In this issue:

1. Brexit: Possible Impacts on UK Consumer Payments
2. Internet Payments in Germany: Diversity is king
3. MasterCard said to be bidding for VocaLink
4. The mysterious third party card issuer in the PSD2

Brexit: Possible Impacts on UK Consumer Payments

(written by our guest author Chris Jones)

We invited Chris Jones to highlight the consequences of the Brexit for the payment industry. Chris is director of the London-based PSE Consulting (Payment Systems Europe Ltd.), British member of the European Payments Consulting Association (EPCA).

Chris, with over 16 years' experience working for PSE Consulting and Accenture, has worked across the telecoms and payments industry helping develop innovative product strategies. He has worked across Europe for major institutions assessing topics such as: mobile NFC payments, virtual prepaid products, mPOS, credit transfer payments at the POS, omni-channel transaction handling, and tablet based POS. Chris has recently completed assignments looking at: in-store mobile acceptance and pay-at-table technologies, the roll out of next generation tablet POS to the SMB community, the development of MNO NFC products, and the evolution of the bank account payments intermediary model.

Following Britain's momentous decision to leave the European Union our thoughts must inevitably turn to the potential impact on UK consumer payments. In this blog we provide some early thoughts on how the UK market may be affected, beginning with recent European regulation which will have to be untangled.

First, let us look at how the two Payment Services Directives may be approached by the UK government. Will the PSD1 remain on the statute book, and the PSD2 implemented as planned? The answer at this stage is probably. Many aspects of European legislation related to consumer protection are likely to remain because they did not fundamentally change existing UK rights. The UK government's approach to account access is generally more progressive than that embodied in the PSD2, so this will probably be superseded by UK Open Data Initiative.

The biggest change will be in the area of licensing and passporting. The FCA has established a good reputation with innovative European payments businesses for its regulatory regime. These E-Money and Payment Institutions will probably to move their headquarters to other European markets, and we will be poorer for it both commercially and from an innovations perspective. Changing the approach to passporting will affect the UK's cross border acquirers the most. Many UK acquirers rely on passporting FCA regulatory licenses to support their local acquiring offers across the EU. Unless they already have licenses in other EU markets, acquirers will need to seek new EU regulatory approval to operate across the continent, and to sign new merchant contracts.

Second, interchange regulation. The UK CMA has always taken a close interest in the payments market, and many issuers expected interchange to decline in the medium term. It therefore seems unlikely that credit interchange will suddenly return to its previous levels. It may be that debit migrates back to the historical fixed price approach. This is particularly important within the context of the announced move to a basic 0.2% (removing the 50p cap and 1p fee) expected for Visa Debit in September. We can therefore expect modest change in the interchange arena.

The European Banking Authority will almost certainly move, possibly to Paris to balance the ECB in Frankfurt. However, may have little impact on the UK consumer payments market as they have played a relatively modest role to date.

How may the international card schemes react? Both have substantial presence in the UK, particularly Visa. It seems likely that Visa Inc. will increase its presence in Continental Europe as part of a wider restructure as other roles are migrated to the US. MasterCard may also to shift its emphasis to Waterloo away from Canary Wharf. Both schemes will need to adapt their licensing approaches, but these are already flexible enough to accommodate the inclusion of non-EU markets. Such moves by the card schemes may be to the detriment of London and the UK, but the impact will probably be modest.

The impact on data processing and data security remains unclear. Will the UK be treated as an off-shore location for card and payment processing? This will be a matter for the lawyers to resolve, but could affect Visa's UK processing hub, or MasterCard's rumoured purchase of VocaLink. New payments processors arriving in Europe from the US or Asia are also much less likely to locate their business in the UK.

Will there be a substantial change in the structure of issuers and acquirers of consumer payments (either cards, credit transfers or direct debits)? We have already highlighted the impact on cross border acquiring, and both regulators and schemes will need to adapt accordingly. On the issuing side markets are unlikely to change their activities as they are either domestically focussed, or already manage operations both inside and outside the EU.

Now let's look at users of payments. Will consumer spend day to day be affected? Again, probably not. Consumers in the UK do not use SEPA Direct Debits or SEPA Credit Transfers domestically. They will continue their preference for cards in store, and online. The growth in online payments will continue, alongside the growth in contactless in-store. Similarly it seems unlikely that there will be a substantial change in the merchant landscape. The UK will remain a vibrant market where retailers online and offline will fight for consumer spend. It seems less likely that our exit from the EU will impact this to any great degree.

We have suggested that there may be some potential downsides particularly in the area of acquiring and processing. Will there be any upsides? At this stage we struggle to see any, which is a great disappointment. Perhaps benefits will emerge from the current maelstrom by 2017. So, in conclusion, impacts on the UK consumer retail payments market will most probably be concentrated in areas such as licensing, cross border acquiring and processing. However, in the long term we are optimistic that the UK consumer payments market is likely to remain innovative and forward looking and get past these issues.

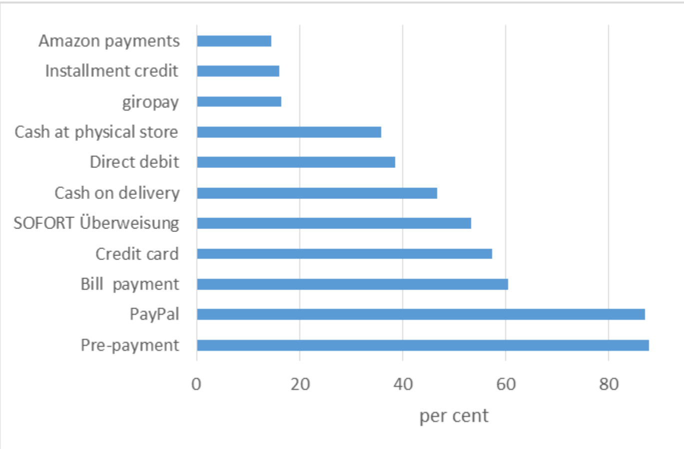
Internet Payments in Germany: Diversity is king

(mk) In March 2016, the ecc Köln published the results of an internet survey covering German merchants and consumers from Austria, Germany and Switzerland (the D-A-CH countries).[1] This survey has been carried out regularly by the ecc Köln (attached to the University of Cologne) and Professor M. Krueger (University of Aschaffenburg/PaySys Consultancy). The results highlight the dynamics of the market as well as the broad variety of payments instruments used in German eCommerce and allow for some comparisons with Austria and Switzerland.

The survey was carried out between November 2015 and January 2016. Key topics are brand awareness and the use and evaluation of internet payment systems from the point of view of shoppers and online merchants. The main results can be summarised as follows:

On average, German online merchants accept 5.3 different payment instruments. While this figure has not changed much compared to a 2014 survey, merchants are still trying to optimise the payment mix, frequently replacing one payment instrument with another.

In terms of number of acceptance points, the top 5 payment instruments are pre-payment (via credit transfer), PayPal, bill payment (credit transfer after goods have been received), credit cards and SOFORT Überweisung (payment initiation service). These instruments are also the ones best known by consumers.



Payment instruments accepted in German online shops

For consumers, bill payment remains the preferred payment method. However, PayPal and credit cards are catching up.

Bill payment is most liked by women, by people with a high preference for security and by consumers who only seldom shop on the internet. Frequent shoppers prefer PayPal. Credit cards are particularly liked by high-income men and SOFORT Überweisung is an important option for infrequent shoppers and young customers.

The survey also covers attitudes towards new POS payment methods such as mobile payment and biometrics. Obviously, these can be used together as in some mobile payment systems such as, for instance Apple Pay. But biometrics can also be used without any additional hardware on the part of the consumer. For instance, biometrics can be used to identify registered users and subsequently initiate a payment (for instance a direct debit). While only 36% of merchants find such an option interesting, a high number of consumers would like to use such a system at the POS. With respect to available biometric solutions, fingerprint is the most popular, followed by iris-scan.

Payment Service Providers can expect to expand. Two thirds of merchants are interested in using a Payment Service Provider or one of the check-out solutions on offer (for instance Klarna Checkout or PayPal PLUS). 40% of merchants cover the credit risk inherent in bill pay-payments via a service provider.

SEPA Implementation has not affected consumers very much. Only a small fraction of consumers resents typing in the IBAN. Similarly, with respect to 3D Secure, most consumers value enhanced security and are not troubled by the need to insert another pass code

Our Comment:

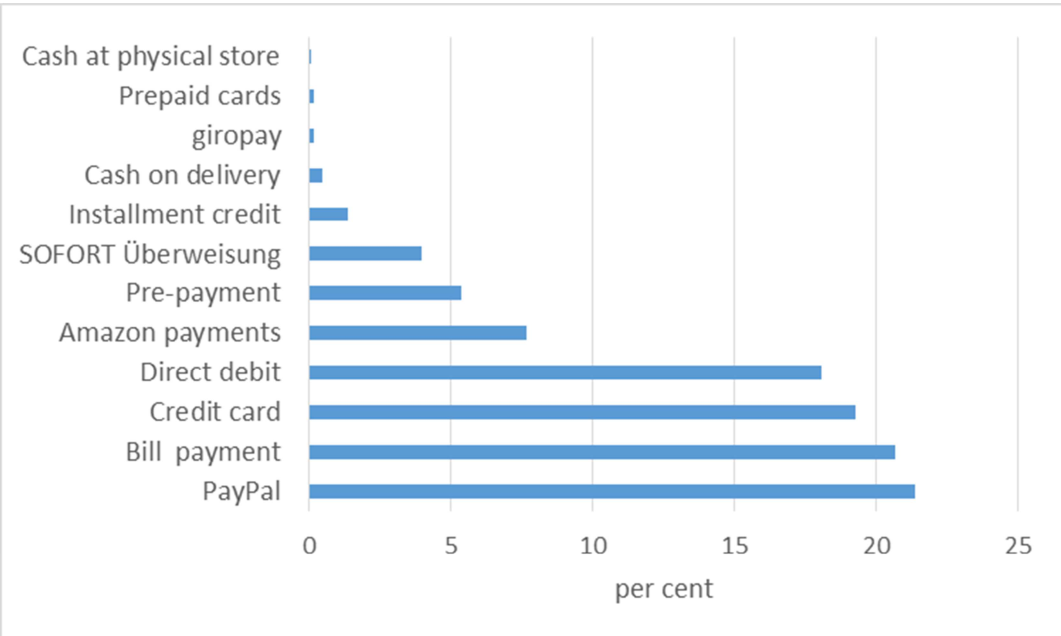
For a long time, the German internet payments market has been dominated by the traditional payment instruments, credit transfers (used for pre-payment and bill payment) and credit transfers. However, this is changing at the moment. When asked how they paid for their last purchase over the internet, 21.4% of respondents answered that they paid with PayPal. This result puts PayPal on top.

The market for internet payments is still a long way from full European integration.

Taken together, PayPal, Amazon Payments and SOFORT Überweisung have a share of one third. Credit cards which had a difficult start in the field of German internet payments now have a share of almost 20% in the survey. Bill payments, pre-payment and direct debits still have a share of 44%. However, only a few years ago these three payment methods were above 70%.

In fact, these figures underestimate the amount of change because in the case of bill payments, the use of PSPs has increased and branded bill payment (for instance Klarna or BillSAFE) has won market share.

Another interesting thing to note is the difference between Austria, Germany and Switzerland, three countries that are often viewed as culturally close and lumped together under the heading “D-A-CH”. When asked which payment instrument they liked best, the answers of consumers from these three countries exhibited some similarities but also noticeable differences.

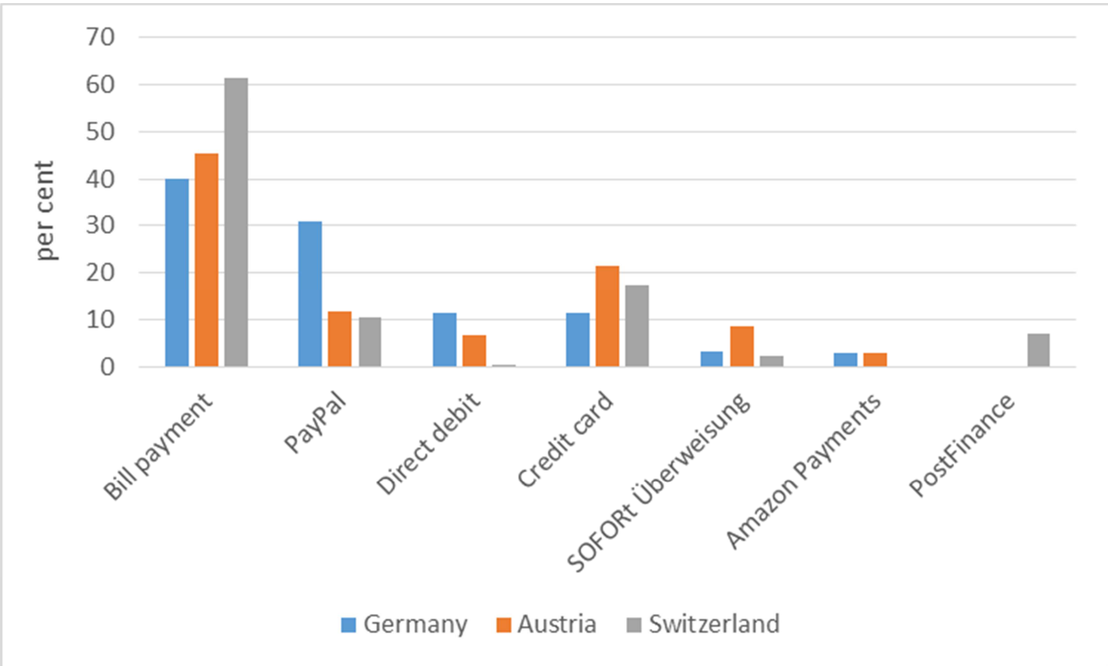


How consumers paid for their last internet purchase

Particularly striking is the high number of bill payments in Switzerland (>60%), the relatively high value of PayPal in Germany (almost 3 times higher than in Austria and Switzerland) and the relatively low value of credit cards in Germany. Moreover, SOFORT Überweisung gets much better marks in Austria than in Germany or Switzerland. Finally, Switzerland has a proprietary system of one of the the top 5 big retail banks (PostFinance).[2]

However, when compared to other neighbours, the three countries seem to be relatively close. For instance, in the Netherlands, iDEAL - an online banking based system developed by the Dutch banks - is the clear market leader with a market share of 56%.[3] In France, Cartes Bancaires (CB) dominates not only at the real POS but also at the virtual POS. In a survey, 80% of respondents answered that they had used CB at least once during the last 6 months. Internet wallets (mostly PayPal) come a distant second with 38% (up from 27%). Interestingly, number three is a gift check (32%, up from 14%).[4]

Overall, the study underlines that the market for internet payments is still a long way from full European integration. Merchants who want to be successful in x-border eCommerce need to offer domestic payment methods. That implies that PSPs aspiring to serve these merchants have to be able to offer a wide set of payment instruments.



Consumers' most preferred payment instrument

MasterCard said to be bidding for VocaLink

(mk) According to press reports, MasterCard is in exclusive talks to take over VocaLink, the UK payment processor. According to these reports, MasterCard is bidding around UKP 1 billion for VocaLink.[5] VocaLink, which is jointly owned by the largest UK banks, has been subject to regulatory scrutiny and a recent (preliminary) report of the UK Payment Systems Regulator (PSR) recommends, inter alia, that shareholders should divest themselves of VocaLink.[6] It is not known, however, whether regulation was the main driver prompting banks to start negotiations.

VocaLink is an essential element of the UK payment infrastructure. It processes direct debits, credit transfers, ATM transactions and real-time transfers:

- Direct credits and direct debits for the scheme BACS. In 2015 six billion transactions with a value of £4.6 trillion were processed.
- Transactions of the UK ATM network Link which services more than 70,000 ATMs and processed 3.1 billion transactions[7] with a value of £128 billion (2015).
- Real-time payment transactions of Faster Payments (launched in 2008). In 2015 1.2 billion transactions with a value of £1 trillion were processed.

If a deal is made, MasterCard's position in the UK payments' market will be significantly strengthened. This is particularly important for MasterCard because it has lost market share in the UK debit card market where its market share has fallen below 4%. The purchase of VocaLink might help MasterCard to come up with a debit card offering that is more attractive for the UK banks.

Our Comment:

So far, UK banks have been jointly running the central part of the UK payment infrastructure. However, the joint ownership model is increasingly coming under regulatory pressure. Therefore, selling VocaLink might simply be a way to get rid of this problem.

If the quoted price is not too far off the mark, banks also stand to gain a nice return on their investment. After the sale of Visa Europe to Visa Inc. that would be the second time that the UK banks have received a sizable amount of cash from the international card schemes. In the post-crisis world with higher capital requirements for banks such inflows of cash must be highly welcome.

However, such a deal would also increase the dependence of the banks on MasterCard. First, if a deal is made it will probably include fairly long-term contracts between the banks and MasterCard. In a way, this provides some certainty for both sides of the deal. But once such contracts have expired, there will have to be new negotiations. Of course, the banks might look for other providers. But given the use of proprietary standards it may not be so easy for a single bank to switch to another processor. Thus, the banks may find themselves "hooked in".

VocaLink would provide MasterCard with access to current accounts.

Of the current three payment processors (Visa, MasterCard and VocaLink) there would only be two left.

For MasterCard, VocaLink looks like an interesting investment

- VocaLink is the central payment processor in the UK (where MasterCard is weak in the debit card market),
- VocaLink may help MasterCard to expand further in the rest of Europe,
- VocaLink has been chosen as provider of a real-time payment system in the US.

In the UK, VocaLink would provide MasterCard with access to current accounts. It could use this position to come up with new products to compete more effectively with Visa, which for the moment dominates the UK debit card market. Within the EU, consolidation in payment processing is expected to proceed and VocaLink might be one of the players surviving in the market. However, with the pro-Brexit vote in the UK referendum trying to conquer the European processing market from within the UK seems less of an option.

There are, however, also some long-term uncertainties. Buying customers via buying a processor is not without risk. Once the contracts between VocaLink and the UK banks have expired, the banks will be free to switch to other processors. In this context, the example of First Data comes to mind. First Data bought the Austrian card processor APSS. However, once the contracts with PayLife Bank had expired, PayLife switched to the Swiss processor SIX.

Payment regulators and anti-trust authorities may be pleased if a deal comes through. For many years they have been critical of the old world of uncontested interbank ventures that have controlled crucial parts of the payment infrastructure – in the UK and elsewhere. Thus, it does not come as a surprise that the UK Payment Systems Regulator proposes a number of far-reaching changes with respect to VocaLink and its ties with the UK banks.

However, one may ask what is gained if VocaLink is not collectively owned by its customers but rather by MasterCard. Does that imply competition? May be so. But for the moment it would imply that of the current three payment processors (Visa, MasterCard and VocaLink) there would only be two left.

But divestment is not the only measure proposed by the PSR. It also wants[8]

a. Competitive procurement exercises,
b. Enhanced interoperability, including a common international message standard, for FPS, Bacs and LINK,
c. Divestment by shareholder PSPs of their interest in VocaLink,
d. Measures that separate common ownership of the functions of LINK from VocaLink and implement industry-led governance changes.

The question is whether a, b and d would also apply in case of a take-over. "a" would be relatively unproblematic because MasterCard has every incentive to establish efficient procurement processes. But "b" is tricky. On the one hand, expansion within the EU would make it necessary to adopt SEPA standards. So MasterCard might move in this direction anyway. On the other hand, adopting international standards would make it easier for banks or groups of banks to switch to a different processor. Standardisation would make the UK processing market more contestable. This is a question of utmost strategical importance for MasterCard and UK regulators are saying that they might like to take this decision for MasterCard. "d" is also tricky. It is in line with European regulation calling for separation of scheme and processing. Indeed, in the future this issue may also come up with respect to Bacs and FasterPayment.

MasterCard's competitor, Visa, is unlikely to be thrilled by the prospect of MasterCard owning the backbone of the UK payment system. It seems highly likely that Visa will file a complaint with the Competition and Markets Authority (CMA). How would the CMA decide? We find that question difficult to answer.

When considering that regulators are treating payments more and more like an essential infrastructure requiring relatively far-reaching regulation, including price regulation, it is surprising that industry players are still prepared to bid relatively large sums for payment processors.

Regulators are increasingly regulating payments with the aim of fostering competition, efficiency and innovation. Whether this is what they will eventually get is still open to debate. But in practical terms many of the interventions have had the effect of simply replacing domestic proprietary systems with Visa and/or MasterCard.

All in all, if the deal goes though it may bring a lot of uncertainty to all players. Whether it will bring the benefits regulators are hoping for looks highly uncertain.

A Scandinavian Survival Test

Increasingly, friends and colleagues who have been visiting Scandinavian countries come back reporting that they did not use any cash at all. Given the large number of reports claiming that Scandinavia is approaching the cashless society this does not seem a big surprise. Rather, it is time to make the opposite test: Is it still possible to pay only with cash? So, when on a 2-day trip to Helsinki your correspondent was firmly determined not to use his payment cards and try to overcome whatever obstacle may be on the way. But believe it or not, trying out "cash only" was not much of a challenge. Everyone happily accepted cash. Thus, for the moment, one has to conclude that those commentators are probably right who argue that the true issue is the "less-cash society" not the cashless society.

The mysterious third party card issuer in the PSD2

(hg) One of the main headlines of the new European Payment Services Directive PSD2 (2015/2366/EU) is about bringing two new kind of payment services under the regulatory umbrella: Payment Initiations Services (PIS) and Account Information Services (AIS). Third party payment providers offering PIS should be licensed as Payment Institutions while AIS providers will only be required to register. Many observers don´t realize the existence of a third entity in the PSD2 that also has access to the payments accounts. According to Article 65, the issuer of card-based payment instruments (who is not identical with the Payment Service Provider (PSP) of the payment account which is linked to the card) should have access to account information too. The account servicing PSP must - on request of the card issuer - confirm the temporary availability of the funds necessary for the execution of the card transaction, which should already have been initiated. The answer could be a simple "yes" or "no". However, the funds cannot be blocked on the payer´s account. The payer (cardholder) should have given their explicit consent and the account should be accessible online at the time of the request.

Our Comment:

Usually a regulatory requirement in an EU-Directive reflects market developments, like new products or eco-systems, innovative technologies etc. It is quite difficult to find this driver behind Article 65 - in contrast to the new PIS and AIS. We asked many observers in several Member States to indicate the usability and the market relevance of any card-based products which could fit into this curious article. Nobody knows. The recitals (67 and 68) linked to Article 65 may help us. Recital 68 states: "*The use of a card or card-based payment instrument for making a payment often triggers the generation of a message confirming availability of funds and two resulting payment transactions. The first transaction takes place between the issuer and the merchant's account servicing payment service provider, while the second, usually a direct debit, takes place between the payer's account servicing payment service provider and the issuer.*" An authorization request is quite usual in card business, but not to the payment account, if the account is not located at the card issuer as required by the application of Art. 65. For credit cards and delayed debit cards linked to external bank payment accounts the article makes less sense as the bank cannot block the funds used by the card transaction (Art. 65 (3)). E-money based card instruments are explicitly excluded from this article, which seems to be a logical consequence, because the issuer has direct access to the prepaid funds. It seems to be that Article 65 is referring to decoupled debit cards, where the card transaction is followed by a direct debit to the payer´s account. This seems to be a promising adoption as debit cards are also mentioned in recital 67. However, decoupled debit cards have to date only had limited market relevance in the USA (since 2007).

Some US retailers have started issuing their own cards linked to bank accounts and processed by ACH, like the Target Red Card. For these kind of products, Art. 65 probably makes sense. However, there is still no market driven reason for Art. 65 within the EU.

Let us have a closer look at the genesis of Art. 65. In its first draft (July 2013) the Commission proposed a comparable article (59). Probably it was a belated consideration responding to the lobbying activities of the "European" scheme initiative Payfair. This merchant driven initiative was based on a decoupled debit card. Payfair urged the Commission to get access to the bank accounts of the cardholders. However, at the time the Commission proposed PSD2, Payfair was not relevant anymore as an alternative European card scheme.

But why regulate phantoms?

During the legislative proceedings, the article was kicked out by the European Parliament and by the Council. Therefore it doesn´t appear in the compromise version of the Triloque process in June 2015. One of the curious reasons for deleting this article was the justification of a MEP: *"This provision can be interpreted as allowing TPPs to issue debit cards linked to accounts held by other PSPs - as card issuers they could claim the MIF and would thus be unfairly compensated since the essential costs would be incurred by account servicing PSPs"*[9]. It was quite surprising for market observers that Art. 65 suddenly appeared in the first reading in September 2015, inserted without any public reasoning by the Commission. The coup of the Commission was accepted by all surprised stakeholders within the legislative process, saying "Why not, it doesn´t hurt without market relevance".

Did somebody push the Commission to bring in this article shortly before the deadline? An new issuer of a decoupled debit card? According to some rumours it could have been PayPal, but we have not yet seen any evidence to that effect. Another application could be a kind of ELV-like card scheme in Germany, whose consumers are already used to retail payments based on direct debit. However, banks would not initiate such a scheme.

It is an unwritten law that regulators cannot stop regulating, always looking for additional issues to regulate. But why regulate phantoms?

Notes

1 Judith Halbach, Sabrina Mertens, Maria Klees and Malte Krueger (2016): Der Internetzahlungsverkehr aus Sicht der Händler und Verbraucher, ECC-Payment-Studie Vol. 20, IFH Institut für Handelsforschung, Köln. This study was sponsored by Klarna AB, Stockholm, MasterCard Europe SA, Representative Office Germany, Frankfurt am Main, PayPal Deutschland GmbH, Berlin, SOFORT GmbH, Gauting, Wirecard AG, Aschheim. http://www.ifhshop.de/studien/e-commerce/150/ecc-payment-studie

2 When looking at the top 10 retailers in each of the three countries, the mix of payments looks even more similar, especially for Austria and Germany. See ecc 2016, p. 21.

3 See Currence: iDEAL payments catapulted in 2015, Press release, 2016 https://www.ideal.nl/en/actueel/ideal-payments-catapulted-in-2015/

4 Total percentages add up to more than 100%. Source: Fevad, Chiffres clés 2015 (http://www.fevad.com/uploads/files/Enjeux%202015/CHIFFRES_CLES_2015.pdf).

5 MasterCard reportedly bids £1 billion for VocaLink: Payment Cards and Mobile, March 2016.

6 Payment Systems Regulator (2016): Interim report: market review into the ownership and competitiveness of infrastructure provision. PSR MR15/2.2.

7 Including balance enquiries and rejected transactions made through the LINK network, but not including transactions made by customers at their own banks' or building societies' ATMs.

8 Interim proposals on remedies (PSR 2016, 1.19).

9 Amendment 423 of MEP Ashley Fox, a British Conservative

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PAYSYS REPORT
June 2016

Layout: cristina dresler | kommunikation+gestaltung

PaySys Consultancy GmbH

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