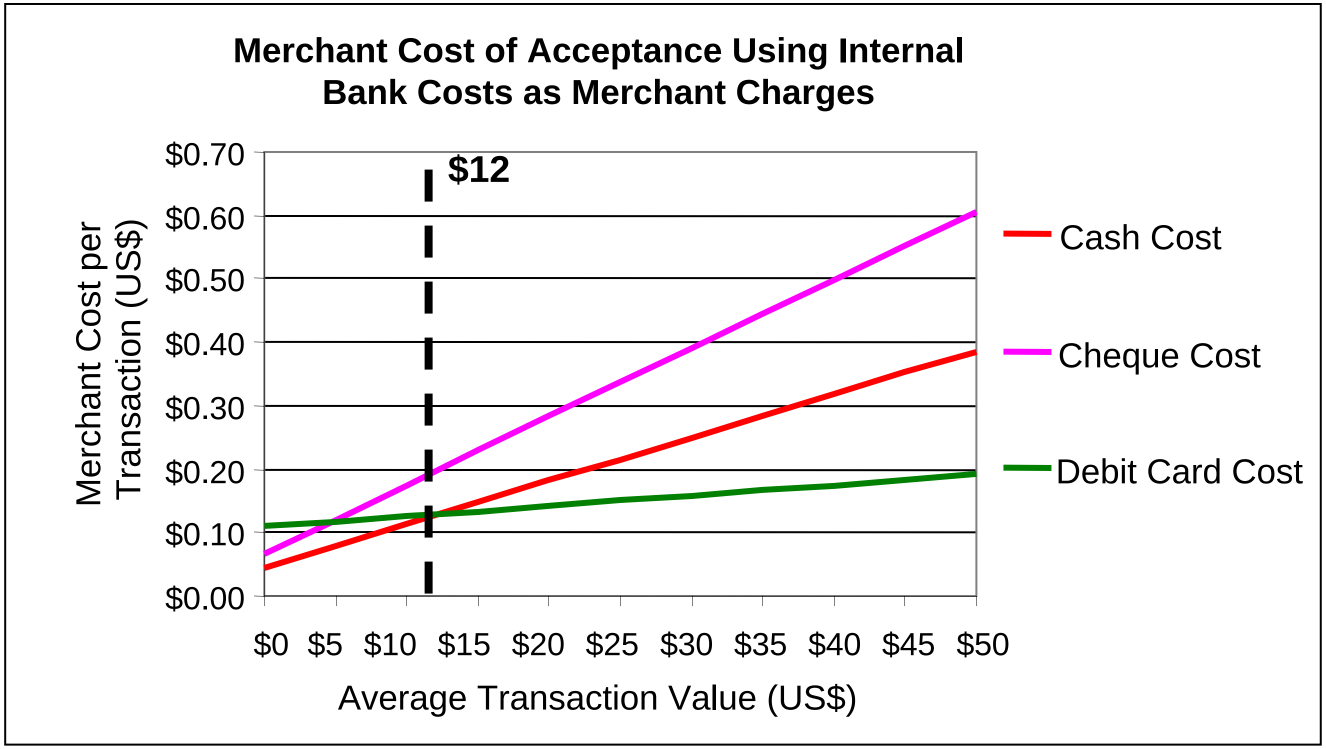
Source: EDC Analysis

From a cost perspective the move from cash towards debit at POS will benefit banks



- **Of these transaction types, debit POS least loss-making payment instrument; still room for growth**
- **Branch cash withdrawals: small volume, but high ticket size; i.e. remaining transactions are cheaper at branch than ATM**
- **ATM cash is major driver of issuer losses on payments**

If merchants were charged for payments on the basis of costs incurred by the banks there would be a migration to more efficient payment types



Source: EDC Analysis

- **In this example the bank charges for each payment type are based upon the bank's internal cost**
- **The optimal point above which debit is cheapest for merchants falls to $12**

Pricing appropriately can accelerate substitution benefits for both merchants and banks

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The European retail payments environment remains sub-optimal for all stakeholders

CONSUMERS

- 'Commodity' requirements
- Security issues
- Cross-border payments
- Black economy impacts
- Acceptance limitations

MERCHANTS

- Need positive customer experience
- POS standards/future proofing
- No understanding of true costs
- Payments subsidisation distorts the market

BANKS

- Profitability problems
- Lack of integrated strategies
- Legacy of cross subsidisation
- Innovation problematic e.g. e-purse

- **Payment systems optimisation needs a 'balanced' economic structure amongst stakeholders**
- **Regulators need to drive towards overall vision and avoid national protectionism**
- **Cost reduction and pricing strategies for payments need to be aligned across Europe (SEPA)**

Conclusions

1. Cost efficiency of payment instruments is impacted by:
   - Distortion of economic behaviour due to cross-subsidisation and inappropriate regulatory intervention
   - Lack of understanding of true costs by major stakeholders
2. Pricing of current account based payment instruments has not reflected true costs in many countries. This results in an adverse impact on retail bank profitability and in inefficient payment systems.
3. An effective migration to optimal cost-efficiencies in retail payments within a SEPA will need the support of all stakeholders to drive substitution from traditional payment forms to e-payments.
4. Removal of costs will not alone improve payments efficiency. Pricing and marketing strategies as well as product innovation and enhancement will be crucial.

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