In this issue:

Regulation 924: Lex Britannica?

(hg) The 2001 EU price regulation 2560 on cross-border payments equalized the fees for payments in euro charged by payment service providers (PSP) to payment users for domestic and cross-border transactions. It was the trigger for the SEPA payment infrastructure and schemes (SDD and SCT). Regulation 2560 was repealed by Regulation 924 in 2009, which brought direct debits into its scope, however without any effect (the volume of cross-border direct debits is still negligible). Since then, all electronically processed payments apart from cheques have been covered: credit transfers, direct debits, card payments (on both issuing and acquiring sides) and cash withdrawals. In the euro zone the fees for cross-border transactions came down to the same level as for domestic payments, which were traditionally at a low level or even zero-priced. PSPs may have suffered lower fee revenues or would have been able to cross-subsidize the cross-border business by increasing other, non-transaction related account fees, card fees or currency conversion fees (which are not covered by the Regulation). On the other hand, the setting up of an efficient euro-clearing system as an indirect impact of the Regulation 2560 may have decreased the costs of the PSPs. The winners and the losers of the market intervention by the price regulations Reg 2560 and 924 are not known. We might doubt the self-assured statement of the regulator, the winner is always the user.

However, the total volume of cross-border payment transactions (euro and other currencies) of users in the EU is still low (around 2% of credit transfers, 9% of card payments and 3% of ATM-transactions). “Real” cross-border card payments are lower as a considerable volume of card-based ecommerce transactions are cross-border from a regulatory perspective (at merchants like Amazon and PayPal based in Luxembourg), but not from a consumer perspective. About 44% of all cross-border transactions initiated in the EU are already covered by the existing Reg. 924 (intra EU euro transactions from the euro-zone including Sweden, who joined the Regulation by the opt-in clause de jure for SEK cross-border transactions and de facto also for euro transactions).

Our Comment:

For political reasons, the initial Reg. 2560 was restricted to euro transactions, excluding non-euro currencies, in order to benefit the euro as incentive for other member states to join the privileged common currency. Although the European Parliament urged the Commission in its resolution on the Action Plan on Retail Financial Services[1] to extend the Reg. 924 to all cross-border transactions in euro and non-euro currencies of the Member States, the Commission proposed the amendment of the Reg. 924[2] only to euro transactions initiated by users in the non-euro area, probably for the same reasons.

The proposed amendment would therefore cover a further 28% of XB-transactions, initiated by users in the remaining 8 non-euro Member States (Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland, Romania and UK). The price of these transactions should be equated to the prices for domestic transactions in these countries.

The main monetary impact of the new Regulation is on card payments

The main argument of the Commission for restricting the amendment to euro transactions are the low costs for the local PSPs for handling these transactions by using the European clearing and settlement infrastructure (EBA clearing), benefitting from the economies of scale. However, this argument is only valid for the relatively low volume of relevant credit transfers as card payments and card-based ATM cash withdrawals are already processed by the efficient clearing systems of the international card schemes.

Impact of 924: Mainly card payments (99%)

In its Impact Assessment, the Commission estimates that around 90% of the credit transfers sent from the non-euro Member States to the euro-zone are transactions of corporates which are subject to negotiated prices with their PSP. According to the Commission, the Regulation would therefore only be relevant for the remaining 10% of credit transfers initiated by consumers and SMEs, who do not have the capacity to negotiate the fees.

The Impact Assessment pointed out that the XB transactions which will be eventually subject to the amendment of Reg. 924 are 99% (!) card-based transactions (POS & ATM). Despite the relatively small impact, the whole legislative initiative (explanatory memorandum, recitals, impact assessment, etc.) is mainly focused on credit transfers with excessive fees charged by PSPs and not on the huge bulk of card payments. As a consequence, the main monetary impact of the new Regulation is on card payments (lower fees for card users, less revenues for card issuers).

Before we analyze the impact in more detail, a few remarks about why the Commission suggests extending “price regulation” as the preferred defence mechanism against the exploitative practices of the banks in the non-euro area.

Price Regulation without alternatives?

The most obvious option would be a voluntary opt-in by the non-euro Member States such as used by Sweden in 2002. After all these years the other non-euro Member States still haven’t used it despite the huge benefits for their consumers and SMEs as identified by the Commission. May be the non-euro Member States don´t share the views of the Commission so why should they agree yet? Anyway, the majority of Member States (euro zone) will probably agree to the proposal whose impact is restricted to PSPs in the non-euro area. Compulsion is simpler than persuasion.

The fee for a cross-border credit transfer in euro charged by banks varies between 1.19 € (Poland) and 24.03 € (Bulgaria) according to the extended analysis made by Deloitte[3], which is the basis for the Impact Assessment (IA) of the Commission[4].If these prices are the outcome of supply and demand in a competitive market, a maximum price below the market price would result in a deterioration of the supply while increasing demand (queue-effect), less transparency through hidden prices (e.g. currency conver-

Well intentioned intentions of regulators cannot offset market laws.

There is still no free lunch.

sion charges) or higher prices for other services (e.g. domestic payments) to compensate for the lower revenues.

As indicated by Deloitte[5] some of these effects occurred after the price regulation of roaming charges (mobile phones) by the Commission in June 2017. The outcome of this very popular price regulation of roaming fees could be a flop at the end of the day. The same skepticism is appropriate regarding the expected impact of the price regulation of the Interchange Fees on card-based payments (IFR 2015). The caps (maximum prices) will simply rebalance the costs of the card system from the merchant (payee) to the cardholder (payer). In the whole EU we see increasing cardholder fees, combined with lower loyalty incentives for card usage as impacts of the lower interchange revenues for the card issuers. Well intentioned intentions of regulators cannot offset market laws. There is still no free lunch.

Would competition work?

Excessive pricing of cross-border credit transfers by some banks could be the result of a low level of competition. That is the favorite diagnosis of the Commission: *"weak competitive pressure in the cross-border payments market, including from the FinTechs"* (IA, p. 22).

That is a sound working hypothesis. More competition should be the best way to hinder excessive pricing (far beyond the costs of the banks) instead of the blunt instrument named "price regulation" (apologies for this obviously totally old-school economics but market mechanisms still apply). In most of the non-euro Member States there is a considerable gap between maximum and minimum prices charged by the banks for XB-credit transfers in euros. If we include the normally lower fees of the non-bank PSP, like Western Union, Moneygram, etc. (not considered by the Commission) the gap could be huge. In Bulgaria the highest fee is 24.03 € (bank) compared to 0.72 € (non-bank).

Could competition work? Yes, however the payer has to become active.

A personal experience: I had to pay a few GB pounds to an organization in the UK. The payee told me I had to pay by credit transfer to his UK bank account. Even in the highly competitive German payment account market, my internet-only bank (a leading market player with still no account fees) would charge me a flat fee of 10 € for transferring a few GBP. I asked my UK partner if he would accept PayPal or credit cards instead of credit transfer. Due to the payee fees for both payment instruments, at first he refused. After I offered to pay a surcharge to cover his fees, the transaction was perfect. I saved about 9.50 € and both payment users were happy. My UK partner probably didn´t realize that the surcharging of my consumer credit card payment was not legal due to EU regulation. Interesting to see how price regulation could effectively hinder price competition!

Do you need to be a payment nerd with deep knowledge in order to by-pass excessive bank fees for XB credit transfers by using competitive payment services from other providers? Maybe the average Bulgarian bank account holder could be overwhelmed. However, it should be the task of consumer organizations (sponsored by the EU?) to inform him about the low-cost alternatives. The Bulgarian SME with frequent payments in euro could easily find a way to avoid excessive bank fees (e.g. second account at a bank with low fees). Competition happens if market players are active, it is not the result of passive law and order.

The Commission is very skeptical about competition as an effective tool to solve the issue of excessive bank fees. Its arguments (IA, p. 22, 31, 42):

- In spite of the market presence of FinTechs, there have only been a few signs of significant fee reductions by the incumbent PSPs,
- Effective competition from new FinTechs will take too long as their services are only used by consumers who are both financially and IT literate,
- Non-bank PSPs (like PayPal) are not offering the full range of XB payment instruments (credit transfer, ATM withdrawal, card transaction at physical POS etc.),
- Restricted reachability on the payee side (Pay-

Pal account is still not a ubiquitous phenomenon),

- Last but not least: Payment services users do not prefer the competition/market solution.

The Commission concluded: *"Non-regulatory measures would not be putting enough pressure on payment services providers to offer services at prices that reflect their internal costs, particularly to euro payments"* (IA, p. 27).

The few arguments against the market solution are not convincing. On the contrary, the forced price reduction of the banks, which are able to compensate their losses by cross-subsidizing to almost zero, could be the end of the business case for their non-bank competitors as niche players.

There is another argument that makes price regulation irresistible for policy makers. It is much more popular compared to the veiled, complex and indirect tool "competitive market". The proposal would – as the Commission stated - entail reputational benefit for the EU. It *"resembles the regulation on telecoms roaming charges, one of the most popular achievements of the EU over recent years"* (IA, p. 39). This "*true European success story*" and "*one of the greatest and most tangible successes of the EU*"[6] makes it hungry for more populist regulations.

Nobody would make a card payment of 10 € for which they would be charged up to 40%!

Market relevance

Let us come back to the market relevance of the proposed regulation for **credit transfers**.
In the Impact Assessment the Commission estimated the relevance for only 14.9 million transactions per year in the non-euro Member States (excluding Sweden) with a total of 161 million inhabitants. Statistically speaking, a consumer in these countries initiates a credit transfer in euro (excluding credit transfers by corporates) every 11 years. The total savings of the proposed price reductions is estimated by the Commission at 114 m euro (7 euro per credit transfer), per inhabitant 0.71 € p.a. These figures prove the lack of relevance. The impact on SMEs in non-euro Member States would be negligible. The Commission´s statement, *"they will be in a better position to compete in the Single Market"*[7] seems to be questionable.

It is therefore not surprising that the interest of banks in this market is extremely low simply due to the lack of demand. For a bank the flat fee for joining the EBA clearing is 100,000 € p.a. Adding IT and costs for personal resources, it would be hard for a local bank to offer attractive fees due to the missing economies of scale.

The proposal will mainly hit card fees

The total impact of the proposed Regulation is estimated by the Commission at 900 m Euro p.a. (savings for payment users, loss of revenues for PSPs). The main part (around 800 m €) is related to card payments (622 m €) and card-based ATM withdrawals (170 m €). See diagram. Let us have a closer look at these questionable estimates.

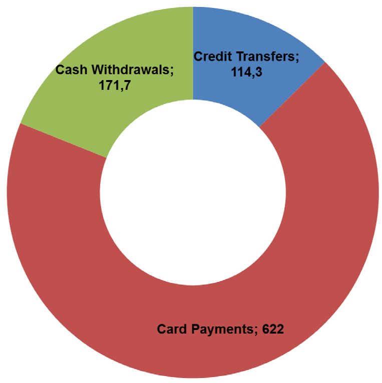


Diagram 1: Total savings as result of the proposed amendment of Reg. 924
(Source: European Commission, Impact Assessment)

Payments in euro with cards issued by banks in non-euro Member States are usually charged with an additional foreign exchange fee. This fee is usually an ad valorem fee (e.g. 1% of the sales amount). After implementation of the proposed regulation this fee will be eliminated as card payments in the domestic currency are usually not charged.

Although exactly this fee is the most important figure for the whole impact assessment, the Commission is very vague in its calculation (contrary to the figures used for credit transfers). All figures are based on the Deloitte study. Unfortunately however, not all figures are published by Deloitte. The Commission published in its Impact Assessment the maximum and minimum fees for a card payment of 10 (!) euro as charged by the banks in the 8 Member States. Obviously it takes the non-weighted average (0.40 €) between both extreme fees as basis for its calculation by taking this average as a fixed fee per transaction.

A correct calculation should be made on the basis of the average fee for a 55 € sales transaction (which is the average transaction volume) instead of 10 € because the fees are usually ad valorem fees! The Commission claims maximum fees of up to 4.10 € (Croatia) for a card sales transaction of 10 € (Poland 2.37 €, UK 1.98 €)[8]. These figures are totally unrealistic, more precisely stated: nonsense. Nobody would make a card payment of 10 € for which they would be charged up to 40%! Even the average fee used by the Commission for a 10 euro card payment would result in a fee of 4%, which is not realistic.

For example, most of the card issuers in the UK charge a foreign exchange fee for payments in euro of 2.75 to 2.99%. If we take a moderate average of 2.5% for a foreign card transaction in euro of a UK cardholder (average amount 67 €) the fee will be 1.68 € per transaction. That is far beyond the estimated average of 0.40 € by the Commission.

Taking into account that about 70% of all card transactions which are subject to the proposed Regulation will be initiated by UK card holders, the average of 0.40 € is much too low, even if all issuers in other non-euro Member States charged zero fees to their cardholders, which is obviously not the case. The impact of the Regulation on UK card issuers (lower revenues after deletion of the foreign exchange fee for euro transactions) could be estimated at 1,820 m €. The total savings as estimated by the Commission for card payments (622 m €) based on the 0.40 € fee reduction (per card transaction) is much too little.

The impact of the Regulation on **ATM fees** is difficult to estimate. The Commission expects a potential savings volume of 172 m € (reduction of the average fee from 2.30 € to 0.63 € per ATM transaction). However, most of the issuers and ATM providers charge different fees based on network affiliation of the card used. The fee for all cards outside the network of the PSP is usually identical without differentiation between domestic or cross-border. In this case the Regulation would not have any impact. However, the foreign exchange fee for sales transactions (e.g. 2.50% fee in the UK market) will be charged for ATM transactions too. This additional fee should be eliminated after implementation. The revenue loss for an average euro transaction made by a card issued in the UK would be around 2.10 €. It is not clear whether the Commission took both fees into consideration.

According to our calculations the direct benefits for card holders (loss of revenues for issuers) are above 2 billion € as compared to the estimate of the EU Commission of 622 million € for card payments. But there are two caveats. First, as pointed out above issuers may recover lost revenue elsewhere and, second, Brexit is looming and may chip away a large chunk of the benefits.

If we take all the transactions in euro which are affected by the proposed amendment of the Regulation (credit transfers, card payments and ATM withdrawals) at least 62% are initiated by payment users from the UK (see diagram). The share would be probably higher (the Commission indicated the share at about 80%).

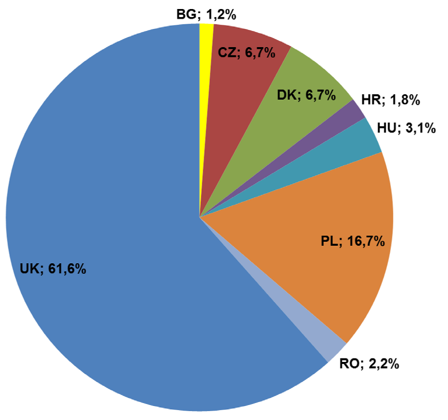


Diagram 2: Affected transactions broken down by country
(Source: European Commission, Impact Assessment & ECB - Data Warehouse)

What about Brexit?

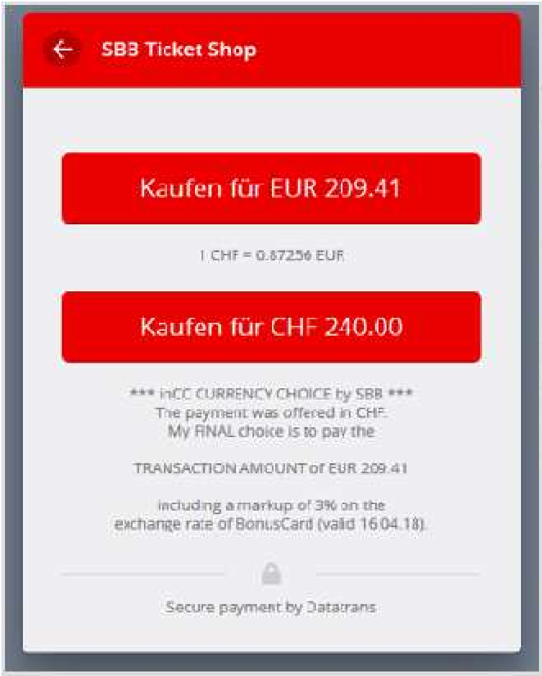
The Commission is suggesting 1 January 2019 as the implementation date for the new Regulation. It's certainly the case that directives and regulations due to be enacted before next March are being brought into UK statutes. The proposed Regulation will mainly hit card payments (POS & ATM) and it will mainly penalize card issuers as well as benefit payment users in the UK if the PSPs are not able to recover their losses any other way. Is it the last attempt of the Commission to convince the stubborn UK inhabitants of the benefits of the European Union?

Last but not least, another suggestion for popular regulation:

Dear Commission, shipping costs may be the highest hurdle for low cross-border ecommerce. Why not equalize these costs within the EU? Sending a small package 900 kilometers from Munich (South Germany) to Kiel (North Germany) costs 5 €. Sending the same package 150 kilometers from Munich to Salzburg (Austria) costs 9 €. All consumers and the whole ecommerce would love you. Applause will be sure, even by EU opponents. The best way to beat populism is populistic regulation.

Regulation 924: Currency conversion

(mk) The EU Commission's proposal to amend the Regulation 924/2009 on cross-border payments also contains provisions regarding currency conversion. The EU Commission wants the European Banking Authority (EBA) to draft Regulatory Technical Standards (RTSs) that define how PSPs present the full costs of currency conversion services (including the fees of alternative services). For the transition period of 36 months, the EBA is also required to set a maximum amount of all charges allowed. The aim is *"to improve transparency and protect consumers against excessive charges for currency conversion services"* (recital 5).



DCC: A personal experience

A few weeks ago, I bought an online ticket (240 CHF) at the Swiss railway SBB, and paid it with my credit card. SBB offered me alternatively a payment in euro based on an exchange rate of 1 CHF = 0.87256 EUR.

Keeping in mind that DCC could be not the best option as user, I decided to deny the offer. In hindsight it was the best way. My card issuer charged the CHF-amount with an exchange rate of 0.843 and added the foreign exchange fee of 1.75%. However, at the end I saved 3.54 €.

How to realize full transparency of all fees and exchanges rate at the moment of payment as required by the Commission?

Kaufdatum Buch.Datum	Umsatzbeschreibung	VK-Währung	VK-Betrag Kurs	Abr-Währung	Abgerechnet
16.04.18	SBB CFF FFS Ticket Sho	CHF	240,00 S	EUR	202,33 S
17.04.18	Bern CHE		1,186158		
17.04.18	Auslandseinsatzentgelt 1.75%			EUR	3,54 S

Our Comment:

> In a way, the industry has been begging for such a move.

The new rules regarding currency conversion are applicable to all EU Member States. They are targeted, in particular, at Dynamic Currency Conversion (DCC). In a way, the industry has been begging for such a move. While there may have been attempts to establish codes of conduct,[9] the overall impression is that banks, merchants and PSPs have not been all too concerned with the interests of their customers. As the EU Commission notes on page 3 of its proposal:

"Consumers have been complaining about dynamic currency conversion practices in particular. This is because they consider that they lack the necessary information to make an informed choice. As a result, consumers often unwillingly choose the more expensive currency conversion option."

But even this statement seems to provide a rather rosy picture of actual practice. Often, consumers are strongly pushed into using DCC. Not only is DCC the first option offered to consumers. If a consumer chooses the other option, he might be asked whether he really is prepared to take on the exchange rate risk.

This a bit like selling two types of Whiskey, a premium brand and a low price brand, and asking each customer who wants to buy the low-cost brand whether he really wanted to take the health risk. On top of this, to make this example really meaningful we would have to assume that the price tags are barely readable. Small wonder that the EU Commission sees reasons to act.

Thus, there may be strong case for regulation. However, it is not known whether problems in connection with DCC are really quantitatively important. Therefore, in its 2017 Consumer Financial Services Action Plan[10] the Commission announced that *"Before deciding on further action, the Commission will undertake a study to develop a broader evidence base and a better understanding about dynamic currency conversion practices and rates."* Such a study is still missing. At least, it is neither mentioned in the recitals nor in the Impact Assessment. Consequently, the Commission's actions seem to be based on reports from some European countries.[11]

Once the regulation has been passed it will be up to the EBA to come up with draft Regulatory Technical Standards in order to define how to put the transparency requirements into practice. Apparently, the EU Commission expects that agreement on the RTSs and implementation thereafter will take some time. Therefore, the proposal includes a transition period of 36 months. So it may sound a long way off until DCC practices really have to change. However, the EU Commission wants to see change fast. Therefore, the EBA is required to set a maximum DCC fee that applies during the transition period.

> A direct comparison of costs may not be feasible.

Once again the EBA is entrusted with a task where a lot of tricky details matter.

First of all, setting a maximum price is not a thankful task, but at least it will not be valid for very long. Finding a way to make the costs of foreign currency transactions transparent is more demanding, in particular because payment service users should be able to compare the *"costs of the currency conversion service and the alternative currency conversion options, where available, before the payment is initiated"*.[12]

For the card holder, the only practical alternative is to let the card issuer perform currency conversion. However, neither the applicable exchange rate of the issuer nor the applicable fees may be known to the merchant, acquirer or DCC service provider. Thus a direct comparison of costs may not be feasible.

The EBA may end up defining how DCC costs are provided at the moment of transaction and it may consider regulating how issuers make foreign currency fees available. Another option, favoured by the European consumer organisation BEUC, is to prohibit DCC.

DCC can be viewed from two angles. To a certain extent it is an attempt by the acquiring side of the market to raise more revenues from card holders. In practice this often implies pushing customers into making ill-informed decisions that are not in their best interests. This is what the EU Commission has in mind.

But there is also the attempt of the acquiring side to divert income away from the issuing side. Of course, issuers do not like this, in particular because they are under revenue pressure due to falling interchange rates. But the acquiring side is currently hit by ever more scheme fees which may ultimately be seen as a reaction of the card schemes to falling interchange fees. Looked at from this point of view, we are in a classic intervention spiral: regulation, market adjustment, yet more regulation, and so on.

Payment relevance of geo-blocking regulation

(mk) While the amendments to regulation 924/2009 are still under discussion, the geo-blocking Regulation has been published in the Official Journal (on 28 February 2018).[13] It will come into force on 3 December 2018 and it will have implications for the way merchants and PSPs offer payment options to customers and conduct risk management.

The geo-blocking Regulation prohibits discrimination for reasons related to the customer's nationality, place of residence or place of establishment. This prohibition is also applicable to payments. Article 5 rules that "*A trader shall not, within the range of means of payment accepted by the trader, apply, for reasons related to a customer's nationality, place of residence or place of establishment, the location of the payment account, the place of establishment of the payment service provider or the place of issue of the payment instrument within the Union, different conditions for a payment transaction*".

Our Comment:

Unlike the proposal to amend the regulation on cross-border payments, the geo-blocking Regulation is already in place and will have to be implemented by the end of the year. This regulation does not force e-tailers to deliver goods to any destination in Europe. However, if they offer to deliver to one country or a certain range of countries, they have to serve anyone who accepts delivery to those places – irrespective of nationality, place of residence or place of establishment.

A simple risk-management rule will no longer be feasible.

From the point of view of the payment industry, Article 5 is particularly important. As pointed out above, different treatment based on nationality or location of the payment account is not allowed. Thus, a simple risk-management rule like *"direct debit payments only with holders of domestic bank accounts"* will no longer be feasible. But European law makers are aware that this may be problematic. Therefore, they suggest the following solution: *"In the case of direct debit, traders should be allowed to request advance payment via credit transfer before goods are dispatched or before the service is provided."* (recital 33) Fair enough. But merchants and PSPs should be careful since different treatment of foreigners "*should be based only on objective and well justified reasons*" (recital 33).

But anyway, why worry about risks in online payments? Don't forget that there is the PSD2 and there are the RTSs on strong customer authentication which *"reduce the risk of fraud for all new and more traditional means of payment, especially online payments"* (recital 33).

Notes

1 European Parliament resolution of 14 November 2017 on the Action Plan on Retail Financial Services (2017/2066(INI))
2 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 924/2009 as regards certain charges on cross-border payments in the Union and currency conversion charges, Brussels, 28.3.2018, COM (2018) 163 final.
3 https://ec.europa.eu/info/files/180328-study-cross-border-transaction-fees-extension_en
4 Impact Assessment (IA), SWD (2018) 84 final of 28 March 2018 (https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-163_de)
5 See Deloitte-Study p. 70-71.
6 http://europa.eu/rapid/press-release_STATEMENT-17-1590_en.htm
7 Executive Summary of the Impact Assessment, p. 2.
8 See IA, p. 17
9 See, for instance, Mastercard: „Dynamic Currency Conversion Compliance Guide," 2016 or http://dccforum.com.
10 European Commission: Consumer Financial Services Action Plan: Better Products, More Choice, Brussels, 23.3.2017, COM (2017) 139 final.
11 Jean Allix & Farid Aliyev: Dynamic Currency Conversion. When paying abroad costs you more than it should, BEUC, 30.10.2017
12 See the newly proposed Article 3a (2).
13 Regulation (EU) 2018/302 of the European Parliament and of the Council of 28 February 2018 on addressing unjustified geo-blocking and other forms of discrimination based on customers' nationality, place of residence or place of establishment within the internal market and amending Regulations (EC) No 2006/2004 and (EU) 2017/2394 and Directive 2009/22/EC

Should you have any questions or comments please contact:

Dr. Hugo Godschalk (hgodschalk@paysys.de)
Dr. Malte Krueger (mkrueger@paysys.de)

Please, send us your views to:
paysys-report@paysys.de

PAYSYS REPORT IMPRINT

PaySys Consultancy GmbH
Im Uhrig 7
60433 Frankfurt /Germany
Tel.: +49 (0) 69 / 95 11 77 0
Fax.: +49 (0) 69 / 52 10 90
email: info@paysys.de
www.paysys.de

PAYSYS REPORT
May 2018

Layout: cristina dresler | kommunikation+gestaltung

PaySys
Consultancy GmbH

Subscription info:
The PAYSYS REPORT is published 10 times a year in English in electronic format (pdf) and contains about 4-6 pages.
The price is
250 EUR per year (single user license)
500 EUR per year (company license)

To order, please send an email to paysysreport@paysys.de indicating the type of license you wish to purchase and the method of payments (credit transfer or credit card).

PaySys Consultancy is German member of

epca
european | payments consulting | association