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In several EU Member States, acquirers licensed by international four-party schemes are complaining about a continuous price increase for services of the schemes and about the creative introduction of new fee types. Rising scheme fees, at least for acquirers, seem to be evident. Some see this development as a consequence of the Interchange Fee Regulation (IFR), according to which the costs of the acquirer side were reduced at the expense of the issuer side. The question is whether there is a legal or illegal circumvention of the IFR.

Update: Market shares of the domestic card schemes in the EU 2018

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Rising of Card Scheme Fees: Circumvention of the IF Regulation?

(hg) In four-party payment card schemes, the licensed issuers and acquirers usually have to pay fees to the schemes for the overall scheme & brand services, product development and for usage of the processing platform for authorisations, clearing & settlement etc. These payments are usually subsumed under the term "Card Scheme Fees" (CSF)'.

In Europe, the rapid increase in the CSF of Mastercard and Visa is already being publicly addressed by retailer organisations in several Member States (like HDE in Germany and CMSPI in UK). The awareness of CSF has increased in the market after large merchants have concluded IF++ contracts for the acceptance of cards with their acquirers. In these contracts, the CSF are explicitly shown along with the interchange fees and the acquirer margin. In the meantime, the regulators have also become aware of this issue.

The annoyance comes from the merchant side of the card business. The acquirers are complaining about a continuous price increase for services of the schemes and about the creative introduction of new fee types. Some merchant representatives suspect that by changing their pricing policy, the schemes are counteracting the readjustment of the cost burden between both sides of the market by the European Interchange Fee Regulation (IFR 2015). The reduction of the IF caps for consumer cards led to cost relief for acquirers (and indirectly for merchants) and on the other side of the market to a reduction in revenue for issuers (and thus indirectly to an incentive to increase cardholder prices).

An increase in the CSF on the acquirer side in connection with a simultaneous reduction of the net CSF (including any incentives) on the issuing side by the schemes would counteract the regulatory readjustment. This raises the question of whether there is a legal or illegal circumvention of the IFR.

Our Comment:

Some figures

The CSF issue was one of the reasons for the UK Payment Systems Regulator (PSR) to have been carrying out a market review since July 2018:

- *"the fees that card scheme operators charge to acquirers (called "scheme fees") and the rules they set, favour larger acquirers",*
- *"the scheme fee portion on the fees that merchants pay to acquirers is increasing significantly"*[1].

In the meantime, the PSR substantiated the focus of the study in January 2019[2]. The focus is on clarifying the increase in CSF and the extent to which these fees influence the level of MSC. The PSR does not investigate whether the increasing fee burden for the acquirer is justified or not. The development of the CSF on the issuer side is also not analysed, although this question would be interesting for the suspicion of a circumvention of the IFR. First results of this review are expected in the beginning of next year.

The British consultancy CMSPI[3] reports a rise of the scheme fees of Visa Europe for UK merchants. The interpretation of the data reported in table 1 is not straight-forward. But given the cap on interchange fees which became effective in late 2015, the observed shift in the structure of fees must be due to rising scheme fees rather than falling IF. Thus, table 1 confirmes the concern of the PSR.

Table 1: Scheme fees as percentage of the MSC (Visa UK)

% of the total merchant service charges (MSC) Visa UK	2016	2018
Interchange	74%	63%
Scheme Fee	17%	30%
Acquirer margin	9%	7%

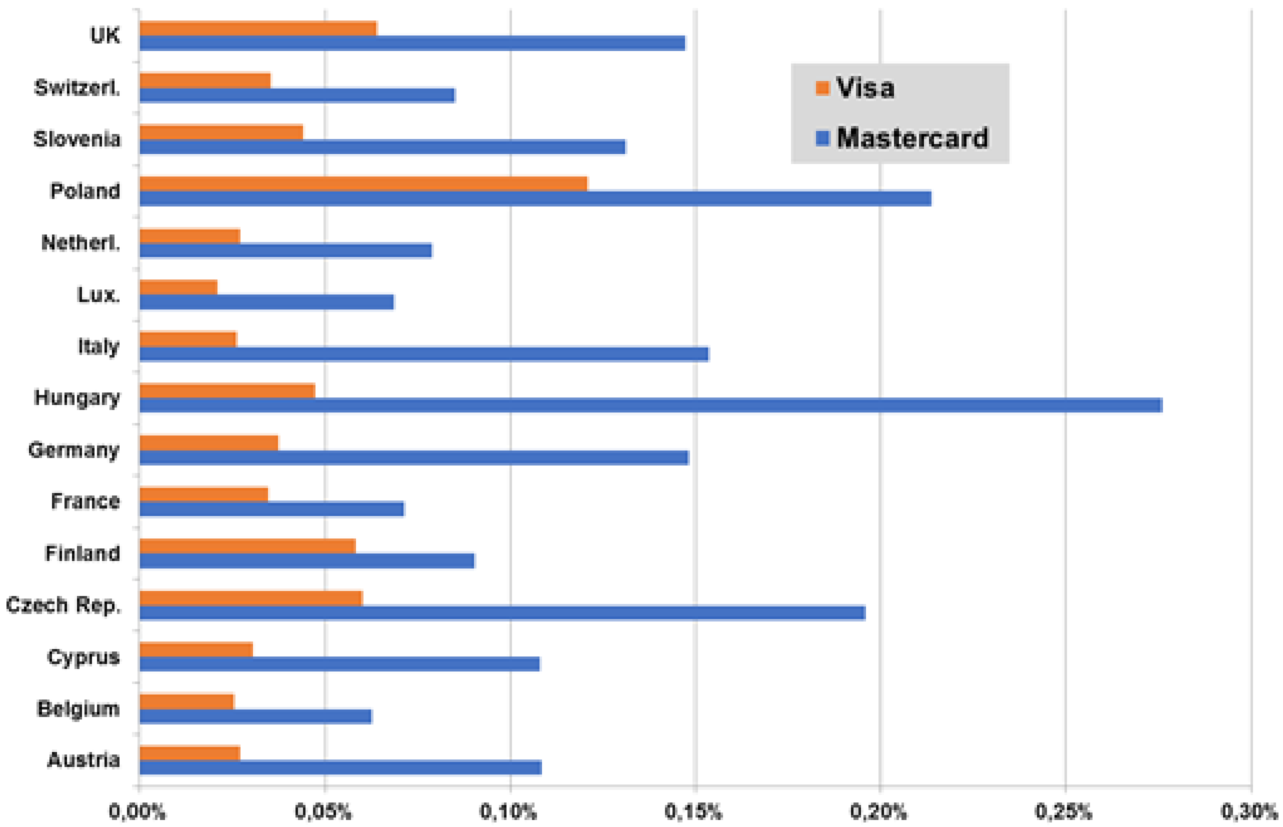
Source CMSPI (2018)

CMSPI estimates an increase in fees of the international schemes at least 2 billion euros per year since 2016 in Europe.[4]

In **Germany,** the critique voiced by merchants is particularly aimed at Mastercard. Based on data provided by a large German retailer, EHI Retail Institute reports a 100% increase in CSF for Mastercard transactions from 0.12% (2015) to 0.24% (2018) in the face-to-face segment (percentages relating to an average value for debit, credit and commercial cards). According to the EHI report, the price increase for Visa in Germany was more moderate in the same period: from 0.09% to 0.15%.

Mastercard in particular has introduced a number of new fees in Germany in recent years. These fees relate not only to processing services, but also to fundraising to promote the German market (e.g. a German development fund and innovation fund). There are no

Figure 1: Indicative Scheme Fees (Mastercard & Visa) in Europe for a face-to-face domestic card transaction, to be paid by acquirers (2018)



Source: SIX Payment Services

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A definition of "scheme fees" is missing in the IFR.

Scheme fees cannot be fees for processing, offered by entities owned by the schemes.

statements as to whether the issuer side is also used to finance market promotion (equally) or whether the issuing side is subsidised with these funds.
Due to the country-specific fees, the CSF within the EU are not identical for each country. See figure 1. According to the results of the analysis made by the acquirer SIX Payment Services, the indicative CSF of Visa for a face-to-face domestic card transaction are generally lower than the fees of Mastercard. The difference is remarkable, 50% or more. One reason for this striking difference may be that European banks lost of ownership of Visa Europe only in 2016. Due to the resulting commercialisation of Visa Europe, there is still some catching up to be done with regard to the scheme fees.

Mastercard's scheme fees show a clear east-west divide. Acquirers in Poland, Hungary and the Czech Republic pay 0.2% or more. So far, outside Germany and the UK, only critical discussions within Austria and Poland have been made known to us. Several reasons are conceivable:

- The IF++ contract (as option besides a blended fee required by the IFR since June 2016) is not common in all countries, at least for large dealers. Accordingly, in these markets there is a lack of fee transparency and thus a lack of sensitivity to this type of fee.
- In other countries - due to country-specific CSF - the increase in CSF is not as evident as in the UK and Germany.
- There are indications that dominant and strategically important acquirers in certain countries are not subject to the standard fee table of the schemes, but have agreed acquirer-specific prices with the schemes.

What do the Scheme Fees include?

According to Art. 9, the IFR requires from acquirers unblending of the MSC. They shall include in their agreements with merchants

"*specified information on the amount of the merchant services charges, interchange fees and scheme fees applicable with respect to each category and brand of payment cards, unless the payee makes a different request in writing*" (Art. 9 (2)).

The merchant services charges and the interchange fees are legally defined, however, a definition of "scheme fees" is missing in the IFR. As a consequence, acquirers are free to consider which fees they subsume in the category CSF. Some of the acquirers consider only processing fees, others are including all payments to the schemes. This could be the reason for substantial differences regarding CSF in the pricing agreements based on IF++ by the acquirers in the same country. Another reason could be the rebates offered by the schemes based on the acquired volumes.

The initial question raised by the PSR (2018) of whether large acquirers continue to enjoy significant competitive advantages through volume discounts seems to be off the table. The schemes are said to have adjusted their fee structures accordingly. This new pricing policy by the schemes was also confirmed in our discussions with acquirers.

However, the absence of a legal definition in the IFR does not mean that a clear definition cannot be derived indirectly, at least theoretically.

According to the definition of a payment card scheme in Art. 2 (16), a scheme explicitly does not include "*any infrastructure or payment system that supports its operation*". This separation of payment card scheme and processing entities of the scheme is required by Art. 7. The rationale behind this separation is the approach of the Commission to break up the former monopolistic processing services of the schemes (authorization, clearing & settlement) for competition. Acquirers (and issuers) should also be able to use these services from other processors.

The schemes did their job, however until now without any of the consequences the Commission had intended. It still seems unattractive for processors to step into this new market. Issuers and acquirers are still using the processing entities, owned by the schemes. Art. 7 remains a dead letter.

However, by definition schemes are not processing entities. Therefore, scheme fees cannot be fees for processing, offered by entities owned by the schemes. If an acquirer were theoretically to use another processing entity, it would be hard to declare these fees as "scheme fees". It is remarkable to see that Visa is using a more consistent definition of "scheme fees" in its annual reporting (see appendix "Visa Europe").

However, the Commission does not follow its own logic. The study on the application of the IFR according to Art. 17 (IFR), which is being carried out by Ernst & Young (Germany), is currently in progress. Results are not expected until the middle of next year. One important topic of this analysis will be data of the *"annualized scheme fees charged to acquiring and issuing financial institutions"*[5].

For this review analysis, the Commission defined "scheme fees" as all fees, explicitly paid by issuers and acquirers to the card scheme - including processing fees! [6]

There is ample scope for legal circumvention by the schemes.

Would the redistribution via CSF from the issuer to the acquirer side be an infringement of the IFR?

Higher CSF for acquirers and lower fees for issuers would counteract the intention of the IFR by rebalancing the overall costs of a card-based transaction from the acquiring side to the issuer side of the market. Would this assumed scheme pricing policy be illegal?

We have to take a closer look at the relevant article 5 of the IFR where the circumvention is prohibited. Article 5 says:

"For the purposes of the application of the caps referred to in Articles 3 and 4, any agreed remuneration, including net compensation, with an equivalent object or effect of the interchange fee, received by an issuer from the payment card scheme, acquirer or any other intermediary in relation to payment transactions or related activities shall be treated as part of the interchange fee."

To prevent circumvention the Commission introduced the concept "*net compensation*" of the issuer as part of the interchange fee. It does not, however, apply this concept the acquiring side. Net compensation is defined as

"the total net amount of payments, rebates or incentives received by an issuer from the payment card scheme, the acquirer or any other intermediary in relation to card-based payment transactions or related activities" (Art. 2 (11)).

The net amount of payments received by the issuer (in a four-party payment scheme) may not exceed the cap of 0.2% for consumer debit card transactions respectively 0.3% for credit card transactions. A card scheme should be considered as "other intermediary". To calculate the net position of an issuer, not only all revenues received from the scheme (e.g. incentives) but also fees **paid** to the scheme (including processing fees) should be taken into account (see recital 31). The Issuer is in a regulatory safe position as long as he does not receive more from the scheme than he pays.

Additional CSF paid by the acquirer to the scheme (e.g. 0.05%), which is reallocated by the scheme to the issuing side (as incentive) is not a circumvention of the IFR as long as the net compensation of the issuer is still below the cap (e.g. 0.3%). See example.

Table 2: Example for a reallocation by CSF

Credit card transaction (IF=0.3%)	Case A	Case B
IF (acquirer to issuer)	0.3%	0.3%
CSF (acquirer to scheme)	0.1%	0.15%
CSF (issuer to scheme)	0.1%	0.1%
Incentive (scheme to issuer)		0.05%
Total CSF (net)	0.2%	0.2%
Net compensation of issuer	0.2%	0.25%

The question is justified as to whether the issuer cannot deduct further costs in relation to his net compensation position. There are no logical reasons why he cannot deduct other costs for processing services not provided by the scheme. Even remuneration paid by the issuer to agents and co-branding-partners could be taken into account for its net compensation position after the ruling of the European Court of Justice of

February 2018 (Amex case)[7]. Anyway, there is ample scope for legal circumvention by the schemes.

The regulated interchange fee is a fee for each card-based transaction paid between the acquirer and the issuer. Circumvention by other fee payments (directly or indirectly through intermediaries) could be prevented by taking into account the net position of both sides: the payee and the payer. The asymmetrical consideration of the net position of the issuer only seems to be a constructional flaw of IFR.

One approach would be to consider the CSF paid by acquirers to the scheme as part of the IF as well. Another idea would be regulation of scheme fees, mandating equal fees for both sides of the market. Both proposals amount to a price regulation of the CSF. It could be seen as "collateral damage", because price regulation never comes alone.

In any case, the CSF should be defined clearly by excluding the processing costs. We will see how the Commission solves this problem in the proposal for the IFR2.

Appendix:
Visa Europe: Increase in operating revenues per transaction since 2017

The revenue recorded by Visa Europe under the heading "operating revenues" in its annual reports, consists (according Visa) mainly of three sources:

- Scheme fees: "*determined by the number of cards issued and the extent to which these cards are used*" (seems to be issuer-only fees),
- Data processing fees: "*determined by each member´s connection to the Visa Europe processing systems and the extent to which these systems are used*" (fees for authorization, clearing, settlement and other activities; levied to issuers and acquirers),
- International fees: "*determined by the extent to which Visa cards issued by Visa Europe customers are used outside of the Visa Europe territories and Visa cards issued elsewhere are used within Visa Europe territories*" (levied to issuers and acquirers).

The figure "operating revenue" is a net position. Rebates and incentives paid back to licensees or other partners are offset against the revenues.

Since 2017, we see a strong increase of the operating revenues per transaction (sales and cash worldwide), generated by a Visa card issued in Europe. Within 2 years the revenues per transaction almost doubled from 3.8 € cents to 7.4 cents. Due to the relatively stable average transaction values (ATV), we see the same development of the revenues in relation to the card expenditure volume. See Figure 2.

One reason for this development is the IFR, according to which schemes in the EU have since June 2016 no longer been allowed to charge fees for transactions with so-called co-badged cards in which another brand (usually the national scheme) is used (Art. 8 (4)). For example, Visa is no longer allowed to levy a fee for a transaction with a co-badged card (Visa and ServiRed) in Spain, if the transaction is made through the domestic ServiRed brand and Visa is not involved. Since then, more than 10 billion transactions generated within domestic schemes can no longer be charged fees by the co-badged schemes. Since these fees were on average lower than the fees for "genuine" Visa transactions, the average fees per transaction increased.

A second reason for the rising operating revenues, put forward by Visa, was the transition of Visa Europe from "*an association to a commercial model*" and the removal of rebates (annual report 2017). Due to the synchronicity of both events (IFR and the sale of Visa Europe to Visa Inc.), it is difficult to speculate on which event has been more important for the observed fee increase.

At least for Visa Europe (figures of Mastercard Europe are not publicly available), fee revenues per transaction increased. Unfortunately, there are no findings as to whether the acquirer side was more affected than the issuer side.

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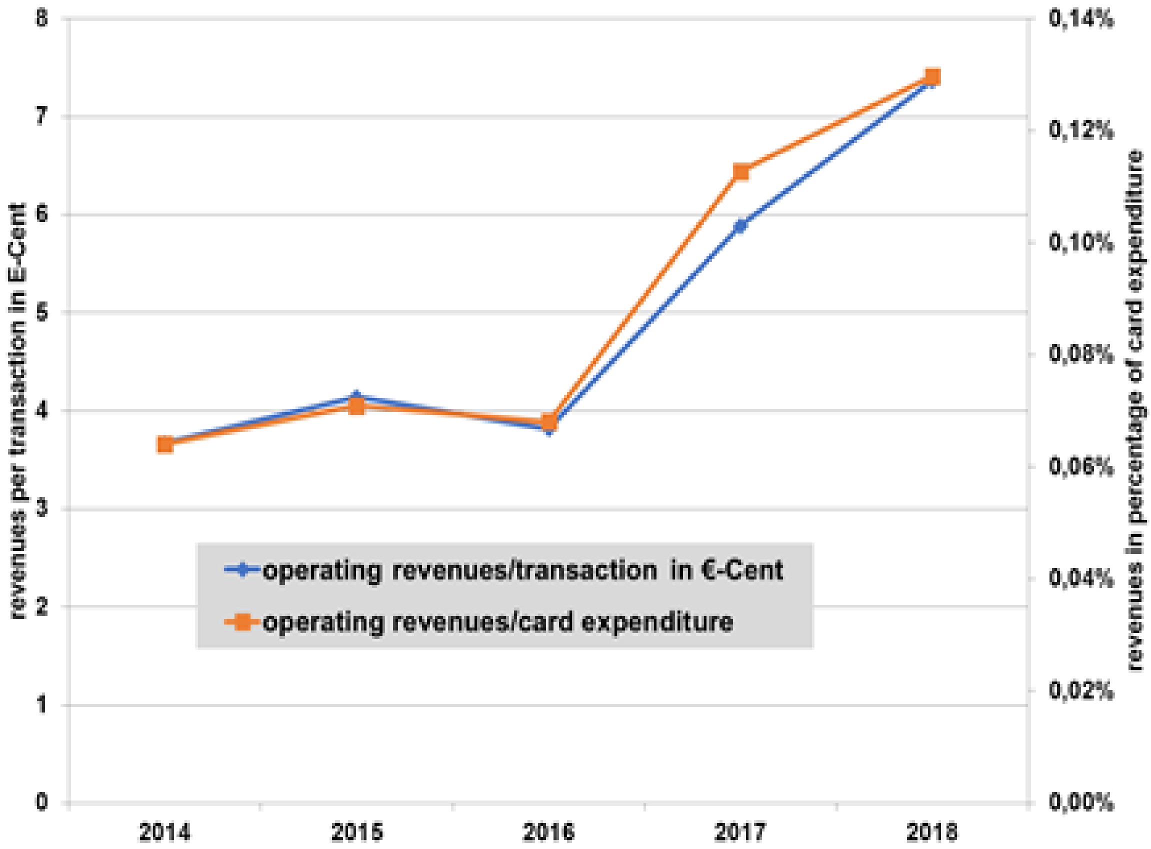
Figure 2: Operating Revenues of Visa Europe (2014-2018)



Source: Annual Reports

Update: Market shares of the domestic card schemes in the EU 2018

In our report issue of May/June 2019 (issue no. 3/4), we discussed the ECB's analysis of market shares "national vs. international card schemes" in the EU. We analysed the market share of the main domestic card schemes in 7 Member States in their home market and the total market share of the domestic schemes as percentage of all card payments generated by cardholders in the EU.

At that time, figures of 2018 were not available. Please find an update of both graphs below based on the new data for 2018. In the ECB statistics, data for UK 2018 are still missing. Therefore, we took the British card payment data published by the Bank of International Settlement (BIS). In contrast to the ECB figures (2014-2017), the BIS volumes of UK card payments are correct (they are excluding ATM figures).

In the seven markets with large domestic schemes, the average share of the domestic schemes has been slightly declining from 74.8% (2015) to 71% (2018) (see Figure 3).

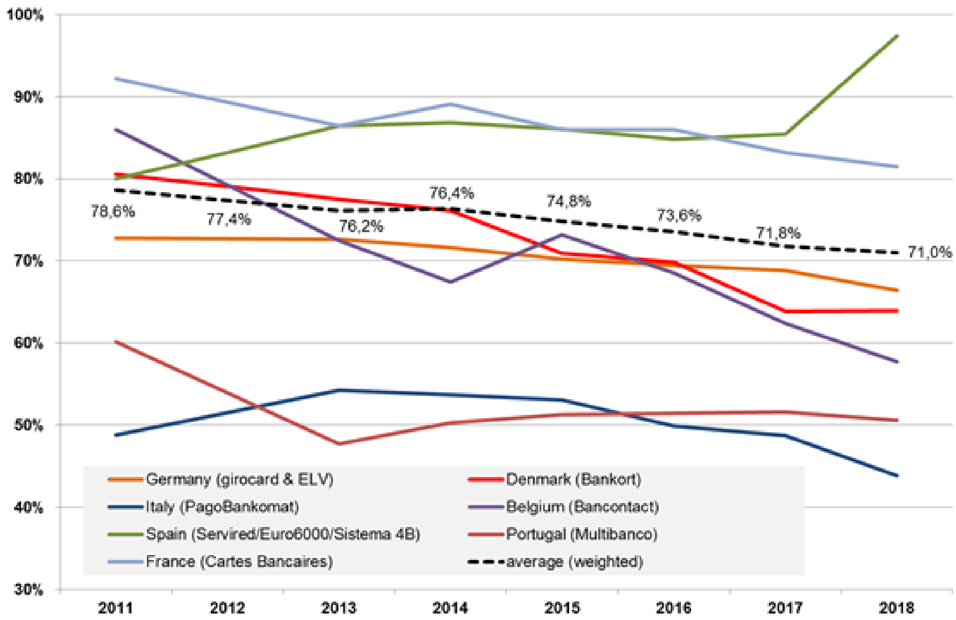


Figure 3: Development of market shares of national schemes as percentage of the total value of payments (sales) by cards issued by resident PSPs per country (2011-2018)

When looking at the entire EU market, we can see that the market share of domestic schemes has remained almost unchanged since 2015, at approx. 36% (see Figure 4).

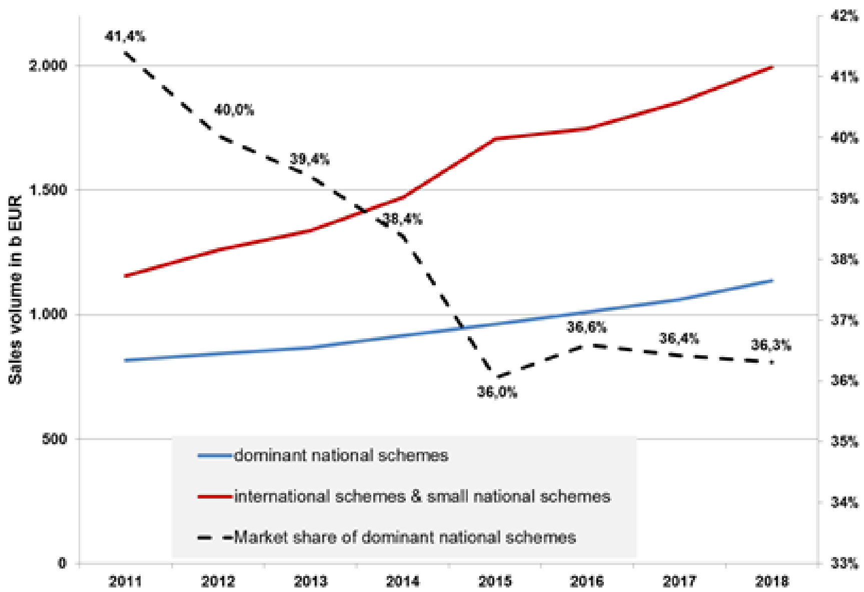


Figure 4: Development of market shares of ICS (incl. small national schemes) and the dominant national schemes, based on the value of card payments (sales) (2011-2018)

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Notes

1 PSR, Market review into supply of card-acquiring services, Draft terms of reference, July 2018, p. 5. See also issue 6 (August 2018) of our report.
2 PSR, Market review into supply of card-acquiring services, Final terms of reference, January 2019, p. 10-11
3 CMSPI, Scheme Fees, The true cost to the industry, 2018, p. 10
4 CMSPI, The €2 billion problem. What can merchants do about scheme fees increases?, in: Payments Intelligence, Autumn 2018, p. 15
5 Call for Tenders (COMP/2018/005), p. 9
6 See Support Study on the application of the Interchange Fee Regulation (COMP/2018/005), p. 7. It is remarkable to see that more definitions mentioned in this document are not compliant with the definitions according to the IFR.
7 See Issue 1 of February 2018 of this report.

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