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1. **ECB demands a renewed focus on cards**
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3. **Does the ECB propose a new e-money definition?**

1. ECB demands a renewed focus on cards

The ECB has published a new report dealing with the European card payment landscape and the long road towards SEPA for cards.[1] The report contains a wealth of information on the European card market. Moreover, and more importantly, it sketches out the Eurosystem's view on the future of "SEPA for Cards". Many issues are addressed and for each issue there is a "Eurosystem policy line" summarising the Eurosystem's views on what ought to be done.

After a brief discussion of SEPA and the competencies of the Eurosystem in the field of payment systems the ECB describes the basic features of the card payment market. Subsequently, it focusses on card schemes and card payments trends in Europe. After these introductory chapters a number of policy-relevant areas are addressed:

- Security of card payments
- Separation of schemes and processing
- Business practices and rules
- Standardisation

Summarising the report, the ECB concludes: "*Following the migration to SEPA credit transfers and direct debits, a renewed focus on cards is needed.*" (p. 7) Once again, it quotes the definition of "SEPA for cards" as "any card at any terminal"[2] and concludes that "*considerable efforts are still required over the coming years*." (p. 5) Moreover, it announces: "*The Eurosystem will reassess the SEPA compliance criteria for card schemes and decide whether or not to update and maintain them.*" (p. 11). So, overall, the ECB clearly states that a lot of work still needs to be done.

[1] ECB: Card payments in Europe – a renewed focus on SEPA for cards, April 2014.
[2] On page 10 the ECB makes the qualification that "any card at any terminal" is "*limited only by acceptance on the part of the merchant*".

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Since this report is fairly long, we can only provide a brief sketch of the ECB's extensive to-do list. In the Comments-section we will discuss the ECB's vision of SEPA for Cards. In Article 3 below, we are looking at the ECB's e-money definition. Other issues will be discussed in the May issue of this newsletter.

- Euro-system policy line on the basic models (p. 19)

In general, three party systems also have to comply with the rules regarding "the separation of scheme management from processing, business practices and rules and/or standardisation". The Euro-system acknowledges, however, that sometimes a differentiated approach might be necessary.

- Eurosystem policy line on the trends in payment behaviour (p. 28)

The Eurosystem demands the elimination of commercial limitations for merchants and differences in "payment experiences" for cardholders across Europe.

- Eurosystem policy line on card schemes active in one or more Member States and at the EU level (p. 32)

The Eurosystem wants harmonisation in a large number of areas: legal framework, business practices and rules, technical standards, security requirements and evaluation, certification, and geographical reach. It also supports the expansion of domestic card schemes to expand across borders.

- Eurosystem policy line on initiatives for the establishment of a new European card scheme (p. 34)

The Eurosystem stresses the importance of competition between card schemes. It favours the introduction of an additional European card scheme in order to enhance efficiency and allows a European governance structure. "*A European card scheme would, …, help to pursue European policies as a first priority.*"

- Euro-system policy line on security of card payments (p. 39)

The Eurosystem points to the recommendations of the European Forum on the Security of Retail Payments (SecuRe Pay) for card-not-present transactions. For card-present transactions it favours full EMV implementation (a chip-only policy). Furthermore, it supports measures such as blocking non-EMV transactions when EMV cards are used in countries that do not support EMV.

- Eurosystem policy line on separation of scheme management from processing (p. 41/42)

The Eurosystem reiterates that the separation of card schemes from card payment processing is a core element in SEPA for Cards. Separation should consist of "operational separation, information separation, financial/accounting separation, commercial separation and ideally also legal separation." Furthermore, clearing and settlement also seems to be included in the list.[3]

- Eurosystem policy line on the SEPA card processing framework (p.43)

The Eurosystem demands a SEPA card processing framework and a technical interoperability framework.[4]

- Eurosystem policy line on interchange fees (p. 45/46)

Pointing to the competence of DG Competition in this field, the Euro-system states that it takes a neutral position with respect to interchange fees. Nevertheless, it formulates its own interchange principles, namely a cost-based approach: *"Interchange fees, if any, should not lead to negative price signals towards payers and payees, distracting them from using more efficient payment instruments. Therefore, interchange fees (if any) should be used primarily as a means of reflecting the costs which are directly related to the processing of the payment transaction (e.g. costs of acceptance, switching, authorisation and/or security measures)."*

- Eurosystem policy line on transparency of fees (p. 48)

The Eurosystems favours transparent prices and is against packages or blended prices. Euro-system policy line on issuing or acquiring licenses subject to geographic restrictions. (p. 49)

- Euro-system policy line on fee differentiation based on geographic criteria (p. 50)

Fee differentiation based on geographic criteria should be phased out. "*As long as different interchange fee levels for domestic and cross-border payments within SEPA are in place, any card scheme operating within the EU should leave it up to its members to choose which of the two levels they would like to apply*".

- Euro-system policy line on co-branding (p. 51)

"Issuers should neither be forced nor forbidden to co-brand."

[3] See p. 40: "*The underlying assumption is that card issuers and acquirers should be free to choose their processors and clearing and settlement service providers.*"
[4] Interestingly, the Eurosystem mentions the example of credit transfers in this context (p. 43): "*In the same vein as what was needed for credit transfers, the relevant processing infrastructures and Processing were invited to develop a "technical interoperability framework for SEPA-compliant card payments processing"*.

- Euro-system policy line on honour-all-products/cards (p. 51/51)

Merchants should have the right to differentiate between the different brands of scheme.

- Euro-system policy line on choice at the checkout (p. 52)

"Customer and merchant should agree jointly on the conditions of payment, including the payment instrument and card scheme or brand to be used."

- Euro-system policy line on standardisation of functional and security requirements (p. 55/56)

The Euro-system supports the work of the CSG and the implementation of ISO 20022. It criticizes the existence of too many legacy standards. (p. 53)

- Euro-system policy line on certification and labelling (p. 58)

The Euro-system favours a harmonised security evaluation and certification process for cards and terminals and wants the CSG to address the labelling process.

Our Comment

This is a long report containing the view of the Euro-system of status quo in the European payment card market and how it should be changed. The to-do list is long, as well. Some of the items in the to-do list do make sense. The wisdom of others is debateable. Overall, most of the points raised have been addressed by the Eurosystem or the EU Commission before. As the Eurosystem rightly points out, SEPA for Cards is still a long way from completion. The question is whether the renewed activism in the field of payment cards will change this. To make it short, we are sceptical.

What is striking about this report is the lack of a clear and consistent vision of SEPA for Cards. The Eurosystem says it wants competition but it does not seem to have a clear view of how the market functioned in the past and how it functions at the moment. Most importantly, the Eurosystem confuses the existence of a large number of schemes within Europe with competition.

Commenting on the growing importance of "schemes with an EU-wide focus" (basically Visa and MasterCard), the Eurosystem remarks (p. 30):

"This increase in relative importance, combined with the gradual phasing-out of local schemes, has already led to concerns about there being potentially reduced competition in the European card payments market in the mid to long term, while competition is, of course, considered beneficial for the efficiency of the European card payments market as a whole."

And on p. 31:

"Consumers and merchants are likely to benefit from the creation of SEPA through sufficient competition in the card payments market to assuage the potentially monopolistic tendencies."

This remark clearly indicates that the Euro-system assumes that there has been competition in the past and that the demise of some of the European schemes has led to less competition – even a danger of "monopolistic tendencies". However, in the past, there has been very little competition – if at all. The domestic schemes were just that "domestic" – each confined to its home market. Rough and ready, this is still the case. In many markets, Visa and MasterCard were also present. In fact, in many countries the domestic cards were co-branded cards with either a Visa or a MasterCard brand supplementing the domestic brand. However, there was no competition between the international brands and the domestic brands – both residing on one card - because clear priority rules made sure that the domestic brand was used for all domestic transactions and the international brand for x-border transactions.

Thus, there is absolutely no competition between the national schemes – and there never was – and competition between domestic and international brands was very limited. Therefore, it is logically impossible that a reduction of the number of domestic schemes leads to less competition. Actually, since the priority rules mentioned above have been deemed un-competitive by regulators they had to be discontinued. Therefore, international brands on co-branded cards are now, for the first time, competing with domestic brands. Thus, in spite of the falling number of schemes, competition has been increasing.

It has been repeated ad nauseam that some of the domestic schemes had very low costs. Thus, it does not come as a surprise that the Eurosystem expects a new European scheme to do the same. (p. 34)

"It would increase competition, particularly if the new scheme was to follow an economic model different from the international (credit) card schemes. It would also provide an opportunity to substitute cash for cards, through wider acceptance, particularly if the new scheme were to follow a cost-efficient model."

But would competition favour the successful implementation of a "cost-efficient model"? To answer this question it would first have to be decided what "cost-efficient" means. Since *many cards (in particular debit cards) are free of charge for consumers, cost-efficient is often interpreted as "low costs for merchants" and "low-costs for merchants" is frequently equated with low interchange fees.*[5] *However, since the card market is a two-sided market, it is not clear at all that scheme competition will lead to lower interchange fees. The Eurosystem cites theoretical evidence in favour of this hypothesis (see footnote 5). But there is also large body of literature that shows that competition may have a limited effect on merchant charges or even make pricing more skewed - i.e. even less favourable for merchants.*[6] *In fact, a newly introduced scheme would have to attract merchants as well as card issuers. In order to attract merchants, interchange fees have to be low but in order to attract issuers interchange fees have to be high. Thus, the assumed simple relationship between merchant costs and competition does not exist. But the question whether or not scheme competition lowers interchange fees has become largely an academic question since interchange fees are heavily regulated in the EU and will be even more regulated in the future.*

In the past, there were "cost-efficient" monopoly schemes run in a co-operative fashion by the domestic banking systems. Looking at other segments of the payments market we find this model applied also to SEPA: SEPA Direct Debit (SDD) and SEPA Credit Transfer (SCT) are jointly run schemes. There is no scheme competition – only competition within the scheme. Such within-scheme competition also exists within card schemes (competition between issuers and between acquirers).

In fact, given the amount of standardisation the authorities want, technical standards, standardised business rules and even uniform (maximum) interchange fees, one wonders what good scheme competition is supposed to bring. Thus, either there is scope for true competition between schemes (implying that there may be less than full SEPA coverage by individual schemes and, possibly, more freedom to set interchange fees) or the authorities may simply push for a SEPA Card Scheme along the lines of SDD and SCT. Otherwise the European Payment Card Scheme may remain a phantom forever. [7]

[5] The Euro-system also seems to have merchant service charges in mind. See p. 31/31 where the following statement can be found: *"Bolt and Schmiedel (2011) conclude that increased competition between card schemes pushes down merchant service charges and increases card acceptance by merchants."* (The Eurosystem refers to: Bolt, W. and Schmiedel, H., "Pricing of payment cards, competition and efficiency: a possible guide for SEPA", Annals of Finance, 2011, pp. 1-21.)
[6] For instance Guthrie, G. and J. Wright (2007), "Competing Payment Schemes", Journal of Industrial Economics, LV, 37-67. A less formal treatment of 2-sided markets is: Wright, J. (2004), "One-Sided Logic in Two-Sided Markets", Review of Network Economics, 3, 1.
[7] See Ewald Judt and Malte Krueger: A European Card Payments Scheme forever a phantom?, Journal of Payment Strategy & Systems, Vol.7, No. 4, 2013, 344-358.

2. Russian Lessons for "SEPA for Cards"

As consequence of the US sanctions against Russia both „American“ schemes, Visa and MasterCard undertook a precautionary blocking of the credit cards of four Russian banks during a few days in mid-March 2014. Several shareholders of these banks (SMP Bank, InvestCapitalBank, Rossiya Bank and Sobinbank) are obviously closely related to the Putin administration. During these days cardholders were not able to use the card for most of their retail purchases in Russia or elsewhere. However, on-us ATM-transactions, which were processed in-house by the sanctioned banks, were not affected. The blockage of the Rossiya Bank, SMP and InvestCapital Bank are still in place.

Both schemes do not welcome these measures against the four Russian cards issuers, but they point out that they have to comply with US law. Both schemes are dominating the Russian card market with a market share of approximately 95% (Visa: 60%; MasterCard 35%). Although most of the 200 million Russian cardholders were not affected by the blockings, the collateral damage is immense. In fact, the entire return of Visa´s investment of sponsoring the Sochi Winter Olympics could be vanishing. Visa´s CFO Byron Pollitt already pointed out that the blocking of Russian cards will probably be hurting Visa´s card transaction volume in Russia. But Putin´s announcement of the development of an own Russian card payment system in response to US and EU sanctions could pose a more significant threat to the domination of Visa and MasterCard of the USD750 b. card market (POS and ATM).

Our Comment

One thing we asked ourselves is: How could Visa and MasterCard technically block domestic card sales transactions within Russia? The answer is simple. The card issuing banks in Russia are processing transactions in-house, each with an interface to the international card schemes (ICS). Therefore about 60% of all domestic transactions (except on-us ATM transactions and on-us transactions where issuer and acquirer is the same bank) are passing the ICS networks outside the country. Former initiatives to set up a local processing platform as national switch (about 10 years ago) were not successful. In 2011 a legislative proposal of a national payment system law included an article, which obliged the issuers and acquirers to process the domestic card transactions domestically within the territory of the Russian

Federation. But in 2011, the Russian parliament (the Duma) deleted this article after successful lobbying of the ICS. This decision is going to be reversed until October 1, 2014. The law will be amended with a local processing requirement, to be implemented before 2016. Besides this legal measure, the government wants a domestic payment card to be initiated. Several ideas are in discussion. The new system, probably controlled by the Russian Central Bank, could be based on already existing components, like the e-identity card which has been introduced last year. Cross-border acceptance of the new Russian card brand could be reached by co-badging with the ICS or by setting up an own worldwide acceptance network, following the successful examples of JCB and CUP.

Alexey Martsinkowsky, Partner of the consultancy Radian and Russian EPCA-member says: "The plan of Russian Government to set up a Russian card scheme is quite realistic, because Russian business has enough solutions and capacity. The problem is to choose the right one. During the last years there has been several new solutions implemented in the market to provide market players with effective instruments for transaction traffic localisation and optimisation. To upgrade such technologies to the multi-bank or national level will not take a lot of time if economic and political reasons demand it."

What could be the lessons learned?

First, the SEPA requirement of separation of card scheme and card payment processing entity makes sense.

Second, domestic card transactions should be processed within an eco-system subject to national law or to a supranational legislative umbrella of which the country is part of. It should not be possible for foreign governments, regulators, intelligence services (NSA & Co) or third-party private companies to block domestic transactions, to freeze local card accounts or to have free access to card transaction data. In the (now almost silent) discussion about the creation of a European Card Scheme besides the ICS these arguments played a subordinate role. The Russian case could re-open this important discussion.

Third, there is a more overarching argument regarding the ongoing War on Cash. Cash is an anonymous means of payment not linked to its user. Nobody could block cash transactions or freeze individual cash funds, held by its user. The central banks could only invalidate the currency in circulation in total, but not the cash amounts used by a particular group of users it dislikes. Even in case of an overnight currency reform, individuals could still use the cash issued by other central banks. Individual account-based payment instruments, which are *regulated and supervised by national authorities, can be blocked or depreciated by legal act. Cyprian account holders already had this painful experience, waking up last year on a Monday morning with "haircut" deposits in their bank accounts. Russian oligarchs surely regretted to have deposited funds into bank accounts in the EU which are now frozen. Before getting rid of traditional cash, real digital cash should be available as a bearer instrument (which is not account-based). Such digital cash could be stored in a personal device (smart phone, PC, tablet etc.) without linkage and traceability to its user.*

3. Does the ECB propose a new e-money definition?

In its recently published report "Cards Payments in Europe – a renewed focus on SEPA for Cards" (April 2014[8]) the ECB uses the outdated former marketing slogan of MasterCard to describe its three basic concepts of card payments: pay now (debit card), pay later (delayed debit card and credit card) and pay before (prepaid cards). In case of a prepaid card, the ECB stated: "*the cardholder has to make a certain amount of funding before the card can be used ("pay before" model). In terms of its usage, that is to say, for making payments and cash withdrawals, it can, however work in a similar way to a debit or even a credit card. A prepaid card should not be confused with an "electronic purse". For an electronic purse, an amount of electronic money can be stored on the chip of the card or on a central server, which is debited when a payment is initiated. From a European legal perspective, such payments are regarded as e-money instead.*"[9] In this paragraph, the ECB seems to suggest that, from a legal perspective, prepaid cards are not e-money products. Furthermore, in its "policy line on the types of payment cards" the Eurosystem lists debit, delayed debit and credit cards as cards which are within the scope of its policies for payment cards and/or card payment transactions. The third category of card payments, "prepaid cards", is notably missing in this list.

Our Comment

The definition of e-money used by the Eurosystem is really a "renewed focus". It is reminiscent to the original conception of e-money as digital cash, a bearer instrument stored

[8] See Topic 1 of this Newsletter.
[9] ECB: Card payments in Europe – a renewed focus on SEPA for cards, April 2014, p. 15

on an electronic device (chip, hard-disk or server). This definition was used in the second half of the nineties, when products like stored-value chipcards, Mondex and DigiCash constituted a new step forward in the evolution of money. However, these token-based products were not successful in the European market. Most e-purses, as additional payment application on domestic debit cards, have been terminated by now.

From a legal point of view it is important that at least since the second European E-Money Directive (2009) account-based e-money products are included in the e-money definition. Such second generation e-money products are linked to a "prepaid" account. The funds in these accounts are e-money from a legal perspective. Most of the so-called prepaid cards in the European market (e.g. prepaid cards branded with MasterCard or Visa) are now regulated as e-money products. The inclusion of these account-based products into the e-money definition makes it necessary to distinguish clearly between e-money accounts and other prepaid accounts (like current accounts without overdraft facility).

A regulatory criterion is inter alia the interest of these paid-in funds and the payment facilities of these accounts. From a legal point of view, a "prepaid" card linked to a current bank account or to an interest-bearing payment account is a debit card; a prepaid card linked to a non-interest bearing payment account, which is not a current account, is usually an e-money product. The specifics of the account are therefore essential. The outdated typology "pay before" does not provide a clear distinction between the products. It is misleading not only from a legal perspective, but also from a user perspective. The payment with a card related to such account-based e-money is "pay now", exactly like a traditional debit card! The cardholder puts his funds into several different accounts (current account, another payment account or an account filled with e-money), which is held at a bank, payment institution or at a licensed e-money institute. No "pay before" at all, otherwise funds in a current account would also have to be considered as "paid before" or "prepaid". A payment with a "prepaid" card linked to an e-money account is card payment transaction, subject to the Payment Services Directive. It should be within the scope of the Eurosystem's rules for payment cards and payment transactions.

As we already stated in our newsletter of July 2013 ("The ECB on e-money and virtual currencies: Does the regulator know the regulations?") the ECB obviously has its own distinct understanding of e-money which is not in line with today´s legal definition and regulatory perception in the EU. This is confusing for the market. But from an economic point of view, the ECBs perception of e-money seems to be more adequate. It goes back to the roots of *genuine token-based e-money. It would be helpful if the EU Commission would consider this view within the ongoing review of the EMD II.*

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