

# A note on the price- and cost structure of retail payment services in the Swedish banking sector 2002

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## Abstract

We estimate private costs in the Swedish banking sector for the production of payment services and investigate to what extent the price structure reflects the estimated cost structure. We find that (i) banks tend to use two-part tariffs but (ii) variable costs are poorly reflected in transaction fees towards both consumers and corporate customers. (iii) There exist large cross subsidies between different payment services, foremost from acquiring card payments to cash distribution to the public, while payment services as a whole are not subsidized.

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## 1. Introduction

Cheap and efficient payment services facilitate the exchange of goods and services and are of vital interest for a modern economy. It is usually assumed that electronic payment instruments and electronic payments are more cost efficient than paper-based equivalents. The payments markets in the Nordic countries (Denmark, Finland, Norway and Sweden) are, with one exception, very similar to each other. In the late 1990s and early 2000s cards,

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measured as card payments per capita, were used less frequently in Sweden than in the other Nordic countries. At the same time, the use of cash was high in Sweden, irrespective of whether it is measured as the value of notes and coins in circulation in relation to GDP or the value of notes and coins in circulation per capita, see Table 1.

The fact that cash is often viewed as an expensive means of payment and the difference between Sweden and the other Nordic countries in this example could be an indication that the Swedish retail payment system was used in a less efficient way in this sense. Experiences from Sweden and Norway suggest that the demand for a payment service responds significantly to changes in its price and to transaction prices of other competing payment instruments, see Humphrey et al. (2001) and Nyberg and Guibourg (2003). This, in turn, raises the question of to what extent prices on payment services in Sweden reflect the corresponding production costs and thus, support an efficient use of payment instruments. To answer this question, this study estimates the costs for banks in the production of different payment services and compares them to the prices charged by banks for these services. We find that first; there are considerable differences in costs between payment instruments. As expected, paper-based payments are more costly to produce than electronic payments, and debit card payments are less costly than credit card payments and cash withdrawals. Second, banks tend to use two-part tariffs but costs are poorly reflected in prices, in particular towards private customers. Third, the provision of payment services yields an annual profit for the banking sector. However, cash distribution to the public is, to a large extent, financed through substantial cross subsidies from other payment services, foremost the acquiring of credit- and charge card payments. Hence, the banks could reduce total production costs and probably increase overall profitability by adopting more cost-based pricing strategies that would redirect demand from cash toward less costly payment services.

The costs of different payment instruments and cost recovery from the perspective of the banks have been investigated in a few earlier studies. Brits and Winder (2005) investigated bank and merchant payment expenses for cash, debit-, credit-, and prepaid cards. In terms of total cost per transaction, cash was shown to have a lower (higher) cost than debit cards for point of sale payments less (larger) than 11 euros. The prepaid card had the lowest variable cost but, due to low volume, the highest average cost. Focusing on the banking sector, they showed that the average debit card payment was more costly than the average cash payment. However, for two reasons their results for cash payments cannot be directly compared with our result on cash withdrawals. First, cost for withdrawals only covers the distribution of cash to consumers, not banks' costs for handling deposited cash which is included in the Dutch study. Secondly, there is no reliable Swedish data on the cash payments at the point of sale. This is needed to translate the average withdrawal into the corresponding number of cash payments.

Table 1  
The use of cards and cash in the Nordic countries

	Notes and coins in circulation (M0)		Card payments (POS)
	Per capita (USD)	Relative to GDP (%)	Number of transactions per capita
Denmark	941	3.0	80
Finland	511	2.1	73
Norway	1145	3.1	80
Sweden	1107	4.2	40

Source: ECB (2004) and Norges Bank (2003).

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