



PAYSYS REPORT

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Implementing application selection at the POS

(mk) The EPC has published a Bulletin¹ dealing with the electronic identification of payment instruments and the tricky issue of application selection at the POS. This issue has to be addressed due to the Interchange Fee Regulation (IFR)² that was passed in 2015. Art. 8 (6) states:

"Payment card schemes, issuers, acquirers, processing entities and other technical service providers shall not insert automatic mechanisms, software or devices on the payment instrument or at equipment applied at the point of sale which limit the choice of payment brand or payment application, or both, by the payer or the payee when using a co-badged payment instrument. Payees shall retain the option of installing automatic mechanisms in the equipment used at the point of sale which make a priority selection of a particular payment brand or payment application but payees shall not prevent the payer from overriding such an automatic priority selection made by the payee in its equipment for the category

of cards or related payment instruments accepted by the payee."

Thus, there is a kind of hierarchy. At the low end are issuers and schemes who may not limit the choice of payment brand. Payees (merchants) may make a priority selection but payers (card holders) may override this selection. So, in the end, the card holder has the final say.

The EPC basically proposes three different ways that can be used to implement these provisions regarding application selection:

- All mutually supported applications are presented without discrimination and the payer makes a choice.
- The card acceptor puts the preferred application on top but the payer may choose any one of the applications presented.

- The acceptor presents only the preferred application but the payer has the right to override the selection of the acceptor.

According to the timeline set in the Interchange Fee Regulation, the changes must be implemented by 9 June 2016.

Our Comment:

Application selection is an issue that may impact the market in fundamental ways. That is why we have repeatedly written about the topic in this newsletter.³ In the past, for co-branded cards, there were usually clear priority rules of the type “domestic brand for domestic transactions, international brand for x-border transactions”. This means in those days brands were not competing. However, SEPA rules made such a distinction between domestic and x-border transactions impossible. After all, there should only be one integrated European Payment market. Thus, in principle both brands can be used for a particular transaction, it suddenly becomes an issue, who can select the brand. If issuers have the right to select the brand, they will pick the brand with higher interchange fees. In fact, they might even consider raising these fees. If merchants get to decide, they will pick the brand with lower fees which then puts strong competitive pressure on schemes to lower interchange fees.

However, with the passing of the Interchange Fee Regulation, the topic has lost most of its strategic importance. For debit card payments, the maximum interchange fee is 0.2%. In practice, there may be some slight differences in fee levels but they are likely to be small. So, what remains is more or less a consumer protection issue. Consumers are given the final say.

It remains to be seen how it will work in practice. There is room for scepticism as well as hope. Considering that most German card holders still do not understand why they sometimes have to sign and sometimes type in a PIN one is inclined to be sceptical. Even after 20 years, German card holders are simply not aware that this is based on two different types of payment (Giro-

card and ELV). Moreover, in the past, they were subjected to a branding muddle. Having been used to the brand “ec cash”, they were increasingly confronted with “Maestro” and finally with “Girocard”. So, how can they make an informed choice? In all likelihood, they will simply disregard the option to make a selection. Other countries have implemented application selection for many years. In Finland, for instance, card holders have been able to make a choice between debit and credit. As far as we know, this seems to work well and does not create undue delays during the payment process. However, explaining the choice between two debit brands may be somewhat more challenging.

All in all, it does seem likely that card holders will make little use of the option to select a certain brand. Thus, one could conclude with Shakespeare, “Much ado about nothing”. Unfortunately, there is more to it. First, implementation will be costly. Terminals will have to be upgraded (if possible) or replaced, acquirers have to educate smaller merchants and both merchants and acquirers have to educate customers. Some merchants may decide they would rather stop accepting cards. Second, it is still unclear how non-guaranteed payments such as ELV will be affected. In principle, ELV does not fall under the Interchange Regulation. Thus, any rules regarding application selection should not apply to ELV. This is particularly important, with respect to the EPC Bulletin's provision that *“the POI shall always provide an override mechanism to the Cardholder. This mechanism shall be made available before Card Risk Management is performed.”* Such a rule could easily kill non-guaranteed payments such as ELV. Thus it should be made clear that application selection rules do not apply to ELV.

Nets' Annual Report 2015 full of great surprises

Nets, the Nordic payment processor, has released its Annual Report for 2015⁴ - the first full financial statements under the new private equity fund's ownership structure.⁵ There are some big surprises, indicating that process efficiency, customer orientation, consolidation and acquisitions have provided a significant acceleration in profits. EBITDA (before special items) increased from 1.663 billion DKK (215 m €) to 2.25 billion DKK (302 m €) - a growth of no less than 35%. Broadly, this growth can be explained by:

- A 4% growth in net income to 6.8 billion DKK,
- A decrease of 6% of the total operational costs of 4.6 billion DKK.
 - sales costs fell by 9% to 1.0 billion DKK.
 - expenses for wages were reduced by 4% to 1.9 billion DKK.
 - improved purchasing terms (presumably for POS terminals)
 - a higher proportion of rental-based terminals
 - reduced consumption of external consultants.

This suggests that there have been many small changes that add up to a significantly improved bottom line.

In the more descriptive part of the annual report, management stresses the following points:

- In the future there will be a unique Nordic focus (an expansion outside the Nordic region and the Baltic areas is no longer a strategic priority),
- The Nordic market is far from saturated with digital services yet,
- Growth in Sweden has a high priority,
- Nets will make the Region a leading mobile payments area,
- Nets will open its terminals and systems to all types of mobile payment transactions - whether it is from current or new Scandinavian providers or Samsung Pay, Apple Pay or other international actors,
- In 2016 Nets will launch a "Token Service" for both national cards (Dankort and BankAxept) and the international card systems (Visa and MasterCard).
- About 27% of the business comes from "Merchant Services" (particularly terminal business), 32% from "Financial & Network Services" (including issuing & processing of international cards, "Card Management Services", and operating and processing of national systems Dankort and BankAxept), and about 40% of "Corporate Services" (e.g. payment services for corporates in Norway and Denmark, NemID password, etc.).

Our Comment:

(written by our guest author
Henning Jensen*)

Indirectly the report shows that Nets needed a "loving" hand, a forward commitment from its owners and a faster decision making process with a considerable investment willingness, in particular for acquisitions of related businesses.

The potential has probably always been there, but now it has been unlocked through a new dedicated ownership. In addition, a strong international benchmarking culture has been helpful.

66% of employees received a performance bonus in 2015 for their performance in 2014, which undoubtedly helps to strengthen internal understanding of the many changes that have occurred in Nets.

Evidence suggests that it has come as a bit of a surprise for the new owners how fast "the strategic journey" from bank-controlled to market-driven organization has gone. Apparently there were dormant economic forces in Nets that needed a wake-up call.

There is no doubt that the new owners have now succeeded in reaping some of the great synergy effects that were mentioned in connection with the merger between PBS and Norwegian BBS in 2010, which the previous management of the Nets never completed. Amongst other things there comes to mind the national struggle between indigenous organizations in Norway and Denmark. Positive effects may also be due to reduced staffing levels, where the new management has consistently streamlined the organization and closed duplicate functions. A process that is not yet fully completed.

The previous owners no longer had a great willingness to invest. So, here are the new owners injecting capital resources, international knowledge and decision-making competence, which is not only necessary to penetrate deeper into the Swedish market, but has also given the organization increased internal trust as it goes into the future.

What about the eventual exit of the new owners?

Given the strong performance in 2015 and a bullish outlook for 2016, what about the eventual exit of the new owners? The annual report says nothing on this topic. But there is little doubt that the current owners certainly want to accompany Nets for a little longer and benefit from its large investments, for instance in the mobile payment area. No one knows yet what will happen on this front, but a public offering is probably one of several natural scenarios. For the moment, PlusCON sees such an option not as an "exit strategy", but rather as a way to reduce debt (from the purchase of the Nets in 2014 for about EUR 2.4 billion) and thereby reduce risk.

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Missing harmonization of IFR regarding commercial cards

Commercial cards (a collective name including business, corporate, purchasing cards, which can be issued to undertakings, public entities or self-employed natural persons) are not subject to the Interchange Fee caps of the IF-Regulation 2015/751. Not all the issuers of these cards welcomed this exclusion, because the IFR changed the "liberal" definition of a commercial card as being used by the international card schemes in a very restrictive manner.

Card usage should not only be restricted to business expenses, but also be charged directly to the account of the business. This new restrictive definition by the IFR will have a significant impact on the European commercial card business as most of the commercial cards were charged to the private accounts of the employees.

Our Comment:

(hg) In the initial draft of the IFR the Commission justified the exclusion of commercial cards from the IF-caps *"as they have limited market share in the EU and different fee structures and this is not expected to change in the future"* (p.12 of the proposal of 24 July 2013). Since then the European Parliament had included (probably accidentally) commercial cards in the legislative procedure but the final result was that they were excluded. In the final text of the IFR the justification for the special treatment of these cards is missing.

Before the IFR caps came into force (December 2015) commercial cards accounted for approx. 4% of all cards and for about 8% of the transaction volume in Europe (figures from Galitt⁶). In some travel and entertainment segments (like hotels) acquirers even reported a much higher share of the total card volume. More than half of the traditional commercial cards will be out of scope as not fulfilling the new core require-

ment for a commercial card of direct settlement through the company. In contrast to many other IFR articles, the Commission made the same clear statement in two different places in the final version of the text: *"The payments made with such cards are charged directly to the account of the undertaking or public sector entity or self-employed natural person"* (Recital 38 and Art. 2 No. 6).

However, in some Member States, like Germany and France, the designated competent authorities allow commercial card settlements from private employee accounts (cardholder), if its company assumes the liability for card expenditures. This liability risk can be covered by a special insurance, offered as part of the package by the card issuer. The contract partner of the issuer could be the company or the employee. In both cases the company will have access to the data of the card statements.

We don't see a loophole for circumvention.

The consequence would be a disharmony between IF-Regulation in EU Member States.

In contrast to Germany and France, the British competent authority PSR (Payment Systems Regulator) takes the text of the IFR literally. In its new Guidance Document of March 2016⁷ PSR states (for credit cards): *"the funds that are used to settle with the issuer come **directly** from the business account"* (Art. 3.13). In the case of commercial debit cards, the cards should be linked to the current account of the business, where the transactions are directly debited from this account.⁸

Regarding this strict and clear position of the PSR, we don't see a loophole for circumvention. The consequence would be a disharmony between IF-Regulation in EU Member States. We expect that competent authorities with divergent opinions will have to follow the

British interpretation, which is much closer to the original text of the final IFR.

However, the more intriguing question is the long-term benefit of commercial card issuers being excluded from the IF-caps. The gap between the IF of consumers (regulated) and commercial cards (not regulated) is 100 basis points or more for Visa and MasterCard branded credit cards. Merchants are allowed to surcharge the commercial cards (in most Member States) or even to refuse acceptance. From today's perspective, the willingness of merchants to discriminate against high-spending cardholders with commercial cards is difficult to assess. The Commission has to consider this issue in its review analysis of the IFR in 2019 (Art. 17 g)⁹.

Notes

- 1 EPC, SEPA Cards Standardisation Volume v7.1, Bulletin 01 - 20160229 - Book 2 (Approved by the EPC Board on 20160226), 17 February 2016.
- 2 REGULATION (EU) 2015/751 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 29 April 2015 on interchange fees for card-based payment transactions.
- 3 See, for instance, "Application selection at the POS: Merchant options" in the November 2009 edition of this newsletter. EBA: Discussion Paper on future Draft Regulatory Technical Standards on strong customer authentication and secure communication under the revised Payment Services Directive (PSD2), EBA/DP/2015/03, 8 December 2015.
- 4 http://www.nets.eu/SiteCollectionDocuments/annual-reports/Nets_annual%20report_2015.pdf
- 5 In 2014, Nets was acquired by private equity firms Advent International and Bain Capital, along with the Danish pension fund ATP. See: Nets to be acquired by private equity 2014. Press release from Nets, 24.03.2014. <http://www.nets.eu/media/news/Pages/Nets-to-be-acquired-by-Advent-International,-ATP-and-Bain-Capital.aspx>.
- 6 "Inclusion of commercial cards in the EU draft legislation capping the interchange fees level", impact study by Galitt (October 2014).
- 7 Guidance on the PSR's approach as a competent authority for the EU Interchange Fee Regulation (March 2016).
- 8 A statement on prepaid commercial cards is missing in the PSR's Guidance. Although prepaid transactions should be regarded as debit card transactions (according to Art. 2 No. 4), transactions with these cards could probably be settled by a special prepaid account (funded by the company) which is not the current account of the company.
- 9 See Art. 17 (9) of the IFR.

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