PAYSYS REPORT

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IF regulation: Is it the end or just a beginning?

After a compromise has been reached between the presidency of the Council and the EU Parliament, the IF regulation is set to become European law. This regulation marks the endpoint of a long history of competition cases against interchange fees in Europe. In the past, there have been proceedings within individual Member States against domestic interchange rates and proceeding at EU level against the intra-European cross-border interchange rates. The new regulation will cover both spheres. Only inter-regional transactions (i.e. European cards used outside Europe, or third country cards used inside Europe) have not been covered, so far.[1]

Our comment:

At first sight, it all looks very simple. The regulation „on interchange fees for card-based payment transactions“ sets a cap of 0.2% for debit card transactions and 0.3% for credit card transactions and it only ap-

plies to 4-party systems. However, as one digs deeper, none of the three basic concepts referred to above – „interchange fee", „card-based payments", „4-party system" – is defined in a straightforward manner.

- First, it is not clear at all what is meant by „interchange fee" and how it is calculated.
- Second, from the point of view of the Regulation, most 3-party systems are treated as 4-party systems.
- Third, „card-based payment transactions" also seem to include e-money transactions.

Below, we will discuss these issues and a few additional topics: transitional period, additional options for domestic schemes and "interchange export".

Interchange fees are an old and rather simple concept. The new regulation is changing this concept, however. Article 2 (9) defines interchange fees as „a fee paid for each transaction directly or indirectly (i.e. through a third party) between the issuer and the acquirer involved in a card – based payment transaction. The net compensation or other agreed remuneration will be considered as part of the interchange fee".
A „fee paid between issuer and acquirer" sounds fairly straightforward. But the inclusion of „net compensations" complicates the matter considerably. Such compensations are defined as:
„the total net amount of payments, rebates or incentives received by an issuing payment service provider from the payment card scheme, the acquirer or any other intermediary in relation to payment transactions or related activities"(Article 2(9a)).

The inclusion of other compensations can be easily explained. The EU Commission fears that interchange caps may be circumvented by changes of other fees. Therefore, it included a provision against circumvention (Article 5).[2]
„For the purposes of the application of the caps referred to in Article 3 and Article 4, any agreed remuneration, including net compensation, with an equivalent object or effect of the interchange fee, received by an issuer from the payment card scheme, the acquirer or any other intermediary in relation to payment transactions or related activities shall be treated as part of the interchange fee."
As the term „**net** compensation" suggests, fees paid by the issuer to the scheme are also considered and have an off-setting effect – at least when they have "an equivalent object or effect of the interchange fee." This is made clear in Recital (23):
„...When calculating the interchange fee, for the purpose of checking whether circumvention is taking place the total amount of payments or incentives received by an issuing payment services provider from a payment card scheme with respect to the regulated transactions less the fees paid by the issuing payment services provider to the scheme should be taken into account. Payments, incentives and fees considered could be direct (i.e. volume-based or transaction-specific) or indirect (including marketing incentives, bonuses, rebates for meeting certain transaction volumes). ..."
So, from the point of view of interchange regulation, the relevant interchange fee is a "net interchange fee". It has to be distinguished from the "gross interchange fee" that normally referred to when using the term "interchange fee". The use of a net concept makes it difficult to apply the maximum values set in Articles 3 and 4[3] – in particular, when considering that the Regulation addresses fees paid **and** received. Recital 23 states:
"It is important to ensure that the provisions concerning the **interchange fees to be paid or received** by payment service providers are not circumvented ..."
Unfortunately, the net interchange received may differ from the net interchange paid. To illustrate this, we constructed a simple numerical example (see Table 1).

	Issuer	Acquirer
Licence fee, processing etc.	-0.15%	-0.05%
Incentives	+0.03%	
Gross interchange	+0.30%	-0.30%
Net payment	+0.18%	-0.35%

Table 1

In this example, the gross interchange fee is equal to the 0.3% cap. However, considering the other fees paid, the net interchange fee received is equal to 0.18% and the net-interchange fee paid is 0.35%. Thus, in this case, it is not clear how high the gross rate should be: a fee of 0.42% would lead to a net-interchange fee "received" of 0.3% and a gross rate of 0.25% would lead to an interchange fee "paid" of 0.3%.

Calculating interchange will become a complicated exercise which in likelihood will lead to new conflicts between merchants and issuers

It has to be feared that the interchange regulation will be the starting point for an intensifying price regulation

Given the complexities of scheme fees, calculating interchange will become a complicated exercise which in likelihood will lead to new conflicts between merchants and issuers.[4] For instance, at the moment, Apple Pay is all the rage. According to press reports, Apple receives a fee of 0.15% from participating card issuers in the US.[5] Imagine, the schemes in Europe were to pay Apple the 0.15% and would in return charge this amount to issuers. Issuers´ "net compensation" would be reduced. Would that be a case for a rise of the gross interchange fee (to be paid by the acquirer)? Our main point is not that things will be complicated ("such is life"). Rather, it has to be feared that the interchange regulation will be the starting point for an intensifying price regulation. It will simply be very hard for regulators to resist the temptation to move into this direction and regulate other card fees as well.

Another interesting issue is the definition of „card-based transaction". It is defined in Article 2 (7):
„a service based on a payment card scheme's infrastructure and business rules to make a payment transaction by means of any card, telecommunication, digital or IT device or software if this results in a debit or a credit card transaction. Card-based payment transactions exclude transactions based on other kinds of payment services".
In order to fully understand what this means one has to know the meaning of „debit card transaction" (Article 2 (4)): „'debit card transaction' means a card-based payment transaction, including those with prepaid cards, that is not a credit card transaction".
Thus, debit card transactions include transactions carried out by a prepaid card. So what actually is a prepaid card? Article 2 (32) also answers this question:
„'prepaid card' means a category of payment instrument on which electronic money, as defined by Article 2 of Directive 2009 / 110 / EC, is stored."[6]
As far as we can see, this implies that any e-money transaction is a prepaid card transaction and thus falls under the interchange regulation. As a consequence, not only so-called „prepaid credit cards" fall under the interchange regulations but also e-money schemes such as PayPal or Paysafecard are potential candidates. As long as they adhere to the set-up of a strict 3-party system they are not affected by the IF-caps. But any move towards working with co-branding or agents would immediately force them under the interchange regulation – including its Chapter II on the IF-caps.
That leads us to the third aspect, the treatment of 3-party schemes. Article 1 (3c) flatly states that the interchange regulation (Chapter II) does not apply to "transactions with payment cards issued by three party payment card schemes".
Moreover, Article 7 (Separation of payment card scheme and processing entities), as well, does not apply to three party payment card schemes.
But, the status of a 3-party scheme can be quickly lost.

As Article 1 (4a) states:
"When a three party payment card scheme licenses other payment service providers for the issuance and/or the acquiring of card-based payment instruments, or issues payment cards with a co-branding partner or through an agent, it is considered as a four party payment card scheme."

Under the new rules, Amex would be a 4-party scheme and it would be treated as such. There is nothing in the proposed text that suggests that only the transactions of cards with co-branding partners or agents are falling under the regulation. It is clearly stated that the scheme in question is "considered as a four-party scheme". This, however, raises the question of the relevance of the IF-caps for all transactions within the scheme. How should interchange be calculated in relevant transactions were Amex (or some other three-four party scheme) is issuer and acquirer? If the merchant is charged 3% – what part of this is interchange? The IF Regulation does not contain any rules for calculating such an "implicit" IF! A possible option might be to use internal calculation prices between the acquiring and issuing department. But the question remains whether an IF exists, at all, if there is no real payment flow between the issuing and acquiring side.
The same question will be relevant for the German ec cash system. Due to its licensing of banks as issuers, the scheme should be regarded as 4-party-scheme (based on the definition of Art.1 No.4a). Until now, the German banking organisation "DK" is still defending the view that the IF-caps do not apply to ec cash. However, according to the European Commission, the German Ministry of Finance und the German Cartel Office, the ec cash scheme will be in scope. If it is in scope, the exiting question is which fee should be treated as interchange fee. Is it the bilateral agreed fee between the merchant (or group of merchants) and the issuer (or group of issuers) or only a fraction of this fee?

One could argue that the bilateral fee in ec cash is only the remuneration for the bank in its role as acquirer. In this case, the fee is representing the acquirer margin (excluding IF and scheme fees) in a traditional 4-party scheme, which is definitely not regarded as the IF.
Member States still have the option to introduce lower IF caps for all domestic debit and credit card transactions (domestic: issuer, merchant and acquirer are located in the same country). This rule will protect local acquirers against acquirers from abroad. The option to set lower card IFs for domestic transactions contradicts the stated intention of the Commission to create an integrated European market and to foster competition.
Member States can also allow the implementation of higher IF-caps for a part of the domestic debit card transactions (e.g. low value). We doubt that this option would make sense. Merchants will initiate acquirer-arbitrage by routing these transactions to acquirers outside of the country.

The option to set lower card IFs for domestic transactions contradicts the stated intention of the Commission to create an integrated European market and to foster competition.

The final proposal also deleted the strange and highly controversial Art.6a, suggested by the European Parliament. According to this provision, domestic acquirers would be able to "export" the domestic IF by going cross-border and acquiring foreign merchants. Indeed, Dutch acquirers were preparing themselves already to conquer the German debit card market with the very low Dutch IF for Maestro-transactions. German issuers of co-badged Maestro/Girocard cards were considering to thwart this "attack" by issuing new debit cards, branded only with the German domestic scheme (Girocard). This idea can now be put to rest.
Last but not least, the deletion of the time delay (transitional period) between cross-border and domestic transactions in the initial proposal of the Commission is a huge improvement. It prevents an unjustified privilege for international acquirers to the detriment of the smaller local players.

Who are the new kids on the regulatory PSD II-block?

The second Payment Services Directive (PSD II) entered the trilogue-process in December 2014. The presidency published its compromise-version[7] on December 1st, which will be the basis for the negotiations with the EU Parliament in the coming months.

The PSD II extends the list of relevant payment services (1–6) in Annex 1 of the PSD I by two new services: Payment initiation services (no.7) and account information services (no.8). These service providers will have to become Payment Institutions.

Our comment:

As rule of thumb, under the existing Payment Services Directive (2007), a payment service provider (PSP) is an entity which holds or controls the user´s funds in some stage of the payment chain (even if only for a short time) and whose insolvency would be to the detriment of the user. As a consequence, one of the main requirements to protect the user´s funds are the safeguarding rules of the PSD. In the new PSD II (compromise of December 2014) the close link between possession of user's funds and regulation does not apply anymore. Both of the new PSP categories do not hold any funds of payment users. As already discussed in an earlier newsletter (October 2014) the new acquirer definition includes also players, which do not provide a transfer of funds to the payee (see Recital 19a). If we assume that the definitions of the PSD II will be identical to definitions now agreed as part of the IF-Regulation, the same broad issuer definition will also be included in the PSD II. In card business, the move from PSD I to PSD II implies that more players will be regulated.
In comparison to the traditional PSP of the PSD I (Annex 1 categories 1–6) the requirements for the new categories of PSPs included in the PSD II will be different (see Table 2).

Requirements → / PSP-category ↓	Minimal Initial Capital (Art.6)	Own Funds (Art.7)	Safeguarding requirements (Art.9)	Professional indemnity insurance (Art.6)	Waiver (Art.27 and 27a)
PSP regulated in the PSD I already (1–6)	125,000 € (1–5) 20,000 € (6)	Yes	Yes	No	Waiver as option for member states for small PI
Payment Initiation Services (7)	50,000 €	Yes	No	Yes (considering the value of the transactions)	No
Account Information Services (8)	No	Yes	No	Yes (considering the number of clients)	General exemption of several requirements

Table 2

The waiver of the safeguarding requirements is a logical consequence of the fact that the new categories do not receive funds from the users. Even the issuers and acquirers (category 5) that come into the regulatory regime due to the broad definition of the PSD II will probably be exempted if they are not holding any funds of their customers. Most of the Member States have implemented the waiver for small PIs. In the future, small Payment Initiation Service Providers will not be able to profit from this optional waiver.

Let us have a closer look at the definition of the new account service providers. The inclusion of Payment Initiation Services is an indirect consequence of the complaints of Sofortüberweisung (meanwhile taken over by Klarna in December 2013) to DG Competition about the non-access policy of the banks. The price to be paid for the paved way into the online banking payment market is regulation. Sofort/Klarna is probably the largest independent third-party provider of payment initiation services, since iDEAL, Giropay, EPS and MyBank are owned and controlled by banks. In Recital 18 the Commission refers in particular to the market segment of Sofort & Co, where a third-party initiates a credit transfer between bank accounts of the payer and payee building "a software bridge between the website of the merchant and the online banking platform of the payer's bank." Based on the definition of the payment initiation service (Art.4 No.32), other services could also fulfill the criteria for a payment initiation service. Compared to the original definition of this service by the European Commission and the amendments made by the European Parliament, the latest definition of the Council is the broadest one in order to "allow for the further development of new types of payment services" (Recital 10).

Art.4 No.32	European Commission	European Parliament	Council
Legal definition of payment initiation services	a payment service enabling access to a payment account provided by a third party payment service provider, where the payer can be actively involved in the payment initiation or the third party payment service provider's software, or where payment instruments can be used by the payer or the payee to transmit the payer's credentials to the account servicing payment service provider	a payment service enabling access to a payment account where a payment transaction is initiated by a third party payment service provider at the request of the payer, from a payment account held by the payer with an account servicing payment service provider	a service to initiate a payment order at the request of the payment service user with respect to a payment account held at another payment service provider

Table 3

Unlike the definitions of the Commission and Parliament, the Council extends the service rendered also to the payee (payment service user can be payer or payee). However, the addition of "the payment account held at another PSP" (Council definition) is unclear. The payment account where a transaction is initiated, obviously is the account of the user. This account should be held at a PSP, which is not identical with the Payment Initiation Service Provider (see Recital 51), although these providers are usually not offering payment accounts. The requirement is not aimed at the account addressed by the payment initiation (usually of the payee). If one makes a payment from a bank account to a merchant's bank account, for example by Sofort, it cannot be relevant as criterion for the regulation of this payment service whether the payer and the merchant have an account at the same bank or at different banks. It is also important that payment initiation services are not restricted to ACH-payments (credit transfer or direct debit), but can also be offered based on card-based payments and card accounts. Therefore, the service of Apple Pay could be a Payment Initiation Service,

too, because Apple Pay initiates a card payment. As consequence, Apple Pay would need at the minimum a license as Payment Institution. This would not be an obstacle for Apple but its service would also be subject to most of the transparency and information requirements of Title III, in addition to the specific requirements for Payment Initiation Services (e.g. Art. 39, 40, 58 etc.). In this case, Apple Pay could have to amend its product for Europe in order to comply with the PSD II.

The service of Apple Pay could be a payment initiation service too, because Apple Pay initiates a card payment

The broad definition could also affect third party providers, which are initiating payment orders on behalf of the merchant, like the network providers ("Netzbetreiber") in the German domestic debit card scheme (ec cash) which are currently not regulated. These Netzbetreiber are initiating direct debits in the interbank clearing system on behalf of the card-accepting merchant. In e-commerce, payments are often initiated by non-regulated Third Parties on behalf of merchants. One could argue, that regarding this broad definition of payment initiation services, most of the technical processors in the payment market are initiating payments as outsourcers on behalf of other PSPs. Would these processors be subject to the PSD II, too? The crucial criterion for the decision whether a payment initiator is "in" or "out of scope" probably would be the type of customer of the initiation service. If the customer is a payment user (payer or payee) you are "in", if the service is provided to another PSP (as outsourcer) you are "out" (see also Recital 19a).
If accounts are involved: no payment initiation is possible without the usage of authentication credentials (PIN,TAN etc.) issued or set by the account servicing PSP (e.g. bank or a card issuer). Sharing these data with the payment initiation services provider is still a critical issue regarding data protection and security. One of the IT security principles is not to share these data with third parties. The PSD II proposes the development of regulatory technical standards by the EBA, which will probably be based on the proposals of the ECB (see Art. 87a).

Another solution could be the use of authentication data provided by the payment initiation service itself, instead of the credentials offered by the account servicing providers. Of course, the account servicing providers have to accept these external security credentials. This is exactly the security principle of Apple Pay based on the touch ID technology (fingerprint) of the iPhone. The initiated transaction is still a card transaction, based on the rules of the used card scheme, but the authentication credentials are not issued by the card issuer but set by Apple, which are accepted by the card issuers. The next step could be ACH-payments by Apple Pay, secured by Apple´s biometric security technology. Apple is offering the authentication credential service in addition to its payment initiation service. Could this be an exciting new payment service to be regulated by the PSD III?
Less controversial are the so-called account information services, identified by the Commission. The providers of this online convenience service will have access to one or more payment accounts of the user held at PSPs in order to aggregate this information to an overall view of its financial position. Some mobile apps are already delivering this service. Keeping in mind these services, the latest definition (Art. 4 No. 33) of the Council is a broad one again: "an online service to provide consolidated information on one or more payment accounts held by the payment service user with one or more other payment service providers".
The initial definition of the Commission (July 2013) specified the account holder as the addressee of this service, thereby excluding other parties. The European Parliament added the provision of this service on request of the account holder. Both consumer-friendly preconditions were deleted.

Notes

1 This may change in the future. The EU Commission has set its sight already on interchange fees „in relation to payments made by cardholders from non EEA countries". Such fees are an item in the proceedings against MasterCard which the Commission initiated in 2013. See European Commission: Antitrust: Commission opens investigation into MasterCard inter-bank fees, Brussels, 9 April 2013
2 Circumvention became an issue when MasterCard increased acquirer fees in 2008. See October 2008 edition of this newsletter. These fee rises were repealed in 2009. See April 2009 edition of this newsletter.
3 See the Sept./Oct. 2013 edition of this newsletter.
4 In recital 23 it is stated that even payments flows with respect to cards issued in foreign countries may be considered.
5 Kelly Fiveash: Apple Pay is a tidy payday for Apple with 0.15% cut, sources say, The Register, 13 Sep 2014. http://www.theregister.co.uk/2014/09/13 apple_to_get_15_cents_for_every_100_dollar_payment_on_its_pay_service_says_ft/
6 For curious readers, the definition of payment instrument (Article 2 (16)) is as follows: „any 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".
7 http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2016154%202014%20INIT
8 In some legislations within the EU, accounts at the card issuer related to a charge or credit card (not the current account linked to a debit card) and merchant accounts at the acquirer are not regarded as payment accounts according to the PSD I. Assuming a synchronization and harmonization of definitions between the PSD II and the IF regulation, these local interpretations could be controversial, because such accounts are definitely payment accounts according to the IF regulation.

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