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Exemptions from Strong Customer Authentication

(mk) Article 97 of the PSD2 mandates strong customer authentication (SCA) and Article 98 rules that the European Banking Authority (EBA) shall, inter alia, specify exemptions from SCA. In December 2015, the EBA published a discussion paper containing its views on this topic. There were 118 responses of interested parties and in August 2016 the EBA published a first draft of Regulatory Technical standards (RTS). The consultation closed in October 2016. This time there were over 200 comments. In these comments the market voiced major reservations. Some of these were subsequently taken on board. However, the final version of the RTS published in February 2017 still raised fundamental criticisms. Market participants wrote to the EU Commission requesting further revisions and clarifications of the RTS. One of the two most contentious points in this process is the definition of exemptions from strong customer authentication (the other being access to accounts).

The EBA has defined such exemptions from SCA for

- low value and contactless transactions
- transport fares and parking fees
- recurring payments
- trusted beneficiaries

- low risk transactions (based on transaction risk analysis).

The exemption for low risk transactions only applies if the fraud rate lies below certain reference rates.

	Reference Fraud Rate (%) for:	
ETV*	Remote card-based payments	Credit transfers
EUR 500	0.01	0.005
EUR 250	0.06	0.01
EUR 100	0.13	0.015

Reference fraud rates proposed by the EBA

* ETV: Exemption Threshold Value; Source: EBA: Final Report. Draft Regulatory Technical Standards on Strong Customer Authentication and common and secure communication under Article 98 of Directive 2015/2366 (PSD2), 23 February 2017, p. 25.

Moreover, after the intervention of the EU Commission, the EBA has agreed to exempt B2B payments - "payment transactions, where dedicated payment processes and protocols that are only made available to payers who are not consumers are used" - if the fraud rate is below 0.005%.[1]

The idea of using reference rates has its merits. In fact, we have regularly proposed the definition of outcomes such as acceptable levels of fraud rather than means of reducing fraud, such as SCA.[2] Defining outcomes leaves it to market players to think about the best ways to achieve these outcomes. However, as will be discussed below, the devil is in the details.

Our Comment:

The PSD (and, of course, also the PSD2) has two faces. On the one hand, there are many provisions regulating the payments business. These regulations are part of banking regulation (in the wider sense). On the other hand, it has a lot of elements that can be subsumed under the heading "consumer protection". The issue of security and fraud prevention touches both aspects.

European actions with respect to payments are frequently motivated by hinting at rising fraud (not always on an empirically sound basis) and the resulting lack of consumer trust. According to the EU Commission, lack of consumer trust translates into an underuse of the digital economy.[3]

"These crimes create significant costs to the EU economy, as they result in a reluctance of users to fully engage with the digital economy."

The task of defining exemptions from SCA has been delegated to the regulatory body in charge of banking regulation, the EBA. Banking regulators are first and foremost concerned with the safety and soundness of the banking system. The RTS, however, are also relevant for consumer protection issues.

So, why should regulatory action be needed and why should it be tight? Looking at the consumer protection argument, to what extent are consumers hit by fraud? Often fraud rates or fraud values are cited. For instance, the EU Commission, DG Migration and Home, states that

"In 2013, fraud using cards issued in the Single European Payment Area SEPA reached EUR 1.44 billion, representing a growth of 8% on the previous year. The growth was driven by a 20.6% increase in card-not-present (CNP) fraud."[4]

However, such rates do not provide any information with respect to the financial damage that consumers are suffering. In fact, as the "Non-cash payment fraud experts group" points out, *"the financial damage of a fraudulent payment card transaction is usually covered by the issuing bank"*.[5] Unfortunately, this well-known fact is missing in any of the documents of the EU Commission we have seen so far. It is not clear why this is the case. But one thing seems to be fairly straightforward. Fraud is not a *financial* problem for the consumer side of online payments. As the experts group rightly points out, consumers may be hit by side effects, such as identity theft, negative entries in their credit history, etc. Of course with fewer incidents of fraud there are also fewer side effects. Thus, there may still be a case for regulating fraud and mandating fraud rates. But there is also a different approach: dealing with the side effects, for instance, strengthens consumer rights in case of identity theft.

Fraud is not a financial problem for the consumer side of online payments.

Yet, given that consumers do not usually carry any financial risk in the case of third-party fraud there is no reason to be overly strict and it also seems to make little sense to have six different thresholds.

The EBA, however, has opted for threshold values that will have a severe impact in many markets. Take France as an example. Leaving aside the UK, France is by far the largest card market in the EU. In 2016, card fraud in France amounted to 0.064%.[6] For French transactions (use of French card in France) the rate was only 0.037% - well below the threshold values set by the EBA. However, for card-not-present (CNP) payments the fraud rate is much higher (0.199%) than the reference values (ranging from 0.01% to 0.13%). Thus, French market participants will be obliged to use SCA in most transactions.

point-of-sale payments	0.008%
of which contactless payments	0.020%
withdrawals	0.029%
card-not-present payments	0.199%

Fraud rates for French cards (2016)

Source: Observatory for the Security of Payment Means: First annual report from the Observatory for the Security of Payment Means, Paris, 18 July 2017.

Other markets may be less affected. As the ECB report on Card Fraud revealed, large card markets like France or the UK have fraud rates that are higher than corresponding rates in smaller card markets. Still, European merchants are concerned and have demanded higher threshold values that *"realistically reflect the industry fraud performance today"*.[7]

Moreover, as argued in this newsletter, a look at the long-term trend shows that fraud rates have been coming down over the years. The 2016 fraud figures for France are in line with this trend. The fraud rate declined from 0.070% to 0.064%. Even on the internet, card fraud in per cent of purchase value has come down. If there is a fraud problem, it does not seem to be getting out of control.[8]

	2011	2012	2013	2014	2015	2016
%	0.341	0.29	0.229	0.251*	0.229	0.199

Domestic fraud rates for French cards used on the internet

Source: Observatory for the Security of Payment Means: First annual report from the Observatory for the Security of Payment Means, Paris, 18 July 2017 and 2015 Annual Report of the Observatory for Payment Card Security, Paris 2016.
* The increase in the fraud rate for internet payments are largely attributable to a change in the statistical methodology.

The same can be said if we consider for a moment the fact that the EBA is a banking regulator. Since card issuers are usually banks regulated by national banking regulators or by the EBA and since the issuers carry most of the fraud risk, regulators may also consider the safety of their regulated institutions. France, by far the largest EU post-Brexit card market, experiences relatively high fraud rates (ECB: Fourth report on card fraud, July 2015). However, card fraud is hardly a threat to the safety of French banks. According to the Observatory for the Security of Payment Means, in 2016, the total amount of fraud on French payment cards amounted to EUR 399 million.[9] This compares to the equity capital of French banks (incl. reserves and revaluations) of EUR 564 billion in 2016.[10] So, also when taking this aspect into account there seems to be no reason for strict action.

Leaving aside the question whether tight reference rates are needed at all, there is also the problem of clarity of regulation (partly due to conflicting provisions in the PSD2). European regulators have left details to be defined by the EBA – supposedly under the assumption that a banking regulator would be more competent than a legislator to define the nitty-gritty of SCA and SCA exemptions. Unfortunately, the wording of the RTS is difficult to reconcile with the reality of 4-party payment schemes. For instance, Article 16.1 (RTS) refers to *“electronic payment transaction, identified by the payment service provider as posing a low level of risk”*. There is no distinction between issuing and acquiring sides.

In recital 24, the EBA does acknowledge, that there may be two service providers, one from the acquiring side and one from the issuing side: *“both payees’ and payers’ PSPs could trigger such an exemption under their own and exclusive responsibility but with the payer’s PSP having the final say.”* The first part of this statement definitely helps to understand Article 16. However, the second part *“the payer’s PSP having the final say”* makes the whole statement hard to interpret.

The EBA’s statement quoted above contrasts somewhat with the wording of Article 74.2 of the PSD2 which states: *“Where the payee or the payment service provider of the payee fails to accept strong customer authentication, it shall refund the financial damage caused to the payer’s payment service provider.”*

Why does the EBA rule that the issuer has the final say and what does that mean in terms of liability? Does “final say” also mean “final liability”? In this case, issuers would have no incentive to accept transactions without SCA. In this context the question also arises whether there will be a single fraud rate or whether issuers and acquirers each calculate their own fraud rates.

In a letter to Jean-Claude Juncker, European merchants are demanding that their role as risk-managers should be more clearly acknowledged. They want to be able to decide about the use of transaction risk analysis and they want to be evaluated against their own fraud rates – not the fraud rates of their PSPs.[11]

SCA makes it more difficult for consumers to reverse a card payment.

The meaning of “fraud” is another aspect that requires clarification. In the PSD2 and the RTS, the term remains vague. Fortunately, the EBA plans to remedy this and has published a “Consultation Paper on Draft Guidelines on fraud reporting requirements” (EBA/CP/2017/13, 02 August 2017). The aim is to ensure that *“comparable and reliable payment fraud data are reported to competent authorities across the EU and the EEA”*. Moreover, the Guidelines are also important when comparing actual fraud with the reference rates for exemptions from SCA defined in the RTS. *“Competent authorities, in turn, would be able to use the data gathered under these Guidelines to supervise and monitor the use of the exemptions to SCA and the fraud rates calculated by PSPs for the purpose of potential transaction risk analysis exemptions under the RTS on SCA and CSC.”* (p. 7)

A look at the long-term trend shows that fraud rates have been coming down over the years.

The wording of the RTS is difficult to reconcile with the reality of 4-party payment.

In Guideline 1, three different types of fraud are distinguished

- unauthorised payment transactions
- payer fraud (a payer that acted dishonestly or by misrepresentation)
- payee fraud (the fraudster impersonates a payee).

The lawmakers drafting the PSD2 seem to think that fraud can generally be fought effectively with the help of technical means such as SCA. As is stated in the PSD2:

"Security of electronic payments is fundamental for ensuring the protection of users and the development of a sound environment for e-commerce. All payment services offered electronically should be carried out in a secure manner, adopting technologies able to guarantee the safe authentication of the user and to reduce, to the maximum extent possible, the risk of fraud"
(Recital 95).

However, such a view neglects that in case c. (payee fraud) things may be different. What if payment is made before delivery and a merchant does not deliver? It will not be of any help at all that the payment instrument was "safe". In fact, the opposite is true. Payments that allow a payer to reverse a payment would protect the payer. Unfortunately, such instruments are "unsafe" from the point of view of the merchant. Because such instruments open the door to consumer fraud.

Indeed, simple reversibility may explain why cards or, in some countries, direct debits are so successful. Imposing SCA means that payers are protected against third-party fraud. However, as discussed above, they do not carry much financial risk in such cases anyway. SCA makes it more difficult for consumers to reverse a card payment. After all, if there is no proper authentication, card holders can always claim "I did not do it". SCA means this option will be lost. As a consequence, in conflicts with merchants consumers are worse off when using SCA.

In this respect it is interesting to consider the experience with 3DSecure and SET – two industry attempts to make card payments safer. SET was a complete failure.[12] 3DSecure is a mixed success. It had a slow start but current systems with a very flexible use of 3DSecure seem to be gaining traction.[13] SCA looks a bit like going back to SET. Copying past failures – that hardly looks like a road to success.

Still, the card schemes seem to be mildly optimistic. Given improvements in consumer experience when using 3DSecure ("3DSecure 2.0"), they hope that SCA can be implemented without putting customers off. That of course presupposes that current solutions fulfil the regulator's requirements for SCA. But this also seems to be a field full of question marks.[14]

Cash & Cards: Insights from the new ECB payment statistics

(mk) In September 2017, the ECB updated its payment statistics which now contain data on 2016.[15] The new data are in line with the general findings of recent years. In a press release, the ECB summarises the 2016 data for the EU as a whole.[16]

- The total number of non-cash payments in the EU: 122.0 billion in (+8.5%),
- The total value of non-cash payments in the EU: EUR267.8 trillion (-3.2%),
- The relative shares are: cards 49%, credit transfers 25%, direct debits 20%.

The number of cards with a payment function rose to 804 million (+1.9%). That is equal to around 1.6 payment cards per EU inhabitant. The number of card transactions is equal to 59.6 billion (+12.2%), and the total value is €2.9 trillion (+12.5%). That implies an average value per card transaction of around €49.

The new data provide us with an opportunity to take a closer look at the evolution of card and cash payments.

Our Comment:

Every year the Eurosystem provides an update of its payment statistics. Over time, its statistical report has been growing substantially. It is an indispensable read for European payment experts. But sometimes one wonders whether less would be more. The report has become increasingly difficult to navigate and consistency of data remains an issue.[17] Moreover, users have to grapple with frequent data revisions.

As the report shows, card payments in the EU are growing healthily. In the period 2011 to 2016, the average annual growth rate has been 9%. Since the growth rate for 2015/2016 was 12.5%, it can be concluded that there is no sign of a slowing down. Rather card payments growth seems to be speeding up.

Interestingly, the value of banknotes in circulation is also expanding relatively rapidly. In the period from 2011 to 2016, euro area cash has been growing at an average annual rate of almost 5%. At the end of 2016, the value of cash in circulation reached almost EUR1.1 trillion.

However, the stock of cash is not to be confused with the value of cash payments. For obvious reasons, the Eurosystem does not provide data on this particular variable.

But there are data on cash withdrawals and cash deposits which can be used to form estimates of cash payments. Assuming that cash is withdrawn in order to make payments and that the recipients will deposit the cash received in the banking system, cash withdrawals are equal to cash payments. Since most people withdraw cash in order to carry out payments in the retail sector and since retailers are likely to deposit their entire cash receipts in the banking system, this assumption does not seem to be too far off the mark.[18] The estimates derived in this way can be used to compare cash and card payments.

In the past, there were two sources of cash: ATMs and bank counters. Recently, a third channel has emerged, cash-back at the point of sale. For now, many countries are not able to provide data on cash-back. Since the value of cash-back is likely to be small, this does not constitute a grave problem.

	2015	2016	change in %
Total cash withdrawals	2.106	2.045	-2,87%
- OTC withdrawals	968	873	-9,74%
- ATM withdrawals	1.138	1.172	+2,98%
Total card payments	1.460	1.579	+8,16%
Cash + cards	3.566	3.624	+1,65%
Share of cash	59%	56%	-4,44%
Share of cards	41%	44%	+6,41%

Table 1 The value of cash withdrawals as an estimate of cash payments

EUR billions. OTC: Over-The-Counter; 21 countries (see Figure 1). Non-euro countries: values converted in EUR by the ECB.

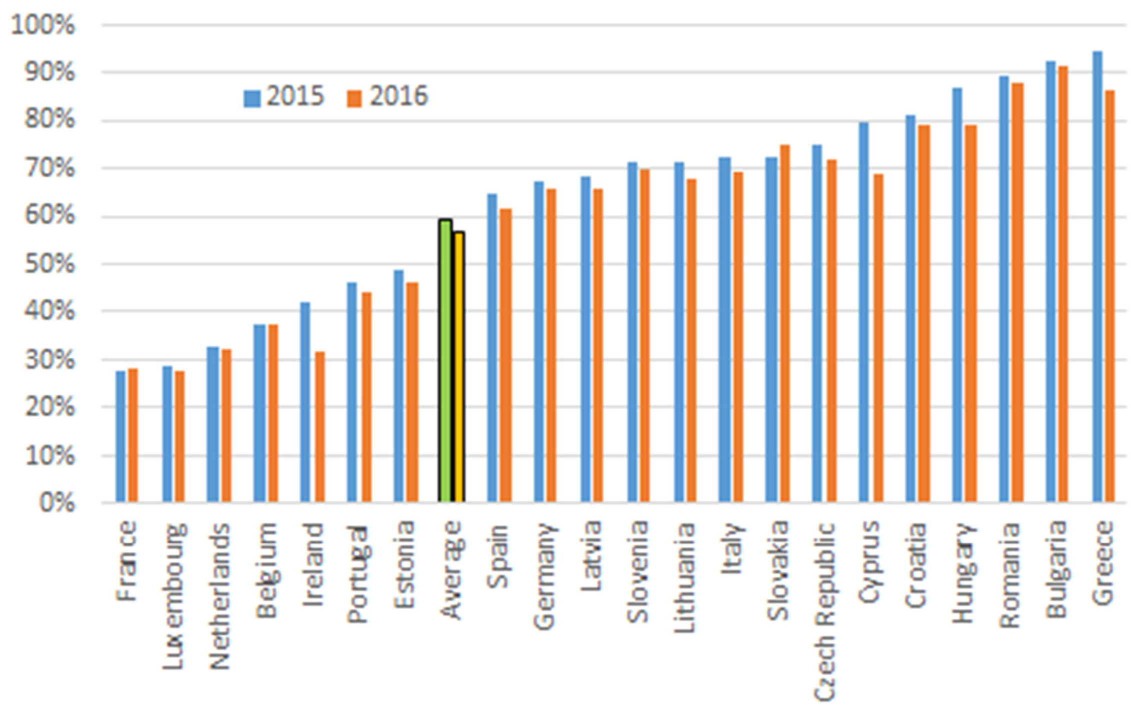

Figure 1: The share of cash payments (in terms of value): 2015 and 2016

Value of cash withdrawals (ATM plus OTC) in per cent of cash withdrawals plus card payments. Only countries with data on ATM and OTC cash withdrawals. Source ECB, PaySys Consultancy (for German card payments) and own calculations.

Unfortunately, however, a number of countries have also been unable to provide data for over-the-counter (OTC) transactions. For the 21 countries that do provide data for both types of cash withdrawals (see Figure 1), overall cash withdrawals have been a little over EUR2 trillion in 2016. Compared to 2015 there has been a reduction of 3% (see Table 1). ATM withdrawals have been rising since 2015, at a rate of 3%. OTC withdrawals have been declining by 10%.

Cash is still ahead of cards in many countries.

A comparison of cash withdrawals and card payments shows that cash is still ahead of cards in many countries. However, cash is slowly losing ground. In almost all of the countries, the share of cash transactions between 2015 and 2016 has fallen.

A year on year change only provides a short-term snap shot. It would be more informative to look at data over a longer period of time. Unfortunately, going further back in time reduces the number of countries with data on OTC cash withdrawals. For the period from 2011 to 2016, there are only 12 countries that are able to provide all of the data. For this group, there is a clear downward trend for cash (see Figure 1) but the value share of cash payments was still equal to 56% in 2016. However, for all EU countries together, the share is likely to be smaller, since the group of missing countries contains some intensive card users.

Cash back services, cash withdrawals at the POS, have become more widely offered in recent years. Unfortunately there are only few countries that are providing

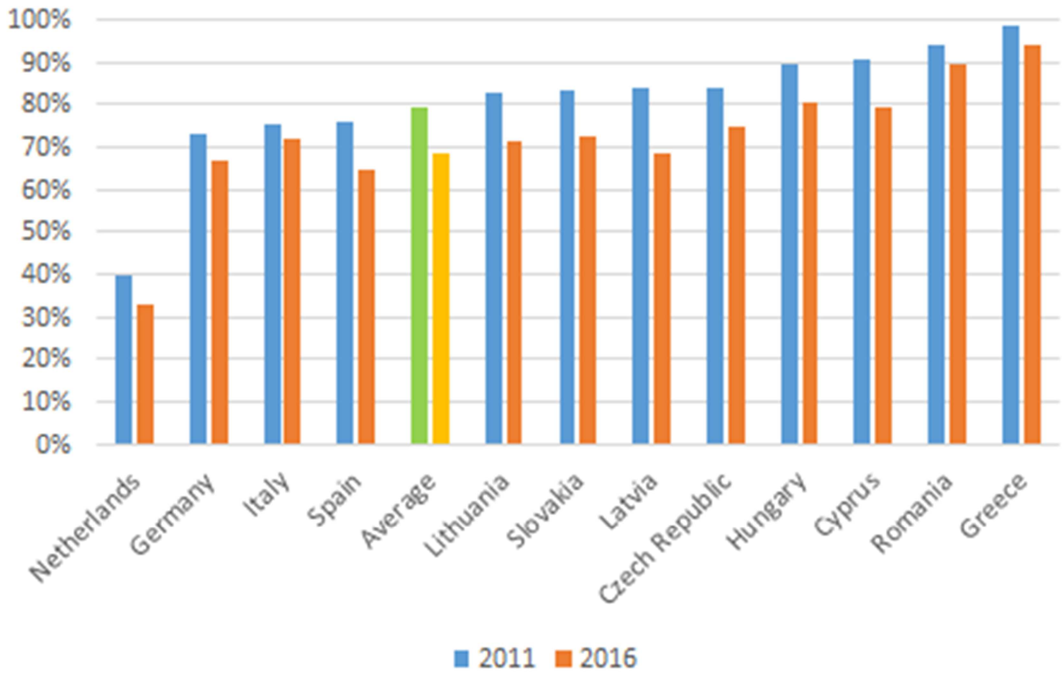

Figure 2: The share of cash payments (in terms of value): 2011 and 2016

Cash withdrawals (ATM plus OTC) in per cent of cash withdrawals plus card payments. Only countries with data on ATM and OTC cash withdrawals. Source ECB, PaySys Consultancy (for German card payments) and own calculations.

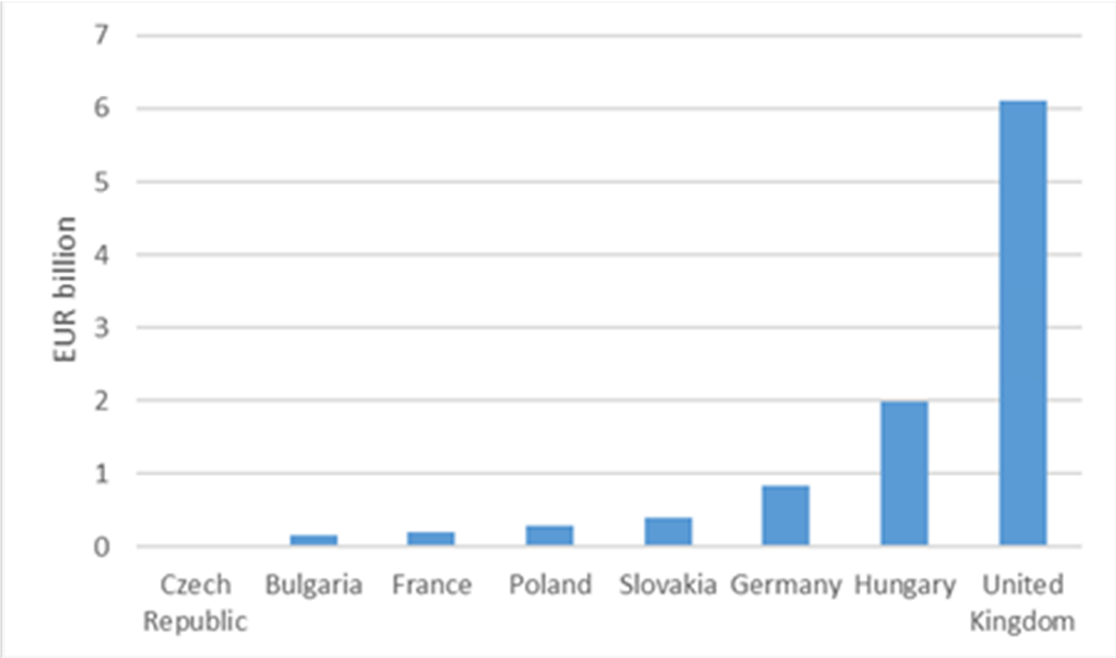

Figure 3: The value of cash-back transactions in 2016 (Source: ECB)

data on the value of cash back transactions. According to existing data, cash back is still little used. With the exception of Hungary and the UK, usage lies below 1 billion Euro.

Again, however, such figures should be interpreted cautiously. The German value of €832 million seems too low. It is also unlikely that cash back has declined from 2015 (€851 million) to 2016, as suggested by the official data. It also seems surprising that cash-back in France should have fallen from EUR1.06 billion in 2015 to EUR20 million in 2016.

Notes

1 EBA: EBA Opinion on EC proposed amendments to RTS on SCA and CSC under PSD2, (EBA/Op/2017/09), 29 June 2017, p. 6.
2 See "The EBA's Regulatory Technical Standards: Regulation gone astray" in the October 2016 edition of this newsletter.
3 EU Commission, DG Migration and Home: Inception Impact Assessment. Combatting Fraud and Counterfeiting of Non-Cash Means of Payment, 4 May 2016, p. 1.
4 EU Commission, DG Migration and Home: Inception Impact Assessment. Combatting Fraud and Counterfeiting of Non-Cash Means of Payment, 4 May 2016, p. 3.
5 Non-cash payment fraud experts group: Fraud and counterfeiting of non-cash payment. Experts meeting 31 May 2017. Discussion Paper.
6 The same is not true for the UK where fraud ratios have been rising. However, as argued in this newsletter, this does not imply a trend reversal. See "UK card fraud increases" in the December 2016 edition of this newsletter.
7 Industry Letter to the EU Commission on the EBA SCA RTS, 25 September 2017. https://www.ecommerce-europe.eu/app/uploads/2017/09/EBA-RTS-on-SCA-Industry-letter-about-merchant-concerns-1.pdf
8 Even in the UK where fraud rose in 2016, fraud rates have come down again in the first half of 2017. See UK Finance: 2017 half year fraud update: Payment cards, remote banking and cheque, September 2017.
Observatory for the Security of Payment Means: First annual report from the Observatory for the Security of Payment Means, Paris, 18 July 2017.
9 Source: Banque de France: Bilan des IFM France, Passif, Capital, réserves et comptes de réévaluation (encours).
10 Industry Letter to the EU Commission on the EBA SCA RTS, 25 September 2017. https://www.ecommerce-europe.eu/app/uploads/2017/09/EBA-RTS-on-SCA-Industry-letter-about-merchant-concerns-1.pdf
11 Secure Electronic Transaction (https://en.wikipedia.org/wiki/Secure_Electronic_Transaction)
12 Marco Fava (Clever Advice): Recommendations for improving European online payment regulation, August 2016.
13 AccentureConsulting: Defining New Customer Journeys, 2017.
14 Payment data can be downloaded from the ECB's Statistical Data Warehouse under http://sdw.ecb.europa.eu/reports.do?node=100000760. This site also contains a pdf-version of the full report.
15 ECB: Payments statistics for 2016. Press release, 15 September 2017.
16 See also „The inconsistency of card-related ECB-statistics", in issue 1-2017 of this newsletter.
17 Different methods to estimate the value of cash payments are discussed in Krueger, Malte and Franz Seitz: Costs and Benefits of Cash and Cashless Payment Instruments in Germany. Module 1, Overview and Initial Estimates, expertise for the Deutsche Bundesbank, Frankfurt 2014.
18 In the 2015 edition of the payment statistics, the 2015 figure for cash-back in Germany was much higher: €2.4 billion.

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