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1. **National SEPA interchange rates?**
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## 1. National SEPA interchange rates?

Little by little, more information on interchange in SEPA is emerging. MasterCard has already published its SEPA rate for Maestro. Visa has settled on a flat rate of 26 ct. for V PAY. However, it has become clear that these rates will probably not be uniform rates for the entire SEPA region. Thus, the board of V-PAY Germany decided on a domestic V Pay interchange of 0.3% (minimum 8 ct.) which is exactly equal to the German ec cash fee.

In Belgium, MasterCard quickly reacted to the announcement that Belgian Banks would not switch to Maestro in 2008. It was announced that Maestro would be introduced after all – as a Belgian debit scheme. Since merchant resistance against maestro SEPA interchange fees was at the heart of the Belgian bank's reversal this only makes sense if the Belgian Maestro fees will be lower than the SEPA rate.

Meanwhile in Holland, Currence entertains the idea to continue with the Dutch PIN system beyond 2010. Last week the Dutch minister of finance declared that the new SEPA card payment products should have the same or even lower prices like today. If this happens, the Dutch Maestro and V PAY acquirers will have to come up with reduced Dutch rates for these brands. On the whole, what emerges is the return of domestic interchange fees.

***Our Comment:***

*It was clear from the start that interchange would be one of the most contentious issues in SEPA. It is seen as essential by banks, attacked by retailers and viewed with suspicion by regulators. Thus, the first big question was whether interchange would be allowed in SEPA. By now it is probably safe to say that the answer is an unqualified "yes". However, as the 2002 agreement between the EU Commission and Visa and also the recent Commission report on the cards sector have made clear, there will be conditions imposed on the calculation of interchange. In all likelihood, a cost-based methodology will have to be applied.*

*What is much less clear is whether there will be a uniform interchange fee for the entire SEPA region or not. The EPC's SEPA Card Framework*[1] *from 2005 explicitly included the possibility to have multilateral domestic interchanges that are different from the SEPA rate. The Commission SEPA Incentives paper*[2] *from 2006 did not touch this issue. However, the European Central Bank most firmly opposes the idea of national interchange fees within SEPA. In its 4th Progress Report*[3]*, it wrote "Whenever a card scheme sets up an interchange fee, there should not be any differences in the fee level based on geographical factors." (p. 5) and "The Eurosystem strongly invites the EPC to reconsider this provision because differentiation on purely geographical grounds is not compatible with the SEPA concept." (p. 19).*

*The card schemes, however, seem to be optimistic that, at least initially, interchange differences along national borders will be possible. Thus, in a recent interview, Peter Ayliffe, President of Visa Europe, stated:*[4] *"I think that the EU Commission understands, that it would be mistaken to demand an immediate harmonisation of interchange fees in all member states."*

*As the Belgian example shows, the schemes themselves are not necessarily the drivers in the direction of differentiated interchange. For them, a harmonised rate close to the current average may well have been an acceptable opinion. But such a scenario does not please merchants in those countries that currently have below average fees. The Belgian example has made that clear. And for anyone only slightly familiar with merchant sentiment these developments did not come as a surprise.*

*So, if merchants in some countries are strictly opposed to harmonisation close to average rates and if banks are opposed to harmonisation close to minimum rates (basically zero), the only feasible option remains maintaining national differences of interchange fees. Therefore,*

[1] http://www.europeanpaymentscouncil.eu/documents/SEPA%20Cardsframework_027_05_Version2%200.pdf

[2] http://ec.europa.eu/internal_market/payments/docs/sepa/sepa-2006_02_13_en.pdf

[3] http://www.ecb.int/pub/pdf/other/singleeuropaymentsarea200602en.pdf

[4] Das Bezahlen wird revolutioniert. Peter Ayliffe, Präsident von Visa Europa über Zahlungskarten und den Preis des Bargelds, Frankfurter Allgemeine Zeitung, February 2, 2007.

*with respect to interchange the new SEPA world may look very much like the old Pre-SEPA world.*

*One thing is likely to change, though, SEPA and the increasing pressure of competition authorities are likely to lead to some form of cost-based interchange fees.*

**Table 1: Interchange: How much change?**

| Old (Pre-SEPA) | New (SEPA) |
|---|---|
| Domestic interchange<br>nationally regulated | Domestic interchange<br>cost-based (?) |
| Intra-regional rate<br>(fall-back rate)<br>cost-based (in principle) | SEPA-interchange<br>(fall-back rate)<br>cost-based (?) |

## 2. Co-badging issues

Recently, Germany's credit co-operatives announced that they planned to issue V PAY cards. This statement has been clarified in so far as it is planned to issue debit cards which are co-badged with ec cash and V PAY. Meanwhile, Visa announced that they already have licensed V PAY to a couple of German acquirers. In addition, a German domestic interchange fee was agreed at 0.3%, which equals the ec cash issuer fee for retailers.

***Our comment:***

*It is an interesting question, what will happen if an ec cash / V Pay (Maestro) co-badged card meets a terminal which is capable to process both schemes. The question is quite new, as until recently no competing brands were badged on the same card. Merchants and acquirers have already plans announced, to configure terminals in a way that for every transaction the lowest interchange is selected. The question is whether this would be compliant with the SEPA Cards Framework (SCF) and EMV. The SCF states for the case that "several payment applications are contained in the same card and supported by the same terminal" that "cardholders will have the choice of which payment application they will use. Prevalence [...] for a particular payment application may not be mandated by a card scheme." From this, it follows that neither the merchant nor the acquirer (terminal provider) are allowed to pre select the payment application.*

**Table 2: Co-Badging: An overview**

| | traditional co-badging of domestic brand with international brand | SEPA co-badging of two SEPA brands |
|---|---|---|
| *brands* | *not competing* | *competing* |
| *application selection principle* | *default set by domestic brand (not SEPA compliant!)* | *according to rules: SCF, EMV* |
| *merchants/acquirers prefe-rence for application selection* | *n/a* | *lowest interchange* |
| *issuers preference* | *n/a* | *highest interchange* |
| *cardholders preference* | *n/a* | *agnostic* |

*EMV specifications allow a terminal to require confirmation of the cardholder for the selection of the payment application. Otherwise, the priority of applications which is stored on the card by the issuer must be applied. We can hardly believe that retailers in hypermarket or petrol sector will welcome terminals which require selection of payment application by the cardholder, as this would substantially slow the process. Moreover, cardholders primarily are used to think in terms of* ***payment cards*** *and not* ***payment applications.***

*So, it appears that SCF/EMV is making co-badging impractical. However, one may interpret the SCF in that way that the required cardholders' choice does not have to be executed on a transaction-by-transaction basis. Rather, cardholders can make a choice when applying for a card. This choice of priority is than stored on the card. This would be inline with EMV which allows for a priority of payment applications on the card which must be applied by terminals.*

*Accordingly, SCF-compliant use of co-badged cards will (only) work, if the priority indicator is used as default for application selection. In other words, the issuer ultimately decides which application is prior on the card. This sounds like bad new for merchants.*

*However, matters are changing when strategic issues are taken into account. Currently, card holders usually own a single-badged card or a co-badged card where the second brand is not directly competing with the primary brand i.e. can only be used in foreign countries. In this situation, merchants do not really have a choice; they have to accept all brands. If they* *decline to accept a particular brand they are going to lose sales. However, if co-badged cards with competing brands are issued, merchants are not longer "locked in". Termination of acceptance of one particular brand will not longer harm a merchant when cardholders normally have a second brand on the same card. So, ultimately the concept of co-badging with competing brands reverses the current situation where merchants normally are "multi-badged" and cards are actually "single badged". Accordingly, in a world of multi badged cards, merchants will win the freedom of choice to decline acceptance of a particular brand, which currently cardholders enjoy.*

***Table 3: Co-Badging: Strategic Issues***

| | **traditional co-badging of domestic brand with international brand** | **SEPA co-badging of two SEPA brands** |
|---|---|---|
| *lock in to multi badging* | *merchant* | *issuer* |
| *application selection at POS* | *default implementation* | *cardholder or issuer merchants selection not allowed* |

## 3. ECB: Oversight Framework for Card Payment Schemes

On April 24th the European Parliament passed the Payment Service Directive with a set of regulatory requirements to all payment services providers, card payments included. Only one week later the ECB published – hardly noticed by the press or even by the card journals - a draft paper: "Oversight Framework for Card Payment Schemes – Requirements"[5]. The ECB says it is a parallel initiative to SEPA to promote reliability of card payment schemes and a level playing field across the euro area. The oversight framework covers the entire payment cycle and card schemes which will have to comply with requirements in five areas - legal issues, transparency, operational reliability, governance and clearing and settlement. The framework is based on a risk analysis covering legal, financial, management reputational and operational risks.

5 http:/www.ecb.int/ecb/cons/current/html/index.en.html

***Our comment:***

*The synchronism of this draft paper with the passing of the PSD is probably not a coincidence. During the consultation process of the PSD the ECB stressed its role as overseer of payments to promote the smooth operation of payment systems. This task – the ECB says - should not be limited or changed by the PSD regulation. The ECB is now setting its position within this infighting of regulatory competence. It is not surprising that the paper starts with an explicit reference to this mandate. Probably, the requirements of the ECB (especially to the capital requirements of payment institutions) were not completely fulfilled within the PSD compromise. So, for players in the card industry the PSD and its national implementation will not be the final regulation which they have to deal with. The new ECB oversight framework could set additional requirements for example coverage of liquidity and credit risks of card acquirers. But the ECB has invited all interested parties (not only the schemes, but also issuers, acquirers, processors, vendors and merchants) to comment on the proposal until the beginning of August.*

**Should you have any questions or comments please contact**

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