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1. **Presidency on interchange fee regulation: version 2**
2. **PSD II: A new definition of "acquiring"**

1. Presidency on interchange fee regulation: version 2

On October 31, 2014 the Presidency of the EU Council has come up with a new compromise for the proposed interchange regulation. [1] If adopted by the Permanent Representatives Committee, this compromise will define the Council's position in Trilogue negotiations with the Commission and the EU Parliament.

Little-by-little it is difficult to keep track of all the different versions under discussion. Therefore, we will re-use the table presented in our July/August newsletter and add the new version of the Council. One aspect, the new definition of "acquiring", will be dealt with in a separate article (see below).

Table 1: Comparison of the four proposals

Article	Commission proposal	Parliament first reading	Council 5 Sep. 2014	Council 31 Oct. 2014
Art 1 para 3 IF caps for commercial cards and three party	Out of scope	In scope	No amendment proposed to the Commission proposal	No amendment proposed to the Commission proposal
Art 2 point 6 Definition of commercial card	Card issued to undertaking	No amendment proposed to the Commission proposal	Card issued to undertaking ***and*** payments charged to the account of the undertaking	In addition: cards issued to self-employed
Art 3 Intermediate period between introduction of IF caps for cross-border and domestic payments	Intermediate period of 22 months	No intermediate period	No intermediate period	No intermediate period

[1] Council of the European Union: Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on interchange fees for card-based payment transactions - Presidency compromise (14773/14), Brussels, 31 October 2014.

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Article	Commission proposal	Parliament first reading	Council 5 Sep. 2014	Council 31 Oct. 2014
Art 3 Effective date for IF caps	2 / 22 months after entry into force for cross-border / domestic	12 months after entry into force	Not specified	6 months after entry into force
Art 3 IF caps for immediate debit cards	0.2%	0.2%, 7ct max	To be discussed: 0.2%, 7ct max 0.1% for transactions below 20 EUR	x-border: 0.2%; domestic scheme: two-part tariff possible with an average rate of no more than 0.2%[2]
Art 6a	n/a	For cross-border transactions, the interchange fee applicable shall be that of the country of the acquirer	n/a	n/a
Art 7 para 1 Effective date for separation of payment card schemes and processing entities	immediately	No amendment proposed	Phased approach	12 months after entry into force (Art 7 para 5)
Art 9 para 2 Unblending of merchant service charges	Interchange ***plus plus*** model Acquirers shall provide interchange fee, scheme fees and service fee separately	No amendment proposed to the Commission proposal	Interchange ***plus*** model Acquirers shall provide interchange fee, and service fee separately	Interchange ***plus*** model unless merchants request blending in writing
Art. 10 Honour all cards	No specific deadline.	Electronically identifiable: one year after entry into force Visibly identifiable: when newly issued	No specific deadline.	Electronically identifiable: 12 months after entry into force Visibly identifiable: when newly issued
Art. 15b Universal cards	n/a	n/a	n/a	if it cannot be distinguished between debit and credit the debit card IF cap applies*

*: applies to domestic transactions

[2] If, for instance, the average transaction size is 60 EUR, a rate consisting of a flat fee of 6 cents plus 0.1% would come down to a fee of 12 cents. This equals 0.2% of the average transaction amount and would be in line with the proposed regulation.

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As the General Secretariat of the Council points out, one delegation did not agree with compromise.[3] This delegation would like a different treatment of domestic card-based payment transactions with so-called "universal cards" (payment cards which are not distinguishable as a debit or a credit cards). This delegation proposed a cap of 0.25% for domestic transactions with universal cards. Alternatively, this delegation proposes a transition period for the application of IF caps to universal cards.[4]

Our Comment

The new paper mostly re-affirms the position taken in September 2014. There are some helpful changes such as a longer (but still ambitious) dead line for separation of scheme and processing (12 months) or the possibility that merchants may request blending in writing. But the most notable change consists of the clarification of the interchange cap for domestic debit card transactions. According to the proposal, on average, the rate may not exceed 0.2%. But the Council is prepared to accept a two-part tariff which would lead to a higher percentage rate for small value transactions and a lower percentage rate for large transactions. This makes sense, because debit card transactions with online authorisation are mainly characterized by fixed costs per transactions. From an issuer-perspective, a pure percentage rate would basically destroy the business case for small-value transactions.

However, while laudable in theory, the actual relevance of this feature of the proposal may be small. The reason is simple. Regulators seem to be determined to neglect contradictions in their regulatory framework. If a transaction between, say, a German merchant and a German card holder can be transformed into a x-border transaction via use of a foreign acquirer, it is easy to escape the relatively high percentage terms for small value payments. A merchant can simply use a domestic acquirer for large value transactions and a foreign one (or a foreign subsidiary of his domestic acquirer) for small transactions. Thus, given the way "x-border" is defined, it will not be possible to have one rate for x-border transactions and another one for domestic transactions. Well, there would be one solution: allow "domestic schemes" to restrict acquiring to local acquirers. But that would be a kind of "anti-SEPA" policy.

[3] Council of the European Union: Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on interchange fees for card-based payment transactions – General approach (14774/14), Brussels, 31 October 2014

[4] Since the definition of "universal cards" applies to Cartes Bancaires cards in France, it seems highly likely that the delegation referred to is the French delegation.

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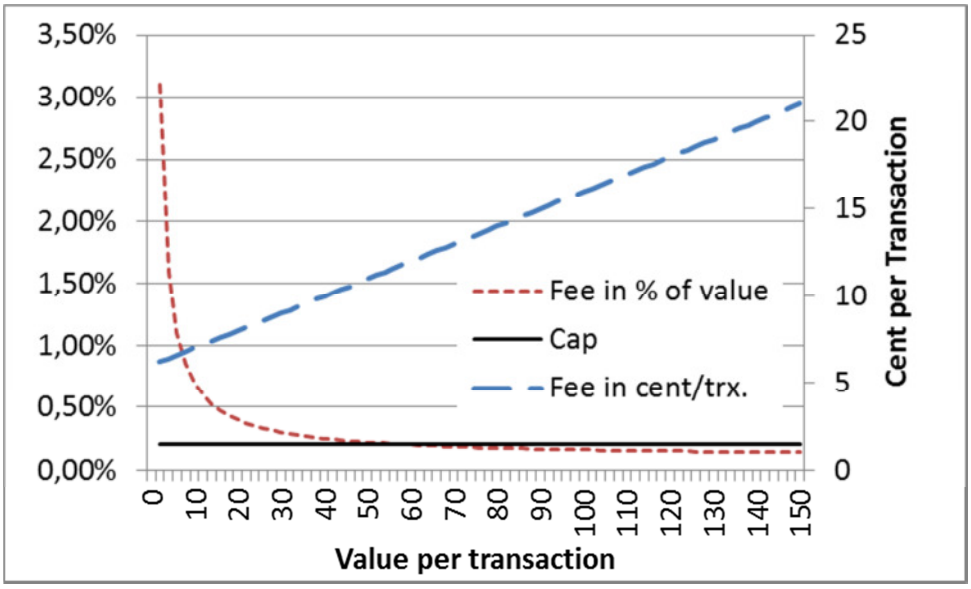
Figure 1 the proposed rate for domestic scheme interchange fees*



*: Based on an assumed fee of 6 cents per transaction plus 0.1% of the value.

The issue of small value payments versus large value payments in domestic schemes is not the only problem. In January 2015, the Visa commitments will take effect. From then on, for Visa transactions, the distinction between x-border and domestic will be more or less the same as in the proposed regulation. As we have pointed out repeatedly, this will lead to fee-arbitrage.[5] Domestic rates above regulated x-border rates will no longer be feasible (at least not for large merchants). This will lead to market distortions because acquirers with purely domestic operations will not be able to compete against acquirers offering x-border rates.[6]

2. PSD II: A new definition of "acquiring"

The "acquiring of payment transactions" is one the payment services which is subject to the Payment Services Directive (PSD I of 2007[7]). As consequence of the PSD I (which had to be implemented in national laws until November 2009[8]), the non-bank acquirers of network-branded card schemes need at least a Payment Institution license. Surprisingly, the PSD I does not provide a definition of the newly regulated payment service. Moreover, in the

[5] See "Presidency draft compromise on regulation of interchange fees" in the July/August edition of this newsletter.
[6] This is the very reason why Polish law makers, who have passed a legal cap only last year, are thinking about reducing interchange fees again, before 2015.
[7] See Annex I, no. 5 of the PSDI.
[8] Deadline for PSD I implementation.

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recitals of the Directive nothing can be found about the motivation of the Commission for regulating acquiring – a business mostly related to card payments. During the consultation process following the publication of the Commission's proposal for a new PSD (PSD II), the European Central Bank proposed to fill the void. The ECB saw the need to include a proper definition in the PSD II as well as in the proposed IF-regulation.[9] Indeed, especially the proposed IF-regulation, where the acquirer is directly affected by the IF cap, makes a clear definition overdue. In February 2014, the ECB proposed the following definition of acquiring:
'acquiring of payment transaction' means a payment service provided, directly or indirectly, by a payment service provider contracting with a payee to accept and process the payee's payment transactions initiated by a payer's payment instrument, which results in a transfer of funds to the payee; the service could include providing authentication, authorisation, and other services related to the management of financial flows to the payee regardless of whether the payment service provider holds the funds on behalf of the payee".

This definition has been adopted without modification by the European Parliament in its amended version of the PSD II (approved in parliament in April 2014). In addition to the EP, the European Council also addressed this issue iIn the "Presidency Compromises" regarding the PSD II and the IF regulation, we see the results of a constant change of minds of the Council members regarding the proper definition of "acquiring". The acquirer is the entity which enters into a contract with the payee (usually the merchant). Should the acquiring contract only be related to the acceptance of the payee´s payment transactions or also to the processing of payments? In the latest version of the Presidency Compromise on the PSD II (20 September 2014) processing is included in the definition provided by Article 39:
"acquiring of payment transactions" means a payment service provided by a payment service provider contracting with a payee to accept and process payment transactions, which results in a transfer of funds to the payee."

However, it is stated that technical processing, storage of data and the operation of payment terminals will not constitute acquiring. This definition is aligned with the latest definition of an acquirer in the Presidency Compromise of 15 October 2014 regarding the IF-Regulation. However, more to the point is the statement (not part of the legal definition, but stated in both

[9] See: Opinion of the European Central Bank of 5 February 2014, p. 17 (https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2014_09_f_sign.pdf?73d64e18ec98eb3e129415ac6d3e289e)

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proposals in the recitals[10]), that the holding of funds on behalf of the payee is not a constitutive criterion of the acquiring business.

Our Comment:

Under the PSD I – as a rule of thumb - a payment service provider will be in scope of the regulation, if the provider is (usually temporarily) in possession of the client´s funds or has access to these funds in order to carry out the payment transaction. To protect these funds, the PSD I established a set of safeguarding requirements for regulated payment service providers. In the clearing and settlement process of a card transaction the acquirer is receiving the funds from the issuer on behalf of the merchant. Therefore, the traditional card-based payment acquirers belonged the class of payment service providers that are "in scope" since 2009. In the proposed PSD II, the possession of or access to the client´s funds is no longer the constitutive criterion. The scope of the PSD II will be extended to payment initiation service providers (like SOFORT AG), which usually have no contact to the funds of the payer or payee.

The introduction of a clear legal definition is to be welcomed. But what is the reason for extending the scope? Why are the competent authorities wishing to change the "definition" of the acquiring of payment transactions that has been in place since 2009? The reason mentioned by the ECB, who originated the extension, is "to insure that all providers involved in payment services come under the proposed directive as provided for in Annex I"[11]*. The Presidency Compromise is more concrete. Obviously, some acquirers of card payments have tried to avoid regulation by establishing new business models based on forms of payment settlement which* "do not provide for an actual transfer of funds by the acquirer to the payee"[12]*.*

Besides the acquirer (licensed by the payment scheme), in the card acquiring business several entities can be involved: terminal providers, independent sales organizations (ISO), third-party processors etc. They could operate on behalf of the acquirer or independently. Within the total value chain of merchant related services acquirers are not necessarily the

[10] PSD II: Recital 19a (Presidency Compromise of 20 September 2014); IF-Regulation: Recital 22b of 15 October 2014.
[11] Opinion of the European Central Bank of 5 February 2014, p. 18.
[12] Presidency Compromise (PSD II) of 20 September 2014, Recital 19a.

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most important service provider. In some countries (especially in the USA), acquirers are staying somewhere at the back without a direct merchant-relationship.

So what are the key functions of the acquirer, which distinguish an acquirer from other payment service providers? The core business of the acquirer is related to the exchange of funds on behalf of the merchant between the issuer and the merchant. The acquirer can be regarded as the merchant's interface to the clearing and settlement of funds. The acquirer collects funds, reimburses the merchant by crediting the merchant account, authorizes the payment at the POS and – last but not least - guarantees the flow of funds to the merchant. In doing so, he is bearing most of the risk of charge backs initiated from the issuing side by providing a credit line to the merchant.

Let us take a closer look at the proposed new definition. The constitutive element of the new proposed legal definition of acquiring is a contract with the merchant (payee) to accept and process payment transactions. The previous key role of the acquirer (exchange of funds & guarantee of payment) is not explicitly mentioned. Thus, it is not constitutive anymore. Mere technical processing is also not essential. But the provider is "in scope" if the contract covers "acceptance and processing". But if exchange of funds, guarantee of payment and technical processing are not constitutive, what are the remaining criteria covered by "acceptance and processing"? Every contracted activity which causally results in a transfer of the funds to the payee? Should all providers in the acquiring business be involved (ECB position)? What about ISO´s, internet payment service providers and payment facilitators in a sub-acquirer role? What about the so-called commercial network providers in the German ec cash scheme (many of which do not have a bank or PI-license today)? In the past, unclear definitions in Directives would result in non-harmonization by leaving it to the local competent authorities how to interpret and implement such unclear definitions into local laws.

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