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1. SecuRe Pay: Be SuRe to hear more of it

In 2011 the Eurosystem set up the "European Forum on the Security of Retail Payments" (SecuRe Pay). Following a consultation process the Forum has published its recommendations in January 2013.[1] The aim is to foster the "establishment of a harmonized EU/EEA-wide minimum level of security" (p.1).

The SecuRe Pay recommendations for internet payments cover the following transactions:

- card payments
- registration of card payment data for use in wallet solutions,
- credit transfers on the internet
- issuance and amendment of direct debit e-mandates
- e-money transfers

Excluded from the scope are:[2]

- other internet services such as brokerage
- payments initiated by post, telephone order, voice mail, or SMS,
- mobile payments other than browser based payments
- credit transfers where a third party accesses the customer's account
- payments made by an enterprise in dedicated networks
- card payments using anonymous and non-rechargeable prepaid cards
- clearing and settlement transactions

[1] European Central Bank: Recommendations for the security of internet payments. Final version after public consultation, January 2013.

[2] The Forum has published separate draft recommendations for mobile payments and payment account access services. See: European Central Bank: Recommendations for "payment account access services". Draft document for public consultation, January 2013; European Central Bank: Recommendations for the security of mobile payments. Draft document for public consultation, November 2013.

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Addressees of the recommendations are payment service provider (PSPs) and governance authorities (GA) of payment schemes.

The Forum makes 14 recommendations regarding the "general control and security environment", "specific control and security measures" and "customer awareness, education and communications".

As the Forum itself notes, the "recommendations are formulated as generically as possible". Thus, a lot of the recommendations are fairly general. However, the Forum also makes some specific recommendations, most notably, it recommends strong customer authentication for internet payment transactions and the issuance of direct debit e-mandates (p. 9-10).

Strong customer authentication is defined as "*a procedure based on the use of two or more of the following elements – categorised as knowledge, ownership and inherence: i) something only the user knows, e.g. static password, code, personal identification number; ii) something only the user possesses, e.g. token, smart card, mobile phone; iii) something the user is, e.g. biometric characteristic, such as a fingerprint.*" (p. 3) This is in line with the draft version of the PSD2.

The Forum itself does not have any legislative power. The recommendations have to be implemented by national supervisory authorities. Moreover, some of the proposed measures, such as strong authentications, have found their way into the draft version of the PSD2. Thus, domestic legislation transposing the PSD2 would form an additional legal basis.

Notwithstanding the link with the PSD2, the implementation deadline is 1 February 2015.

Our Comment

Security of payments is an issue going right to the heart of central banks. Security of cash and security of wholesale payments systems (or "systemically important systems") have always been under the wings of central banks oversight. Increasingly, however, e-payments in general are also getting into the focus of central bank regulation. A case in point is the SecuRe Pay document with "recommendations" regarding the security of internet payments and m-payments.

*The Forum justifies its approach with the observation that "*payments made over the internet are subjects to higher rates of fraud than traditional payment methods*" (p. 1). The recommendations are expected to "*contribute to fighting fraud and enhancing consumer trust

in internet payments*" (p. 1). This sounds good. However, it can hardly be accepted as a sound basis for regulation. What regulators are basically saying is that the internet is a fairly risky environment and that, unsurprisingly, users of internet payments are subject to higher risk. The document does not make any attempt that the level of risk is inefficiently high and that there is some type of "market failure". It does also not mention other aspects, such as systemic issues, which might be of importance.*

Given that regulators have not built a clear case of market failure, it is not surprising that they come up with a long list or rather general issues of good conduct that a reasonable service provider will observe anyway. But maybe one or the other provider will find inspiration in this document for improving security.

Thus, it could be argued that the recommendations may do some good and will do little harm. However,

- *the document also contains specific measures such as strong authentication which may be expensive to implement*
- *there are a number of vague exemption clauses*

Clearly, it is true that less risk is better than more risk. However, reducing risks usually involves costs and thus risk reduction and costs have to be balanced. In the case of internet payments one important element of "costs" is loss of convenience for users.

Recommendation 7 (Strong customer authentication) expresses as a general rule that "the initiation of internet payments, as well as access to sensitive payment data, should be protected by strong customer authentication." (p. 9)

*First of all, it is not clear what exactly "should" means. For instance, in 7.3 it is stated that "*all card issuing PSPs should support strong authentication of the cardholder. All cards issued must be technically ready (registered) to be used with strong authentication.*" Thus, the Forum differentiates between "should" and "must" and the wording seems to leave some room for interpretation.*

Second, the range of exempted types of payments is ambiguous. The stated exemptions include inter alia (p. 9)

1. *outgoing payments to trusted beneficiaries included in previously established white lists for that customer;*
2. *transfers within the same PSP justified by a transaction risk analysis;*
3. *low-value payments, as referred to in the Payment Services Directive*

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As to 1: "trusted beneficiaries" that is a term that leaves wide room for interpretation. For instance, are Visa merchants "trusted beneficiaries" of card payments? Or recipients of recurring payments, could they be treated as such trusted parties?

As to 2: "Within the same PSP" would be applicable for payments between PayPal accounts?

As to 3: It remains unclear what low value payments are.

The PSD defines low-value payment *instruments* *as allowing "individual payment transactions that do not exceed EUR 30 or that either have a spending limit of EUR 150 or store funds that do not exceed EUR 150 at any time (Art. 34(1) and 53(1).*

A little below in the text of the recommendations, the Forum takes up the issue of alternative authentication, again. It states that such alternative ways may be permissible for providers of wallet solutions and PSPs offering acquiring services:

"The use of alternative authentication measures could be considered for pre-identified categories of low-risk transactions, e.g. based on a transaction risk analysis, or involving low-value payments, as referred to in the Payment Services Directive." (p. 10)

So, apart from low-value payments which are mentioned already in the exemptions, "pre-identified categories of low-risk transactions" may also be carried out with the use of alternative authentication. Again, this is a fairly general term that is open to interpretation.

The PSD2 draft also contains the idea that strong authentication may – under certain conditions - be replaced by other methods. The draft proposes to require strong authentication "unless EBA guidelines allow specific exemptions based on the risk involved in the provided payment service" *Furthermore, it is stated that "*EBA shall, in close cooperation with the ECB, issue guidelines" *and that those guidelines shall be issued within two years from the date of entry into force of the PSD2 (Art. 87). So, more guidance on this point may be provided some time in the future. But will this be in a timely fashion that allows market participants to comply with the February 2015 deadline? The proposed PSD2 seems to leave considerably more time than the date set by the Forum.*

As long as the ambiguities mentioned above remain, the market is left with a lot of uncertainty. Rumors abound. In a recently published article a German business magazine SecuRe Pay was seen as the result of lobbying by the banks who want to gain market share

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in the online payment market against PayPal, Amazon and the likes.[3] *Others, however, fear that possible exemptions for wallets ("use of alternative authentication measures") may even create additional advantages for these players.*

While regulators have pondered the question how to address risks in internet payments some weighty market players have come up with their own ideas.[4] *The credit card networks have presented a proposal to use tokenization*[5] *to make internet payments more secure and at the same time retain convenience. The question here is whether this approach is compatible with the recommendations or could be made compatible without sacrificing convenience for users.*

Finally, the Forum repeatedly refers to the PSD2 but does not clearly spell out what the relationship between the PSD2 and the "recommendations" is. Is it necessary that the recommendations have to become an element of the PSD2? If so, what is the status of the deadline given in the document (1 February 2015)? If this is not the case, why does the Forum elude to the transposition of the PSD2 as legal basis? For market participants this matters a lot. After all, they may be required to implement far reaching changes within the next 14 months.

2. Card Payments in the Netherlands: No innovation anymore?

Recently, the central organization of the German banking associations "DK" (Die Deutsche Kreditwirtschaft) published its position paper on the proposed IF-Regulation of the European Commission.[6] As a representative of its card issuing members it harshly criticizes the proposed regulation. We want to highlight some of the most striking statements of the DK. First, the German banks are expecting that only acquirers and big retailers would benefit from the proposed IF-decline, arguing that the service fees of most of the small and medium sized card accepting retailers will not be affected. A second interesting statement is the

[3] See Heinz-Roger Dohms und Meike Schreiber: Banken planen Großangriff auf PayPal, manager magazin online, 15 November 2013 (http://www.manager-magazin.de/unternehmen/banken/a-933732.html)
[4] MasterCard, Visa and American Express Propose New Global Standard to Make Online Shopping Simpler and Safer. Invite Industry to Collaborate and Eliminate Need for Account Number at Online Checkout and Ensure Consistent Purchasing Experience Regardless of Device or Technology, PURCHASE, N.Y., FOSTER CITY, Calif. and NEW YORK – October 1, 2013.
[5] A token is a unique identifier that replaces the traditional card number.
[6] http://www.die-deutsche-kreditwirtschaft.de/uploads/media/DK_Stellungnahme_MIF-VO_20131107.pdf

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conjecture that merchant fees in the German domestic debit card scheme "ec cash" (which are directly paid from merchants to issuers) would NOT be subject to the proposed IF-regulation. We discuss this topic below in section 3 of this newsletter. Finally, the DK is claiming that low interchange fees lead to a stand-still within card schemes because of lacking incentives for innovation. As an example, the Dutch debit card scheme is mentioned. As the DK states, after the decrease of interchange fees in the Netherlands "de facto, no progression is observed".

Our Comment

First of all, it is remarkable to see that the German banking community expects a sustainable windfall-profit for credit card acquirers, tacitly assuming a lack of competition on the acquiring side of the market. Apparently, the two bank-owned German acquirers (ConCardis and B&S) with a market share of approx. 65%, do not have assertive advocates within the DK.

The interrelation between IF-level and innovation seems to be a tricky topic providing room for different views. The DK assumes that the consequence of low IF is stagnation because issuers lack resources for innovation. However, the European Commission represents the opposite hypothesis in its Proposal for IF-Regulation: low IFs encourage issuers to innovate[7]. Both prop up their arguments by pointing to the Dutch case. So let us have a closer look at the Dutch card market.

In the Netherlands, we have seen low (bi-lateral) interchange fees within the debit card schemes and therefore low merchant service fees (MSC) for more than a decade. But the IF for delayed debit cards and credit cards are still European average. Regarding the high volume of debit card payments per inhabitant, which is far above the European average, the causality between low IF and the high volume of debit card transactions, should be obvious. Even after the termination of the domestic debit card scheme "PIN" at the end of 2011 and the migration mainly to Maestro (only a few V PAY cards have been issued until now) the IF and MSC remain low. Merchants are paying a fee of a few cents per debit card transaction due to a domestic MIF of only 3.4 Euro cent (Pin- and chip-based Maestro). Following the argument of the DK innovation should have been stagnant in the Netherlands for more than 10 years. However, a comparison of the Netherlands with other European countries e.g. Germany, shows that the DK's assessment cannot be supported. All Dutch cards have been

[7] http://ec.europa.eu/internal_market/payments/docs/framework/130724_proposal-regulation-mifs_en.pdf, p. 12

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equipped with EMV-chips. The Dutch debit card can be used without PIN for parking and toll ways. Banks can issue personalized photo cards and they offer geo-blocking to their cardholders. The leading issuers, like ABN AMRO and ING, initiated the national rollout of NFC-chips for contactless payments in 2013 and a joint-pilot project of the banks for mobile payment (with a direct connection to the current bank account) started in Leiden in September 2013. Compared to Germany, we do not see an innovation backlog in the Netherlands. Rather the opposite is true!

So maybe the Commission is right? Unfortunately, the statements of the Commission on the Dutch market in the context of the recent IF-regulation are contradictory and confusing. Inter alia, the Commission makes the following claims:

- *The bank-owned internet-payment scheme iDeal is a result of low IF (of the debit card scheme), which encouraged banks to innovate[8] (well, not quite: credit cards are competing with iDeal as internet payment instruments and IFs for credit cards are still relatively high in the Netherlands);*
- *Reducing high IF of credit cards would improve the export potential of iDeal as low-cost payment scheme into other countries where expensive credit cards are dominating online payments;[9]*
- *The Dutch banks replaced the domestic debit card scheme "PIN" by international schemes due to the higher IF offered by these international schemes;[10]*
- *The Dutch domestic debit card scheme still has significant market shares[11] (well, not quite: PIN has been terminated at the end of 2011…).*

We cannot discover a clear and consistent analysis of the European Commission with respect to the Dutch payment market. The Impact Assessment Study seems to be poorly researched. It would make sense for both parties (DK and Commission) to study the Dutch case more carefully.

[8] We already discussed the lack of rationale of this argument in our newsletter of August 2013, p. 7.
[9] See Impact Assessment, p. 157.
[10] See Impact Assessment, p. 152 (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2013:0288:FIN:EN:PDF)
[11] See Impact Assessment, p. 100.

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3. Scope of the proposed IF-Regulation: Which scheme is in and which is out?

After the publication of the regulatory package by the European Commission on July 24th, some card schemes have started to explore whether they are in or out of scope of the price regulation of the IF (Chapter II: caps for IF). Article 1 makes two exclusions: card schemes operating within a "limited network" according to the definition of a limited network of the PSD and three party payment card schemes. A three party scheme is only out of scope if the scheme does not "licenses other payment service providers for the issuance and/or acquiring of payment cards" (Art. 2 Definition No. 15). Otherwise it will be considered as a four party payment card scheme, which is in scope. During the last few months, in several conference presentations, representatives of DG Competition have declared that **PayPal** and the German debit card scheme "**ec cash**" are included, while transactions based on **ELV** (mainly Germany) and **iDeal** (Netherlands) are excluded.

Our Comment

The in- or exclusion of some schemes mentioned by the representatives of DG Competition are remarkable. Let us have a closer look to find the rationale behind these declarations.

*According to the Commission, **PayPal** would be subject to the proposed IF caps. That is curious because PayPal is a three-party system (without licensed issuers or acquirers) and a PayPal transaction is not card-based as defined in Art. 2 No. 17. A PayPal payment transaction is without doubt a credit transfer as defined by Art. 2 of the EU Regulation 260/2012 and therefore not a card-based transaction, even if the funds used are funded by a card transaction. In case of funding by a card transaction, PayPal takes the role of merchant within the respective card scheme. However, if this scheme is a four party card scheme included in the IF-regulation, this funding transaction is – like all other card-based transactions accepted by merchants - only indirectly affected by the proposed caps. For PayPal as a merchant, the merchant fee to be paid to the acquirer of this funding transaction will probably be lower after the regulation has come into force. Thus, as a merchant, but not as a scheme, PayPal is affected by the IF-Regulation.*

*We agree with the Commission´s statement that **ELV** would be excluded. ELV is not a card scheme although the German debit card "girocard" is used to initiate a direct debit, which is still based on the rules and regulation of the domestic direct debit scheme (soon be based on*

SEPA Direct Debit scheme). There are no specific or additional ELV-rules. Therefore, it is not a payment card or card-based scheme according the definition of Art. 2 No. 13. In addition, the merchant is not paying an interchange fee or any "other agreed remuneration with an equivalent object" to a payment service provider. However, the Commission's approach is not consistent. On the one hand it excludes ELV from IF regulations, on the other hand, ELV transactions are included in the impact analysis of the European Commission. The Commission mistakenly assumes that the IF-regulation will reduce the average MIF-rate for ELV transactions of today 0.49% (!?) to 0.2%[12].

*What about **iDeal**, the Dutch online payment scheme with direct access to the current account of the banks? The scheme does have all the attributes of a four party payment scheme (issuers, acquirers, interchange and a single set of scheme rules, practices and standards) and it is dominating in the Dutch epayment market. But an iDeal-transaction is not a card-based transaction, it is a credit transfer[13].Therefore, the scheme is excluded. It would be an interesting question whether the same payment transaction would be still a credit transfer if iDeal would issue cards too, e.g. a debit card which initiates a push transaction (credit transfer at the merchant´s POS in the same way as the traditional iDeal transaction is processed and under the same rules).*

*The inclusion of the German **ec cash** debit card scheme – as stated by the Commission in its Impact Assessment analysis - is at the time being a hot discussion topic. Recently, the (legal and technical) construction of a new fee has been initiated. Under pressure of the German competition authority (Bundeskartellamt), the centralized uniform fee which is set by the scheme owner (German banks) and directly payable by a merchant to the issuer, will be discontinued. Instead, there will be a bilateral fee negotiated between individual issuers (or groups of issuers) and individual merchants (or a groups of merchants). In its recently published position paper on the EU-IF-Regulation[14],the German banking association "DK" (Die Deutsche Kreditwirtschaft) is arguing that a fee paid directly by the merchant to the issuer is not subject to the IF regulation, if the fee is the result of a bilateral negotiation process between an issuer and a merchant. German banks argue that the rationale behind the regulation of MIFs is the restriction of competition due to multilateral price-setting by a scheme or by a dominating group of issuers and acquirers. Therefore, bilateral price*

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[12] See Impact Assessment, p. 203.
[13] As defined by Art. 2 of the EU Regulation 260/2012.
[14] http://www.die-deutsche-kreditwirtschaft.de/uploads/media/DK_Stellungnahme_MIF-VO_20131107.pdf

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negotiations between an issuer and a merchant should not be subject to regulation. These arguments of the DK are certainly valid. Never-the-less, on the basis of the text of the draft proposal, ec cash would probably be "in" rather than "out":

- *The regulation is not restricted to MIFs, but also to bilateral interchange fees and even to every "other agreed remuneration with an equivalent object or effect"*
- *The ec cash system is considered to be a four party scheme because cards are issued by payment service providers (banks) and not the scheme (see Art. 2 definition No. 15)*

So the key requirement for being out of scope would be the demonstration that the negotiated prices of the ec cash system (which cannot be interpreted as an interchange fee between payment service providers) are not a "remuneration with an equivalent object or effect". But this point is not discussed in the DK-position paper.

Recently, a representative of the German Savings Banks said at a payment conference, that if the ec cash fee will be subject to the proposed IF-regulation, the Savings Banks could rebuild the scheme as a real three-party scheme, in order to avoid the regulation. But would there be a business case? The uniform remuneration of ec cash was 0.3% (except fuel transactions) and will soon be less after the negotiations and the technical implementation. The gap between the new merchant fees and the 0.2%-cap would be modest, too modest for rebuilding a scheme.

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