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Letters to the editor

1. Will the PSD II pave the way for EURO-ELV?

In the draft report of the ECON Committee[1], the rapporteur suggests to insert an Article 53a in the PSD II:

> ***Proposed Article 53a***
> ***IBAN readability***
> Issuers of debit cards or of mobile or online payment applications based on payment cards excluding prepaid cards shall ensure that the IBAN, of the current or deposit access account which is debited by the debit card or payment application are visibly identifiable and can be read electronically by the merchant on the terminal or device enabling card-based payment transactions.

In combination with the provisions regarding access to accounts for third party payment instrument issuers (Art. 59), which are already part of the proposed PSD II, the mandatory provision of account details would provide a sound legal basis for a setup of a European ELV. We recognise that Article 59 has been deleted in the draft report. However with the suggested amendments 78 in the draft report and 389 in the amendments document[2] the relevant provisions have been included in Article 58. For the convenience of the reader we continue referring to these provisions as Art. 59.

In Germany, the transition of the German ELV scheme into the SEPA-era is one of the most important issues which retailers demand from the German authorities. Accordingly, some SEPA rules are waived for ELV transactions until 31.1.2016. Moreover, the German Bundestag asked for preservation of ELV in SEPA. The German Cartel Office, as well,

[1] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-522.958+01+DOC+PDF+V0//EN&language=EN
[2] http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-526.371&format=PDF&language=EN&secondRef=01

supports ELV. Repeatedly, it has made clear statements that it would not accept the introduction of technical obstacles that would make ELV transactions impossible.[3]

The proposed Article 53a basically confirms this position and extends it to all European debit cards. Therefore, the question does not seem far-fetched whether the proposed article 53a will pave the way for expanding ELV to all of SEPA.

Our Comment

The proposed regulation is addressing two key issues for setup of a European ELV.

1. *So far, ELV lacks a technological basis in SEPA: On German debit cards, account details are encoded on the magstripe and on the chip. With these data one can create a direct debit, debiting the cardholder account. In other debit card schemes than the German Girocard scheme, card transactions are usually cleared between issuers and acquirers rather than directly between merchant and cardholder. Accordingly, the card contains a card number (i.e. a reference to the bank account) rather than the original data of the account. The same applies to cards issued under the international brands. The SEPA Cards Clearing (SCC) framework also allows to clear card transactions based on card numbers. The card number refers to the bank account and allows an issuer to post a transaction to the correct current account of the card holder. However the card number does not enable a third party to derive these account details. The proposed new article in the PSD II exactly addresses and solves this problem.*
2. *Lack of online authorisation: Currently, a merchant (or supplier) which accepts ELV bears the entire fraud risk and credit risk. There is no means to authenticate a card, to check the status of a card or the status of the bank account connected with the card. Accordingly, ELV suppliers need to run sophisticated risk management systems. For SEPA-ELV, these risk management systems would have to be scaled up to European scale. This could be challenging. However, with the new rules proposed by the EU Commission, this could be different. If an ELV supplier is considered to be a third party payment instrument issuer, the proposed provisions of Art. 59 would allow access to account information. This could serve as a means of authorisation.*

[3] Such as a change in the rules of the German debit card scheme that would make it impossible for third parties to read the account stored on a debit card.

We believe that both these issues are the biggest obstacles to expand ELV to a European scale. With the proposed new rules, these obstacles would no longer exist. However, given the regulatory activity with respect to interchange fees, this does not mean that a European ELV will succeed.

The business case for ELV strongly depends on prices for debit card acceptance. The relatively high interchange fees in the German ec cash scheme can be considered as the key success factor for ELV. As far as risk-based costs can be kept below the interchange fee, there is a compelling business case for ELV. The same counts for systems like the German "Sofortüberweisung". The success of Sofortüberweisung in Germany is mainly caused by the high interchange fee of Giropay[4], the OLEP-scheme of German banks. This contrast with the experience in the Netherlands: interchange fee for debit cards and the internet payment scheme iDeal are low, and accordingly neither an ELV-like scheme was setup by Dutch merchants nor did Sofortüberweisung succeed.

If the EU Commission's proposal for a cap of 0.2% on debit card interchange fees should well be adopted, we believe, there still could be a business case for ELV. Actual loss rates in Germany are significantly lower than the 0.2% threshold. If, however, interchange fees are further lowered – potentially after a revision of the regulation – from a pure cost perspective, there will be no business case for ELV. In the US, decoupled debit cards - which are based on a comparably business case as ELV – exited the market, as the cost to provide such a service were undercut by the regulated interchange.

It would be an irony of history if the EU Commission, in its legislative package, were to enable a sound legal and technical basis for a true European ELV and, at the same time, were to destroy the fundament on which the business case for such a system is built.

2. PSD II: Baseless extension of regulation - the missing case for the inclusion of "limited networks"

The implosion of the negative scope (Art. 3), proposed by the European Commission on 24 July 2013, is one of the most important "amendments" to the new Payment Services Directive ("PSD II"). It may have far reaching market impacts: e.g. deletion

[4] And a more aggressive and flexible approach to acquire merchant customers.

of the exemption of ATM services offered by independent ATM providers, the limitation of the so called "telecom exemption" and last but not least the more restrictive definition of "limited networks".

We want to analyze this last amendment more closely in order to scrutinize the methodological approach of the Commission and its legitimacy. Payment services (e.g. store cards, petrol cards) accepted within a limited network of service providers or to be usable only for a limited range of products or services were waived within the PSD I. What are the reasons for limiting the negative scope of the Directive? The EU Commission says that "*certain exemptions set out in the PSD appear too general or outdated with regard to market developments and are being interpreted very differently*."[5] The Commission is referring to *"feedback from the market"* regarding *"massive payment volumes"* within limited networks (recital 12). In its "Impact Assessment" the Commission mentions the threat of massive and extensive payment schemes - but without any further specification or examples:

"The main impact of a new, more focused definition would be on these service providers who built extensive payment operations based on very broad interpretation of the exemption or purposefully use it to avoid regulation." (p. 66).

"As a result, feedback from the market suggests that the activities covered by this exception often comprise massive payment volumes and values and hundreds or thousands of different products and services, which has nothing to do with the original limited network concept. This implies uncertainties for market actors and greater risks for PSUs." (p. 141)

With these "massive volumes" and extended payment operations in mind, the Commission suggests as a remedy a more precise definition of a limited network, adding the requirement "specific instruments that are designed to address precise needs" to the original definition of limited networks in Art. 3 (k) of the PSD I.

As a consequence of the new definition, the Commission expects in its Impact Assessment (p. 233) that approx. 156 to 284 new Payment Institutions, which are at

[5] COM (2013) 547 final, p. 7

present not subject to the PSD I, would fall under the PSD regulations. 80% of these new PIs are small players (!) with a payment volume below 60 m € p.a. (expectation of the Commission).

Our Comment

Summarised in two words, the proposed PSD II implies "more regulation". This does not come as a surprise. It is a fact of life that regulators intend to extend their playing field. Indeed, the definition of "limited networks" in the PSD I was already very vague, inviting national supervisors to make their own interpretations. It resulted in a regulative patchwork instead of harmonization. Thus, in its recital 12 of the Proposal the Commission is on the right track when commenting that "a more precise description of a limited network in line with Directive 2009/110/EC, is necessary"*. But adding the requirement* "specific instruments that are designed to address precise needs" *(wording of the E-Money Directive II 2009) does not make the definition more precise or clearer.*[6]

As stated in the external study on the economic impact of the PSD I (made by London Economics/iff/PaySys[7]*), the feedback from stakeholders was very clear: "*The exemption for limited acceptance instruments … should be formulated much more precisely in order to avoid existing concerns expressed by all stakeholders over the scope of exempted activities and the position of the consumers making use of exempted services." *(p. 279).*

If the "massive" volumes of the limited networks (as assumed by the Commission) are considered as main risk for payment users, the proposed amendment of the definition will not solve this problem. Payment schemes (limited networks) with considerable volumes (like actual store cards or petrol cards in the EU market) would still be out of scope of the PSD II - notwithstanding the proposed amendment of the definition.

Questionable is also the assumption of the Commission of the existence of payments systems, waivered as "limited networks" with massive volumes, which imply greater risk and no legal protection for payment users as "feedback from the market". This feedback is scarcely documented in the external analysis on the economic impact of the PSD I. Some credit institutions (country unknown) fear a competitive disadvantage from unregulated limited network services (store cards?) and some industry experts are referring to limited

[6] The regulatory practice of e-money-regulation in the Member States since the implementation of the EMD II in 2011 is a case in point. It uses the same wording and has not provided clarity.
[7] http://ec.europa.eu/internal_market/payments/docs/framework/130724_study-impact-psd_en.pdf

acceptance exemptions in the UK market, "representing a market that may already be bigger than the market for cards issued under the PSD/EMD II." *(p. 121). But where is this market? In the UK market we only see some store cards which may have been waived as limited networks, but the payment volumes of these cards are much lower than volumes of bank issued cards. So, the external analysis delivers no hard facts regarding massive payment volumes within limited networks. Indeed, the Commission admits:* "authorities lack any transactional details about such operators. However, their assessment is that, in many cases, non-regulated entities managed to gain much larger share of the market than their regulated competitors." *(Impact Assessment, p. 229). But this seems to be a myth. We see no empirical evidence of extended payment schemes with massive volumes in EU Member States, operating under the exemption of the PSD I for "limited networks". The Commission should deliver hard facts.*

The proposed restriction of the negative scope of limited networks would mainly hit small companies, as even the Commission expects in its Impact Analysis. The aim of the proposed amendment of the definition and its expected practical consequence are evidently contradictory. Within this perception of alleged "massive volumes" the introduction of a threshold for a waiver of limited networks (e.g. based on the monthly payment volumes) would be more consistent.

The main reason for restricting the negative scope for limited networks is the assumed risk for users of payment systems with "massive volumes". The proposed amendment of Art. 3 (k) does not make the definition any clearer or more practicable for national regulatory authorities. As a consequence, these regulators are forced to find their own interpretations as practiced since the PSD I. A harmonization within the EU cannot be reached by this vague definition. The only rationale behind this amendment is a synchronization between the PSD II and the EMD II by taking over the unclear definition of limited networks in the EMD II.

LETTERS TO THE EDITOR:

On "IF-Regulation – comments of the EP committees", in the Dec. 2013 edition of this newsletter

Dear editors:

After wishing you and all members and guests a good start into the new year, I would like to drop a small remark on HAIR and HAPR as I do not fully agree with you in this aspect.

HACR, HAIR and HAPR is not just limited to eventual differences in the pricing. More importantly, the finality of card payments is especially at threat in internet payments as some credit cards like VISA and MC corporate and prepaid cards (according to the terms and conditions of our acquirer) are subject to a liability shift in the internet (= no guarantee cover for the merchant)!

So, if finality of the payment is the main issue (and not costs that could be compensated in a higher price), then it is of utmost importance that no liability shift or guarantee leak is allowed for certain cards - unless these cards can be electronically identified as such and if the merchant is eligible not to accept those cards at his discretion. No merchant will foolishly block cards without need - which would otherwise increase his turnover and profit.

I think the "bad taste" you mentioned which card users might feel when their cards are rejected should not be blamed to the waiters (merchants) but to the bad cooks (issuers).

Last of all, I would like to highlight that the HAIR might lead to increased fix costs for merchants if they would be compelled to accept and this implying also to technically adopt each and every issuer scheme that might try a start on the European market. This of course does not apply for differing issuers under the same card scheme, provided all other conditions (especially in view of pricing and guarantee cover/finality) remain the same.

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Our Comment

We agree entirely with Peter Frambach's views. Meanwhile we recognized that an amendment[8] *(see Amendment No 293 on page 151) to Article 10, paragraph 4 has been suggested by Ms. Sari Essayah, MEP:*

[8] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bCOMPARL%2bPE-524.782%2b04%2bDOC%2bPDF%2bV0%2f%2fEN

Text proposed by the Commission	*Amendment*
4. Issuing payment service providers shall ensure that their payment instruments are visibly and electronically identifiable, enabling payees to identify unequivocally which brands and categories of prepaid, debit, credit or commercial cards or card based payments based on these are chosen by the payer.	4. Issuing payment service providers shall ensure that their payment instruments are visibly and electronically identifiable, enabling payees to identify unequivocally which brands and categories of prepaid, debit, credit or commercial cards or card based payments based on these are chosen by the payer***, when these kind of categories affect the business rules or terms for accepting the cards. At minimum the merchant systems should be able to identify the merchant and interchange fee category of the payment instruments and when this is not possible the default value should be the corresponding instrument with the lowest merchant fee***.

Even if the proposed amendment will not entirely meet Peter Frambach's concerns, it is remarkable that the provision takes account of the importance of "business rules" rather than to focus on costs only. Obviously, a regulation of interchange fee deals primarily with cost issues. However, cards do not only differ with respect to costs. Different categories of cards also differ (inter alia) with regard to risk and chargeback rules, which can result in significant costs for merchants but also concerns the benefits of accepting a particular category of cards. As far as the proposed regulation is focussing on cost aspects alone - ignoring differing business rules - there remains the risk that the provisions lead to unintended consequences. The wording in the amendment above is too vague to tell whether it addresses such differences and would therefore allow merchants to decline acceptance of particular categories. If this is actually intended, we would welcome this as a new approach to regulation.

Please, send us your views to: sepa-newsletter@paysys.de.

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