

# XIX MEJDUHAPODHNYЙ HAYЧHЫЙ KOHГPECC «ГЛОБАЛЬНЫЕ СЕТИ В ФИНАНСАХ & БИЗНЕСЕ И ИНФОРМАЦИОННЫЕ СИСТЕМЫ УПРАВЛЕНИЯ»\*

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## IMPROVING THE PROFITABILITY OF THE SPANISH FINANCIAL ENTITIES' MEANS OF PAYMENT BUSINESS THROUGH THE INCREASE IN CREDIT FOR CONSUMPTION USING FINANCIAL CARDS\*\*

Исследуется эффективность потребительского кредитования населения. Показано, что стратегия увеличения кредита с использованием пластиковых карт повышает доходность объектов финансового бизнеса.

The objective of this paper is to contrast whether the increase in credit for consumption using financial cards is a valid strategy to be developed by Spanish financial entities in an attempt to improve the profitability of their means of payment business and hence compensate the negative effect of the implementation of the agreement (2/12/2005) signed by the main merchants' associations and financial entities represented by the three Spanish networks (Servired, 4B and Euro6000). The latter implies a considerable fall in the interchange rates that these entities apply on the use of financial cards in shops and therefore of the profits generated by this kind of business.

### 1. Introduction

In order to describe the nature of the bank card business, the following figures must be contemplated:

- **Issuer:** Financial entity that puts financial cards into circulation.
- **Holder:** He who holds and uses the latter.
- **Acquirer or Merchant:** Financial entity to receive the operative using the devices enabled to this effect, whether through POSTs (Point-of-Sale Terminal) for purchases in shops, or through the ATM (Automated Teller Machine) network.
- **Shop:** Depositary of the device enabled for the reception of the cards' operative (POST).

Ultimately, cardholder's have a product made available to them by issuing entities that will allow them to carry out purchases and cash withdrawals. However, in order to make these purchases possible, the Merchant must have previously given the shops the technology capable of managing these means of payment (POST). Similarly, regarding cash withdrawals, financial entities have installed an ATM in their own offices or have rented the space to do so in commercial establishments.

In this respect, it must be pointed out that there are three clearly differentiated businesses in the bank card world: a) the **issuing business**; derived from the entities' placing of cards in the market; b) The **acquiring business** that results from the installation of POSTs with which entities collect the total card billing at shops; c) **The ATM-network business**.

Given the aim of this paper, we shall focus on the use of financial cards for purchases in shops, leaving the ATM-network business aside. With respect to the "**Structure of Commissions or Interchange rates paid/charged in purchases**", the latter always originates at the merchant or acquiring entity (via POST) and reaches the issuer. From an issuer point of view, the rate of exchange is being received, whereas from the opposite perspective, as an acquirer, it is being paid.

Nevertheless, in order to have the complete picture, we must bear in mind that the acquirer, i.e. he who pays the rate, charges the shop where the purchase is being made a given amount known as the discount rate, which, at least from a theoretical viewpoint, will exceed the total paid as rate of Exchange. This amount charged in excess, is justified with transaction costs, fraud borne etc. as well as with a legitimate profit motive.

In 2005, the pillars of the traditional bank card business were seriously modified. This was the result of the then Spanish Competition Defence Court sentences, which culminated in the Framework Agreement that regulates the interchange rates, with significant reductions to be implemented over the period 2006–2010.

The latter Agreement on interchange rates applied on the use of cards in shops, signed (2/12/2005) between the main merchants' associations and financial entities represented by the three Spanish networks (Servired, 4B and Euro6000), implies a notable phasing-out of these rates, such that the rate to be applied in 2010 (0,64 %) versus that in 2005 (1,55 %) reveals a 58,71 % fall in percentage terms. Further, it could even be worse in the future if the agreement signed between the European Commission and MasterCard (a 0,26 % rate) were applied to domestic interchange rates, in which case there would be a fall of 83,23 % with respect to 2005.

These reductions in the interchange rates applied on the use of cards in shops are causing the fall in revenues in financial entities' income statements, a drop that amounts to approximately 3,300 million euros

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for the entities in all, over the 2006–2010 period., and an annual loss of at least 800 million euros as of 2011, possibly even close to 1200 million if the agreement between the European Commission and MasterCard finally is applied to domestic interchange rates.

All the above implies a need for financial entities to reconsider their commercial strategies in this business in order to rebalance their income statements. In this respect, it is possible that the rebalancing strategies will be oriented towards the increase in activity, taking advantage of the potential that the Spanish market presents particularly on two fronts that could even concur: firstly, aim to make the cards more active as a means of payment for purchases in shops, somewhat replacing the use of cash, and secondly, the objective is that the cards be used more intensively as a source of finance for the purchase.

This paper aims to contrast whether the increase in credit for consumption via financial cards constitutes a valid alternative to counter the negative effect on financial entities' income statements of the application of the agreement signed 2/12/2005.

## 2. The empirical research methodology applied

### 2.1. Delimitation of the field of research

This research paper focuses on the Spanish financial sector and, more specifically, on its two main participating groups, i.e., Banks and Savings Banks.

Given that in the Spanish means of payment market financial entities are associated to three distinct networks, we have taken the cross-list of members as of December 2008 as a starting point: 101 entities associated to Servired, 27 entities associated to 4B and 37 entities associated to Euro6000, making a total of 165 entities.

Taking this census, some have been discarded based on different criteria: entities that do not carry out the acquiring activity (3); entities that do not cover "retail banking"; in other words, individuals and small and medium-sized firms (35); foreign entities with branches in Spain, since they depend on the matrix criteria (11); credit cooperatives, specifically "cajas rurales", given that they fall under the umbrella of Banco Cooperativo, an institution that will be included for our research (51); entities that are part of grupo Banco Popular and that are therefore not independent when it comes to means of payment management (5).

After making these adjustments, the total population size to be researched amounts to 60 entities.

Once the total population has been defined, it was considered appropriate to carry out a segmentation in terms of entities' sizes with the aim of establishing whether this factor affects the conclusions of our research. To this end, the total assets figure was considered as a parameter. Responding to these considerations, the following groups have been defined by sizes:

- "Large entities": those whose total assets as of December 2008 are above 80,000 million euros. Applying this criterion, 9 entities were selected.
- "Medium-sized entities": those whose total assets as of December 2008 are between 20,000 million and 80,000 million euros. Applying this criterion, 19 entities were selected.
- "Small entities": those whose total assets as of December 2008 are below 20,000 million euros. Applying this criterion, 33 entities were selected.

Ultimately, according to these size criteria, the collective of banks and Savings Banks to be considered for research is detailed in table 1.

Table 1

Population breakdown using a size criterion

Entities	Population	Total entities, %	Total assets, %
Large	9	15,0	69,0
Medium-sized	19	31,7	23,0
Small	32	53,3	8,1
Total	60	100,0	100,0

### 2.2. Designing the research process

#### SOURCE CLASSIFICATION

The primary source of information was a questionnaire that was sent to those responsible for means of payment in the 60 entities included for our research.

There were additional secondary sources, of which the following must be mentioned: Bank of Spain<sup>\*\*\*</sup>, Servired, 4B and Euro6000, AEB (Asociación Española de Banca), CECA (Confederación Española de Cajas de Ahorro), DBK<sup>\*\*\*\*</sup> and The Nilson Report<sup>\*\*\*\*\*</sup>.

\* Refer to Mercado C., Castillo C., Corral D. "El nuevo entorno del negocio de la tarjetas bancarias en el sistema de pagos español", in "Creativity and Survival of the Firm Under Uncertainty". European Academic Publisher. Madrid, 2009.

\*\* The same criterion was used by Castillo C. in his doctoral thesis "La normativa ISO 9000 como herramienta para incrementar el valor percibido por el cliente en las entidades financieras españolas", 2005.

\*\*\* Bank of Spain report available at: <http://bde.es/sispage/estadisticas.pdf>

\*\*\*\* DBK is a Spanish firm owned by Informa D&B, leader in sector and competition reports.

\*\*\*\*\* The Nilson Report magazine is the global reference in the means of payment area.

## TEMPORAL DIMENSION OF THE RESEARCH

Concerning the hand-out of the questionnaire, it was carried out in a single phase over the month of June 2009, by regular mail and addressed to the departments responsible for means of payment in the selected entities.

The data collection process was completed on 30th September 2009, the same date when the treatment of results and extraction of conclusions commenced.

### 3. Hypotheses to be contrasted

As the introductory section to this paper indicates, the negative effect of the application of the agreement for the sector as a whole may be quantified at no less than 800 million euros per year in 2011, possibly even reaching the worst possible scenario of 1200 million euros per year.

This situation requires to redirect the means of payment business as a whole, to compensate for such a negative effect. As part of this new approach (that we are trying to validate), we have focused on the improvement of those aspects that, as has been discussed already, have traditionally constituted a weakness in the Spanish means of payment system. In particular, we are referring to the use of credit cards in shops and more specifically to the financing of consumption via these credit cards.

Bearing in mind all the above, for the formulation of the hypothesis that follows we have taken the so-called "Anglo-Saxon model" as a reference, which acts as a general name to refer both to the structure that prevails in the UK and to that which is promoted in the USA (a market that shows a use similar to that in the UK):

**HYPOTHESIS:** Spanish financial entities must redirect their current business model over the next few years aiming at the Anglo-Saxon model as a reference, which reveals levels of consumption funding via credit cards that are much higher than those in the Spanish market.

## 4. Results

### 4.1. Questionnaire response level

The table 2 summarises the specifics of the response level obtained, classified in terms of the size criteria previously described.

Table 2

Questionnaire response level

Entities	Number of questionnaires (sent)	Number of questionnaires (received)	Questionnaires received (number), %	Questionnaires received (total assets), %
Large	9	8	88,9	94,9
Medium-sized	19	15	78,9	82,5
Small	32	21	65,6	72,5
Total	60	44	73,3	89,6

### 4.2. Hypothesis testing

First of all, we asked the financial entities to come up with a judgement to reflect their assessment of the level of consumption funding via credit card, obtaining a conclusive result given that 97,7 % of entities subjected to the questionnaire consider the percentage financed by credit cards to be "very scarce" or "scarce", where the latter option was the most popular (68,2 %).

At the same time, we asked those responsible for means of payment how they believe they would be affected by a shift towards what we have termed a more "Anglo-Saxon model", based on high rates of use of credit cards for purchases in shops and to finance consumption, and again we have obtained a result which leaves no doubt, since 97,7 % of the entities consider such a shift to be "positive". The analysis considering the different entity-sizes comes up with identical results.

Finally, we wanted to research how the "increase of credit card funding" is ranked, compared to other possible future policies that may be pursued by financial entities in the means of payment business.

To this end, the questionnaire also asked which possible actions may be carried out in the future, bearing in mind the foreseeable scenario. The results clearly show how two of the proposed alternatives are markedly preferred above the rest by the respondents:

- "Manage to make cards more active in purchases" comes first, with 93,2 % of the answers.
- "Achieve a larger percentage of financing with respect to purchases" immediately follows, with 79,5 %.

This second action is clearly linked to the first, given that a greater card usage in purchases increases the base for entities to work with in order to achieve increased credit card financing.

- The rest of the alternatives under consideration fall behind, with a significant distance with respect to the former: "issuing a greater number of cards" falls third with a 47,7 %, "increasing the acquiring activity" comes in fourth place, with 25 %, and finally we can find "get the cards more actives in ATM,s" with a 15,9 %.

- Taking the entity size into account, the order does not change regarding the two Basic priorities, the "increase in the activity in purchases", and the "increase in the percentage of Financing with credit cards". However, it is possible to appreciate that, while for "medium-sized entities", and "small entities" "issuing a greater Lumber of cards" constitutes the third priority, for "large entities" this position is held by the "increase

in the acquiring activity". The explanation we find is that it is these entities that have been more active over the last years when it comes to promoting the introduction of credit cards in the market using aggressive cross-selling policies, so that their clientele base presents greater saturation measured in terms of number of cards.

To sum up, and as a consequence of all the above, the results CONFIRM THE HYPOTHESIS, since they have allowed us to conclude that Banks and Savings Banks do consider that the current percentage of credit card financing is "very scarce" or "scarce" (97,7 %), which leads them to regard a move towards the Anglo-Saxon Business approach positively (97,7 %). Furthermore, they consider the "increase in card financing" as one of the future and priorities lines of action for this Business (79,5 %).

### 5. Conclusion

After carrying out the research, the results obtained confirm that Spanish financial entities consider that the reorientation of their credit card business, in order to counter the negative effect on their income statements due to the 2/12/2005 agreement, should involve an improvement of the business' current weaknesses discussed. In so doing, the shift should be towards the "Anglo-Saxon model" characterised by a much higher level of consumption financing with credit cards than the Spanish market. To this end, it will be necessary to previously develop an increased use of credit cards as a means of payment in shops, and not merely as an instrument of cash withdrawal at ATMs prior to making the purchases (97,7 % of those banks and Savings Banks participating in the research positively regard a shift towards this model, and 79,5 % of them consider the increase in financing via cards to be one of the possible future lines of action for this business).

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