



PAYSYS REPORT

Issue 10 - December 2016

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EU Regulators Must Deliver on Credit Transfer Consumer Redress

(written by our guest author Peter Jones)

We invited Peter Jones of PSE Consulting (our British EPCA-member) as guest author for his views on redressing credit transfers

Peter Jones, Managing Director, has over 35 years business and IT experience, 4 with a major European retailer (C&A Brenninkmeyer), 17 with a UK clearing bank (Royal Bank of Scotland) and 23 as Director and owner of PSE Consulting. He is from a processing and IT background and has led and managed major development projects relating to payments systems.



The Credit Transfer is the workhouse of the EU's electronic payments. Barely a week goes by without an announcement of new uses. Recent developments include realtime SEPA credit transfers (SCTs), payments initiation and sev-

eral new payment products based on the credit transfers common simple mechanism. But all is not well with our beloved credit transfer! Many suggest the EU's regulators are sleepwalking around the credit transfer's failure to offer Citizen Europe the level of consumer redress now expected of modern payment instruments!

Most, consumers are probably unaware of their exposure to risk and lack of redress when using new and seemingly low cost 'Alternative' forms of payment that

have rapidly gained traction across the EU, often developed by the non-bank and Fintech sector and built on the traditional credit transfer.

Lack of redress is not surprising for the credit transfer was never designed with modern retail payments in mind. Its 60-year-old roots are in cash and cheque displacement supported by the interbank Automated Clearing House (ACH) payments mechanisms. Finality of settlement and no repudiation were core features of the early credit transfer used for business to business payments and electronic

payrolls. Today, across the EU, once a credit transfer is authorised, the payment is more or less absolute. There is little the consumer can do to obtain return of funds fraudulently obtained or even erroneously transferred to the wrong individual.

Our Comment:

So, what is the market telling us? There is growing evidence in some markets of consumer complaints over banks' refusal to refund transfers as a result of account intercepts when making very high value purchases. Similarly, in others, many consumers are blocked after using credit transfers to pay fraudulent eCommerce merchants even though their bank holds the fraudster's account.

Contrast the credit transfer process with card based payments and it is obvious that there is an enormous difference. Card payments have Chip and PIN, secure online authorisation and are risk checked and monitored for merchant and cardholder fraud. Cards allow consumers to chargeback disputed transactions and have funds returned in the event of merchant fraud and bankruptcy. In some countries issuers also guarantee full refunds for faulty goods and services. Credit transfers offer none of these features. Too often banks reply 'caveat emptor' to the poor consumer who's paid away funds to a vanishing corporate fraudster.

Unfortunately, it's not just simple credit transfers that offer no redress. For many years, the card business has looked on with concern at the proliferation of new payment products based on the credit transfer. Most countries now have mobile P2P payments based on the credit transfer. Many alternative payments use ACH infrastructure for eCommerce and for direct to merchant account top ups. Across Europe there are 30+ such payments methods, all operating with the minimum of consumer redress. Regulators in national markets, and at an EU level, have failed to recognise these limitations. Many hoped the PSD2 would close

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Some suggest that it is the fault of bank and non-bank product designers who lack the long experience of card retail payments. Often, within banks, electronic payments and cards operate in silos with little communication and cross fertilisation of ideas. As credit transfer based payments have developed, the electronic payments teams have given building of consumer redress features low priority to reduce costs and enable speed to market.

Similarly, Fintech entrepreneurs assume that because they are using a traditional bank payment method it must be fit for purpose. As a consequence, consumers across the EU are exposed to unknown risks, cheats and fraudsters. Only banks have the capacity and the tools to check that new merchants and corporate accounts are not fraudulent and to block their activities.

Some banks are reticent and quite a few complacent. Their customers and the Fintech sector want low cost and simple transfers but the process of adding card-like controls and guarantees is complex and requires substantial investment and resources to deliver. However, there is no doubt that first mover banks who offer modern redress features will undoubtedly win the competition for new customers.

Many hoped that the UK Payment Systems Regulator (PSR) investigation initiated by the Consumer Association (Which) in September 2016 would trigger DG Competition and Markets or the ECB into an EU wide investigation. However, consumers have once again been disappointed. In mid-December 2016, the PSR

“let the banks off the hook. The outcome for people is unfortunately they will continue to be scammed out of millions of pounds. We need swift action and not see this kicked into the long grass in the second half of 2017” said Which in response to the PSR's action plan.¹ The PSR blandly proposes that banks must do more to prevent scams happening in the first place must produce better data on fraudulent schemes and react quicker to help recover consumer losses. But most importantly it did not recommend banks adapt card redress practices and become legally liable for any financial loss.

So, no radical change in the UK to set an EU benchmark. As a result we may find Citizen Europe in the strange position of having strong regulations (PSD2, technical requirements of the EBA) with respect to instruments such as payment cards that already provide a high degree of protection for users, and no regulation of instruments that provide no protection at all.

“Still crazy after all these years”² (10 years of PaySys-Report)

(mk) 10 years ago, we started this newsletter. This provides us with a welcome opportunity to look back at a turbulent period in the world of European card payments. In November 2006, when the first edition appeared, the Dutch still had their domestic debit card scheme, PIN, and they were contemplating keeping it for many years to come. Visa declared its plans to go public (only a few months after MasterCard's successful IPO) and the ECB's Gertrude Tumpel-Gugerell

was hoping for “at least another European scheme” (in addition to Visa and Mastercard). What has happened since? The Dutch abandoned PIN and opted for Maestro, the ECB has become silent on the topic of a European card scheme and Visa and Mastercard are successfully ploughing the payment waves.

Our Comment:

Since 2006 the evolving payment landscape has supplied us with an unending flow of material for our newsletter. Some of the topics have come up again and again, the most important ones being

- Interchange fees
- Co-badging issues
- Application selection
- The European card scheme
- Access to schemes and to accounts
- Consolidation within the industry
- SDD and SCT
- Surcharging
- Data (in particular problems with official data).

Many of these topics were regulation-driven and it does not seem to be an exaggeration to characterise the payments business as a compliance business.

Payments touch on a surprisingly large number of issues that are interesting for regulators:

- completion of the common market,
- consumer protection,
- data protection,
- anti-money-laundering and anti-terror finance,
- tax avoidance and black market activities,
- systemic risk,
- efficiency considerations,
- anti-trust,
- governance,
- innovation.

To be sure, payments have always been regulated. But in the past, regulation was much more limited. Moreover, a lot was simply covered by general banking regulation. This is no longer true.

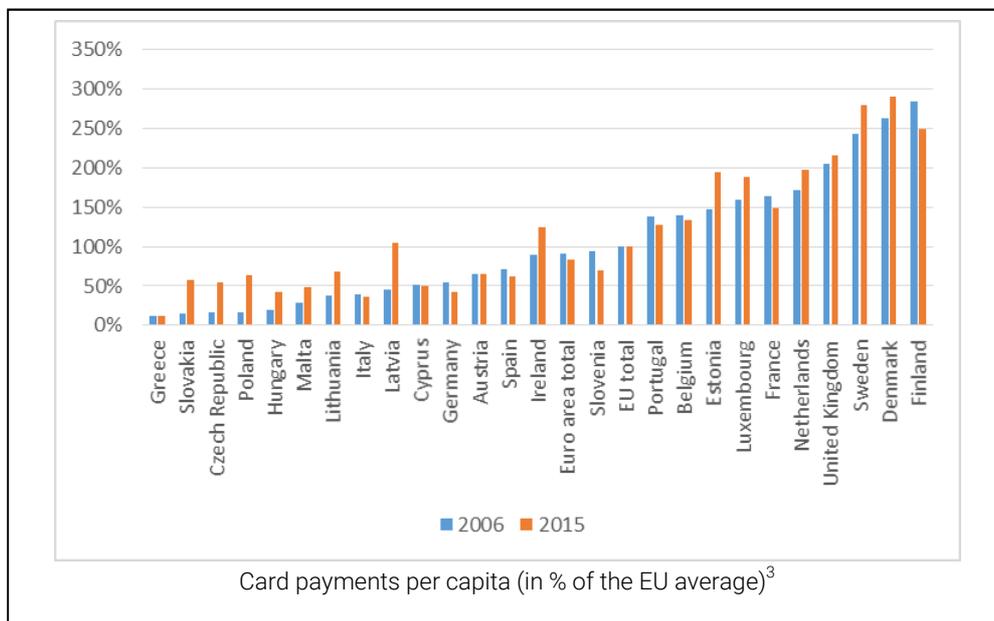
There is an increasing number of specific payment regulations (the most important being the PSD2) and there are more and more other regulations with very specific implications for payments (for instance, AML regulations or data protection regulation). Central banks, which always have been active in wholesale payments, have increasingly looked at the retail-side of the payment sector. In fact, the “ECB may make regulations, to ensure efficient and sound clearing and payment systems”.⁴ Efficiency – that is a worthy goal. But if the regulator is in charge of efficiency – what is the task of the market?

Anti-trust policy has been another important driver of the payment market. While it is true that there were already anti-trust cases in the 1980s, it is fair to say that the year 2000 formed a kind of watershed. In the year 2000, the Cruickshank Commission published its banking report⁵ which came up with a long list of complaints. It received a lot of attention in the UK and abroad. The Cruickshank Report triggered an investigation of UK interchange fees by the OFT (Office of Fair Trading). In the same year, the Australian regulator initiated a series of investigations and regulations of the card market that has still not come to an end. Finally, in the year 2000, the EU Commission sent Visa International a Statement of Objections regarding interchange fees. In the following years, the EU Commission investigated first Visa’s and then MasterCard’s business practices. After a string of anti-trust decisions, the European Commission finally proposed

a Regulation on interchange fees which was adopted in 2015.⁶ Will this be the end of the “European Interchange Saga”?

The “interchange war” may not be over.

Don’t bet on it. When the EU Commission proposed 0.2% for debit cards and 0.3% for credit cards, retailers were still not satisfied. Needless to say, card schemes are not satisfied either. “Innovations” in acquirer fees can be seen as a means to increase the overall level of fees on the acquiring side. Thus, the “interchange war” may not be over. In fact, ambiguities in the definition of interchange may be one of the triggers for further conflicts over interchange fees.



But in the world of cards, we still have “domestic” schemes.

The ECB has become silent on the topic of a European card scheme.

In European payments, “SEPA” has been the big thing since the early 2000s. Over the years, the regulatory framework and some of the most important payment instruments such as credit transfers and direct debits have, indeed, become European. But in the world of cards, we still have “domestic” schemes. The “European Card Scheme” or better “the lack of a European Card Scheme” has been a frequent topic in this newsletter and it looks as if this topic is going to accompany us for quite some time yet. When considering EU-wide issuance, at the moment, Amex is the third such scheme. As far as EU-wide acceptance is concerned, Amex, UnionPay and JCB are competing for the third rank.⁷ Big European schemes like Cartes Bancaires or girocard are mainly confined to their respective home countries and have to be considered “domestic schemes”.

Domestic forces can also be noted elsewhere. When it comes to access to accounts, there is talk of “domestic APIs”. In the field of instant payments there are a number of “domestic” schemes. EBPP solutions are still “domestic”.⁸ Existing instant payment solutions such as Swish (Sweden), FasterPayments (UK) or BlueCash and ExpressElixir (Poland) have all been developed on a domestic scale (maybe to be exported later on). Finally, payment habits still diverge strongly between member states so that we can still speak of distinct payment cultures within Europe. To be true, there has been some conversion. When comparing card transaction per capita in 2006 and 2015, the spread has become a little narrower. However, this is mainly due to a catching up effect with respect to eastern European countries, in particular, Slovakia, Czech Republic, Poland, Latvia and Lithuania. These countries have pulled the group of “card laggards”

closer to the average. But when looking at some of the large continental European markets, Italy, Spain and Germany, it becomes evident that these countries remain below average and have even fallen further behind.

“Applications selection at the POS” (AS) has been a topic for a long time. Repeatedly, we have pointed out that AS is strategically of utmost importance. When interchange fee levels are diverging, AS sets the issuing side, favouring high interchange fees, against the acquiring side, favouring low interchange fees. Now, with the regulation of maximum interchange fees, AS will become the battlefield between schemes.

Regulation has been a dominant theme of the past years and it is likely to remain of utmost importance in the future. There may be some shift in emphasis, however. In the past, regulation focussed on customers’ funds. From the point of view of regulators, it was important “where the money is”. Thus a PSP who was touching customer funds was regulated, a PSP who was not in possession of customer funds was not regulated (or only lightly). With the PSD2, a second aspect has become important, customer data. This aspect is likely to become even more significant in the future. Regulators will keep an eye on who stores data, who has access, how are data protected and what can be done with data. In all likelihood, these aspects will keep the “regulatory machine” busy.

Good news for us! Regulation (and innovation) are likely to provide enough material to keep the PaySys Report afloat for at least another 10 years.

Notes

- 1 See <https://press.which.co.uk/whichstatements/has-let-the-banks-off-the-hook-which-response-to-the-payment-systems-regulators-response-to-its-super-complaint-on-bank-transfer-scams/>. The PSR's response to the super-complaint of Which can be found under <https://www.psr.org.uk/psr-publications/news-announcements/which-super-complaint-our-response-Dec-2016>
- 2 Paul Simon (1975).
- 3 Source: European Central Bank and on calculations. We would like to remind our readers that the ECB figures cannot always be relied on. In particular, year to year changes for particular countries have to be interpreted with care. See "ECB card payment statistics: The missing 792 billion Euro" in the April 2015 edition of this newsletter.
- 4 "Art. 22 of the Statute of the European System of Central Banks and the European Central Bank. Art. 3.1 of the Statute is somewhat less demanding "to promote the smooth operation of payment systems."
- 5 See Don Cruickshank (2000): Competition in UK Banking. A Report for the Chancellor of the Exchequer, HM Treasury, March.
- 6 In the US, as well, interchange regulations have been enacted. In July 2010, Congress passed the Financial Stability Act which includes far-reaching provisions with respect to card payments, in particular debit card payments. See Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), enacted into Law on July 21, 2010. Sec. 1075 (known as "Durbin Amendment").
- 7 UnionPay Company News: Two million merchants in Europe accept UnionPay cards, 02.09.2016. (<http://www.unionpayintl.com/en/enaboutUpi/ennewsCenter/encompanyNews/3014048.shtml>).
- 8 The Euro Retail Payments Board (ERPB) has diagnosed „a high degree of domestic 'centricity' and a lack of interoperability". See ERPB: Report from the ERPB Working Group on E-invoicing solutions related to retail payments, ERPB Meeting 28 November 2016, p. 3.

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