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1. Dutch Debit Card Agreement

The Dutch banks and retail organisations have agreed on a number of issues that will open the way for Dutch banks to issue international debit cards and dis-continue the Dutch PIN system.[1] The most important element of the agreement is the guarantee of Dutch banks that debit card fees for merchant will not be raised for the next 5 years. Thus, whatever brand is chosen, merchant charges are fixed to the current PIN level. Other elements of the agreement are:

- EMV will be implemented by the end of 2011.
- The banks will contribute EUR 24 million to the retailers' costs of implementing EMV.
- The attempts to promote card payments will be continued.
- 2013 the agreement will be reviewed.

The agreement, which is endorsed by the Dutch government, has to be cleared by the Dutch competition authority NMa.

Our Comment

In essence, the agreement completes a process that started with the decision of several big Dutch banks not to make the PIN system EMV compliant and the decision of ING to offer merchants Maestro and V PAY acceptance at the same rates as PIN (5.2 €-cents).[2] However, with the retailers on bord, it is likely that the agreement will get the blessing of the NMa.

The process has been slowed down somewhat by the insistence of the Dutch antitrust authority (NMa) that banks may not <u>*jointly*</u> *shut off the national PIN system.[3] Now these*

[1] See www.hbd.nl/pages/2905 (in Dutch).
[2] See our SEPA newsletter from March/April 2008.
[3] See our SEPA newsletter from November/December 2008.

decisions are made by banks individually. Two big banks (ING and probably ABN AMRO) decided already to terminate their PIN issuing licence from 2011 onwards. ING already announced that their debit cards will be migrated to Maestro (only). It is expected that the third big bank will follow. If the three big banks – with a market share of more than 90% of the debit card issuing market – stop the issuance of PIN-branded cards, the national debit card scheme will be phased out in 2011.

So, now Holland will become the first country that has been induced by SEPA to abandon its national debit card scheme (within a "market-driven" process) in favour of international schemes. This looks like a fine success for the international schemes and for the European Commission. The Commission may view the development with some reservation, though, because one of Europe's most efficient card payment system (according to the Dutch minister of finance THE most efficient system) will be replaced by the international ("American") schemes.

But even if the agreement will make the Dutch debit card systems SEPA-compliant, the question how much is really going to change still remains. The prices the Dutch banks have guaranteed to merchants are cheap compared to other European countries. Thus, banks must either have received highly favourable terms by Visa and MasterCard or – and this seems more likely – there will be 'on-us' processing whenever a Dutch card is used at a Dutch terminal. In this case, the change would consist of a re-branding and upgrade of the Dutch card processing system to EMV.[4] However, such a solution would imply that there still is a distinct system of Dutch card processing (supposedly run by Equens) and a distinct Dutch price for debit card payments.

Another clever move of the Dutch banks is the avoidance of a domestic MIF by agreeing bilateral interchange agreements, which is feasible in a centralised market with a few big players. Market insiders say that the interchange level is below 2 cents. Even a prohibition of domestic MIFs in SEPA and the introduction of a SEPA-MIF by Maestro (and V PAY) at a higher level than 2 ct., would not disturb this „polder model" of low (subsidised?) merchant fees because the MSC are based on <u>bilateral</u> interchange agreements. Foreign acquirers must join the bilateral agreements with Dutch issuing banks, otherwise market entry is blocked (as long as the intraregional MIFs of the international schemes are still far above the Dutch level). The Dutch issuers who are also acquirers, could try to boycott these competitors. On the other side of the market, small Dutch banks without acquiring activities

[4] In the past, the Dutch banks argued that they wanted to migrate to the international schemes in order save the costs of upgrading the PIN system to EMV. One may wonder, how much cost savings there really are.

or even foreign banks could take a free-rider position benefiting from the (higher) intraregional fall-back Maestro-MIF that applies if a bilateral interchange rates cannot be agreed. But at the moment, we see no real driver at the issuing side of the market to level out the interchange-based price differences. So the result could be a Dutch "polder" of with a very low interchange/MSC-level within SEPA, protected by high dikes. But the Dutch case could have a strong influence on the interchange decisions of the European Commission. The Commission could take the (comparatively low) Dutch interchange level as benchmark for the SEPA-wide interchange for debit cards. This will equalize the SEPA landscape at the Dutch level. Another breach in the dike may come from the anti-trust authorities. They could have a problem with a system of bilateral price agreements (all at a more or less equal price level) within a highly concentrated market.

2. Waiting for the third card scheme

In its 6th SEPA progress report, the ECB questions the EPC's decision to remain relatively passive in the filed of card payments.[5] *"The EPC could reconsider the position it has taken with regard to the SEPA for Cards, i.e. its choice not to create a SEPA scheme for card payments, but instead only to develop a SEPA Cards Framework."* (p. 25) This point has been addressed by the EPC's Gerard Hartsink at a recent conference of the ECB and the Dutch Central Bank (DNB).[6] Hartsink defended the decision not to create a European card scheme with the argument that the EPC had not seen a business case for doing so. Still, he conceded that more and more banks would see a need to give in to public pressure. But, as he pointed out, co-operation among banks is not easily achieved. Therefore, he appealed to governments to put pressure on the "top dogs". Moreover, once again he pointed out that more clarity on interchange could be a factor that could further the cause of a third scheme.

Our comment:

In spite of the existence of three projects aiming to create a European card scheme (EAPS, Monnet and PayFair), regulators still seem to be concerned that in the end there will only be

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[5] ECB/Eurosystem: Single European Payments Area. Sixth Progress Report, November 2008. http://www.ecb.int/pub/pdf/other/singleeuropaymentsarea200811en.pdf. See also our SEPA newsletter Nov./Dec. 2008.

[6] Retail payments: integration and innovation. A joint conference by the European Central Bank and De Nederlandsche Bank, Frankfurt am Main, 25 - 26 May 2009.

Visa and MasterCard. Thus, they are continuing to pressure banks – in particular the EPC – to become more active in this field. Still, for the moment, the future of European card payments remains as uncertain as ever.

We would argue that one reason for this uncertainty is the inconsistency of the regulatory treatment of card payments. On the one hand, card payments are treated as part of the basic payment infrastructure – like direct debits and credit transfers – and on the other hand, they are treated like a product (or value added service) that is provided by a competitive market.

The "public infrastructure approach" calls for joint production, standardisation and regulatory oversight. The "product approach" calls for competition and, at least in network industries like payments, some form of cooperation.

If card payments are part of the general payment infrastructure, it would, indeed, make sense to define a "SEPA Card Payment" just like a SEPA Direct Debit or a SEPA Credit Transfer. However, in this case, it would not be necessary to have "at least three systems" as demanded by the EU Commission. Just as in the case of SDD or SCT, one system would be enough. The advantage would be a high level of standardisation and economies of scale with the resulting low costs (unless the system is much more complex than the national legacy systems). The back-drop would be less choice and product innovation (given the slow pace of change known from interbank ventures). The advantage of the "product approach" would be more competition, choice for consumers and merchants and more product innovation. There would be, however, less standardisation, less use of economies of scale and, possibly, higher costs. To put it somewhat less abstract, the question is, whether we want a no choice/low cost "Mao look" for card payments or a more diversified set of products.

A possible compromise between the two views would be to define a SEPA clearing and settlement system that is suitable for cards and leave the rest to the market.

3. CUP: new kid on the block

The Chinese bank card system CUP (China UnionPay) opened its first USA branch end of April 2009. In Europe, CUP already established a branch in Paris. The New York-based branch is a further milestone of the CUP strategy to expand its global acceptance and to become an international brand, like Visa, MasterCard and JCB. At the time being, about 430,000 merchants outside of China accept the CUP-brand. The press release of May 7th stated: *"In the future, CUP will further reinforce its international cooperation and build itself into an international bank card organization with competitiveness and influence through its* *sustained efforts. And it will also build CUP brand into a domestically established payment brand not only serving China, but also serving an increasing number of countries and regions".* At the same time CUP and the US payment processor and acquirer Global Payments signed a global cooperation agreement that should enable both partners to extend global reach.

Our comment:

CUP started 7 years ago. Meanwhile, with almost 1 billion CUP-branded issued cards, it is one of the dominating international brands (compare Visa: worldwide 1.7 billions card in 2008). It is a real Chinese card system, based in China, subject to Chinese legislation, roots, policy logic and business model in China, approx. 90% of the cards are debit cards and it is probably a very efficient monopolistic system with high economies of scale. From this point of view it could be a blueprint for the SEPA-dream of the ECB of a European card scheme (see article 2 of this newsletter).

Well, there is one little flaw: the scheme is a state-owned monopoly and there is no fair competition between CUP and the other international schemes within China. It is still not possible for Chinese banks to issue MasterCard or Visa cards for domestic transactions denominated in the national currency Renminbi (Yuan). At the same time CUP controls the acquiring market, also for Visa and MasterCard acceptance of foreign issued cards. Only a small percentage of the CUP credit cards are co-branded with MasterCard or Visa which are linked to Dollar-accounts.

From Mastercard´s and Visa´s point of view CUP is indeed a competing brand! CUP made only a reciprocal agreement with the US Discover Card to expand CUP acceptance at Discover Card accepting merchants in the US. To reach global acceptance of its cards, CUP has to expand the acceptance of the CUP-brand at merchants outside of China. The US-player Global Payments will give substantial support. CUP consequently seeks to become a real international brand. The strategy of the 4th worldwide brand JCB was and is still the same: worldwide acceptance based on the JCB-brand and no co-branding with the competing brands Visa and MasterCard. It should be the strategy of a European card scheme as 5th international brand too. The ECB still believes that co-branding between the competing *international schemes could be the solution to reach global acceptance for the new European card scheme. That is not realistic. Why should MasterCard and Visa do this?*

By the way: Banks in Europe can obtain issuing licences from JCB and CUP at very low costs compared to Visa and MasterCard. If these schemes were to achieve a certain acceptance level within Europe, the argument of the feared duopoly of "American schemes" would become meaningless. The only remaining rational behind the insistency on a European card scheme would be a political one.

4. New E-Money Directive adopted by European Parliament

In its plenary session of 24 April 2009 the European Parliament adopted the proposal for a new E-Money Directive (EMD II) repealing the former E-Money Directive 2000/46/EC (EMD I), which is still relevant in the EU. It is expected that the EU Council of Ministers will endorse the EMD II in October 2009. Based on this time line the member states should implement the Directive until April 2011.

In our newsletter of October 2008 we already discussed the preliminary proposal of the Commission. Compared to the former proposal of October 2008 the most important amendment is the increase of initial capital from 125,000 to 350,000 € (instead of 1 million € today). Own funds should amount at least 2% of the average outstanding e-money. Further, E-Money Institutions could grant credit (with the same restrictions as for payment institutions), but not from the funds received from the public. Limited networks and mobile operators could be exempted based on the same requirements as those specified in the Payment Services Directive 2007/64/EC. The initially proposed lower threshold for an optional full or partial waiver of a maximum of 3 m € of outstanding e-money is cancelled and restored to the existing level of 5 m €. Last but not least redemption of e-money in cash should be granted (in general) free of charge. Optimistically, the Commission states "*The new rules will offer a second chance to the e-money market to take off*".

Our comment:

In October 2008 the Commission expected a strong increase of outstanding e-money from 1 billion today to 10 billions € by 2012. The main reasons for this optimistic forecast was the proposed lower thresholds for a waiver, the reduction of the initial capital to 125,000 € and the extension of the e-money definition to new prepaid (account-based) products. We concluded in our newsletter of October 2008 that this expected magical surge of e-money is based, to large extend, on a wider definition and an extended scope of regulation.

The forecast of 10 b € outstanding e-money by 2012 was based on an extensive analysis[7] of the impact assessment of the proposed Directive taking into consideration the relevant parameters, like initial capital requirements, threshold for waivers etc. Now in the new proposal of April 2009 these relevant parameters have changed considerably, but the forecast of 10 b. € remains the same! That may be funny, but it is not sound! Another useless forecast!

With the new e-money definition the Commission hopes to provide a technically neutral definition that should cover all situations of issuance of prepaid stored value products. The Commission does not seem to realise, however, that the adjective "electronic" is - from an intrinsic point of view - not technically neutral compared to other non-electronic prepaid means of payments. Magnetically stored value is explicitly included, but paper-based value not! It is difficult to understand (and never explained!) why, for example, an issuer of (multi-merchant) paper gift vouchers is not subject to any regulation while e-vouchers are regulated as e-money! The holders of both kinds of vouchers do have the same risk of issuer bankruptcy.

Another problem of e-money is the definition of "prepaid". The EMD II extends the definition of e-money to account-based e-money products without clarifying the misty term "prepaid". That is likely to lead to confusion. After all, every account with a positive balance is "prepaid".

[7] Commission Staff Working Document „Impact Assessment accompanying the Draft Proposal" of 9.10.08.

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