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1. The proposed regulation of business rules

The proposal of the EU Commission for a regulation on interchange fees (IFs) published on July 24th contains a number of provisions with respect to "restrictive business rules and practices".[1] So far, these provisions have received relatively less attention than the proposed interchange cuts.

The proposed IF regulation covers the following areas: Licensing, separation of payment card scheme and processing entities, co-badging and choice of application, unblending, honour all card rules, steering rules and information to the payee on individual payment transactions. A detailed discussion of all of these proposals is beyond the scope of this newsletter. Below, we will comment on some aspects, in particular implementation.

Our Comment

The proposals of the EU commission constitute a drastic intervention into the card market. Some of these rules are absolutely impossible to implement in the short run. The proposed business rules need to be adopted in the rulebooks of the card organizations. In a next step technical implementation must be prepared. This requires amendments in the card organizations' backend processing systems and in the processing systems of each issuer and acquirer, as well as in card and in terminal software. Whereas terminal software can be updated via download, for cards there is no standard procedure. Ultimately some hundreds of millions of cards may be forced to be replaced.

Hopefully, regulators will come to understand that it is simply impossible to implement the new business rules it in a big bang approach. If we only consider the availability of resources and timelines for thorough testing or simply extrapolate the experience from implementation

[1] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on interchange fees for card-based payment transactions, Brussels, 24.7.2013, COM(2013) 550 final. The provisions regarding interchange fees are discussed in the August 2013 edition of this newsletter.

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of SEPA mass payments, such a project will require years rather than months. To put it in a nutshell, if the EU Commission insists on the entirely unrealistic timetable for entry into force of the business rules rather than getting back to a reasonable and more co-operative approach, the integrity of the European card payments is highly at risk.

What these proposal in combination with the tight timeline makes particular painful is that the proposed rules are all but clear. Furthermore, the provisions of chapter II (the IF-regulation) are also not as clear as necessary for issuers and acquirers to prepare for a fundamentally changed business environment.

*The English version of the proposal sets in Article 3 a cap for cross border debit /credit card transactions whereas Article 4 sets a cap for debit/credit card **based** transactions. We wonder what the difference in the scope between these articles is and what the EU Commission intended with the difference in scope. Neither the recitals nor the impact assessment provide any guidance regarding the different treatment of card transactions vs. card **based** transactions. The confusion gets even worse when considering that the French version of the proposal does not make the difference at all. In the French version of the document both articles are dealing with "opérations par carte" (in contrast to "opérations de paiement liée à une carte)".*

As regards the abolishment of the honour all cards rule (HACR), the aim of the EU Commission appears to be clear: Merchants shall be free to decide about acceptance on a "brand or category" of cards depending on the IF they will pay for transactions with the respective card. This is supported by the provision of unblending (article 9) which requires acquirers to charge individually (by brand and category of card) charges. Obviously, categories and brands of cards must be distinguishable, i.e. visible for cardholders and electronically identifiable for merchants. However, it is not clear what exactly is meant by the term "brand or category" of card. We all know what a brand is and we all know that card brands do not allow to distinguish cards by interchange-rate. We understand that the EU Commission introduced the term "category" to separate cards with regard to applicable IF rates (e.g. debit, credit,...) but which may nevertheless be badged with the same brand. What remains open is the degree of granularity of categories which is demanded by the EU Commission. In the respective clause of the proposal, a few categories are enumerated: prepaid, debit, credit or commercial. We wondered if this enumeration should be read as an exhaustive list or more as an exemplary enumeration. Given the rational of the HACR, it appears reasonable to require that "categories" shall reflect the IF-tables one to one. But *since the actual granularity of IF-tables is finer than the above mentioned four categories one finds that this approach will not work for practical implementation – even when taking into account that Visa Europe has committed itself to reduce the number of interchange fees by 25%.*[2]

The question of what exactly is meant by the term "category" is also of relevance in Art. 12 (Information to the payee...). In addition, in article 12 the term "application" is used: "information [...] may be aggregated by brand, ***application*** *and [...] categories]". One should expect that the granularity of information which is demanded in Art. 12 coincides with the respective granularity in Articles 9 and 10. But what did the EU Commission intend when it added "aggregation by application"?*

Overall, the EU Commission seems to find itself in the regulators' trap. Initial regulations lead to market reactions or the expectation that the market will react. In order to safeguard the intended effects of the initial regulation the regulator has to make new and more detailed regulations. However, such detailed regulations increasingly require a level of expertise that a regulator may not have. As a result, regulation loses touch with market realities. In its current form, the proposed regulation is un-implementable.

2. More on the proposed interchange regulation

We have discussed the proposed regulation of interchange fees (IF) already in the last issue of this newsletter. One of the issues we discussed is the applicable IF in x-border transactions. Meanwhile, we have learned that there are competing interpretations of this issue and we would therefore like to take up the issue again.

A point we have mentioned in passing in our earlier article is Article 5 "Prohibition of circumvention". It states that "*any net compensation received by an issuing bank from a payment card scheme in relation to payment transactions or related activities shall be treated as part of the interchange fee*". The aim is clear. The EU Commission does not want schemes to compensate issuers for their loss of interchange revenues via other revenue streams. However, the problem is that it is by no means clear how this provision should be implemented.

[2] See "Simplification of MIF table" in: CASE COMP/39.398 - VISA EUROPE. COMMITMENTS OFFERED TO THE EUROPEAN COMMISSION PURSUANT TO ARTICLE 9 OF COUNCIL REGULATION (EC) NO 1/2003.

Our Comment

- Prohibition of circumvention

An explanation for Article 5 is given in the recitals (No. 23). At first glance, it is fairly straight forward. It states that the cap shall apply to the issuers' net compensation from IF (i.e. net of any applicable scheme fees) rather than to the nominal IF-rate. In other words, the nominal IF-rate (to be paid by acquirers) may be set slightly (by the amount of scheme fees paid by issuers) above the 0.3% cap. However when one considers implementation issues, questions arise: Clearly all regular volume fees and processing fees shall be included in the equation. But what does this mean, given that these fees are banded (or stepped)? Furthermore, shall irregular fees also be included into the equation? From various fee-analysis-exercises we have conducted in the past, we know that the total fee amount as a percentage varies significantly across issuers and card programs. Shall the cap apply to the average fee, a card organization receives from all issuers such that the nominal IF could be set at "0.3% + Ø-fee income"? Alternatively one could interpret the clause in a way that for every single issuer (even for the largest issuers which pay the lowest fees) the equation "nominal IF minus fee paid by that issuer ≤ 0.3%" shall hold. As the addressee of articles 3 and 4 are the individual payment institutions (i.e. issuers and acquirers) rather than card organizations our understanding is that no single issuer must receive a net compensation above 0.3%. Accordingly, the nominal IF-rate would be set by the card organization such that no issuer at any time receives a net compensation higher than 0.3%. Obviously this measure seriously limits the card organizations' scope to incentivize particular issuers e.g. for piloting of new technology etc.., once an IF is fixed. For issuers and acquirers it means that it is still uncertain, which nominal IF-rate will be compliant with the proposed regulation.

- *Cross border acquiring*

With regard to the cross border acquiring rule we recognized an important difference between the proposed Visa-Commitments and the proposed IF-Regulation. Besides these different rulings some acquirers and market experts consider a third interpretation, which we suggest to name the "export model".

Applicable IF	Status Quo	Visa Committments	EU Proposal	"Export model"
Issuer country = Merchant Country = Acquirer Country	Domestic (if locally set)	Domestic (if locally set)	Domestic (if locally set), capped in stage 2	Domestic (if locally set)
Issuer country = Merchant Country ≠ Acquirer Country	Domestic (if locally set)	Acquirer can opt for either domestic IF of **merchants's** country or capped intra-regional IF	intra- regional IF, capped in stage 1	Acquirer can opt for either domestic IF of **acquirers** country or capped intra-regional IF

Depending on which interpretation applies, the group of acquirers that stands to gain most from the proposed regulations may differ.

Country of transaction → Homeland of acquirer ↓	High domestic IF	Low domestic IF
Status Quo	n/a	n/a
Visa committment	Any xb acquirer	n/a
EC Proposal	Any xb acquirer	Any domestic acquirer
Export model	Xb acquirer from low IF-country	Any domestic acquirer

The group of acquirers that stands to lose most from the proposed regulations:

Country of transaction → Homeland of acquirer ↓	High domestic IF	Low domestic IF
Status Quo	n/a	n/a
Visa committment	Any domestic acquirer	n/a
EC Proposal	Any domestic acquirer	Any xb acquirer
Export model	Any domestic acquirer	Xb acquirer from average to high IF country

Depending on which interpretation applies, the effects on IF may also vary.

	Status Quo	Visa Committments	EU Proposal	Export model
Rationale	IF reflects only the origin of the participants in the original transactions	Abolishment of the binding of xb acquirers to local IF agreements in combination with avoidance of market foreclosure through low IF	Abolishment of the binding of xb acquirers to local IF agreements	Allowance of “export” of domestic IC through xb acquiring, but actually binds issuers to local agreements in ***other*** countries
Limit to which market force will drive down IF	n/a	0.3%/0.2%	0.3%/0.2%	<< 0.3%/0.2% (lowest domestic IF across EEA)

In our view the rationale behind Visas commitment is the most compelling from a competition perspective. It should be noted that the Visa commitment is entirely consistent with the proposed regulation of the EU Commission – as long as no cross border acquirer will opt for a higher domestic IF. Accordingly, card organizations would be free to implement a cross border IF-rule following the Visa commitment, when the European regulation will be adopted. However, the same is true for the “export model” as long as no acquirer tries to export a higher domestic IF. For issuers and acquirers there is a high degree of uncertainty as long as card organizations have not decided how they will implement the regulation regarding cross border acquiring.

3. Meanwhile in the US

Europe is not the only place where regulators have come to the conclusion that they have to do something about interchange fees. In the US, the legislative response to the financial crisis, the so-called Dodd-Frank Act, includes provisions on debit card interchange fees and a prohibition of network exclusivity arrangements.[3] The Act mandates that the Federal Reserve is to define a maximum interchange fee (cap) for debit card transactions and that it has to define rules that restrict network exclusivity provisions. The Fed duly came up with a

[3] See January 2011 edition of this newsletter.

cap that implied a substantial reduction of interchange fees and mandated that that issuers have to use at least two unaffiliated debit networks.[4]

The reduction definitely was a blow for card issuers. However, merchants, as well, were not happy with the maximum rate set by the Fed and went to court, arguing that neither the cap nor the rules for network exclusivity were in line with the provisions of the Dodd-Frank Act.

The District Court of Columbia agreed with the merchants' reading of the Dodd-Frank Act and ruled against the Fed on both counts: "*the Court concludes that the Board has clearly disregarded Congress's statutory intent by inappropriately inflating all debit card transaction fees by billions of dollars and failing to provide merchants with multiple unaffiliated networks for each debit card transaction*"[5]. The Fed has decided to appeal. Until the appeal is reviewed the current Fed rules will stay in place.

Our Comment

The events in the US are also interesting for the European card market. Congress has formulated relatively clear rules how interchange fees have to be calculated. The Fed has to set interchange fees on the basis of marginal (or "incremental") costs of card issuers associated with authorization, clearing and settlement of an electronic debit card transaction. In order to determine these costs, the Fed has conducted its own cost study.

Initially, the Fed proposed a maximum of 12 cents plus an unspecified percentage to cover fraud prevention costs. In the end, it came up with a maximum of 21 cents per transaction plus 0.05%. If the Fed's appeal against the ruling of the district court is unsuccessful, this rate will have to be lowered substantially.

There is a lesson here for European card issuers: Even if you think that current interchange proposals are bad, it still can get worse. In Europe, the Commission has proposed a cap of 0.2% for debit card transactions and 0.3% for credit card transactions. That is well below the current level in many European countries. But that does not mean that it cannot get any lower. As Rita Wezenbeek (DG Competition) pointed out at the Bankkartenforum 2013 (Frankfurt, 26 Sept.) a number of countries have already complained that the proposed debit card rates are higher than the existing rates in these countries. These countries are pushing

[4] See June/July 2011 edition of this newsletter.
[5] NACS v. Board of Govs. of Federal Reserve Sys., Case No. 1:11-cv-02075-RJL, Opinion (July 31, 2013).

for lower European rates. It is highly likely that European retailers will try to move things in a similar direction.

In the future, it will also be very interesting to see how the restrictions on network exclusivity will affect the market. The Fed regulation requires two unaffiliated networks (a kind of "mandatory co-badging"). That could be a PIN-debit and a signature debit network. Retailers have argued, however, that there should be at least two Pin-debit and two signature-debit brands on one card. The district court agreed. No matter what the final regulation will look like, if there is more than one brand on the card and retailers get to choose which one is selected, there will be continuous downward pressure on interchange fees. Thus, it does not come as a surprise that voices can be heard in Europe that also demand mandatory co-badging.

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