PAYSYS REPORT

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In this issue:

PSD2 requires harmonized and techno-logy-neutral interpretation of definitions

We invited Simon Lelieveldt as guest author to write some comments to the new Payment Systems Directive (EU/2015/2366, just published in the Official Journal of the European Union on December 23th.

Simon is an independent regulatory consultant in payments active in the Dutch Banking and Payments sector. In his career, he has worked both as a supervisor and a banker in different roles, including project manager, consultant, senior policy-advisor and head of a department of professionals.

Our Comment:

(written by our guest author Simon Lelieveldt)

Summary
In order to achieve a true European level playing field 'on the ground', it would be very welcome if regulators and local supervisors could discuss and publish –early on- a FAQ that explains how the PSD2 definitions will apply – in all member states - to the variety of business models and transaction mechanisms that exist.

This harmonized guidance is just as important as the guidance provided for the first PSD. Both regulators and the market have further developed since PSD1 and it is essential to recognise some of the underlying dynamics and developments in the payments market.

1. Out of scope, limited network or regulated?

At present, member states use the harmonized PSD-rules to determine whether or not a certain business model is defined as a payment activity or can be categorised as an exemption. Both in terms of content and process, supervisors vary considerably in their approaches. Their feedback varies from an elaborate argumentation to merely the brief outcome of an internal review process.

Also in terms of content, the approaches vary. Business models that are out of scope in one member state may be exempt or require a license in others. The lack of a central register of supervisory statements on those matters makes this hard to identify, but the PSD2 will change this. All business activity exempted under article 3j and 3k, must be notified and the exemption decision will be published in a central register.

The practical consequence is that market participants can more easily determine which business models are exempted in which countries. This means that the supervisors must ensure that their judgements are well-grounded and harmonized. One of the major challenges in this respect is to take into account the technological and market developments.

2. Technological developments: open and device-agnostic

Just one look at a user's technical environment demonstrates that the major trend in payment technology development is the move from closed, bespoke systems and standards to more open structures. Whereas previously payment providers would control (sometimes own) all technological instruments to be used in a payment transaction, this is no longer the case.

The future infrastructure setting is one in which consumers and merchants will use their own technical device, and providers need to ensure that it can be used safely. We can now see card-based payments, where no plastic is used anymore, as the payment is made via a virtual card application in the mobile phone or PC. At the same time, in the back-office, the systems are opening up to the outside world via Application Programming Interfaces (APIs). Rather than having one instrument that operates as a shopping and a payments tool simultaneously, we can see that the value chain of search, shop and pay can be arranged via modularized interfacing of channels and technologies.

Therefore, when assessing technologies in today's payments environment, an open and functional approach is required. The classical approach, in which one tries to find the main device (such as a card) that serves as the payment instrument and then further classifies a system around that instrument, will no longer work. There will be all kinds of devices and technical tools and while some may classify as payment instruments, others may not.

Fortunately, the definition of payment instrument in the payment services directive enables this functional approach. The definition mentions both 'a personalized device' and/or a 'set of procedures' to be viewed and defined as the payment instrument:

"payment instrument" means a personalised device(s) and/or set of procedures agreed between the payment service user and the payment service provider and used in order to initiate a payment order."

In the coming years, we will witness a shift away from devices as the actual payment instrument.

Supervisors should thus not immediately label 'the card' or any specific technical tool in a commercial business model as the payment instrument.

3. Where is the commerce and where is the payment transaction?

As technology slices up the commercial value chain, we should note the relevance of the last element of the definition of payment instrument: 'to initiate a payment order'. There is a clear difference between the commercial use of devices for purchases (apps, shopping carts on the web, NFC-identification devices) and the later moment in which aggregated purchases are actually being paid. This can be compared to the difference between the shopping card/button on a website and the payment button.

The main question to ponder is therefore: does the technology service allow the user to make a payment to any other payee in Europe (under the SEPA rules) and is the transaction actually a payment order, or is it merely a shopping transaction, with payments being arranged later on?

I wouldn't be surprised if in the coming years, we witness a shift away from devices as the actual payment instrument. It may be more suitable to put the (user) accounts centre stage than the actual payment instrument. When applied by retailer organisations, such a choice will enable them to build a multi-channel sales-channel in which the device used is irrelevant. The sales channel aggregates purchase transactions towards the user account at the retailer. In cases where the retailer merely aggregates these purchases and initiates a direct debit for the total sum to be paid, this remains an administrative account as the actual payment account in the process is that of the bank. Only in cases where actual payment orders are initiated from such an account would it become the payment account as well as the payment instrument for commercial transactions.

Supervisors should thus not immediately label 'the card' or any specific technical tool in a commercial business model as the payment instrument. It is crucial to distinguish the commercial from the payment process domain when evaluating apps and identification tools on the market. The actual payments can be expected to become the afterthought of commerce, rather than a primary service. These can flow via a payment account in the background, which is provided by retailer, bank or payment service provider. It is that account that will then function as the payment instrument in the commercial transaction and not the purchase device/application used.

4. Areas and definitions of interest for the application of the PSD2

We've seen that the democratisation of technology allowed non-bank payment service providers to enter the payment space. Amongst these will also be retailers that can leverage the technology to provide a better customer experience. If these retailers are to use a services and customer contract with a monthly SEPA direct debit agreement in the background, the payment services directive will not be relevant for them.

Similarly there is the question whether the payments services directive would have to apply to intermediary web-based platform companies that help users transact among themselves. Such business models could be in or out of scope based on the interpretation whether:

- the payments are seen as a regular occupation or business activity (art 1,2b),
- the agency model applies,
- the new definition of acquiring applies,
- the limited network exemption applies.

I hope that the collective of regulatory players involved in the transposition and application of the PSD2 will succeed in addressing these scoping and definitions issues early on. In this respect the publication of a FAQ on these issues, may be a very effective tool to clarify and ensure a level playing field.

Square’s debut on the stock exchange

(mk) Square has had its debut at the stock market and commentators cannot agree what to make of it. “Square IPO flops: Unicorns going extinct?” (CNN), “Square Turns the IPO Corner” (Bloomberg) and The Economist comments: *“A private fundraising last year valued Square at roughly $6 billion. The initial public offering (IPO) priced it at $2.9 billion, down by half.”* (The Economist, November 21, 2015). But due to the post-IPO rise of Square’s stock price the current market cap of the company is around USD 4 billion (Yahoo Finance, 21 December 2015).

So while there is still room for debate on how Square is going to perform in the future, the IPO has allowed market participants to take a closer look at some important numbers regarding Square’s business model.

Our Comment:

Square is a company that entered the market with a free payment card reader that can be attached to a mobile phone. Employing a kind of sub-acquiring model, Square allows its customers to accept card payments. Only when customers reach a sales’ volume beyond a certain threshold do they need a contract with an acquirer.[1] The pricing model is simple: 2.75% of the value of transactions.[2] In the first years of its existence, Square has been growing vigorously and in 2015 it has entered the stock market.

For a company starting in early 2009 the figures are impressive. In 2014, the sixth year of operations, Square processed an estimated USD 32 billion in payments (USD 24 billion excluding Starbucks).[3] Such a payments volume equals almost half the German credit card market. Moreover, growth rates are still impressive. In 2014, there was an increase of Gross Payment Volume (GPV) (excluding Starbucks) of 42%.

<table>
<tr><th></th><th>Gross trx. revenue (USD m)</th><th>Gross trx. revenue (% of GPV)</th><th>Net trx. revenue** (USD m)</th><th>Net trx. revenue** (% of GPV)</th><th>Gross payment volume (GPV) (USD m)</th><th>Operating expenses (USD m)</th><th>Operating loss (USD m)</th></tr>
<tr><td>with Starbucks*</td><td>831</td><td>2.62%</td><td>229</td><td>0.72%</td><td>31,742</td><td rowspan="3">377
(1.19%)</td><td rowspan="3">150
(0.47%)</td></tr>
<tr><td>without Starbucks</td><td>708</td><td>2.98%</td><td>257</td><td>1.08%</td><td>23,780</td></tr>
<tr><td>Starbucks*</td><td>123</td><td>1.55%</td><td>-28</td><td>-0.35%</td><td>7,962</td></tr>
</table>

*: estimate
**: gross transactions revenue minus interchange fees
Source: Square, Inc.: SEC Form S-1, Registration Statement under the Securities Act of 1933[4] and PaySys Consultancy estimates

Acquiring Starbucks as a merchant customer was a huge success for Square. But the figures presented show that Square has had to pay a price. Obviously, the fee that Starbucks had to pay to Square was below interchange. Once again this shows how important prominent key accounts are for acquirers and how far acquirers are prepared to go.

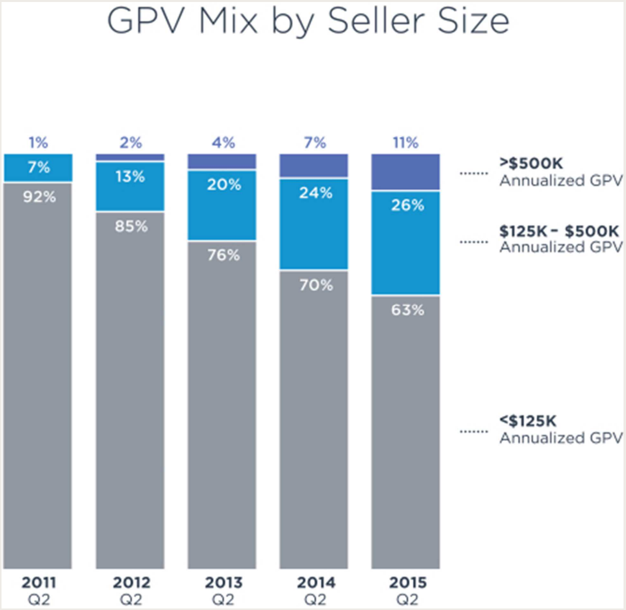
It is also noteworthy that Square has to operate in a high interchange environment. The upside of this is that there are many card holders. But the downside is that a large chunk of Square's merchant charges goes to card issuers. Thus, a merchant service charge of roughly 3% of the value of transactions translates into a fee for Square of about 1.1% (all figures excluding Starbucks). This has not been enough to cover operating expenses and the losses stemming from the Starbucks contract.

Is it possible to serve very small merchants and make a profit?

Given healthy growth, Square may grow out of its current loses. However, acquiring is a highly competitive business and there are already other providers in the market that have imitated Square's business model. For instance, there are service providers like Adyen, iZettle or Payleven. Even if Square is the front-runner, there are no strong network effects in acquiring and competition is fierce.

In a way, Square and its imitators are the principal actors in an interesting experiment. For decades now there has been talk of a cashless world. But so far the vision of a cashless world has been far-fetched. Even the most widely used cashless payment instrument, the payment card, has enjoyed far from ubiquitous acceptance. Indeed, the very success of Square – in terms of attracting "merchants" – shows how large acceptance gaps have been, even in the United States. Square is working hard to fill these gaps. But the interesting question will be whether it is possible to serve very small merchants and make a profit.

Up to now Square has been burning money. Moreover, things are not getting easier. The introduction of EMV implies higher costs for terminals. Therefore, Square has to start selling terminals rather than giving them away. In fact, the size-structure of Square merchants is already evolving towards "normality". Micro businesses (below 125k Gross Payment Value "GPV") have been reduced from 92% of Square's business (Q2 2011) to 63% (Q2 2015).



Source: Securties and Exchange Commission Washington, D.C. 20549 , FORM S-1 SQUARE, INC
GPV: Gross Payment Value

From an economic point view, the interesting question is not so much whether Square will be able to survive or even thrive. Rather the big question is whether there really is a business case for serving micro merchants. If cards (or mobile phones) want to replace cash, they have to demonstrate that there is a business case for also serving the really small acceptance points. Whatever the answer, regulators are not making it any easier for e-payment service providers.

First Russian National Card Scheme (MIR) launched on December 17th

We also invited **Alexey Martsinkovsky** as guest author of this Report deliver us some background information to the just launched Russian National Payment Card Scheme "MIR".

Alexey, based in Moscow, is senior consultant with many years of experience in card business. He is Russian Member of the European Payments Consulting Association (EPCA).

Our Comment:

(written by our guest author Alexey Martsinkovsky)

History

There have been several attempts to create a nationwide payment scheme (PS) based on the development/merger of private label local PS. Fifteen years ago, the author worked as a general manager of one such scheme and was involved in the processes of extending acceptance networks of the local PS through bilateral agreements. But nobody wanted to lose their identity, so up to now a real national PS has not been created. As soon as the fees of the International Payment Schemes (IPS) became more acceptable due to economic growth and IPS started to sponsor card issuers, the local PS gradually lost their market share and in the end only one regional scheme survived.

Turning point

The first call for local payments securitization came from IPS after the 1998 Russian default followed by a banking crisis when IPS blocked the cards of several banks. But because of the economic reasons behind this action this call was ignored. The last call came at the beginning of Y2014 when Visa blocked the operations of several banks as a result of US sanctions applied in response to the Ukrainian crisis. This time the Russian Parliament updated the law to set up a domestic national PS (NPS) to process all intra country transactions inside the country without dependence on the card related IPS.

Looking for an NPS operator

Because of the very short timeframe for implementation of the new payment processing initiatives (less than 1 year), initially one idea was to choose an NPS operator from the list of existing PSPs. Finally two companies were selected - Universal Electronic Card (ID card processor) and the last surviving local PS, mentioned earlier - Golden Crown. But after discussion by banking experts and an external audit no winner was chosen and it was decided to set up the NPS under the auspices of the Central Bank and to build the NPS operator from scratch.

NSPK Creation

The NPS Operator was registered in the middle of summer 2014 under the name National System of Payment Cards (NSPC). The task was very ambitious: to create a Payment Processor (HW, SW, Rules etc.), agree procedures and fees with Visa and MasterCard, sign agreements with about 100 IPS Principal Member Banks, test their connections and operability and launch the system in seven months!

The First Steps

As a first step, key team members were gathered from the best specialists in the market. Secondly, an SW supplier was chosen - according to the law it should have been a Russian company, to avoid dependence on a foreign supplier. Then in a very short period - practically 3 months - NSPC developed its rules and made the first presentation to the banking community at the beginning of December 2014. But not everything went so smoothly - negotiations with IPS were delayed and some key banks were conservative and not eager to connect to the new system. Huge security deposits were legally applied to IPS in case of not transferring their intra-country traffic to NSPC. Finally, some of the banks believed that the law would be relaxed and time limits would be moved forward.

Operations Launch

Nevertheless the first banks launched their operations on time on 1st April 2015. Not all of course, and without full functionality, because it was not physically possible to go live with such a project within predefined time limits. Especially taking into account the fact that the agreement with IPS was only signed one and a half months before the NSPC processing launch, NSPC key staff were working from morning till night all these months to make this project possible.

1st Year Results

Since September 2015, most Russian IPS principal member banks have been using NSPC. The Russian MasterCard and Visa member banks are obliged to use NSPC as a processor for their intra-regional transactions and have to pay NSPC for this service. Moreover, by 1st October NSPC operational rules were published and the national payment card brand name „MIR“ (the Russian word for “World”) was chosen as result of a nationwide survey. At the same time, technical standards and local EMV applications are still under development and the first MIR card should be issued by pilot banks at the end of this year.

Key figures

According to the legislation, the MIR Card should be issued to any bank customer who receives wages, pensions and other social payments from the state. It will give NSPC about 80 million potential customers. On the other hand, all member banks are obliged to accept MIR Cards at their merchant outlets. So from a business point of view, NSPC will be guaranteed customers and merchants, but only one thing remains – to persuade customers to use these cards for payments, because it is clear that most of them have other IPS cards.

Scheme Fees and Interchange Fees

To make NSPC more attractive for the banks and their customers, first the question of IRF has to be solved. On the Russian market the key IRF is Cash Advance Fee, because most card transactions are cash withdrawals. Taking into account that the IPS IRF has remained stable at the level of 40 RUR (1 Euro) for the last few years, banks have been charging their customers 100-150 RUR (2.50-3.80 Euro) for each ATM cash withdrawal at a non-issuer bank. This has greatly limited the number of off-us transactions and given huge competitive advantage to Sberbank- the biggest Russian bank with 50% of market share. To compete with Sberbank, smaller banks have concluded bilateral/multilateral agreements to optimize cash advance IRF to 0.5% which has given their customers access to an extended ATM network at no fee or at a very low fee. To make its product more competitive, NSPK has fixed the Cash Advance IRF at 0.45% and thus the need for all these bilateral/multilateral agreements has disappeared. After this, IPS took the same action and changed their Cash Advance IRF to the same level. In future when banks start issuing the MIR card, we will see how the IPS competes with the new scheme on the Russian market.

The IF for sales transactions - starting from 0.15% (Government Fees and Penalties) via 0.50% (e.g. high volume grocery) to 2% for transactions at high-premium merchants - are still in line with IF-levels of the international card schemes to avoid premature competition for the new issuer’s and acquirer’s card business at its start.

The Next Steps

The third step in NSPC development after the launch of the MIR card is the development of international acceptance. This could be done via co-badged programs (Maestro, JCB and AmEx are already involved) and direct inter-scheme agreements for mutual cards acceptance where appropriate.).

American Express UK is subject to the interchange fee caps

(hg) In our last PaySys-Report of November 2015 we discussed the tricky issue of the relevance of the Interchange Fee Regulation (IFR) for the biggest "three-party scheme" American Express in the EU, where most of the Amex cards are issued (and acquired) by American Express Services Europe Ltd., located in the UK and therefore regulated by the British PSR (Payment Systems Regulator). Just a few days after the publication of our Report, the PSR published on 2 December its Draft Guidance Paper.[5] On 9 December a press release of the PSR stated:

"We have provisionally concluded that the market share of American Express between 9 September 2014 and 8 September 2015 was above the 3% threshold. A scheme which is above the threshold may not be exempted from the interchange fee caps on domestic transactions and must comply with the fee caps. Therefore, our provisional conclusion is that American Express and any payment service providers participating in the American Express scheme must comply with the interchange fee caps on UK domestic transactions until 31 March 2016." [6]

Our Comment:

Why is the relevance of the IF-caps such a tricky issue for the card scheme Amex? To summarize, we discussed these topics in our Report:

- How are Regulators interpreting the relevant Article 1 (5) of the IFR? Is Amex as a whole scheme subject to the IF-caps (scheme-based approach) or are only the transactions with the Amex-portfolios, issued in cooperation with licensees (payment providers), agents or co-branding partners, relevant (sub-scheme-based approach)?

- How to determine the references for the caps if there is no dedicated IF in the Amex scheme?

Based on feedback from the readers of our Report (including Competent Authorities) we got the impression that these issues are not only controversial for Amex and its competing card schemes (Visa & MasterCard). In the meantime, the PSR has put its foot down. The PSR follows our scheme-based interpretation of Art. 1 (5) of the IFR based on the plain text of the IFR: *"We do not consider that it is appropriate to look at the system more narrowly than this (e.g. by only examining transactions on cards issued by licensee issuers which necessarily involve four parties rather than three). This is because Article 1(5) says that it is the scheme that may be exempted, not the arrangements between the scheme and its licensees"* (p. 19 of the Draft Guidance).

Even in case of an exemption for domestic transactions (issuer, acquirer and merchant are located in the UK) for a period of maximum 3 years, all cross-border transactions with Amex cards issued by Amex UK are subject to the IF-caps (transactions outside the UK with Amex cards in Germany, Poland, Spain, Italy, Netherlands etc.) from 9 December onwards. Based on the figures of Amex in the UK, the PSR made the provisional decision that Amex domestic transactions exceed the 3%-limit for an exemption. Market experts estimate the market share of Amex to be about 9% in the UK. Therefore domestic transactions are also subject to the caps.

By the way, it is interesting to see the consistent approach of the PSR in measuring market shares of the semi three-party schemes, like Amex: the percentage of the value (not the number) of all domestic transactions in the UK (issuer, acquirer and merchant are located in the UK), which is consistent, but not in line with the poor wording of Art 1(5).

What are the practical consequences of this decision?

For example, a transaction with an Amex consumer card, issued to a German cardholder by Amex UK, is subject to the IF-cap of 0.3%. So far, so good. The transaction is acquired by the same entity as the issuer (American Express Services Europe Ltd.). In this case, there is no IF and no remuneration comparable to the IF. The conclusion of the regulator is simple: there is no interchange fee to be capped! What about a co-branded card or a card issued by an agent of an Amex-licensed bank? The compensation paid from Amex to a co-branding partner (e.g. the Payback loyalty scheme or an airline) is treated in the same way as the compensation to a licensed issuer. It is subject to the IF-caps.

Conclusions:

- For a semi three-party scheme, the IF caps only have relevance for card-based transactions where the issuer and the acquirer are not the same entity.
- The issuer is not identical with the acquirer in cases of licensing other PSP at the issuing and/or acquiring side or if the issuer is issuing the card in co-operation with an agent or a co-branding partner.
- The remuneration to the licensed issuer, to the agent or co-branding partner is considered as the compensation which is subject to the IF-caps.
- In cases of non-existing IF, IF cannot be regulated and therefore these transactions will not be subject to Art. 62 (4) of the new PSD2 (no surcharging for transactions of payment instruments for which IF are regulated).

In consequence, the internal revenues within the Amex eco-system are probably changing. There will be winners and losers. For example, a transaction by an Amex card issued by Amex France, used at a German merchant and acquired by Amex UK will probably generate an IF from the UK acquirer to the French issuer of maximum 0.3%. Another consequence is the limiting of the provisions to licensed PSPs, agents and co-branding partners. If these provisions are today above 0.3%, the IFR will turn Amex as a scheme into a temporary winner by allowing it to make windfall profits.

The conclusion of the regulator is simple: there is no interchange fee to be capped!

On the merchant´s side there is no direct positive effect (from a merchant perspective) because there is still no competition on the acquiring side. All Amex transactions in Germany (and in many other Member States) are acquired by the same entity (Amex UK). Even in case of the existence of an IF, the acquirer could argue, the MSC of e.g. 1.5% includes an IF of 0.3% and the remaining part (1.2%) is simply the acquirer margin.

Besides the indirect effect of pressure on the merchant fee by lower Visa and MasterCard fees, the only direct effect for the merchants is negative. For a German merchant who accepts Amex (all transactions are cross-border) it will be difficult to communicate to its customers/cardholders that they have to pay a surcharge on transactions made by all cards, except Amex cards issued in co-operation with a licensed bank or agent (e.g. Commerzbank and for cards issued with co-branding partners (like Payback). It is not even a realistic option for the merchant from a marketing and consumer friendly perspective to accept only Amex cards, on which transactions have an intrinsic IF which are subject to the IFR.

However, the PSD2 could have more important consequences for the semi four-party schemes like Amex. As a consequence of Article 35 (& Recital 52), the whole card scheme would be subject to the access provisions for payment schemes. Is this the end of the acquiring monopoly of Amex?

Notes
1 Square works with JPMorgan Chase and Wells Fargo.
2 If card data are entered manually the charges are: 3.5% plus 15 cents.
3 Many figures provided by Square are excluding Square's business with Starbucks because Starbuck has terminated the relationship with Square and is switching to a different processor. We have tried to estimate the Starbuck figures to get an idea of both types of figures including and excluding Starbucks.
4 Form S-1 is an SEC filing to be submitted by companies who want to go public and have to register their securities with the U.S. Securities and Exchange Commission (SEC).
5 https://www.psr.org.uk/psr-publications/consultations/gc-152-IFR
6 https://www.psr.org.uk/psr-publications/news-announcements/provisional-determination-card-schemes-subject-to-cap-Dec-2015

We wish all our readers a Happy New Year!

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