



PAYSYS **REPORT**

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1. Are smartphones, PCs or even cars payment instruments?

The basic definition of a payment instrument for PSD2 can include a physical device, a payment application or both. This outdated definition, which may only apply to the traditional plastic payment card, is no longer suitable for digital payment applications based on devices that are not offered by the application issuer. The adherence to the old definition by the regulators EBA and the European Commission are currently leading to strange requirements in the area of regulation in the Limited Network Exclusion (EBA) and in the Commission's case against Apple (Pay).

Are smartphones, PCs or even cars payment instruments?

- the confusing definition of payment instrument in PSD2 -

(hg) Currently, the existing EU Payment Services Directive 2015/2366, better known as PSD2, is undergoing an intensive review and evaluation. According to Art. 108, the outcome of this review should be presented by the Commission by 13 January 2021. For several reasons (including the failure of some Member States to transpose within the deadline), the timetable could not be met. The review report is now scheduled for the end of 2022. It is expected that the Commission will present a proposal for a PSD3 in Q1 or Q2 2023.

This new directive is expected to include e-money regulation, replacing the Second E-Money Directive (2009/110/EC). In addition to an external study on the application and impact of PSD2 led by VVA (Valdani Vicari & Associati), the Commission has launched three extensive public consultations with different topics (e.g. open finance and data sharing) and target groups (stakeholders and consumers).¹

Anyone who has been closely involved with PSD2 knows how important the definitions in Art. 4 are in questions of interpretation of the provisions. In the "targeted consultation on the review of the revised PSD2", the Commission would like to

know: *"Do you consider that the definitions in PSD2 are still adequate?"*

The definition of a payment instrument (Art. 4 (14)) naturally plays an important role in this directive. This basic definition reads:

"payment instrument means a personalised device(s) and/or set of procedures agreed between the payment service user and the payment service provider and used in order to initiate a payment order".

This definition, which was already present in PSD1 (2007) and only slightly modified in PSD2, currently leads to strange and curious conclusions in the practice of regulators and supervisors and should therefore be changed in PSD3. We would like to explain this suggestion, which we will introduce into the current consultation process, in more detail below..

Our Comment:

According to this definition, a payment instrument that enables the initiation of a payment order, could be

- a "device" or
- a "set of procedures", or
- a "device" and a "set of procedures"

Based on the use of the term "device"² in PSD2, it should be considered as something physical in this context, while the set of procedures refers to the functionality of the instrument.

PSD2 also refers to card-based payment instruments in recitals and articles, but there is no definition here. However, the Interchange Fee Regulation (EU) 2015/751 (IFR) contains a legal definition of card-based instruments in Art. 2 (20):

"card-based payment instrument means any payment instrument, including a card, mobile phone, computer or any other technological device containing the appropriate payment application which enables the payer to initiate a card-based payment transaction which is not a credit transfer or a direct debit as defined by Article 2 of Regulation (EU) No 260/2012."

How far does one actually want to go with "any other technical devices"?

Smartphone, wearable, PC, on-board units in trucks, car body, storage unit on a server or even the entire server?

At this point, the term "payment instrument" obviously focuses on the characteristic of a payment instrument as a "device": "a card, mobile phone, computer or any other technological device", while the function and procedure is shifted to the term "payment application". According to this definition, the adjective "card-based" has nothing to do with the type of technological device (plastic card or not), but exclusively with the specific functionality of the device as a container of a payment application.

The definition of "card-based transactions" (according to Art. 2(7) of the IFR) confirms this logic:

"card-based payment transaction" means a service based on a payment card scheme's infrastructure and business rules to make a payment transaction by means of any card, telecommunication, digital or IT device or software if this results in a debit or a credit card transaction. Card-based payment transactions exclude transactions based on other types of payment services".

The characteristic of the payment instrument merely as a technical device is also in the foreground elsewhere, such as in the definition of co-badging (Art. 4 (48) of PSD2 or Art. 2 (31) of IFR):

"co-badging" means the inclusion of two or more payment brands or payment applications of the same brand on the same card-based payment instrument.

Here, too, there is a clear distinction between the two levels: "device" and "application(s)".

The meaning of the term "payment instrument" therefore depends on the context: device and/or payment application. In the text of PSD2 we find different interpretations, e.g. Art. 68 and 69 (payment application) or in Art. 70 rather as device. In the recitals, on the other hand, we find confusing and contradictory statements in some places, such as:

"Payment services offered via internet or via other at-distance channels, the functioning of which does not depend on where the device used to initiate the payment

transaction or the payment instrument used are physically located" (recital 95).

The criterion "device" is and will become obsolete

At the "device" level, "card, mobile phone, computer or any other technological device" are mentioned. In a traditional plastic payment card, the carrier (plastic) is directly connected to the payment application. However, the application can also be used without a carrier (e.g. for remote payments in e-commerce). Device and application are provided by the same issuer.

In the case of a chip card, this identity is usually factually given, but not absolutely necessary. The issuer of the chip card with payment application A (e.g. a bank) could make "its" chip available for another payment application B of another issuer (e.g. a retail customer card) as a storage location, which the cardholder can download at a terminal of the retailer. Device and payment application are now no longer a single entity provided by the same issuer. Such models existed in the period of so-called "multi-application" smart cards before the smartphone came on the market.

As a next stage, one could imagine a complete separation: A smart card (or other technical device) provided "naked" (without payment applications) by a neutral third-party technical service provider. The cardholder can download one or more payment apps from different issuers onto this card at will. The issuers of the device and the payment apps are no longer identical. This brings us to the smartphone.

The wallet as an intermediate level

The smartphone manufacturer does not usually offer a payment app itself, not even in the case of Apple Pay, where Apple only provides an empty container (wallet) that can be filled with payment apps from (selected) third parties.

We therefore still see an intermediate stage between device and payment app: the digital wallet as a container that could be offered by a third-party provider, into which various payment apps from different

providers can be loaded (e.g. Google Pay wallet with virtual payment cards from issuer A, B, etc.). The wallet could also be offered by a bank, where only one or more payment apps from that bank can be installed (e.g. that bank's debit and credit cards).

If the wallet contains only one app (such as the Paypal wallet) and is offered as a unit by an issuer of the app, there is no clear separation between the two levels. The terms wallet and app are often used as synonyms in this case.

We will come back to the problem that Apple currently excludes other wallets besides Apple Pay (technically due to blocked access to the NFC antenna) and does not offer the holder free choice in the selection of third-party payment apps in the Apple Pay wallet.

A device on which only third-party payment apps can be installed is not a payment instrument.

Now, the definition of a payment instrument covers the whole gamut from technical device, to wallet, to payment app. How far do you actually want to go with "any other technical devices"? Smartphone, wearable, PC, on-board units in trucks, car body ("car-based payments"), the storage unit on a server in the cloud or even the entire server? There are no limits here to what can be imagined for the future.

However, a consistent application of this hybrid definition of the payment instrument leads to strange results. The smartphone with a payment app offered by a payment service provider (PSP) meets the requirements of the definition of a payment instrument: "a personalised device...and used in order to initiate a payment order."

According to Annex 1 of PSD2, the issuance of a payment instrument is a payment service. The provision of smartphones on which a payment application can be

loaded is not yet considered a payment service by regulators in the sense of PSD2. The same applies to providers of hardware and/or software-based containers. Consequently, either the definition of a payment instrument under Art. 4(14) of PSD2, its PSD2-immanent interpretation or the practice of the supervisory authorities must be wrong.

No payment instrument without an issuer

A PSD2-relevant payment instrument requires an issuer. According to Art. 4 (45), this issuer has a contractual relationship with the holder of the instrument regarding the initiation of payments:

"issuing of payment instruments' means a payment service by a payment service provider contracting to provide a payer with a payment instrument to initiate and process the payer's payment transactions".

If I, as a payer, do not have a contract with the provider of a technical device to initiate a payment, the device is not a payment instrument and the provider is not an issuer of a payment instrument that requires a PSD2-compliant authorisation. Accordingly, a smartphone or a wallet (in the sense of a container) are not payment instruments in the current payment landscape, in contrast to the payment application stored on these devices or in these wallets.

New definition is needed

Back to the definition of payment instrument. Obviously, the PSD1 (2007!) still had the plastic payment card in mind, in which device and application are merged into one unit. Even the virtual card shows that the technical or physical "device" is completely irrelevant. In our understanding, the "set of procedures" agreed between the payment service user and the payment service provider and used to initiate a payment order is not an option, but a criterion and a central requirement for every payment instrument.

Based on the current definition, the device can only be part of the definition if it is inseparably linked to one or more payment applications. In this case, the device and the payment application(s) are issued as a payment instrument by the issuer.

A new definition of "payment instrument", in line with supervisory practice, could read:

"payment instrument means a set of procedures agreed between the payment service user and the payment service provider and used in order to initiate a payment order. This payment application could be contained in a

physical device (like a card, smartphone, tablet etc.) and/or in a personalised digital carrier (e.g. wallet)".

Practical consequences of the flawed definition

Since in supervisory practice no providers of technical devices (smartphones, PCs) and of wallets in the sense of payment application containers (Google Pay, Apple Pay & Co.) currently require permission as payment service providers, the question arises as to the practical consequences of the flawed definition of a payment instrument. I would like to explain the relevance with two examples.

Case 1: Special requirement for issuers of payment instruments in the LNE

Unclear rules for "limited networks"

The PSD2 provides in Art. 3(k) the important exception for so-called "limited network" and "limited range", summarised under the term "Limited Network Exclusion" (LNE). Issuers of payment instruments that can only be used in a limited network of acceptance points (which are not identical with the issuer) (such as city cards, payment cards of a franchise chain across merchants, mall cards, etc.) do not fall under the provisions of PSD2. They do not need a permit and are not obligated parties under money laundering law.

The same applies to payment instruments that can only be used to purchase a very limited range of products or services ("limited range"), e.g. fuel cards, lunch cards, etc.

As the requirements according to Art. 3(k) are interpreted and handled differently in the member states, the European Banking Authority (EBA) adopted guidelines in February 2022.³ These LNE guidelines, which will apply from June 2022, are now to be adopted by the national "competent authorities" (CA) as far as possible according to the principle of "comply or explain".

One requirement (1.7.) reads:

"Competent authorities should take into account that a single card-based or other means of payment cannot accommodate simultaneously payment instruments within the scope of PSD2 and specific payment instruments within the scope of Article 3(k) of PSD2."

The puzzling step of the "means of payment".

Now it gets complicated. Apparently, the EBA envisages a further stage in the form of an unfortunately undefined "means of payment", which can accommodate

several payment instruments, which - like a Russian dolls - can then contain payment applications in a next stage. However, this stage does not exist.



Against this background, the new term "(card-based) means of payment" used by the EBA in the LNE Guidelines is difficult to interpret. Obviously, a single (card-based) means of payment can accommodate one or more payment instruments. Interpreting a means of payment as a **device** means that the means of payment is not a physical device or digital carrier. If one interprets a payment instrument only as a **payment application** ("a set of procedures"), one could interpret a payment instrument as a device or carrier. However, this interpretation contradicts the current legal definition of a payment instrument.

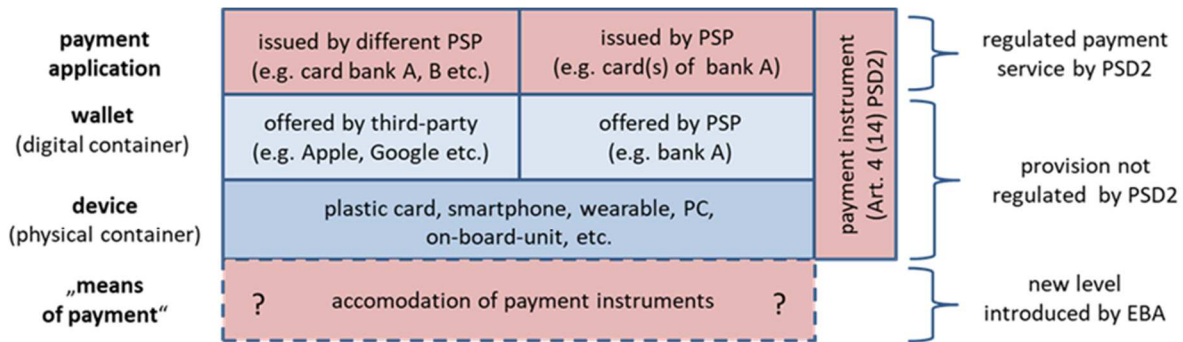
The German Federal Financial Supervisory Authority (BaFin) has published its opinion that the term "means of payment" as used in the EBA guidelines should be interpreted as a "carrier" (without specifying whether physical and/or digital). A card and a wallet are given as examples.⁴

Consequences of the contradictory definitions

If one assumes that the EBA actually also interprets the term "means of payment" as a physical device and/or digital carrier of payment applications, this view has significant consequences.

The restrictions of the LNE Guidelines relate to payment instruments. The respective issuers must comply with these restrictions in order to benefit from the LNE. In practice, only issuers of payment instruments in the sense of payment applications are subject to PSD2, but not issuers of physical or digital devices and carriers.

According to Art. 1.7 of the LNE Guidelines, the issuer of an LNE payment application must now ensure that its payment instrument (in the sense of a payment application) is not hosted by a device/carrier that also contains a regulated payment application. As a rule, issuers can only ensure this if they also provide a specific device and/or carrier for their payment application. At



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Figure 1: The different levels of the payment instrument

the same time, they must technically and contractually prevent the customer from loading a regulated payment application onto this device or carrier.

If **physical devices** fall under "other means of payment", LNE payment instruments cannot be offered as digital payment apps that can be loaded onto a smartphone, tablet or PC if these devices cannot be controlled by the issuer with regard to the use of other third-party payment apps. The bottom line is that LNE payment apps can practically only be made available to consumers on monofunctional plastic cards or other devices (e.g. wearables) that are also issued by the issuer. An absurd and not very consumer-friendly result.

If only the "**digital carrier**" level falls under "other means of payment", Art. 1.7 leads to the result that LNE payment applications can only be loaded as a proprietary wallet of the issuer and not in third-party carriers (such as Apple Pay).

The background to this requirement is presumably to protect the consumer, who seems to be overwhelmed with two differently regulated payment apps on one card (e.g. a Mastercard with an additional fuel card app), in a wallet or a smartphone (or even PC?).

But it is in contradiction to the IFR, in which, in contrast, one assumes an enlightened and self-confident

consumer who is trusted to choose between two payment apps at the POS in the case of a co-badged card.

In practice, however, cardholders do not use this option at the POS. Are they really overburdened or do they rather not care which brand they use?

Case 2: Co-badged digital wallets and action against Apple

A two-pronged approach by the EU Commission

The Commission is currently taking competition law action against Apple (case AT. 40452). At the beginning of May 2022, the Commission sent a "Statement of Objections" regarding the anticompetitive practice regarding Apple Pay.⁵ The accusation is that the company is technically preventing the development of competing payment wallets for its iPhones and iPads in order not to jeopardise its own wallet Apple Pay. For alternative wallets, the access to the NFC antenna necessary for contactless payments is blocked. The Commission's action is justified under competition law (infringement of Art. 102 of the TFEU). The competition law assessment of this case is left to the competition experts.

Interestingly, however, the Commission has also been pursuing the approach of using the Interchange Fee Regulation (IFR 2015) to prevent this practice by Apple

for some time. As we will see in a moment, the definition of a payment instrument, which in our view is flawed, also becomes very important here.

In its "Report on the application of regulation (EU) 2015/751 on interchange fees for card-based payment transactions" (June 2020)⁶, the Commission also transfers the legal provisions regarding "co-badging" of plastic cards to wallets and smartphones. It sees greater relevance here than with plastic cards, for which the co-badging requirements of the IFR have in reality fizzled out without effect.

Co-badging in the Interchange Fee Regulation

Payment instrument holders (consumers) have the right to install two or more different payment applications on a card-based payment instrument (Art. 8 (2)). This right requires that the PSP offers this co-badged product and that the consumer qualifies for the use of both payment applications (e.g. for the application of the credit card alongside that of the debit card).

In the classic plastic card world, this provision has not yet caused any issuer sleepless nights and the bank customer is also likely to be quite indifferent to this right of choice in practice. This could change if the plastic card is replaced as a payment instrument (in the sense of a device) by a wallet or a smartphone. In anticipation of this, the Commission writes: "*The rationale for consumers to request such co-badging is more obvious for mobile wallets.*"⁷ But now the question arises in which cases consumers can request this from their PSP.

The Commission sees two cases: "*...it prescribes to allow to effectively choose*

- (1) which payment application to upload on a mobile wallet and
- (2) which wallet to upload on a smart phone."

This obviously addresses three different levels: Payment application, wallet and smartphone. However, the consumer's right of choice vis-à-vis the PSP according to Art. 8 of the IFR only refers to payment applications (or payment brands). Apparently, the second case refers to a wallet as a "digital carrier"⁸. Does the EU Commission want to get at Apple with this? Consumers would then have the right to another wallet on their iOS devices. However, there is no such claim: the wallet itself is not a payment application and Apple is therefore not a PSP against which the consumer can make a claim in the sense of Art. 8 (2) of the IFR.

The first blow against Apple

The Dutch competition authority ACM also wanted to solve the problem of NFC access for competing wallets via the IFR first in December 2020 (without explicitly naming Apple).⁹ Only after a few months did it realise in July 2021 that you cannot solve this problem with the IFR.¹⁰ However, ACM believes that the IFR would work if competing wallets were available on the smartphone.¹¹ These, however, do not exist on the iPhone. In the Netherlands, more than 30 banks and other PSPs currently offer their payment apps for the Apple Pay Wallet.¹² I would say: sufficient choice and competition at the payment app level, no competition at the wallet level, at least on Apple devices. Application providers rely on the digital container Apple Pay for the iOS smartphone. The ACM case came to nothing.

Co-badging and competing wallets

Would the consumer's right to choose as set out in the IFR apply if there is another competing wallet on the smartphone besides Apple Pay? The Commission and the ACM believe so. However, this thesis does not stand up to scrutiny.

The IFR is a blunt weapon in the Apple (Pay) case.

Firstly, the definition of co-badging presupposes that it is about payment applications that are installed on the same card-based payment instrument. At wallet level, it would therefore have to be the same wallet: Either the Apple Pay Wallet or a competing wallet. Art. 8(2) of the IFR therefore does not help against the lack of a competing wallet on an Apple device.

Secondly, the consumer and holder of a payment instrument has a claim under Art. 8(2) of the IFR against the issuer if that issuer issues a co-badged payment instrument (here in the sense of a device) with two or more payment applications. The device can be a plastic card or a wallet (theoretically also a smartphone or even a PC) issued by the issuer. The IFR requires here that the device is also provided by the issuer of the payment

applications. In this case, a claim against the issuer could be derived.

However, a device on which only third-party payment applications can be installed is not a payment instrument and therefore its issuance is not a payment service subject to authorisation under PSD2.¹³ The consumer and owner of the device (wallet, smartphone, etc.) has no claims against the device provider regarding the payment applications, as the device provider does not issue any payment applications. Nor can she or he demand that the issuer of the payment application install the app on a third-party device.

European Commission at an impasse

As we noted in our PaySys Report No. 8-9 (2020), the IFR is a blunt weapon in the Apple case. Yet the Commission continues to pursue this strategy although it has led to an impasse. It wants to collect further data here

*"on the rights of consumers to choose payment brand and payment application for mobile payments both on their wallets and at the point of sale, and the possible impact on such choice of technical restrictions such as limited access to the NFC infrastructure of mobile devices."*¹⁴

This data is now part of an analysis tendered by the Commission in spring 2022:

*"the technical or other restrictions preventing the effective implementation of the choice of payment application to be inserted on the payment instrument (i.e. co-badging) (for instance, extent to which user requests are followed through) for digital wallets or wearables"*¹⁵.

Now, of course, there is no harm in carrying out this market analysis in a large number of member states. As a rule, however, it will not be a question of violations of the IFR.

The flawed definition of a payment instrument thus leads to confusion and should be urgently revised. The EBA also advocates a revision in its contribution to the PSD2 review.¹⁶

"The EBA is of the view that the current definition of a 'payment instrument' requires further clarification since it leaves too much room for interpretation. In particular, it is not clear what is to be considered a payment instrument and what the specific features of a payment instrument are. In terms of specific examples, it is not clear whether a mobile phone or a computer can be considered as a payment instrument." (p. 13)

The decisive factor is the payment application. The physical or digital device or carrier that hosts the applications is irrelevant, unless the issuer of the payment application offers the device in a technically inextricable unit with the application.

In my opinion, there are no constellations in today's market in which a mobile phone or a computer are payment instruments. Otherwise, the permission to issue payment instruments (according to Art. 4 (45) of PSD2) would have to be extended to the providers of these devices. Hopefully, this will not happen in PSD3.

The analysis shows how important a meaningful definition of the term "payment instrument" is. There is an important task for PSD3 here. As far as the "Apple case" is concerned, payment law is a blunt weapon here. The EU Commission should rather rely on competition law.

Notes

- 1 https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13331-Payment-services-review-of-EU-rules/public-consultation_de sowie https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13331-Payment-services-review-of-EU-rules/F_en
- 2 Only at this point in the respective national language text of the PSD2 in some member states is the word "device" not translated literally or in the correct sense, but with "instrument", as for example in the German and Dutch translations. Due to this translation error, the definition problem discussed here is presumably not evident in these jurisdictions.
- 3 <https://www.eba.europa.eu/regulation-and-policy/payment-services-and-electronic-money/guidelines-limited-network-exclusion-under-psd2>
- 4 See BaFin, Die Zeit läuft, 19.04.22 https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2022/fa_bj_2204_EBA-Leitlinien_Bereichsausnahmen.html
- 5 https://ec.europa.eu/commission/presscorner/detail/en/IP_22_2764
- 6 https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1217
- 7 Report on the application of regulation (EU) 2015/751 on interchange fees for card-based payment transactions" (June 2020), p. 15
- 8 Accordingly, the wallet in the 2nd case can only be understood in the sense of a payment application, but not as a container of different payment applications. In one sentence, the Commission uses two different interpretations of the term "wallet". This is quite misleading.
- 9 <https://www.acm.nl/en/publications/acm-launches-investigation-users-freedom-choice-regarding-payment-apps-smartphones>
- 10 <https://www.acm.nl/en/publications/closure-investigation-payment-apps-confirms-need-new-rules>
- 11 *"The IFR can only be used if there is a choice between different payment apps. That choice currently does not exist in the Netherlands. In other countries, where competitor payment apps do exist, the IFR may be applied".* ACM mistakenly uses the term "payment app", but - according to the context - means the wallet. ACM says that banks in the Netherlands often no longer offer payment apps for smartphones. However, since most banks offer digital card apps that can be used, for example, via Google Pay or, to some extent, via Apple Pay, ACM is obviously referring to the banks' insufficient offer of proprietary wallets with their own payment apps.
- 12 <https://support.apple.com/de-de/HT206637>
- 13 The EBA rightly writes *" the services related to operation of a digital wallet which are of technical nature, and do not constitute a payment service and, therefore, do not require authorisation."* (EBA, Opinion of the European Banking Authority on its technical advice on the review of Directive (EU) 2015/2366 on payment services in the internal market (PSD2), EBA/Op/2022/06, 23 June 2022, p. 13.
- 14 Report on the application of regulation (EU) 2015/751 on interchange fees for card-based payment transactions" (June 2020), p. 15
- 15 European Commission, Tender Specifications, Study on New Developments in Card-based Payment Markets, Including as Regards Relevant Aspects of the Application of the Interchange Fee Regulation, Call for tenders COMP/2022/OP/0002, p. 11-12.
- 16 European Commission, Tender Specifications, Study on New Developments in Card-based Payment Markets, Including as Regards Relevant Aspects of the Application of the Interchange Fee Regulation, Call for tenders COMP/2022/OP/0002, p. 11-12.

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