EU should help payments markets work better

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Payments undergird every aspect of economic life. In the EU in 2016 there were 59.6 billion card payments, 30.6 billion credit transfers and 24.8 billion debit transfers. Sometimes however, structural problems or imperfections impede payments markets' performance, thereby hurt the economy, harm consumers and warrant government intervention.

Dynamic Currency Conversion (DCC) is a glaring example. DCC enables travelers abroad using a credit or debit card to pay in their familiar home rather than the local currency. With DCC 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.

DCC use in the EU is exploding. Between 2013 and 2017 the number and value of DCC transactions within the EU increased by a whopping 128% and 65% respectively. During the same period the average EU DCC transaction value declined from €128 to €85 reflecting more widespread adoption.

The European Commission is the only regulator on the planet interested in cleaning up DCC. Regulators elsewhere haven't been interested because it's foreigners being fleeced and national merchants, ATM owners and processors profiting. The supranational EU, however, has eleven currencies, and millions of consumers under its jurisdiction gouged every year by DCC.

The EC wants a market fix. In March, 2018 it proposed better disclosure of payment-card foreign-exchange fees, and, additionally, that charges on intra-EU cross-border euro and domestic non-euro payments be equalized.

Brussels' interventions to improve payments markets and further economic integration haven't always been market-oriented. Payment Services Directive 2 mandated banks provide payments for free. PSD2 also imposes Brussels' rules for managing risk and determination of acceptable fraud levels over the dynamic determinations of issuers, networks, processors and merchants at risk, of those with skin in the game. In 2015 the EU imposed price controls on networks like Cartes Bancaires', Mastercard's and Visa's interchange fees. And, the Commission's March, 2018 proposal would temporarily cap DCC fees and require prices for cross-border euro and non-euro domestic payments be identical.

In contrast, other regulators' and policymakers' interventions have often 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 they 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 using American Express and Discover. The US Department of Justice forced Mastercard and Visa to eliminate their competition-suppressing bans. And, the landmark 2010 Dodd-Frank Act required banks offer US merchants debit-routing choice between at least two networks. These interventions tweaked rules and market structure to boost competition.

In a similar spirit, the EC's proposal for enhanced disclosure of payment-card foreign-exchange costs is unambiguously pro-market and pro-consumer, and long overdue. The Commission's proposal the European Banking Authority cap DCC fees before more robust disclosure requirements take effect, however, isn't so pro-market. The European Parliament's Committee on Economic and Monetary Affairs while vigorously endorsing enhanced foreign-exchange-fee disclosures, opposes the DCC price cap, rightly noting it "goes against the core Union principles of market economy and free competition as it constitutes in its nature a price regulation." In payments the EU has too often ignored these principles.

The nub of the market problem is significant information asymmetries at the time of payment between consumers, and merchants and ATM owners offering DCC. With their issuing banks cardholders have relationships, fee disclosures, and time to make considered decisions. At a hotel, restaurant or car-rental agency abroad however, cardholders are faced with a one-off decision to pay in their home or the local currency. DCC preys on their natural instinct, absent knowing each option's cost, to pay in their familiar native currency.

If cardholders pay in the merchant's currency, networks perform the currency conversion at close to the wholesale rate. Cardholders pay their bank issuer's markup if any. For its Freedom Rewards Visa credit card Barclays charges a 2.99% fee for nonsterling transactions. However, cardholders have choices. Clydesdale's B Mastercard credit card charges no foreign-exchange fees. Santander's Zero Mastercard credit card similarly has no foreign-exchange fees. Most US issuers charge cross-border rather than foreign-exchange fees to avoid DCC disintermediation. As a result of the 2006 settlement of a law suit, US issuers' foreign-exchange and cross-border fees are robustly disclosed enabling market competition to work its magic. There are consequently plenty of credit cards with no cross-border fees.

On the other side of the network however, the market isn't working. Current DCC competition systemically harms consumers. DCC's enormously profitable for merchants and payment processors. The temptation to fleece one-time customers who will be none-the-wiser is almost irresistible for many merchants and ATM owners. Consumers don't know they're being ripped off. Processors not offering DCC would be competitively disadvantaged and forego profits. Merchants not offering it leave money on the table.

The fix is straightforward. American Supreme Court Justice Louis Brandeis observed, "Sunlight is the best disinfectant." The European Parliament Committee on Economic and Monetary Affairs proposes all currency-conversion options be presented "simultaneously and in a clear and neutral manner to payment service users" and that there be no DCC preselection. Once merchants and ATMs offering DCC upfront fully disclose side-by-side the cardholders' payment alternatives' costs, the market will work.

Disclosing DCC costs above the ECB's reference exchange rate isn't complicated. For the local-currency option, if the issuer isn't charging additional fees, the incremental cost would be the difference between the payment scheme's and the ECB's reference rates, which should be minimal. Where issuers charge additional fees, tables maintained at the network, acquirer and/or issuer could be used to calculate cost disclosures.

Because of competition many issuers have reduced or eliminated cross-border and foreign-exchange fees. Full disclosure at the pos of relevant conversion fees paying in local and cardholder currencies would ratchet up pressure on issuer fees, and, for the first time reward merchants and their processors for reducing DCC fees.

The European Parliament Committee on Economic and Monetary Affairs wants the enhanced DCC-disclosure mandate to take effect 12 rather than 36 months the Commission proposed, after the law takes effect, and doesn't want the EC to outsource rule-making to the EBA. Robust foreign-exchange disclosure as soon as practicable would be best for consumers.

The EC's second notion of equalizing fees for euro payments with domestic non-euro money–transfer fees, at first blush, sounds good for consumers and 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's 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.

To improve cross-border payments and payments with currency conversion, the EU should harness market forces.